



GRATRY & COMPANY

Market Commentary – 1st Quarter 2010

By year-end 2009, world equity prices were up across the board recovering from the worst bear market since the '30s. The MSCI World Index of 23 developed nations was up 27% for the year versus a 42% drop in 2008. Equities in emerging markets and commodity rich nations generated gains often exceeding 50% for the year. Few believe this performance can be repeated, but it does reflect how much improved the situation is today over where it was a year ago. The unprecedented \$15 trillion injection of monetary and fiscal stimulus by governments and central banks around the world prevented the collapse of the entire financial system and ended the first *global* economic recession since World War II. Even though the recovery is slow and uneven among regions, we believe that it will be sustained for the next 24 months as no government will allow a double-dip recession, nor abandon a too-big-to-fail financial institution such as Lehman Brothers. Yet the regulatory reforms necessary to reign in the excesses of “casino capitalism” – the root cause of the financial crisis – are being delayed and watered down by powerful banking interests both here and abroad. Former Federal Reserve Chairman, Paul Volcker’s clear cut recommendations unfortunately lack the much needed support of Messrs. Bernanke and Summers, or of the regulators in Europe who see little reason to break up the “universal banks” such as Deutsche Bank and BNP Paribas. Senator John McCain and other’s recent call for the reinstatement of some of the 1933 Glass-Steagall Act provisions will hopefully move the financial reform process forward.

As we enter 2010, we believe that equity prices will continue to improve: valuations remain reasonable, and corporate profits are growing. The big question remains how and when will central banks withdraw their stimulus programs and start raising interest rates. Withdrawing stimulus too early would undermine the recovery; keeping policy too easy for too long could trigger inflation. Compared to cash and fixed income returns, stocks of large cap high quality companies in both developed and emerging markets look very attractive for the coming year.

In the U.S., the S&P 500 was up 23.5% in 2009 and 64.8% from the March 9th low. This performance correctly anticipated the much-improved economic and financial picture. The index of leading economic indicators has now improved for eight months in a row and that of the Institute for Supply Management (ISM) has reached its highest level since January, 2006. GDP growth is expected to reach 3.0% in the fourth quarter and average 3.0 – 3.5% for 2010. A 13.0% drop in the dollar since March against a basket of six major currencies is helping exports. Inventories are being rebuilt and factory orders have increased in seven of the last eight months. Estimated profits for the S&P 500 companies are now being ratcheted up by 20.0 – 25.0% for this year and next. Equity prices should be up for the year in such an improved environment. Volatility will also increase as the remaining uncertainties surrounding the residential and commercial real estate sectors unfold.

For much of the decade, the U.S. stock market has been a great disappointment losing an average of 0.5% a year due to the twin bear markets. We would argue that a foundation has been built from which a new bull market could begin. Large cap, quality U.S. companies are particularly well positioned to benefit should this trend materialize.

Last year, equity prices in the Eurozone rose 21.2% in euro terms and 24.2% in U.S. dollar terms reflecting the 3.0% appreciation of the euro vis-à-vis the U.S. dollar. Currently, Europe is experiencing a two-track recovery. Industrial countries such as France, Germany, and Italy are growing. Peripheral countries such as Spain, Ireland, Finland, and Greece and the new members of the European Union are struggling out of recession. Business confidence in Germany – Europe's largest economy – recently hit a 17-month high. German, French, and Italian exports are benefiting from the resurgence in global demand. Spain's 19% unemployment rate, resulting from the housing market collapse and artificial credit-infused growth, is not yet improving. Greece and Ireland are in similar positions having to make drastic reductions in public spending and wages to protect their sovereign debt and credit worthiness. As such, the European Central Bank, with only a single monetary policy at its disposal, faces the challenge of accommodating both the stronger and weaker economies. Many would argue that in such a predicament the euro should weaken from current levels. We believe that the European Central Bank will refrain from withdrawing monetary stimulus prematurely. We project that the euro area GDP growth will average a modest 1.5% in 2010 and 2011. That is probably the reason why European equity markets are among the cheapest in the world. Our focus remains on companies operating in areas offering superior growth and generating strong earnings and rich free cash flows.

One of the more important developments in Asia is that China has overtaken Japan in 2009 to become the world's second largest economy. Although this was expected, it does bring home the lessons of steady mismanagement and repeated policy blunders. In the last 18 years, following the bursting of the asset bubble at the end of 1999, real GDP growth in Japan has averaged just 1.2% a year and the Nikkei 225 index is still 70% below its 38,916 peak. The Japanese economy has posted two straight quarters of economic growth (1.3% in the 3rd quarter) helped by strong demand for efficient cars and electronic appliances from China and other emerging nations. Yet, the economy remains fragile – stuck in deflation with weak consumer spending and falling prices. The Japanese corporate sector relies heavily on exports and the success of its foreign subsidiaries. Business confidence, at the last reading, remained negative for the sixth quarter in a row. A strong yen, structural overcapacity and a massive public debt do not bode well for strong economic growth. Although it is tempting to think that Japanese equities are attractive on the basis of a simple catch-up play, we remain underweighted in Japan until the economic landscape becomes more positive.