

In brief

- 2009 was a highly successful year for RCM US, who delivered strong performance with 95% of assets under management outperforming their respective benchmarks on a three year basis
- We believe the US is beginning to show signs of a self-sustaining recovery
- We believe that our portfolios are well-positioned within an overall largely positive economic backdrop



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Scott Migliori, Chief Investment Officer at RCM US, and Rob Parenteau, consulting economist, give an update on strategy, performance, current positioning and the outlook going forward.

Macro review

Rob Parenteau: A year ago the economy was in dire straits with major recessions evolving around the world and policymakers hitting the panic button. We have seen enormous pushes on fiscal policy in the US as well as abroad. Central banks were doing things that are very unusual, including quantitative easing, which involves central banks going out and buying mortgage-backed securities, and, in some cases, corporate bonds and Treasury securities from the private sector. The good news is, during the course of the past year, a number of economies have come back from the brink and an early recovery began to take shape. An economic expansion is certainly underway in Asia.

It appears that the US also is beginning to get some traction. The US has now had two back-to-back quarters of real GDP growth. The last quarter was approximately 5.9%, and it appears that we are heading for something north of 3.5% for Q1. For the full year we are expecting close to 4.0%, which is quite healthy growth for the first year of a recovery unattended by a housing recovery.

We are looking for signs of a self-sustaining recovery with the private sector being able to carry the growth instead of dependence upon policy to drive growth. The first steps already became evident in late in 2009 when inventory accumulations began to appear in October-November and continued into January. During the severe recession and the credit crunch, companies went into survival and cash conservation mode, not just by slashing capital spending plans, but also by slashing inventories and taking their workforces right down to the bone. Now that sales are stabilizing and have actually begun to pick up in dollar levels over the past six to seven months, the time has come to start rebuilding inventories. Beginning in October it was a large part of the Q4 real GDP growth, and we expect it to continue full-bore into the first half of this year and taper off as we get deeper into the year. This inventory rebuild is ample sign that the first step out of recession and a self-sustaining recovery is underway. Production data is also showing a pickup, which confirms the inventory rebuild. We expect to see a good contribution to real GDP growth from actual inventory accumulation, not just lower rates of de-accumulation in the fourth quarter, which was the case driving that GDP number.

An increase in capital spending in the US around mid-year is the second sign that we are looking for. Corporate profit margins and operating leverage is up as companies have completed their cost-cutting with resulting improvement in top line sales growth. This is evident in the S&P earnings and in the GDP earning, and, together, they are pointing to an improved profitability. Capitalization rates are beginning to pickup from their historical post-war lows, and, as a result, a tightening of capacity is beginning to appear.

The third element of a sustainable recovery is new orders being reported, advancing on both the ISM, which is a private industry survey of manufacturers, or the supply of manufacturers. Those new orders are near all-time highs. New orders are also beginning to flow through in the Commerce Department. This makes good sense because once a company's workforce is cut to the bone, labor productivity increases. To cut costs even further, the next step is to put innovative capital equipment into place in order to stay competitive to drive the next leg of product innovation and profitability. We are beginning to see that kick in, and we believe the combination of profits, higher capitalization and new orders confirming it are all suggesting that the handoff from inventory to capital spending will occur by mid-year, and that will carry through the second half of the year.

Housing and nonresidential construction remain a lackluster force through the recovery. Housing looks like it is double dipping – you've got mortgage rates back up again. Home prices have begun to rise, but they may weaken a little bit further from here. And while housing is typically a significant part of recovery, it will not be the case this time around as the current housing overbuild will take a few years to work off similar to the overbuild in the technology sector in the late 1990s.

Against that backdrop of a consumer that is likely to remain lackluster, we would like to see employment pickup, which we believe may be a month or two away. While payroll employment has improved significantly from the very large declines of a year ago, it does not yet show gains. However, we believe that it will increase soon, which should boost consumer confidence, improve cash flows into the household sector, stabilize the wages and salary income and make consumer spending less dependent upon government transfer payments and programs.

While banks are showing more willingness to lend to both households and businesses, their balance sheets are still contracting, which indicates that they are not making new loans and are buying Treasury securities and signals that most of the initial stages of growth will be self-financed out of savings by the corporate sector. There is huge free cash flow on the corporate sector side, and the household sector is now running a pretty decent 3.5%–4.0% savings rate. So, we see good developments there, and again, the motion, in our mind is towards a self-sustaining recovery of the US.

