Global Strategy Views

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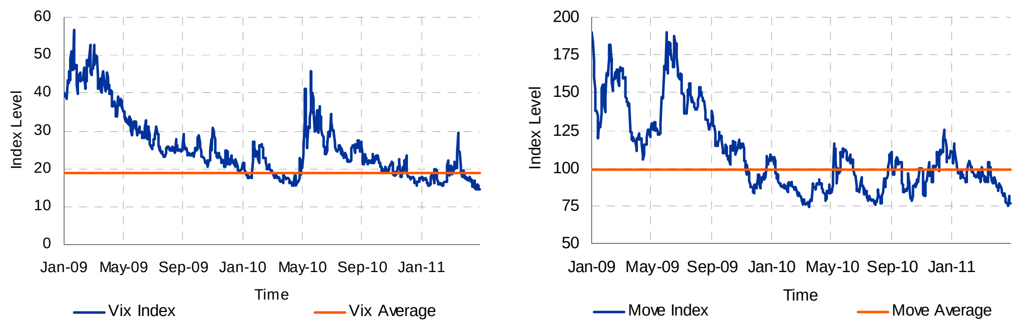
Is the Scheduled End to QE2 a Potentially Trend-Changing Event for Global Equities? Identifying Groups Likely to Outperform

Global equities, as represented by the MSCI AC World index, have posted a stellar 118.9% total return since the low recorded on March 9, 2009. In performing an attribution analysis of the principal macro factors responsible for such sharp recovery in asset prices over such two year period, one must include, of necessity, the following pair of predominantly policy-induced dynamics:

1. Normalization of risk premium levels for a large set of asset markets, including credit and equities (e.g. Panel 1 illustrates the sharp downturn in VIX implied equity volatility and MOVE implied fixed income volatility indices over that period);

Panel 1: VIX and MOVE Indices Decline to Multi-Year Average Levels



The VIX and Move Index Average represents simple average level from 1990 to 2007
Source: Bloomberg

2. Reversal of price expectations away from deflation to modest inflation (e.g. Figure 1);

Figure 1: US 5-Yr 5-Yr Forward Inflation Breakevens Back to Normal Range

Source: Bloomberg

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[1] The author is grateful to Mr. Darshan Bhatt for useful comments and research support.

Read this report in:

- 2 min: Front Page
- 40 min: Full

From our perspective, the dramatic magnitude and speed with which risk premium and price expectations have been restored to historical average levels is the result of the exceedingly well-designed and implemented set of monetary and fiscal measures adopted by the world's major economies, led by the US Federal Reserve, beginning at the end of 2008. In a prior report, entitled *"Deflation Risks in the Developed World: Broad Global Macro and Market Implications"*, published on September 14, 2010, we have laid out the basis behind our highly favorable assessment of Bernanke's Fed during this period of unprecedented stress in the global economy, courtesy of the excessive leverage built up in the developed world since the early 1980s.

Over the past several weeks, market participants' growing focus has gravitated around the fast-approaching end, scheduled for June 2011, of the standing liquidity-supportive mechanism enacted by the US Federal Reserve in November 2010, and referred to as QE2 (for "quantitative easing, part 2"). Specifically, market participants are engaged in a debate over the broad market implications from the scheduled end of QE2 on a large set of asset groups.

In this report, we delineate our views on some of the broad market implications associated with the end of QE2, particularly at a time of (1) persistent inflation pressures throughout much of the world and (2) growing prospects of a tighter fiscal outlook in the developed world than previously expected. In the process, we also aim to identify some broad equity groups likely to outperform global equity indices over the coming quarters.

Our general conclusions on the implications from the scheduled end of QE2 include the following: 1) from a directional perspective, global equities remain attractive relative to cash, commodities and corporate bonds on account of (a) relative valuation considerations, (b) a benign medium-term global economic growth outlook, (c) equities' under-owned status by global asset allocators, including insurance companies and pension funds, (d) the recent turn in relative fund flows away from bonds into equities, following a multi-year period in which the direction of flows are the opposite, (e) our expectations that real short-term interest rates in the developed world are likely to remain negative through the end of 2012, (f) the Fed's determination to maintain its balance sheet size unchanged beyond the scheduled June 2011 end date for QE2 until measures of excess slack in factor and output markets abate; and 2) across equity markets, we identify the following groups as likely outperformers over the coming quarters: (a) emerging markets and (b) US large-cap defensive sectors. We further identify specific subgroups likely to outperform on global macro and valuation factors.

Role of US Monetary Policy in Forestalling Escalation of Great Recession into Depression II, and Laying Foundation for Recovery

As is now widely recognized, in the third quarter of 2008 the world economy came exceedingly close to reentering a depression phase the likes of which had not been seen since the early 1930s. The succession of events that brought the economy to such precipice was similar to that triggering the Great Depression period. Specifically, the latter stages of the economic implosion period in the third quarter of 2008 witnessed a massive escalation of deflation expectations with the accompanying perverse feedback of economic dynamics (of international trade implosion, credit disintermediation, savings-rate acceleration) which, if left unaddressed by policymakers, would have surely resulted in the entry into economic depression.

