GRATRY & COMPANY
Market Commentary – 2nd Quarter 2010

During the first quarter of 2010 most large equity markets posted positive single digit gains in local currency terms, and the MSCI EAFE Index of stocks reached an 18-month high. The broad sustained stock rally is yet another indication that the global economic recovery is gathering pace. The International Monetary Fund now forecasts that global economic growth will increase at a 3.9% rate this year, up from a 3.0% estimate just six months ago, after a 0.8% contraction in 2009.

While we recognize that the unprecedented monetary and fiscal stimulus in late 2008 and early 2009 was necessary to prevent a global collapse, and has allowed for the current improved economic conditions, we are concerned that its unwinding, if mishandled, could set the stage for renewed serious financial problems. Despite the uncertainty surrounding the macroeconomic picture we remain positive on equities given the much-improved fundamentals of the corporate sector in general and of large cap quality global companies in particular. The backdrop of low interest rates, subdued inflation, improving earnings and reasonable valuations should provide strong support for equity prices for the balance of the year.

In the US, the economy expanded at a 5.6% annual rate in the fourth quarter helped by a strong manufacturing sector. The Institute for Supply Management's (ISM) factory index rose in March at its fastest pace since July 2004 and its gauge of export orders jumped to its highest level since September of 1989. Manufacturing jobs increased 14,000 in March, and employers added 162,000 non-farm jobs. Consumer spending grew 3.1% in the first quarter of 2010 and should be sustained as labor markets improve. Yet both the residential housing and commercial real estate markets remain weak with little indication that they will recover any time soon. According to Elizabeth Warren, Chairperson of the TARP Congressional Oversight Panel, about half of all commercial real estate mortgages will be under water by the end of 2010.

On the positive side, company earnings increased 8.0% in the first quarter to $1.47 trillion annual rate. We are estimating S&P earnings per share of $75 in 2010 and close to $90 in 2011 bringing the forward price earnings ratio to a reasonable 15.6 times and 12.9 times, respectively.

The recent bickering between Mr. Sarkozy, Mr. Trichet, Miss Merkel, the IMF, and other EU officials over an aid package to Greece highlighted the lack of cohesion within the sixteen nations of the Eurozone which share monetary policy but not fiscal policy. Preventing Greece from defaulting on its debt seemed like a manageable problem, particularly as the budget deficits of all sixteen euro nations are forecast to exceed the EU limit of 3.0% of GDP this year. The resulting confusion sank the euro to a ten-month low vis-à-vis the dollar and could, in our opinion, undermine the credibility of the euro as a reserve currency for some time.

The IMF projects the $12 trillion economy of the euro region to grow 1% this year in a low inflation environment and 2.6% in 2011. As in the US, the manufacturing sector is the main driver of the recovery. Portfolios will remain underweighted in the euro zone until we regain greater confidence in the euro.

In Japan the macroeconomic picture remains mixed. The rebound in exports, production and employment is helping the economy to recover from the worst recession since WWII. Deflation continues to hinder self-sustaining private demand. Japan was the only country in the group of seven to report consumer price declines (1.2%) in February. The BOJ will probably keep a low interest rate policy for longer than any other central bank. Government spending continues to be out of control. The recent budget calls for capital spending of 92.3 million yen ($1 trillion) adding to Japan's debt, which is twice the size of its economy. Making matters worse, the 2010 fiscal year beginning April 1 marks the first time since 1946 that budgeted bond issuance will exceed tax receipts.

Business confidence however, is improving. According to the most recent Tankan survey sentiment among large industrial companies reached its highest level since 2008. Large manufacturers are basing their expectations on an average yen dollar rate of 91 leaving a cushion for some appreciation of the yen from current levels. Japan has many attractive dominant businesses in their industry selling at low price to book values with large cash positions and reasonable valuation. Yet we remain underweighted in Japan as the negatives of the macro picture continue to outweigh the positives of the microenvironment.

One important positive change in the overall financial picture is the increasing conviction among governments to reach agreement on a framework for regulation of the financial system. The Volcker rule launched by Mr. Obama set the tone. Negotiations about bank capital requirements, capital ratios, liquidity adequacy, derivatives, etc. are under way and a consensus may be reached by year-end.