RCM US Investment Update

Conference call summary

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In brief

- RCM continues to remain constructive despite the challenging past few months. Our GDP assumptions have been ratcheted down into the 1.0%–2.0% range, but we are not in the recession camp as strong corporate earnings, attractive valuations and a significant amount of negative sentiment seem to be in favor of equities.
- Risks to our outlook: A hard-landing in China, contagion in the European debt crisis, and continued political inertia in the US.
- Sector recommendations: Technology, energy and later-cycle industrials.

Market Review

At the time of our last call in July, we flagged Europe as our primary concern and the number one risk to our relatively constructive outlook on the markets. Unfortunately, that has borne out in terms of what has transpired over the past couple of months. We also talked about our expectation that volatility was likely to increase over the remainder of the summer in light of some of these concerns; that clearly has happened as well. The surprise to us has been on the degree of the market downturn. We expected the market to remain somewhat range-bound as we got to a resolution in Europe. Obviously, that has not happened; since the time of the last call, the S&P is down roughly 13%.

Political Inertia and European Debt Crisis So what has happened to cause the downdraft since the last call? Largely it has had to do with macro issues and governments' seeming inability or unwillingness to deal with them in a constructive way, both here in the US as well as in Europe. In the US, we were expecting to have a resolution on an increase of the debt ceiling by August 2nd with some sort of deficit reduction associated with that. The worst case obviously would have been default, which we believe was never really an option. Instead of a resolution, we got what we consider to be the second worst outcome, which was a delay until November of this year, with the formation of a super committee to try to come up with US$1.2 trillion in deficit reduction. This cast a cloud of uncertainty, which the market hates, until the day before Thanksgiving when the super committee is supposed to come up with their proposal. So that was a clear and unexpected negative for us, which also certainly drove the market lower. On top of that, in Europe it is the daily news and latest rumors or discussions about what is going on with Greece and attempts to resolve that; there has not been, up until recently, much progress in that regard. While politicians comment about not allowing the markets to dictate their decisions, the markets have a way of forcing action by virtue of what is going on in the credit markets. Because there has been no resolution to the periphery in Europe, credit spreads are at very high levels. This has been transmitted beyond Europe to the US credit market as well as Asia and has become a global risk factor in terms of credit tightening. That is not good from a global growth perspective, and it has resulted in GDP forecasts coming down in a fairly significant way.

Where do we go from here?

GDP Assumptions Number one in terms of an overall macroeconomic standpoint, we clearly have had to ratchet down our GDP assumptions. We started the year at 3%, which was lower than most, but we are forced at this point to bring them down more inline with consensus, at least for 2011, into the 1.0%–2% range—that is the bad news. Having said that, the market appears to be willing to price in more of a recessionary outlook. That is not what we were expecting. We are watching data points both bottom-up and top-down quite closely. There has been a lot of volatility driven by a number of datapoints such as the Philly Fed and ISM surveys. The problem with a lot of those surveys is they do not have a particularly good hit record historically; they tend to predict a lot of recessions that never occur, so there are many false positive signals.

Initial Unemployment Claims The more accurate and more predictive indicator over time has been initial unemployment claims. This morning's weekly initial unemployment claim report was actually quite positive. Despite seasonal adjustments, the number was below 400,000. In 2000–2001 and 2007–2008, the initial unemployment claims trend showed a slow and steady rise; today it is a very different picture with a flat trend, or an even arguably a downtrend, in terms of initial unemployment claims for the past several months. Based on what we are seeing, we are not in the recession camp.

Earnings Growth The positive side is earnings growth on the S&P has continued to remain robust. S&P earnings for this year are likely to come in at the US$95–$100 level, which has not changed in terms of our expectations. Companies have done a tremendous job of managing expenses and finding avenues to grow despite a fairly sluggish US domestic economy, and we have not seen, from a bottom-up perspective, any signs that S&P earnings are at risk even as recently as the last couple of weeks. There are a lot of concerns about consumer spending and how long the US consumer can hold out, but companies such as Nike, Coach and Bed Bath & Beyond have released strong reports whereas in previous periods and prior recessions they were showing signs of strain at this point. Another factor worth considering is that these companies have been releasing upward revisions.