The manner in which deflation expectations took hold by the third quarter of 2008 was similar to that which set off the early 1930s depression-deflation period. Specifically, a stream of bankruptcies of high profile financial institutions (Bear Stearns, mortgage insurance companies, Lehman Brothers), set off by the massive bubble-like leveraging of household balance sheets that had built up since the early 1980s, led to a massive contraction in the private sector credit multiplier. In time, these dynamics, which first took hold in early 2007, impacted the real economy with a lag, leading to a massive collapse of international trade by the end of 2008. The speed of the transmission effect and its sheer quantum in turn fueled a massive escalation of deflation expectations and further contraction in the credit multiplier by the very end of 2008.

The world population's far greater reliance on the market economy for its day-to-day economic survival, together with today's wider prevalence of democracy as the political system in most of the developed and developing world, as compared to the 1920s/1930s period in which autocracy was the rule as opposed to the exception, brought about, at the end of 2008, a set of resounding synchronized economic policy responses across much of the world. These efforts were led by the United States, especially by the Federal Reserve.

As noted in our report of September 14, 2010, economic history teaches us that periods with a mounting risk of deflation require the speedy implementation of aggressive policy responses. While the set of policy responses ought to include both fiscal and monetary measures, history is clear as to the far greater reliance that merits to be afforded monetary policy tools, for two principal considerations. First, monetary policy works significantly faster than fiscal policy, subject to legislative processes, and is therefore a lot easier, politically, and faster, mechanistically, to unwind, when economic developments so justify. Second, monetary policy is far more potent, "dollar for dollar" than fiscal policy, owing to the power of price expectations and the miracle of the credit multiplier.

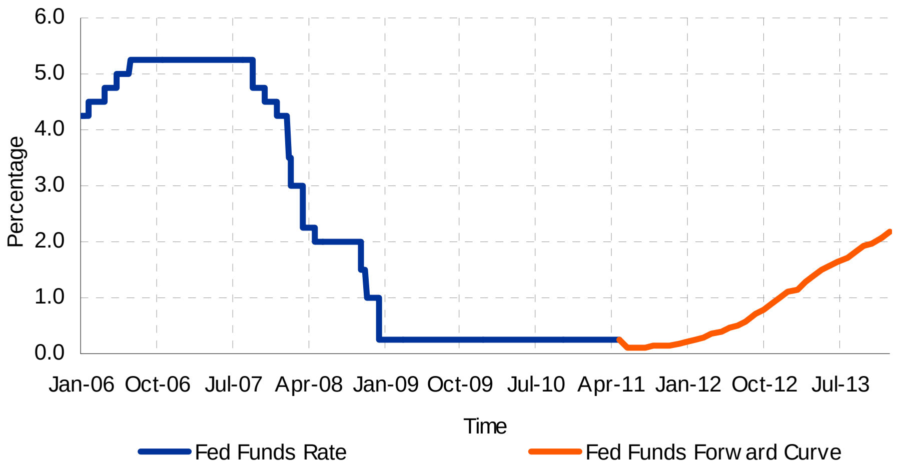
Against the above backdrop, it has always been crystal clear to us, and noted in our September 2010 report, the absolutely critical role played by the US Federal Reserve during the 2007-2009 crisis in its role as the central bank of the world's largest economy and, more importantly, in control of the world's dominant reserve currency, at a time in history when fiat currency represents the prevailing monetary regime.

Zero Interest Rate Bound Paved the Way for Quantitative Easing 1 and 2 as the Course of Monetary Policy Since 2009

Hopefully, the above discussion is of some help in elucidating the crucial role played by the US Federal Reserve in arresting and successfully reversing the downward price spiral at the core of the confidence crisis that almost brought the world economy to a long halt in late 2008, early 2009.

The US Federal Reserve's aim to quickly and successfully reverse deflation expectations prevailing at the end of 2008, a period by when policy rates (Federal Funds rate) were close to zero (Figure 2), meant that additional monetary policy stimulus, of necessity, would need to be quantity-based, as opposed to rate-based. With that as a backdrop, the Fed quickly decided to implement the first (of thus far two) stage of quantitative easing. This action was announced on December 16, 2008 – please refer to Table 1 for the FOMC statement.

Figure 2: Federal Funds Rate Hits the Zero Bound in late 2008



Source: Bloomberg

Table 1: FOMC Statement Announcing QE1

Press Release

Release Date: December 16, 2008

The Federal Open Market Committee decided today to establish a target range for the federal funds rate of 0 to 1/4 percent.

Since the Committee's last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further.

Meanwhile, inflationary pressures have diminished appreciably. In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters.

The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.

The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level. As previously announced, ***over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as***

conditions warrant (our emphasis). The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; Christine M. Cumming; Elizabeth A. Duke; Richard W. Fisher; Donald L. Kohn; Randall S. Kroszner; Sandra Pianalto; Charles I. Plosser; Gary H. Stern; and Kevin M. Warsh.

