

October 4, 2010

Observations Regarding The Economic And Financial Market Outlook

There are no substantive changes in our economic forecast, and we continue to recommend the investment strategies that have served us so well the last 6 quarters.

Our global economic outlook remains positive:

- The global economy is in the recovery stages of a multiyear expansion, which will be similar to but not as strong as the 2003-2007 expansion. We expect global GDP growth to rise 4-5% in 2010 and again in 2011.
- The growth locomotives in this expansion, as in the last expansion, will be the leading emerging countries (including China, India, and Brazil) with GDP growth of 7-10%. The developed economies (including Euro Area, U.S., and Japan) will once again lag with anemic, unsatisfying 1-3% growth.
- Global inflation will run about 3% in both 2010 and 2011, but will vary considerably from country to country. We expect only 1% inflation in 2011 in the developed countries, where governments and central banks will be more fearful of deflation than inflation and will continue accommodative, growth-oriented policies. Inflation in the leading emerging economies will likely taper off from about 5% in 2010 to about 4.5% in 2011; here we expect governments and central banks to relax their currently restrictive policies.
- The huge appetite for infrastructure and food in the emerging economies will keep upward pressure on industrial and agricultural commodity prices. We expect the price of oil to rise gradually to over \$90/barrel in 2011.

We predict that the maturing economic expansion will continue to fuel the global equity bull market:

- We expect some of the key market patterns that prevailed in the last expansion and reemerged in the rally dating back to March, 2009 to continue through 2011. From 2004 through 2007, investors migrated to the stocks of the emerging economies, where growth was most robust: the EEM Emerging Markets ETF (which includes China, India, and Brazil among others) soared 175%, the EFA Developed Markets ETF (which includes Europe, Japan, and Australia among others, but excludes the U.S.) rose 72% and the Standard & Poor's Index gained a modest 32%. In the rally that started in March of 2009, investors have again preferred the emerging stock markets, where growth is strongest and most assured: through September 30, the EEM has ballooned 116%, the EFA has advanced 73%, and the S&P 500 has again trailed with 69%. Investors will need to continue to take a global perspective.
- Prospects are very bright for the stock markets of the leading emerging economies (especially China, India, Brazil, and Chile), where we anticipate double-digit gains in coming years. [See our September 14 blog at mariettallc.com on the outlook for the India economy and stock market.] Especially promising are the stocks of local and multinational companies that provide products and services to the mushrooming middle classes of these emerging economies. Also attractive are companies which help alleviate global shortages in food, energy, water, and industrial commodities exacerbated by the explosive growth of these economies.
- We foresee further advances in the U.S. stock market, but the gains will likely be limited to 5-10% due to subpar economic growth. The positive case for stocks is supported by low inflation and interest rates, an accommodative Federal Reserve, an increasing likelihood of further stimulus measures from the government, strong exports, attractive valuation, and the lack of appeal of alternative investments. On the other hand, corporate profit growth will slow due to slack consumer demand arising from structural problems in employment and housing. In our view, certain

companies in the information technology and health care sectors offer excellent growth opportunities. Many middle-sized tech companies are world leaders and derive 60% or more of their sales from fast growing international markets; some high-growth, mid-cap medical companies with cutting edge products will prosper as baby boomers age and are also candidates for purchase by larger companies seeking to ramp up growth.

- We think slack consumer and industrial demand in Japan and the Euro Area will limit the appeal of their stock markets. Also reducing prospects are recent strength in their currencies, which will damage export potential. More promising are northern European, Canadian, and Australian markets and the stocks of companies in these countries with strong exports to the emerging economies.

We are cautious regarding the U.S. bond market:

- Bond yields, which are near historic lows, are attractive only when compared to the 0% yield on most money-market funds. Also, we think yields will rise in 2011, leaving bondholders with skimpy income and declining principal.
- Since some income is better than no income, we prefer investment grade bonds with short maturities. As of September 30, however, the yields on 2-year and 5-year U.S. Treasury notes were 0.43% and 1.27% respectively, and high quality corporate bonds with 3-year maturities were under 1.5%. Toward the end of the quarter, Microsoft sold 3-year notes at a rate of 0.875%, which was the lowest corporate bond rate in more than 3 decades, and IBM issued 3-year bonds at 1.00%. Another record low yield came with the sale by Johnson & Johnson of 10-year bonds below 3%.
- Tax-exempt bonds present their own difficulties. With many states and local governments in dismal financial shape, we recommend high-quality issuers and short maturities. The problem is that investment grade tax-exempt bonds with maturities of 3 or fewer years and yields above 1.2% are scarce. Investors may be better off to wait even with money-market fund rates at record lows.

We think commodities are still attractive long term, but are currently expensive and will likely be volatile:

- In the words of the Wall Street Journal (10/1/10), “If the 3rd quarter was a dream, commodity fund managers may not want to wake up.” Agricultural commodities were the star performers, but soaring prices were the result of extreme weather events that may not be recurring. Demand for infrastructure metals will continue to depend on demand from the emerging economies, especially China, but we think the best investments here are in the stocks of the world’s leading mining companies.
- A key factor in the commodity price outlook will be currency movements. The recent policy of an increasing number of countries to weaken their currencies in order to strengthen their economies will, if continued, be positive for commodity prices in general and gold in particular.