

Global Commentary

Please refer to Appendix – Important Disclosures and Analyst Certification

Global Divergences Emerging

Bottom Line:

- Global Recession Unwinding
- Commodity Uptrend Intact
- Equity Uptrends Cooling
- On Sentiment: Direction Matters

Global Recession Unwinding. A better-than-expected GDP report in the United States and the emergence of rate hikes by foreign central banks are producing optimism that the global recession is being unwound and a return to growth is well underway. The downturn was in many ways a synchronized global event, and the past eighteen months have produced a sense of a speeding up of reality. The emerging recovery, however, is likely to be uneven and drawn out, both within countries and across countries. **This means that relative opportunities in various asset classes will emerge and fade. Investors must be aware of and poised for such opportunities.** This begins with a more complete understanding of one's own risk tolerances, a process that has already begun.

The central banks in Australia, Israel, and Norway have already raised interest rates, while tightening by the major

central banks remains distant. This is in stark contrast to the easing cycle, which was noteworthy in part for the level of global coordination that accompanied it. Even among the major central banks, policy coordination is eroding. The Federal Reserve is wrapping up its Treasury and Agency purchase program, while the Bank of England is continuing with its asset purchases. Relative opportunities going forward may depend more on the differing direction and speed of such efforts, rather than the aggregate degree of tightening.

Central banks are grappling with two major considerations:

- The degree to which

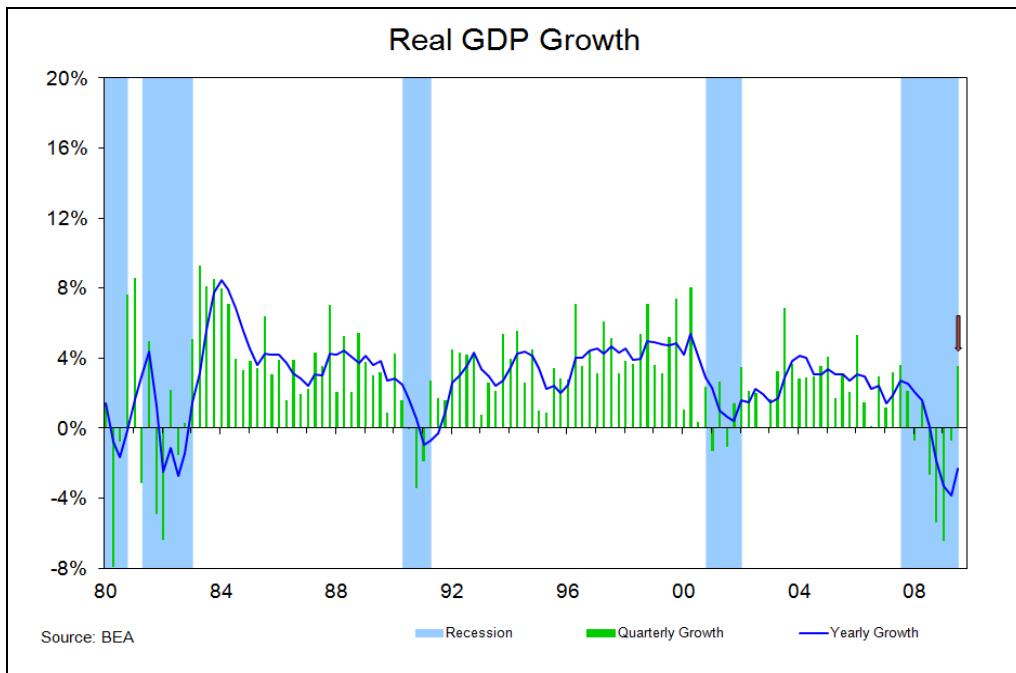
Strategic Outlook Summary

Marketweight Stocks, Underweight Bonds

Global Stock Allocations Tilt Abroad, Towards Emerging Markets

With Recovery Emerging, Favor Quality Cyclical Sector Exposure

Commodity Uptrend Intact



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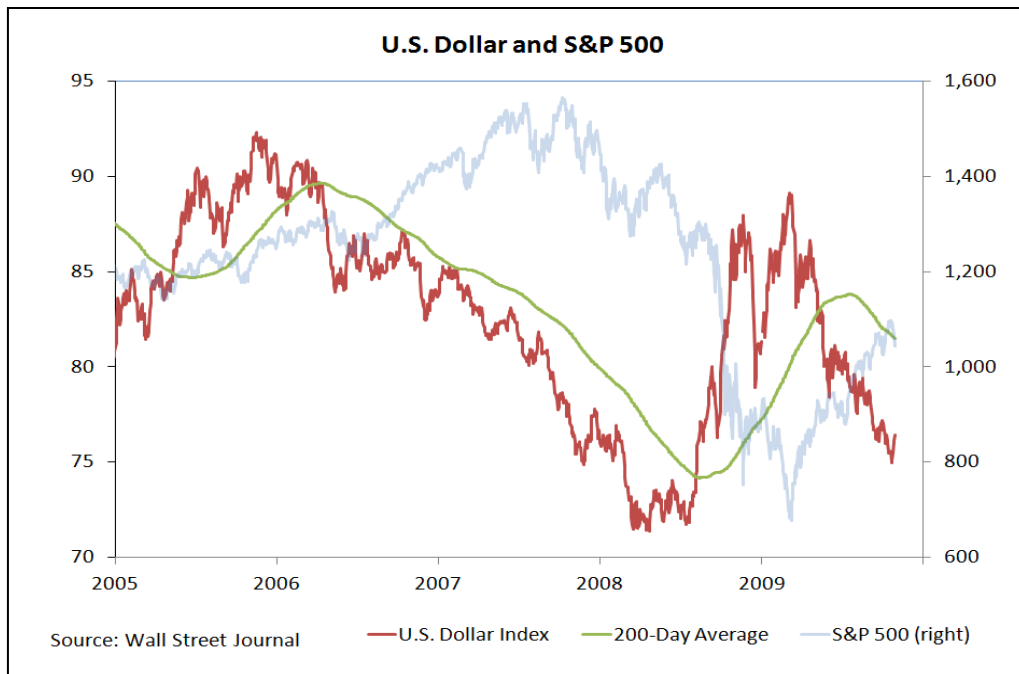
domestic economies have responded to stimulus.

- The effect of such stimulus on the deflation/inflation outlook in coming quarters.

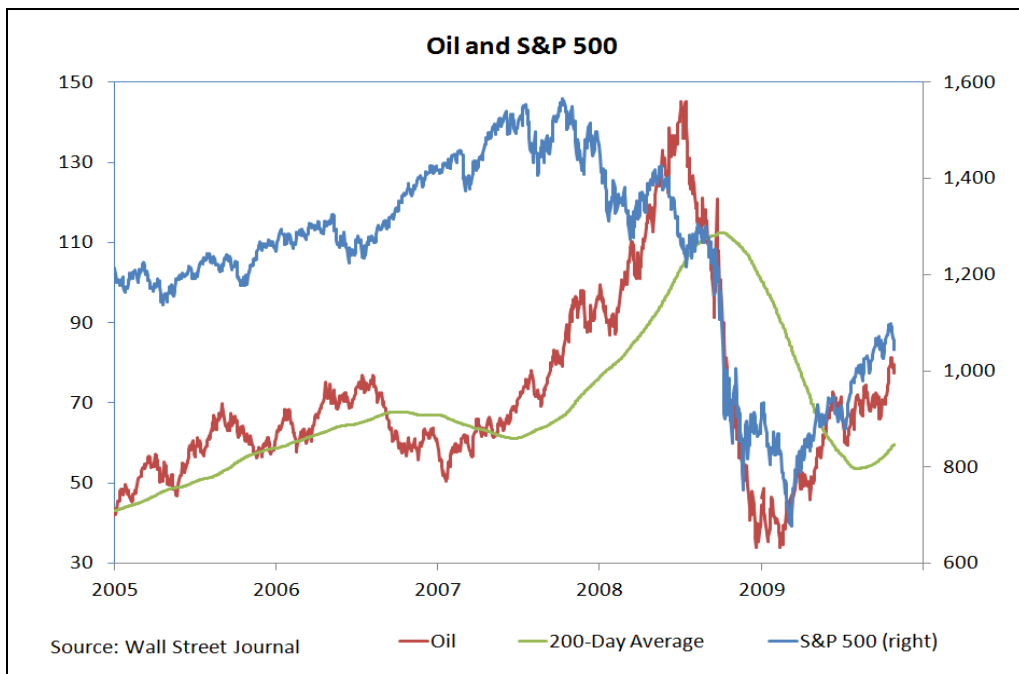
The Federal Reserve has seen sufficient stabilization in the financial markets and the economy that it feels confident that it can step back from direct intervention, while it remains undecided about the long-term inflationary effects of its recent actions. This ongoing debate will shape the timing and degree of Fed actions going forward. For now, excess capacity (of both equipment and labor) and the ongoing deleveraging process are

sufficiently deflationary that even with the massive supply of dollars that has hit the market over the past year, Treasury yields have remained low. In Australia, the economy skirted recession, owing in part to its proximity to China, and the central bank there has a more pre-emptive bent than does our Federal Reserve. Thus, the Australian central bank became the first bank to raise interest rates.