Market Valuation The stock market by most measures is very cheap. Assuming S&P earnings of US$100, the market is currently valued at 11 to 12 times earnings, which is at the lower end of history. Even more compelling is the comparison of the S&P 500 earnings yield to that of corporate bonds. Typically there is about a 150 basis point spread. Today the spread is closer to 600 basis points in favor of equities, which points to historically high levels of earnings yield relative to corporate bonds in the market.

Technicals and Sentiment Technicals and sentiment do not typically factor significantly in our analysis framework because they are not terribly predictive of forward returns, unless they get to extremes. Right now we are definitely reaching very extreme levels in terms of the magnitude of the market decline as well as the negative sentiment building in the market. The NASDAQ tends to be a leading indicator for the overall market, both up and down. Currently, close to 90% of NASDAQ stocks are below their long-term moving averages, which indicates an extremely oversold condition. Over the past 30 years, the only periods where the market was similarly oversold were in October 1987, October 1990, August 1998 and October 2008. All of these period have on thing in common: They were at or near very significant market bottoms. Additionally, the average 4–12 month return on the S&P 500 after hitting those types of extreme oversold levels was over 20%. We believe it argues that we are closer to the end as opposed to the beginning of the decline and that the market has digested already a lot of bad news.

When looking for market bottoms, technicals combined with sentiment is important because bottoms are not defined by any type of discounted cash flow analysis nor any sort of logical or rational endpoints—they are defined by panic and by a maximum level of fear where people are essentially giving up hope. A good proxy for the level of negative sentiment in the market is the VIX Index, which is currently above 40—a highly unusual and very extreme reading seen only five other times in the past 22 years of market history for the VIX; and again, each of those times was at or near important market lows. If history is any guide, a longer-term outlook of 6–12 months certainly seems to be in favor of equities at this point.

There certainly are some issues that could drive the market lower in the short-term, but with any sort of longer-term time horizon, the strength of corporate earnings, the very attractive valuation, and a significant amount of negative sentiment tend to lead to very strong market returns.

Potential Catalysts to Drive Market Growth We do not believe the Fed's recently implemented Operation Twist, which is essentially the Fed selling shorter-dated securities and buying longer-dated securities to flatten the yield curve without any increase in liquidity, will be a catalyst for growth. Relative to QE1 or QE2, where there was a fairly significant expansion of the Fed's balance sheet, with the 10-year yield already below 2%, we

do not believe it will have much of an impact. The market has already voted in that direction with a big thud when Operation Twist was announced. We also do not believe the Obama jobs bill will have much of an impact primarily because it does not really stand much of a chance of making it through Congress in any meaningful way. There likely will be some continued reduction in payroll taxes, but beyond that, it is likely to be de minimis.

Europe is the focal point of the equity and credit markets concerns, and progress must be made there to drive the market higher. There are some encouraging signs that we are finally on the cusp of making some headway with the Eurozone in the process of approving a expanded version of the EFSF, the funding facility to backstop the periphery in the banking system, which will be doubled essentially to close to US$600 billion. It is being voted on right now; in Germany it just passed in a fairly significant fashion this morning. It has to make its way through some of the smaller countries through the next week or so. The next step will be some sort of vehicle to essentially lever that fund to make it much more impactful and much larger than the US$600 billion would suggest. That, I think, would be a positive for the market. The ECB, which raised rates earlier this year just as they raised rates in 2008 much through the chagrin of the markets, has a meeting next week (October 6th), and there is increasing speculation that they will take back some, if not all, of the 50 basis point rate hikes they put into place earlier this year. That also would be a significant positive in terms of reducing the pressure on credit spreads.

The upcoming earnings season is also a potential catalyst for growth. As mentioned, some of the first companies to report have reported fairly strong numbers. With the market where it is today and many companies' stock prices having been pummeled, the bar is set fairly low, and I think, based on what we are hearing from our analysts, that fairly strong earnings reports will continue. Again, that will be a reasonably good catalyst to drive the market higher from here.

Finally, we are getting now closer to the November 23rd deadline for the super committee to come up with some credible deficit reduction plans for the US. Given the record-low approval ratings for Congress, I think they are finally starting to get the message that they need to start doing something. That is what we are hearing from our political consultants, so I think there could be some good news on the horizon there as well in terms of a compromise or bipartisan effort.

Many of the issues that have been overhangs on the market over the past couple of months are now in a position to be resolved. While there is nothing to say that they will be resolved in a favorable way, we are now at a point where the rubber is going to hit the road on a lot of these issues.