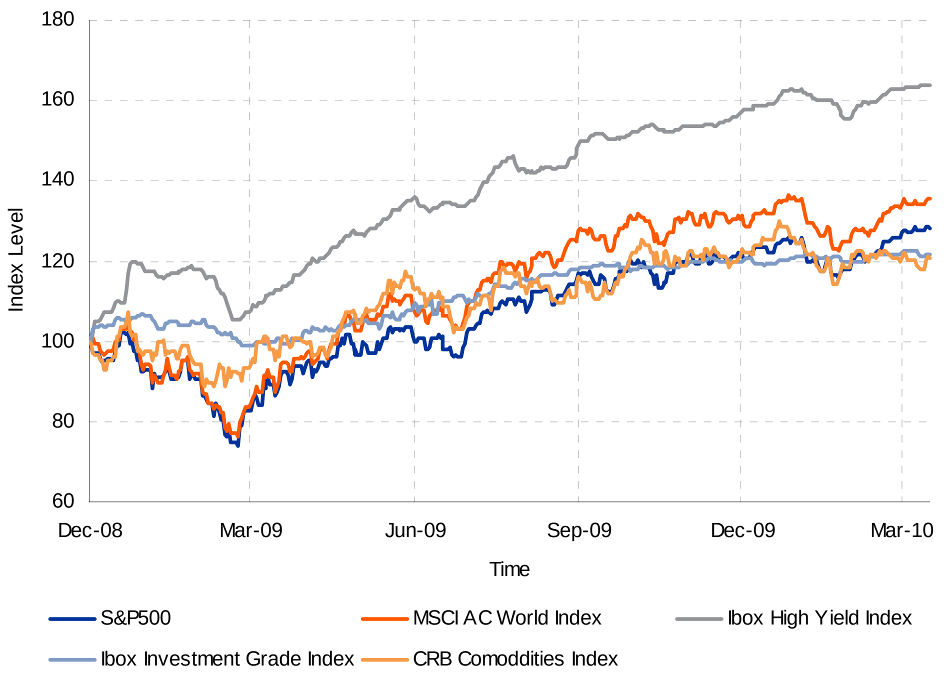
In a related action, the Board of Governors unanimously approved a 75-basis-point decrease in the discount rate to 1/2 percent. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of New York, Cleveland, Richmond, Atlanta, Minneapolis, and San Francisco. The Board also established interest rates on required and excess reserve balances of 1/4 percent.

Source: US Federal Reserve

QE1, as the set of measures came to be known, encompassed the purchase of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets and the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Fed's aim in implementing QE1 was the speedy stabilization of the US financial system. The objective was to be achieved via the QE1 measures' support of asset prices widely held by financial sector participants, including banks.

An objective evaluation of QE1 proves it to have been a resounding success. That QE1 proved a resounding success is evident by looking at Figure 3. Figure 3 illustrates the holding period percentage return for a wide set of asset markets, including credit, for the period covering the QE1 initiative's duration. The figure illustrates the exceedingly sharp recovery experienced especially by credit security prices (summarized in Figure 3 by the Ibox High Yield index), widely held by banks and other financial sector participants. In such manner, the price recovery process generated by the Fed's policies amounted to a de facto recapitalization of the financial system at an order of magnitude measured in trillions of US dollars, significantly larger than the mammoth fiscal program put together by the Chinese government at the end of 2008.

Figure 3. Holding Period % Returns Over QE1 Phase



Source: Bloomberg

Table 2: Return Performance Across Asset Groups Over QE1 Phase

	December 15th 2008 Level	March 31 2010 Level	Return (%)
S&P500	868.57	1169.43	34.6%
MSCI AC World	221.02	307.4	39.1%
Iboxx High Yield Index	98.17	161.66	64.7%
Ibox Investment Grade Index	145.47	179.54	23.4%
CRB Commodities Index	225.7	273.34	21.1%

Source: Bloomberg

The QE1 mechanism was concluded on March 16, 2010. The period that immediately followed the QE1's conclusion entailed a cyclical economic slowdown, brought about by (1) the normalization of the inventory rebuilding process that started in 2009, and (2) the adverse effects of a sequential fiscal contraction, the result of adverse year-ago comparison levels. Against this backdrop, financial markets came under pressure, with the MSCI AC World index recording a sharp 15 pct decline between April 23 and July 2, 2010 (Table 3).

Table 3: Return Performance Across Asset Groups Over the Correction Phase in Q2 2010

	April 23 2010 Level	July 2 2010 Level	Return (%)
S&P500	1217.28	1022.58	-16.0%
MSCI AC World	313.48	267.02	-14.8%
Iboxx High Yield Index	164.78	161.06	-2.3%
Ibox Investment Grade Index	181.81	187.08	2.9%
CRB Commodities Index	279.05	254.48	-8.8%

Source: Bloomberg

The breadth and depth of the asset price declines recorded during the April-July 2010 economic soft patch, combined with market concerns over the uncertainty surrounding the then fast-approaching end of the Bush tax cuts (scheduled for December 2010) and the lack of clarity surrounding the November 2010 US Congressional election outlook, paved the way for another bout of escalating deflation concerns – illustrated in Figure 4. This backdrop raised the specter of a reentry into the vicious cycle of deflation-recession expectations that so threatened the world economic outlook in the fall of 2008. Such dynamics proved sufficient to push the FOMC to implement a second phase of quantitative easing, the so-called QE2.

