

## **GLOBAL EQUITY COMMENTARY**

THIRD QUARTER 2009

### **Global Markets**

For equity markets, the third quarter of 2009 generated significant gains as the rally that began in March built momentum over the summer and continued to rise in September. Both U.S. and global equity markets moved up during the quarter with many low-quality, higher risk stocks generating outperformance. Strategists continued to assess the underlying strength of these stocks and investors seemed skeptical about additional gains, but stocks continued to advance. Unprecedented policy intervention and fiscal and monetary stimulus across the globe appeared to spur economic recovery. Improving financial conditions stimulated global growth as reflected by positive GDP in the second quarter and growth anticipated for the US in the third quarter. Despite one of the worst global financial crises in history, concerted efforts by governments around the world via sustained fiscal and monetary actions have served to stabilize economies and help capital markets to begin the healing process. The key question now is what type of recovery can the world expect going forward?

The MSCI World index was up 14.84% in local terms and 17.45% in USD terms. Index markets were generally positive with major indices in Europe reporting significant gains in local terms: Austria 23.81%; Spain 22.12%; Italy 21.83%; and the United Kingdom 22.04%. In Asia, major country indices reported mixed performance as reflected by Japan -1.16%, Singapore 12.41%, and Hong Kong 14.41%, respectively. On a relative basis, the U.S. market underperformed global markets as the S&P 500 index returned 15.61% versus 17.45% for the MSCI World Index in USD terms. Additionally, performance in emerging markets was solid, with the MSCI Emerging Markets Index reporting 16.82% in local terms. From a global perspective, all sectors reflected significant positive performance over the quarter. From a style perspective, growth outperformed value on a relative basis, as measured by the MSCI World indices.

### **Outlook and Positioning**

The third quarter delivered solid performance across most equity indexes as markets rebounded from last year's financial meltdown. The current investment environment is typical in recovery environments led by high beta, lower quality financial and cyclical company shares. What has been unusual is the magnitude of outperformance by the lowest quality and highest beta stocks, which transcends sectors and is seen in both defensive and pro-cyclical stock performance. In short, significant trading activity has been characterized by the purchase of low quality stocks to gain exposure to the recovery or to cover previous short positions. Historically, this phase of recovery in the equity markets has led to a fundamental value phase where earnings growth and valuations account for stock price returns and regional/sector factors fade in performance.

The US economy seemed to reflect a cyclical recovery, but also exhibited a correction of past imbalances – that will likely make this global expansion a bit different from the past. The U.S. economy is in structural transition, characterized by a recovery that is occurring without current account deficit spending — i.e. it is not led by the U.S. consumer. Given that the US current account deficit and trade deficits are not expanding and will not be a source of global liquidity growth, the major export nations, especially in Asia, will have to self-fund and stimulate their domestic economies. In short, the world economy can no longer rely on the profligate U.S. consumer. Moreover, the recent economic dislocation may shift the long term focus from West to East, specifically, related to relative growth and value opportunities that appear promising in Asia and parts of the developing world. As the third quarter drew to a close, the export dependent nature of Europe led the U.S. in the pace of recovery, especially in France, Sweden, Holland and Germany. However, Spain, Italy and Ireland lagged as their banking, real estate and financial sectors struggled.

We expect that new leadership will emerge from U.S. companies that serve the needs of the emerging and global consumers. On a sector basis, given the vulnerability of some consumer and financial services stocks, we are likely to see new leadership in other sectors such as industrial, materials and technology. We believe that tomorrow's successful companies will be focused on efficiency and abundance with specific

relevance in infrastructure and technology companies. Notably, the 19<sup>th</sup> century was led by coal, the 20<sup>th</sup> century led by oil, and we anticipate that the 21<sup>st</sup> century will be led by electricity – which is an underinvested and undervalued opportunity with significant embedded growth. We anticipate that mass collaboration and communication will lead to a productivity boom akin to the industrial revolution, the difference being that we will be leveraging intellectual power vs. physical power.

Near term, the risk of inflation is low, however, longer term the Asian central banks will play an important role. If these countries do not let their currencies rise they will create an amount of excess liquidity (by matching the supply of weak currency supply) that could lead to a sharp rise in inflation in the next 3 to 5 years. In deflationary environments, high value added, low debt, high free-cash-flow generating firms tend to do best. Inflationary times frequently reward the owners of real assets and commodities, low price-to-earnings valuations, platform company models with flexible cost structures, and value-based consumer stocks.

Hindsight indicates that we have witnessed a change in the investment landscape that must be considered to build successful portfolios for the future. Our investment approach is contrarian and centered on a bottom up, active investment process using a combination of quantitative, qualitative and fundamental analysis. We believe that the secular bull market phase is over and we are likely to see range-bound markets over the foreseeable future, with the exception of some emerging markets that may remain in a bull phase. Historically, markets in general go sideways approximately 50% of the time, which is why picking stocks that outperform in such markets is a challenging endeavor. Range bound markets are payback periods where earnings and the economy grow, but valuations and multiples contract on average. The key factor in a sideways market is the valuation starting point. In short, what you pay and when you pay it can make all the difference in making money. Dividends and dividend growth are important in addition to strong free cash flows. A critical part of our process is to seek sustainable price appreciation, generally from high-quality stocks that can generate a total return comprised of price appreciation, share repurchases, dividends and dividend growth.

In general, markets are always ahead of fundamentals — so stock prices already reflect an economic recovery. We anticipate that following the bounce in low-quality names from the March low to the end of the 3<sup>rd</sup> quarter, we will see a rotation into a fundamental value phase. The underperformance of the highest quality and fundamentally best positioned companies in the world in virtually every sector has created a historic opportunity from a contrarian value standpoint. If the recovery is long and slow, we favor ‘volume monetizers’ versus ‘price dependent’ companies. These firms tend to be industry leaders and have strong structural unit growth, product innovation, exposure to growing markets, flexible cost structures, and a lean capital base. We continue to be positive on platform companies: highly flexible, capital light businesses that focus on high value added activities such as product design, marketing, aftermarket services, research and development, etc. while outsourcing capital intensive manufacturing and distribution needs. Currently, we are evaluating interesting opportunities in alternative energy, Asian stocks, and laggard high quality stocks such as cyclicals, aluminum, packaging/paper, electrical infrastructure, specialty steels, transportation equipment, and global consumer and healthcare stocks. Overall, we see significant opportunity for active management focused on low, fundamental valuations in combination with quality, market leading business franchises. Looking ahead to the fourth quarter of 2009, we believe that by adhering to our time-tested investment discipline, clients will be well positioned to leverage the potential for outperformance of the high-quality value stocks that we purchase for the long term.

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Performance returns and other data are current as of September 30, 2009.