On the inflation question, I think the headline CPI, so far year-to-date, is running close to 3% and there is no question it is mostly driven by energy prices. There is not a lot of price inflation outside of those sectors. Core inflation measures are still varying around 1.5%, which is about where the Fed would like to keep them; we may get above 3.0% for a bit on the headline rate, but will likely be back down below 3.0% by the end of the year. Import prices have come up a little bit. You may have read something about labor shortages starting to show up in China; that is affecting some of our import price complex. But, in general, the household sector does not have as much access to credit as it did before. It is still trying to save money, and the labor market is still weak. It will be hard to push through and keep prices higher in that environment if households do not have the income growth to validate higher prices.

The current difficulty with the Treasury bond environment is figuring out who will be a buyer of Treasuries as the Fed has stepped out of the way and the banks have not stepped up enough. The Fed stopped their quantitative easing purchases back in September of last year. There was not much of a hiccup in the bond market, but if we are right that we are going to see more signs of a self-sustaining recovery, then it is going to be more difficult for some of the bond bulls, who are either voting for or hoping for a double-dip, to hang onto their bond positions. So, our concern here is that as we approach the end of the second level of quantitative easing at the end of this month, the mortgage-backed security purchases will come to an end. We may see more of a hiccup in bond yields. It is doubtful that the ten-year gets much above 4%, if at all, because again, the notion here is the Fed is

very aware of the tentativeness of the housing recovery, which is viewed as one of their major transmission mechanisms for monetary policy, and the odds are they would have to come back in with some sort of quantitative easing to try and get mortgage rates down if we get too much of a backup of the ten-year Treasury yield.

Looking abroad, the European situation looks the weakest to us, and certainly as these countries go through fiscal retrenchment, there will be more downward pressure on their economies. Our analyst earnings expectations are about the same in Europe—high double-digits around 25%-30%—that they are in the US. We believe there is more growth and earnings risk in Europe, and we expect that to come to the fore as we get deeper into the Spring. Against that backdrop, we believe the dollar is more likely to continue appreciating against the Euro, and we believe the Eurozone is going to get out of its problems, in part, through depreciation improving its trade balances.

Asia and the developing countries appear to have a good full head of steam with the stimulus policies they pursued taking hold very nicely, and at this point, it is just a question of whether there is inflationary overheating that shows up in some of those economies. India, for example, was already staring at double-digit inflation. There is some evidence that Chinese food price inflation is starting to filter through, and there is growing concern, as mentioned earlier, about labor shortages showing up along the coastal cities. We also have some residential and property real estate-related bubbles beginning to show up in places such as Hong Kong. As a result, monetary policy is starting to dampen down in those areas, but we have very strong convictions that these regions will not go back into recession.

In summary, we are looking at the US beginning to show signs of its own self-sustaining recovery, with a bit of concern about back up in bond yields, weakness prevailing mostly in Europe and Asia, and the rest of the world holding up well. In general, the early stages of recovery and business cycle expansion tend to favor equities over bonds, and I would expect an equity allocation would do well.

Portfolio review

Scott Migliori: The largely positive macroeconomic backdrop has positive implications for the equity market. On the earnings side a 3.5%–4% GDP growth in the US has a positive implication to earnings, which has been the story for the last several quarters. The surprise factor for the market has been the strength of corporate profits, in part, because of the amount of cost-cutting that took place, but also, because we are now starting to see some traction and demand. Q4 has shown a lot of upside surprises. Over 70% of the reporting S&P 500 companies have beaten the bottom line, and, for the first time in a while, a lot of that has been driven by surprises on top line growth. 2007 was viewed as a peak margin year for many of these same companies. That was part of the bear story for the overall market. However, a number of sectors including technology, healthcare and consumer discretionary are now at operating profitability above the 2007 level, which is an amazing comeback given all the turmoil of the last couple of years.

The sentiment for equities has been neutral to abysmal. Bond and commodity funds had net positive inflows of over \$200 billion in 2009. US equity funds had negative outflows of \$37 billion. Despite improvements in economic performance, there are still a lot of doubters and double-dippers. Ultimately, improvement in employment figures is required to get the retail investor more interested in equities. With the current sustainable recovery, we would expect that to occur in the next couple of quarters.

In terms of the performance that RCM has generated, we have been fortunate enough to be on the

right side of the market over the last couple of years. Performance in 2009 was strong almost across the board, and on a three-year basis 95% of assets under management at RCM US have outperformed their respective benchmarks. The beginning of this year has been a little bit of a rougher start, where we did have a pretty significant reversal in market leadership in January, but we still feel very confident in our positioning for the remainder of the year.