Figure 4. US 5-Year Forward, 5-Year Inflation Expectations Covering 2010 Soft Patch, Culminating With Mr. Bernanke's Jackson Hole speech (August 27, 2010)

Source: Bloomberg

The spirit of the QE2 initiative was first revealed at the August 27, 2010, Jackson Hole speech delivered by Fed Chairman Bernanke. The speech proved pivotal in arresting the mounting deflation concerns and falling asset prices prevailing at the time. The spirit of the QE2 initiative, delivered at the Jackson Hole speech, was further reaffirmed by Mr. Bernanke in an unprecedented op-ed article published in the Washington Post on November 4, 2010, in which explicit mention was made of the monetary policy's aim of bringing about a recovery in asset prices, including equities. The details of the QE2 initiative were fully disclosed at the FOMC meeting of November 3, 2010 – please see Table 4.

Table 4: FOMC Statement Announcing QE2

Release Date: November 3, 2010

For immediate release

Information received since the Federal Open Market Committee met in September confirms that the pace of recovery in output and employment continues to be slow. Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising, though less rapidly than earlier in the year, while investment in nonresidential structures continues to be weak. Employers remain reluctant to add to payrolls. Housing starts continue to be depressed. Longer-term inflation expectations have remained stable, but measures of underlying inflation have trended lower in recent quarters.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate is elevated, and measures of underlying inflation are somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. Although the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, progress toward its objectives has been disappointingly slow.

To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to expand its holdings of securities. The Committee will maintain its existing policy of reinvesting principal payments from its securities holdings. In addition, the Committee intends to purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month. The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability (our emphasis).

The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to support the economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Sandra Pianalto; Sarah Bloom Raskin; Eric S. Rosengren; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.

Voting against the policy was Thomas M. Hoenig. Mr. Hoenig believed the risks of additional securities purchases outweighed the benefits. Mr. Hoenig also was concerned that this continued high level of monetary accommodation increased the risks of future financial imbalances and, over time, would cause an increase in long-term inflation expectations that could destabilize the economy.

Source: US Federal Reserve

In contrast to QE1, whose primary focus was on financial market stabilization and de facto recapitalization of the US (and by extension, parts of the international) banking system through the Fed's massive purchase program of toxic assets widely held by financial market participants, the QE2 initiative's aim was to reverse the spiraling of deflation expectations prevailing in the third quarter of 2010. Viewed through this lens, any objective assessment of the QE2's performance must conclude that the final outcome was a resounding success. This is evidenced, for example, in the sharp recovery of inflation expectations since August 2010 to levels approaching multi-year average levels – Figure 1.

A more general evaluation of the QE2 initiative's level of success ought to include the performance of asset prices, in addition to price expectations, since August 2010. Table 5 illustrates the strong and widespread asset price recovery that has obtained since the Jackson Hole speech. It is also worth noting that, in contrast to the QE1 phase, credit asset prices (denoted by the Ibox indices in Table 5) rose the least over the QE2 phase as the initiative's principal aim was the attainment of overall asset price reflation.

Table 5: Return Performance Across Asset Groups Since the Jackson Hole Speech – De Facto Start of QE2 Phase

	August 27 2010 Level	April 29 2011 Level	Return (%)
S&P500	1064.59	1363.61	28.1%
MSCI AC World	280.97	356.90	27.0%
Iboxx High Yield Index	166.46	186.35	11.9%
Ibox Investment Grade Index	195.37	198.10	1.4%
CRB Commodities Index	267.27	370.56	38.6%

Source: Bloomberg

Quantitative Easing Is No Panacea: If Left in Place for Too Long, Resulting Resource Misallocations May Hinder Long-Term Recovery

The above discussion provides an account of the rationale behind the implementation of QE1 and QE2 as well as the success achieved by both sets of initiatives within the narrowly defined objectives laid out at the initiatives' inception: stabilization of financial markets and banking system, in the case of QE1, and broad asset price reflation, in the case of QE2.

It is of key importance to acknowledge the narrow basis in which the adoption of quantitative easing measures was needed and desirable. However, as is true of most economic policies, the achievement of narrowly defined objectives entails trade-offs, which represent a cost-benefit proposition. Specifically, in the context of the quantitative easing mechanisms in question, the trade-offs, or costs, take the form of the resource misallocations resulting from (1) the massive purchase of toxic assets by the Fed within QE1, and (2) the massive purchase of Treasury securities by the Fed under QE2. In both instances, the Fed has achieved its objectives by managing (or manipulating, depending on one's philosophical orientation) the economy's price vector, the economy's spinal cord of economic signals directing resource allocations throughout the entire economic domain. Specifically, such managing of the economy's price vector took the form of artificially high prices for toxic and Treasury securities versus all other asset prices in the economy. In yield terms, this has meant that credit spreads and Treasury yields have come down to artificially low levels.

