

2010: A Look Ahead

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Following a very difficult 2008, which saw a global financial and economic meltdown that was nearly unprecedented, stocks entered 2009 by falling another 35% in the United States as fears of depression and financial system nationalization gripped investors. From the March 2009 lows, stocks galloped higher as those fears dissipated and as investors witnessed the power of the most massive global monetary and fiscal stimuli imaginable begin to reflate economic activity. We have described it as a tug of war between the forces of debt-induced deflation and those of policy-induced reflation. While deleveraging and other deflationary forces have not left the scene, consistent and aggressive policy ignited the reflationary process.

2009 produced negative real economic growth, weak nominal growth and significant earnings declines. Despite that backdrop, "risk" assets outperformed "safe" assets as sidelined cash (which was producing near-zero returns) moved back into the markets. Emerging markets handily beat developed markets. Inflation fell in most countries, but widespread deflation was avoided. Treasury rates moved modestly higher as the yield curve steepened. Quality spreads narrowed, while equity markets remained volatile, but ended the year with sharp gains. Financial stocks and other low-quality securities led the way back and information technology was the standout sector performer. Government spending reached record proportions, and the year ended with cyclical stimulus leading the way and masking structural problems that remain.

It is with this backdrop that we venture forward with our predictions for 2010:

1. The US economy grows above 3% in 2010 and outpaces the G-7.
2. Job growth in the United States turns positive early in 2010, but the unemployment rate remains stubbornly high.
3. Earnings rise significantly despite mediocre economic growth.
4. Inflation remains a non-issue in the developed world.
5. Interest rates rise at all points on the Treasury curve, including fed funds.
6. US stocks outperform cash and Treasuries, and most developed markets.
7. Emerging markets outperform as emerging economies grow significantly faster than developed regions.
8. Healthcare, information technology and telecommunications outperform financials, utilities and materials.
9. Strong free cash flow and slow growth lead to an increase in M&A activity.
10. Republicans make noticeable gains in the House and Senate, but Democrats remain firmly in control of Congress.

* Data is based on a pro forma estimate of assets under management from BlackRock, Inc. and Barclays Global Investors, and is subject to change.

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In our view, a gradually improving global economy, coupled with the likelihood of some interest rate increases, should create an environment where equities and select credit-sensitive fixed income securities outperform Treasuries and cash. For that to occur, necessary lynchpins would include healthy corporate profit growth, a peaking of US unemployment and a successful tightrope walk by central bankers. Economic growth in the United States and the rest of the developed world is likely to be above trend, but well below the typical recovery after a recession. We expect cyclical improvement to lead to a resumption of modest employment increases, but that a stubbornly high unemployment rate will persist. We hope and believe that inflation remains only a topic of discussion, rather than an economic reality.

We believe there is little room for P/E multiple improvement, and that stocks will require earnings growth to move forward. Therefore, a focus on quality is in order, as we expect to see more balanced performance between cyclical, defensive and growth sectors. Our belief is that the United States will perform at least as well as other developed markets given the likelihood of stronger economic and earnings growth. A good cyclical and secular picture for emerging markets should enable another year of outperformance. We expect that a paucity of growth coupled with strong balance sheets and free cash flow will accelerate M&A activity. In summary, 2010 is likely to be a year of continued modest cyclical recovery, countered by the structural problems that continue to face most of the developed world.

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