The one risk that is starting to become more of a concern for the market, and even today it is having a significant impact on some stocks, is China. Credit has tightened in China fairly significantly recently, so there are a lot of concerns about a hard landing. That is not what our expectation is, but it is certainly something we have to monitor closely. Our sense is a lot of the issues in terms of credit tightening from China are residual or second order effects from what is going on in Europe.

So bottom line, we do remain constructive. The 1400 to 1500 S&P500 target, which was our best guesstimate for this year that we made at the beginning of the year, looks a bit pie in the sky at the moment. If we are anywhere right about the historical examples we have given, while we may not hit 1400 this year, I think over the 6–12 month time horizon, history is on our side in terms of those types of levels on the S&P, so we do remain constructive, although certainly the last couple of months have been more challenging than we expected.

Sector Recommendations

In terms of sector weightings and sector recommendations, really no change there. We came into the year positively disposed toward technology, energy and later-cycle industrials such as aerospace. At the time of our last call, energy and industrials had been outperforming for the year and technology had been lagging; now we have seen a flip-flop on that. Technology has had a nice run, in part because it is seen as somewhat immune to many of the credit issues facing the rest of the world. We still like technology. It typically does have some seasonal tailwinds into the fourth quarter, so we would expect technology to finish the year with a decent run.

Energy and industrials have been pockets of strength. Aerospace in particular has done well, but those companies tied to emerging markets have really been hit, especially in the last few weeks, as concerns have grown about global growth prospects. We are still favorably disposed to those areas and believe they will be the biggest beneficiaries of a resolution to credit issues in Europe. Since we do think we are likely to get the resolution sooner rather than later, I would still favor energy and industrials, especially with a 6–12-month view.

Questions and Answers

Q Do you feel the global economy is poised for an extended period of deflation? And if so, what impact will this have on the global and US mandates you manage for clients?

A **Scott Migliori:** I think what we are expecting is not global deflation but definitely slow growth for the foreseeable future as we work through a lot of these credit and debt issues, and that has a couple of implications for the type of investments you want to own. On the one hand, one type of investment that should do quite well from an equity perspective in this type of environment is high dividend yielding companies. I think dividend yield as a overall component of equity returns is likely to gain some prominence. The other type of stock more on the growth side that should do well in a slow but positive growth environment are secular growth stocks. These are companies that are not particularly tied to any level of GDP but have their own product cycle dynamics—companies like Apple are classic examples, but many names in health care as well and in the consumer area that are in the early stages of their S curve and are not highly dependent on 3%–5% GDP growth.

Q The US dollar has appreciated over the last weeks and months against the euro, will this have an effect on US companies?

A **Scott Migliori:** It will have an effect if this becomes a new trend of dollar strength. Many multinational companies, especially in the consumer staples area, have benefited primarily from currency impacts of a weaker dollar. If the dollar continues to strengthen in the next year, then that tailwind will start turning into a headwind specifically for these large multinational companies.

Q What is your view on the US banking sector, and how could the sovereign debt crisis affect this industry?

A **Scott Migliori:** The US banking system is a shining star by comparison to some of the banking issues in Europe, especially the French banks, which are highly exposed to not only Greece but also to Italy and Spain and have not taken nearly as many steps as our banks have to beef up their capital. On a isolated basis, our banking system looks pretty good. Unfortunately, everything, as you know, is interconnected, so that is why credit spreads matter. As credit gets tighter and tighter interbank lending rates get tighter and tighter, it does have a negative impact on banks'—even here in the US—ability to fund themselves. This is why I believe before there is any sort of meaningful rally in US banks, we need to see signs of resolution in Europe.

Q US companies are still sitting on large amounts of cash, what do you think they're planning to do with it?

A **Scott Migliori:** It ties back into both the valuation as well as the dividend potential. The earnings yields of the S&P are at historically high levels. There is a ton of a cash on the balance sheet that I think will be deployed either via share buybacks, increases in dividends, and/or M&A—all of which should be supportive catalysts for equities. We are starting to see even technology companies, which have been loath to raised dividends, but have a ton of cash, starting to raise dividends and starting to now have above-market levels of dividend yields. The level of cash on the balance sheets is a clear source of downside protection in our view and for the overall market.

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