Economic history and economic theory provide a strong basis for the adoption of QE1 and QE2 as a necessary means to forestall the unwinding of price expectations in the deflationary direction, so long as such measures are transitory. Ultimately, household and public sector balance sheets need to be rebuilt via the creation of economic value (high productivity, growing markets), low inflation (not deflation) and the passage of time (in an economy with positive population/labor force growth). Key ingredients behind the latter mentioned set of economic processes include a healthy fiscal backdrop, pro-business culture and proactive monetary policy.

Selected Global Market Implications Stemming From the Approaching End of the QE2

Given our above discussion, we believe that the Fed is likely to keep, but not extend, the size of its balance sheet beyond the June 2011 scheduled end to QE2. Moreover, the only context in which the Fed is likely to implement a new phase of quantitative easing, to be referred to as QE3, would be in the hypothetical scenario of a sharp economic slowdown unfolding while the economy still posts excess capacity levels. For example, such downturn could obtain either because of a sudden financial sector shock, politically generated shock (excess fiscal tightening measures) or externally generated wealth shock (e.g. Middle East war or financial crisis in Europe). These risks are not insignificant and thus serious consideration must be given to such off-baseline case scenarios in the process of portfolio construction.

As a baseline case, we believe that the process of normalizing policy rates to long-term average levels, entailing the resumption of positive real interest rates, will be exceedingly gradual and slow-moving, for several reasons:

1. First, the US, Europe (especially the periphery and the UK) and Japan economies still post elevated excess capacity levels. It is a well-established fact of developed economies' business cycle dynamics that unit labor cost changes account for the overriding majority of overall price dynamics. Moreover, imported inflation dynamics, fueled either by currency weakness or commodity price inflation, are de minimis in the developed country case (at an order of magnitude close to 1/6 of those afflicting developing countries), especially at a time of incipient commodity price correction and continued productivity growth;

2. Second, imported inflation dynamics are unlikely to accelerate significantly further as (a) agriculture commodity prices have begun to correct since early February of this year, with some commodity staple

prices down close to 30 pct since the early February period, and (b) in our view, the US dollar is unlikely to undergo additional downside pressure, versus other developed country currencies (especially the Euro) at an order of magnitude proportionate to that seen in the past several months. We hold this view on the US dollar outlook on account of the significant downward pressure taken by the short end of the Eurozone yield curve in the past several months, pricing in a succession of ECB rate hikes well above what we deem to be justifiable on real business cycle considerations.

From the above, we believe that beyond the June 2011 period, credit spreads are unlikely to tighten measurably from current levels, and even possibly widen modestly from current levels. Likewise, growing prospects of tighter than expected fiscal policies in the US and continued elevated energy price levels, carry the potential of modest compression in corporate profit margins.

Notwithstanding such risks, we believe profit margins are likely to remain elevated over the foreseeable future on account of labor's continued diminished bargaining power versus capital (on account of excess labor conditions) and the prospects of continued low (though less negative) real short interest rates in the developed world. Moreover, in our view, asset turnover throughout much of the corporate world still faces additional upside potential, lending countervailing support to profit margin downside pressures likely to emanate from the eventual normalization of short policy interest rates and unit labor cost rebound. Finally, productivity growth dynamics remain strong throughout much of the world, on the back of supportive secular globalization dynamics and the adoption of novel IT processes.

Against this backdrop, we believe that global asset allocation programs should overweight the following sectors: (1) emerging markets (owing to the group's cheap valuations, highly visible earnings growth momentum, attractive ownership base, peaking agriculture commodity price pressures, among others); (2) high-quality, high-dividend-paying large cap stocks (owing to attractive relative valuations, large foreign revenue and earnings share of total, attractive ownership base). We discuss below some of the rationales anchoring our specific recommendations.

I. Global equities likely to outperform corporate bonds, commodities and cash on a risk-adjusted basis over the next several quarters.

Our expectations are based on several considerations, including:

(a) Our expectation that real interest rates in the developed world are likely to remain negative well into the end of 2012 – e.g. Figure 5;

(b) Equities' attractive valuations versus cash, as exemplified by the highly extended differentials between free cash flow yield and cost of debt capital;

(c) Equities' still elevated implied risk-premium levels;

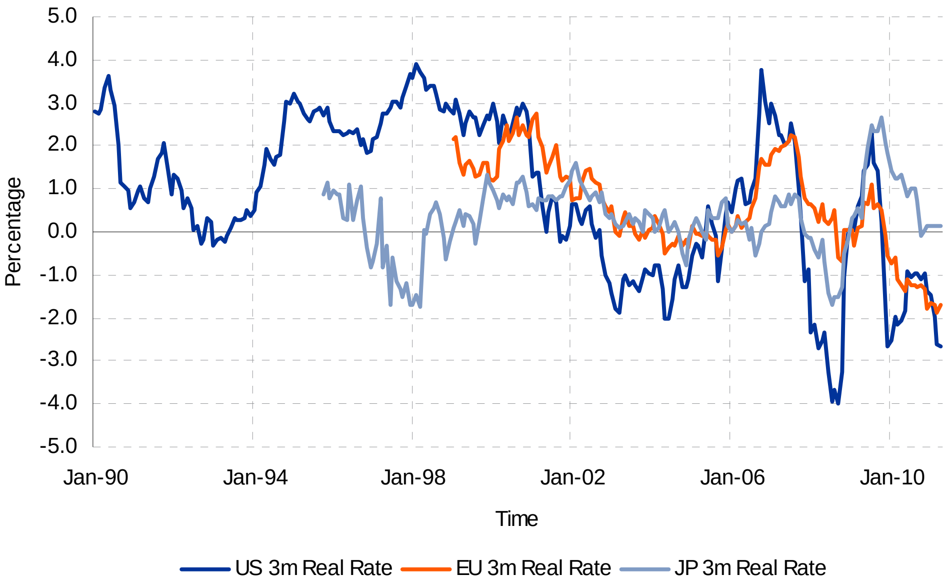
(d) Recent turn in retail investor flows away from bond into equity mutual funds – market history reminds us that such turns tend to exhibit a high degree of temporal persistence;