From a go-forward perspective, we are looking at quite strong earnings growth for 2010. We could see an S&P earnings number approaching \$80 for 2010. Using any sort of a reasonable multiple on that earnings growth, we would expect a market up 5%-10% this year in the US as being a very achievable goal. However, we would be surprised if we got there in a straight line.

US political reform initiatives, whether it be financial services or healthcare reform, is a risk factor that may create some volatility. Another risk factor is inflationary pressure out of Asia and the steps, specifically in China, that are being taken to dampen down that inflation expectation. There has been a number of tightening programs that have taken place. It is our expectation that we will see additional tightening in China, which, again, will create volatility and concerns about the prospects of a hard landing. We think that is unlikely, but as long as tightening initiatives take place, there will be that fear and volatility associated with that.

While no one has a perfect crystal ball, from an overall market standpoint we believe that 2004 is an analogous situation. 2004, which followed a very strong market in 2003, experienced very choppy markets for the first two to three quarters, despite continued economic recovery due to issues surrounding the election as well as concerns surrounding interest rate policy. We believe 2010 could have a similar outcome.

In terms of sectors and positioning of portfolios at RCM US, we have taken some profits in areas, such as technology, that had significant out-performance last year. Areas such as industrials, which are very economically sensitive and did not perform as well as technology, have been areas that we have been adding to on the margin, as well as some areas in consumer discretionary. We have also been adding back selectively to healthcare, where, despite risk of healthcare reform, we believe we know who the likely winners and losers are and that we are at a point where we can look past reform to look for interesting opportunities where stocks look undervalued.

Against a favorable economic backdrop, increased confidence among CEOs and significant cash on the sidelines on corporate America's balance sheets, we have seen an acceleration of M&A activity in just the past couple of weeks and we expect it to continue throughout the year. This has positive implications for the overall market, particularly for smaller cap stocks.

Questions and answers

Q: What are the best growth sectors and can these sectors create enough jobs to help bring the unemployment rate to a normal level?

Scott Migliori: On a longer term basis technology is still the mostly likely driver of economic growth and employment in this country. The US is still on the leading edge in most areas of technology. Alternative energy technology, which has political support in terms of subsidization, is also included in the technology rubric. Wind and solar power, and even nuclear energy is getting a fresh look as there are a lot of technologies that are on the cusp of becoming profitable and realistic in terms of their ability to cut costs and make the industry more efficient.

Q: What is the probability that Congress will balance the budget and begin reducing the deficit given

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that Medicare, Social Security, Homeland defense, etc. seem to be off limits when budget cuts are considered?

Scott Migliori: It is certainly unlikely that we are going to balance the budget anytime soon given the \$1.6 trillion deficit forecast for the coming fiscal year, and deficit spending as far as the eye can see, even with some fairly rosy assumptions. Having said that, I don't think the goal needs to be or should be a balanced budget. What I think you need to see is a deficit as a percent of GDP that's much more reasonable than what you see today. The current run rate for the budget deficit as a percentage of GDP is on the order of 10.6%, which is a scary number in terms of when you look at comparable situations in other countries. So, getting that back down to 4%-5%, which is where Canada is today, would certainly be a worthy goal. The question that was submitted is right in talking about a lot of these areas of entitlements that are untouchable. What that translates to is higher taxes, which certainly becomes an issue in 2011 and beyond in terms of what kind of growth we are likely to see in terms of GDP, given that that tax hike is likely to slow growth down. The responsible thing to do is to reduce the deficit, but I don't think by any stretch of the imagination that we are going to see a balanced budget anytime soon.

Rob Parenteau: We should see a big political backlash developing as the year goes on, and a very different Congress that comes out of that. What is not clear is whether anybody who does get elected will be talking about specific tax cuts, tax hikes, entitlements or entitlement cuts—and that will be the challenge that will come up next year, once they're in office, when they actually have to deliver something. The thing that we want to be focused on here is what types of taxes we should be expecting—a value-added tax? Could that be coming? And how will that affect different companies, different industries, given that it's highly likely they will try to move in this direction.

It seems almost unfathomable that we can get from 12% fiscal deficit as a share of GDP to zero in any short time horizon. I think, at best, we will, get to a 3%, 4%, or maybe 5% deficit of GDP in three to four years. As long as we are delivering nominal GDP growth close to 5%-6% percent, that's enough to stabilize the debt-to-income ratio.

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