Currency moves could become more noticeable as the



global recovery unfolds. The dollar has been a proxy for risk tolerance – as the global crisis unfolded, the dollar surged on increased risk aversion. Since March, the dollar has moved lower as investors have moved beyond safe harbors. More recently, low domestic short-term interest rates and a declining dollar have allowed for the emergence of a dollar-carry trade. **Near-term aversion to the dollar looks to have become extreme and a modest dollar rally has emerged. While the downtrend became overextended, there is little to suggest that it has run its course.**



Commodities have moved off of their recent peaks, but the uptrends there remain intact. Gold has benefitted from both dollar weakness and a perceived shift in asset allocation preference among investors. While gold pays no dividends, investors seem to be foregoing income potential and focusing on its potential as a store of value in an uncertain world. In other words, a small holding in gold may reflect a desire to reduce one's risk profile. *We are somewhat concerned by the rally in oil to above \$80/bbl, which has been accompanied by a rise in gasoline prices back towards \$3.00/gal. While*

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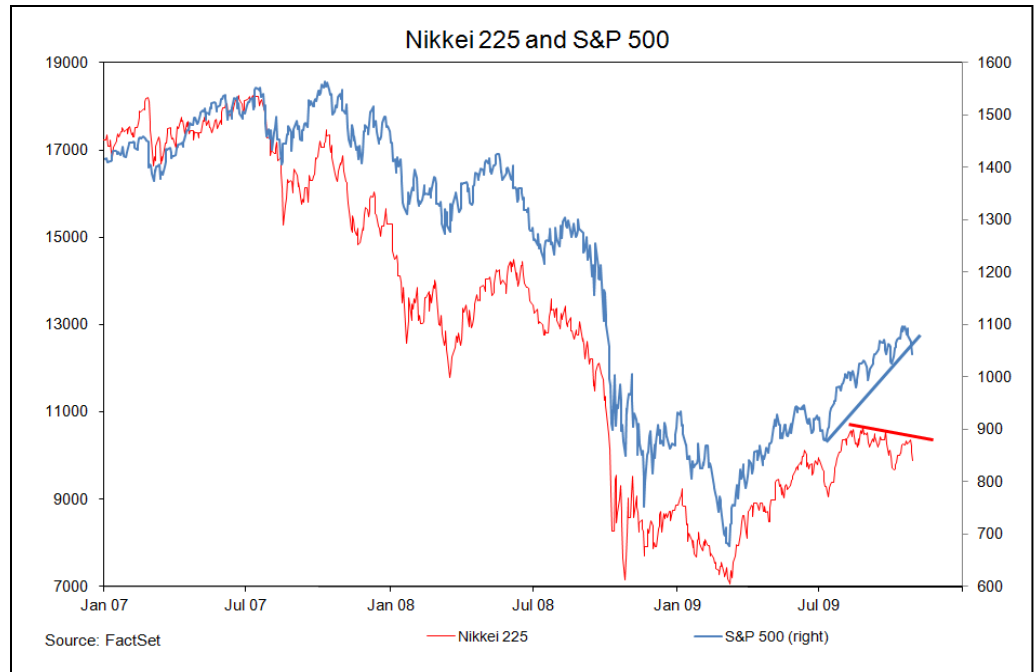
there is nothing intrinsically important about either of these exact levels, the U.S. economy (the 3.5% growth in the 3rd quarter notwithstanding) remains fragile and it may be unable to support a further rise in oil.

On the equity front, **global breadth remains strong**, although not nearly what it was during the earlier stages of this cyclical rally. Most international markets remain in uptrends, but divergences have emerged. The Nikkei and the S&P 500 are no longer moving together and the China Shanghai Composite has not made a new high since July. Thus far in the cycle, both on the way down to the late-2008/early-

2009 lows, many domestic investors found their foreign holdings, particularly in emerging markets, to be the equivalent of higher-beta versions of the U.S. stocks. Absent another panic sell-off, the opportunity for increased differentiation of returns is emerging. **Just as the domestic uptrend is likely to cool over what has been seen in recent months, the trend in the global composites is likely to cool.** Opportunities at a country level may remain. *Our latest global relative strength rankings show continued leadership by emerging markets, although regionally there appears to be little differentiation. This reflects a cooling in the developed markets in Asia and the Americas, and improvement in the emerging markets in Europe. Recent leaders like Korea and Mexico appear to be weakening. Investors seeking China exposure should continue to tilt toward Hong Kong rather than China.*

A few words about **investor sentiment** and **broad market divergences**:

- Investor sentiment discussions typically focus on high levels of confidence (which is considered bearish from a contrarian standpoint) or low levels of confidence (considered a bullish sign). This is the case currently with the Investors Intelligence data, where bulls continue to outnumber bears by roughly two-to-one. These extremes are important only because they



typically signal an imminent reversal. What may actually be more important than the level of confidence is the direction of confidence. Rising optimism typically implies investors putting money to work, while falling optimism may signal funds are being removed from the system. Even absent extreme levels, significant movements in the optimism or pessimism may be headwinds (or tailwinds) for stocks. In the past two weeks, the AAll sentiment survey has shown a decline in bulls from 47% to 34% (one-quarter of those who were bullish two weeks ago now are no longer so). This has represented a headwind for stocks, as has the pullback in the Conference Board's measure of consumer confidence.

- On breadth divergences: these are typically thought of as a failure of one index or indicator to match the highs posted by another index (see the above divergence between the S&P 500 and the Nikkei). Another way to think about it is an inability for one index to hold support levels or trend lines while others do. Both situations bear watching for evidence that this cyclical move off the March lows becomes somewhat more tattered.

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