(e) Prospects for continued low macro volatility throughout the developed and developing world, as governments remain committed to resorting to aggressive fiscal and monetary policy measures so as to forestall a repeat of the 2007-08 financial and economic crisis;

(f) Prospects for near-term correction in the commodities space, especially metals and agriculture, as the leverage community has kept exceedingly extended net long exposure levels, likely to reverse themselves in short order – at present, some of the commodity sectors evidencing significant net long exposures by speculative players include corn, copper, platinum and crude;

(g) Profit margin levels are likely to remain elevated across much of the developed and developing world, courtesy of lingering excess capacity levels, cheap cost of debt capital, high productivity growth performance, growing trade and financial globalization trends and ample room for increased asset turnover levels of corporations (which have kept low leverage).

Figure 5. Real Policy Interest Rates in the US, Europe and Japan



Source: Bloomberg

II. Emerging markets likely to extend return outperformance versus developed-market peers on the basis of several considerations, including:

1. Growing prospects inflation dynamics will be topping out by the middle of the year. As hypothesized in our global strategy report entitled *Emerging Markets' Secular Investment Thesis Meets Mounting Inflation Pressures: Risk or Opportunity?* (February 23, 2011), agriculture commodity prices have begun to correct significantly, with prices for several key staples falling by as much as 30 pct from the high levels reached in early February of this year. In contrast to developed countries' CPI baskets for which energy staples command a high percentage constituent weighting, CPI baskets for most emerging market countries are more heavily dependent on food prices, in turn dependent (subject to a lag) on agriculture commodity prices. Panel 2 illustrates recent price dynamics affecting key agriculture commodity prices. We expect such disinflationary dynamics to help pave the way for equity multiple expansion in the balance of the year.

2. Strong relative earnings growth potential. Emerging market earnings growth prospects are likely to strengthen versus developed-country peers on the back of several dynamics, and despite the more aggressive rate hike cycle permeating the EM space, including: (a) developed countries' tighter fiscal outlook versus EM countries; (b) the lag effects on earnings from recent significant downgrades to economic-growth estimates for developed countries relative to emerging market peers; (c) ongoing strengthening of EM currencies versus the US dollar and EM countries' greater reliance on domestic consumption and investment for their economic growth dynamics; and (d) multiple factors coloring EM countries' secular earnings growth potential, including demographics, financial deepening, urbanization and globalization.

3. Emerging markets' strong and strengthening macro balance sheets at a juncture in which the fiscal backdrop in the developed world is likely to raise concerns over those countries' abilities to restore medium-term economic growth at a pace required to ensure long-term debt sustainability. The recent escalation of credibility concerns facing the periphery of Europe (Figure 6) serves as a reminder of the potential challenges facing other developed economies;

PANEL 2: Agricultural Commodity Prices Correct Since Early February

Source: Bloomberg

Figure 6: The Periphery of Europe's Credit Challenges Remain: 5-Year CDS Spreads for Greece and Ireland Increasingly Discount Restructuring Scenarios

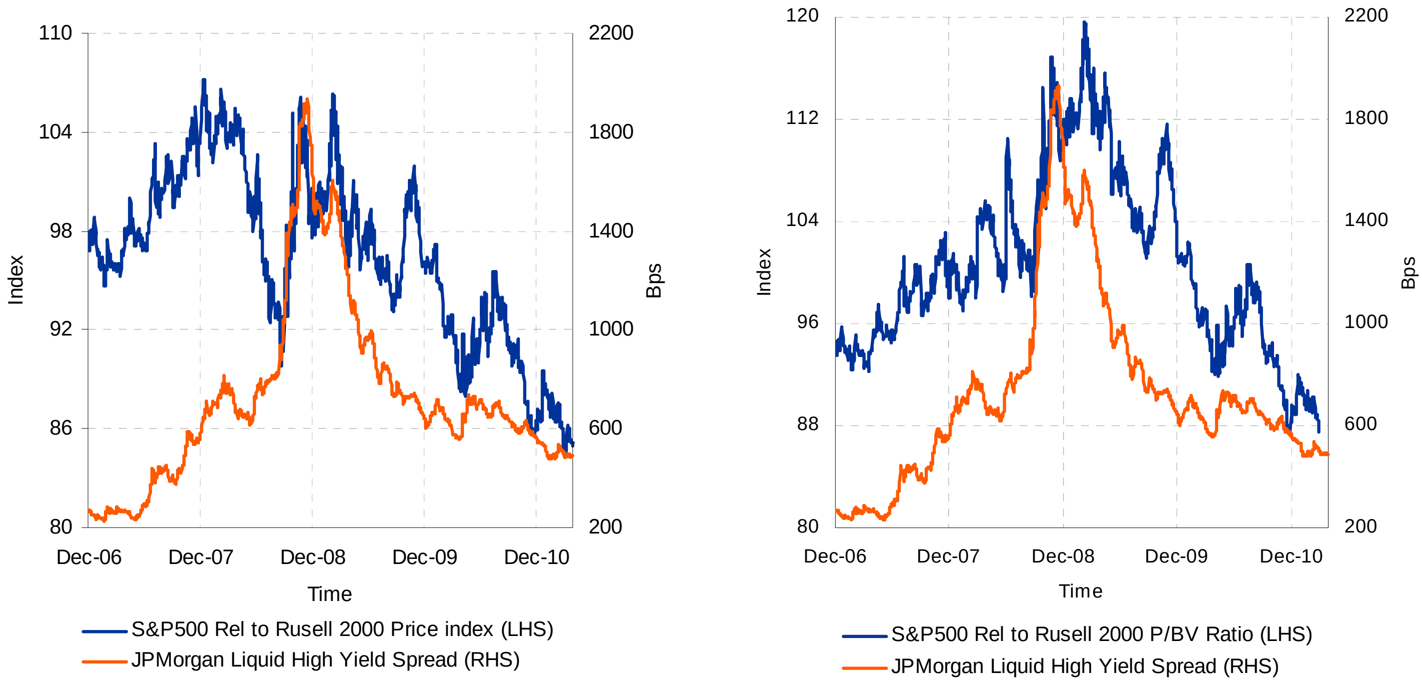
Source: Bloomberg

4. Favorable ownership backdrop, as global asset allocators' exposure levels to emerging markets are close to neutral versus strong overweight levels held at the beginning of the year.

III. US high-quality, high-dividend-paying, defensive-sector-oriented stocks likely to extend incipient period of relative return outperformance over-small cap/cyclically-oriented peers.

We hold such expectation for several reasons, including: (a) the significant likelihood that financial market volatility and credit spreads have already reached or are soon to reach their lowest levels for this market cycle; and (b) relative valuations favor large-cap/defensive-sector-oriented stocks over small-cap cyclical peers – Panel 3. Moreover, with regard to technical market considerations, recent investor surveys suggest institutional investors continue to favor cyclical sectors, holding defensive sector plays out of favor.

Panel 3. US Large-Cap Stocks' Attractive Relative Valuations Versus Small-Cap Peers



Source: Bloomberg

IV. Sector, Region and Country-level Indices likely to outperform in our medium-term macro thesis of continued, though moderated, economic expansion and bottoming US dollar

In our standing medium-term macro thesis, the global economy is likely to remain on (a) an expansionary path, anchored on (b) low real interest rates, (c) persistently elevated corporate profits, (d) healing household balance sheets (following upward move in savings rates these past few years), (e) moderately recovering US dollar (versus euro, and therefore in DXY), and (f) strengthening disposable personal income dynamics (as commodity prices, especially agriculture-related, corrected from February levels, and labor market conditions firm further, albeit modestly, in the US and other developed regions).

The above-mentioned set of macro assumptions are captured in the left side columns of Table 6, corresponding to PMI>50 and DXY change positive. The table encompasses holding-period return performance for the major regional, country and sector-level MSCI US $ indices. Thus, in our thesis, emerging markets and the US (S&P500) indices are likely to outperform the EAFE peers over the coming quarters. In addition, within emerging markets, at the country level, Russia/Turkey/Brazil look poised to outperform their EM peers, while at the sector level, materials and energy are likely to be among the top performers. It is of interest to note that similar implications, at the sector and country levels, emanate from an examination of expansionary periods for which real interest rate changes were positive – Table 7.

Table 6. Ranks on the basis of average monthly performance for the period 1995-March 2011: Nexus between PMI and DXY

	All periods		NAPM PMI > 50				NAPM PMI < 50			
			DXY Change positive		DXY Change negative		DXY Change positive		DXY Change negative	
	Rank	Ann. Return	Rank	Ann. Return	Rank	Ann. Return	Rank	Ann. Return	Rank	Ann. Return
MSCI EM	1	9.8%	1	16.8%	1	18.0%	2	-23.6%	1	22.9%
MSCI EAFE	3	4.6%	3	8.9%	2	14.1%	3	-25.9%	3	16.2%
S&P500	2	7.6%	2	14.2%	3	6.2%	1	-12.7%	2	21.9%
Brazil	3	22.7%	3	34.8%	1	43.0%	11	-32.1%	5	38.6%
China	10	6.8%	6	23.5%	7	18.1%	12	-39.1%	8	17.8%
India	7	15.1%	8	21.7%	3	32.3%	7	-17.5%	10	11.7%
Indonesia	5	17.4%	11	-1.0%	4	31.6%	1	0.8%	4	50.3%
Korea	6	15.1%	5	28.1%	11	0.9%	3	-13.5%	3	58.7%
Malaysia	9	7.0%	10	11.0%	9	11.4%	4	-14.0%	9	15.2%
Mexico	4	19.9%	4	34.1%	6	22.6%	5	-16.8%	6	33.9%
Russia	1	39.2%	1	84.1%	8	14.5%	2	-5.3%	1	72.8%
South Africa	8	10.7%	9	15.2%	5	25.4%	9	-19.2%	11	11.5%
Taiwan	12	4.7%	7	22.7%	12	-4.3%	10	-19.4%	7	18.8%
Thailand	11	6.7%	12	-2.9%	10	6.3%	8	-18.2%	2	64.7%
Turkey	2	26.4%	2	57.1%	2	36.5%	6	-16.8%	12	11.1%
Energy	1	18.7%	2	27.7%	1	33.0%	6	-20.1%	5	24.2%
Materials	4	12.4%	7	13.9%	2	32.4%	9	-29.7%	3	28.9%
Cons Disc	5	12.3%	4	18.5%	6	16.4%	5	-19.9%	2	32.7%
Cons Stap	6	11.5%	8	13.8%	5	19.4%	2	-13.5%	6	22.1%
Financials	7	10.5%	9	10.7%	3	21.3%	4	-19.6%	4	27.1%
Industrials	10	3.7%	10	4.2%	4	20.7%	10	-30.0%	10	14.5%
Technology	3	12.7%	1	42.3%	10	-0.4%	3	-14.2%	8	20.0%
Health care	2	15.0%	5	17.8%	9	13.4%	1	-5.8%	1	37.5%
Telecom	8	10.5%	3	24.0%	7	15.4%	8	-21.8%	9	16.0%
Utilities	9	8.8%	6	17.1%	8	14.1%	7	-21.6%	7	20.3%

Source: Itau Global Strategy

Table 7. Ranks on the basis of average monthly performance for the period 1995-March 2011: Nexus between PMI and Real Interest Rate Changes

	All periods		NAPM PMI > 50				NAPM PMI < 50			
			Real rates Change positive		Real Rates Change negative		Real rates Change positive		Real Rates Change negative	
	Rank	Ann. Return	Rank	Ann. Return	Rank	Ann. Return	Rank	Ann. Return	Rank	Ann. Return
MSCI EM	1	9.6%	1	45.9%	3	-3.5%	2	4.9%	3	-13.0%
MSCI EAFE	3	4.9%	2	28.0%	2	-1.7%	3	-3.5%	2	-10.6%
S&P500	2	8.0%	3	19.5%	1	2.2%	1	5.4%	1	-0.4%
Brazil	3	20.3%	1	66.9%	4	9.1%	10	1.3%	6	-6.6%
China	10	7.5%	5	49.8%	8	-3.7%	12	-10.4%	11	-25.2%
India	7	14.3%	6	49.6%	5	8.0%	6	16.0%	10	-24.4%
Indonesia	5	17.4%	12	15.2%	6	3.5%	2	29.3%	2	10.5%
Korea	6	15.4%	4	56.2%	11	-20.8%	3	28.6%	3	7.0%
Malaysia	9	7.8%	11	24.9%	9	-4.2%	7	15.9%	9	-20.3%
Mexico	4	18.0%	9	33.3%	2	17.2%	5	20.2%	7	-7.6%
Russia	1	37.8%	2	66.6%	1	21.2%	1	52.3%	5	-6.4%
South Africa	8	12.0%	7	48.1%	7	-2.5%	11	-9.3%	4	1.1%
Taiwan	12	4.9%	8	38.4%	10	-13.4%	8	11.8%	8	-15.2%
Thailand	11	6.8%	10	27.4%	12	-22.6%	9	7.7%	1	20.9%
Turkey	2	29.4%	3	61.9%	3	13.3%	4	27.5%	12	-31.1%
Energy	1	18.0%	3	52.7%	2	8.2%	6	5.2%	4	-6.9%
Materials	5	12.1%	2	53.4%	6	-1.6%	9	1.0%	5	-11.2%
Cons Disc	4	12.1%	4	45.9%	8	-5.6%	1	23.9%	9	-18.0%
Cons Stap	6	11.3%	8	28.3%	3	6.1%	4	9.2%	3	-5.9%
Financials	7	10.7%	6	39.2%	7	-3.4%	3	11.1%	8	-12.8%
Industrials	10	4.0%	7	34.4%	9	-6.0%	8	1.4%	10	-24.2%
Technology	3	13.4%	1	57.0%	10	-10.1%	7	4.6%	2	-4.1%
Health care	2	14.8%	10	16.6%	1	12.1%	2	11.7%	1	15.8%
Telecom	8	9.8%	5	42.2%	5	-0.3%	10	0.4%	6	-12.3%
Utilities	9	7.8%	9	28.0%	4	0.4%	5	5.9%	7	-12.3%

Source: Itau Global

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