Ibbotson Quarterly Market and Investment Strategy Commentary

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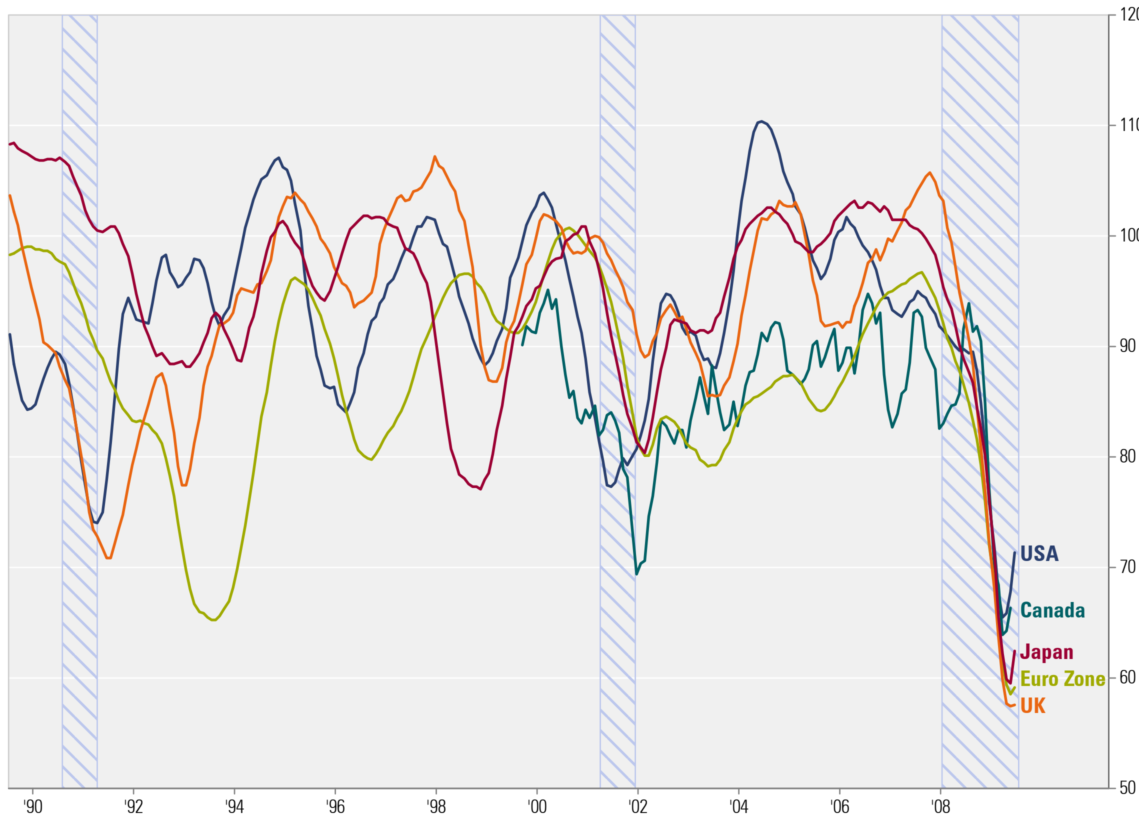
Market Commentary

Macroeconomic Conditions

The current recession has been unusually synchronous. In the past, major economies tended to move somewhat independently of each other. Looking at the following chart of industrial production surveys in different industrialized areas, for example, we see that the trough for the first U.S. recession (represented by the leftmost shaded area around 1991) occurred way before industrial production in the Euro Zone (green line) bottomed around 1993.

However, the liquidity crunch this time took the world by storm, and most macroeconomic measures fell in different countries at the same time, as shown by all lines plunging together in the chart in 2008. This has made life particularly difficult for export-oriented countries such as Germany, Japan, and most commodity exporters (including for example Canada and Russia).

Industry Surveys in G7 Countries



Source: FactSet

While several indicators show that economic conditions may have stopped worsening, it is still unclear whether they have started improving.

United States

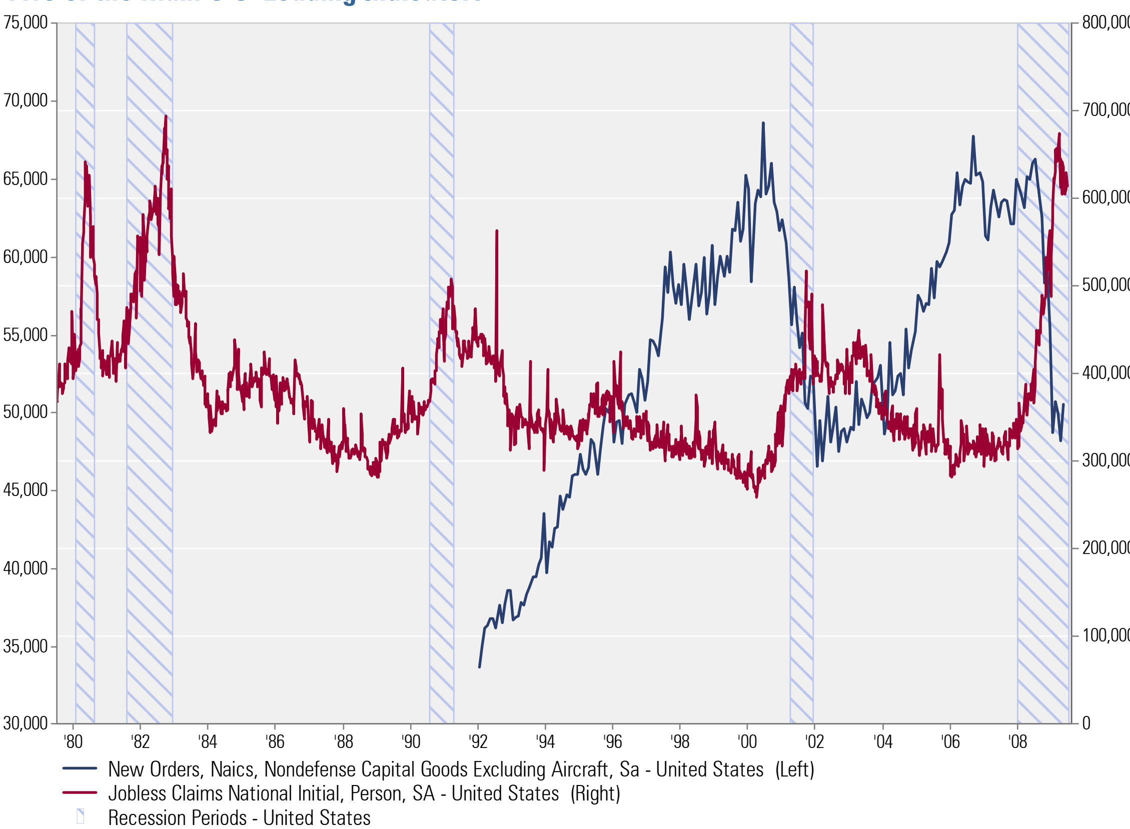
The quarter saw an ongoing debate in the United States, between optimists pointing out signs that the bottom of the recession is approaching and the economy may start improving soon and pessimists replying that the "improvements" seen should be really called "slower declines."

An example about home sales is telling. At each release of statistics about real estate sales, many news outlets emphasize the increase in sales with respect to the previous month, disregarding the fact that fewer homes sell in winter due to seasonal issues—for example, it is impractical to go house shopping when there are several feet of snow outside hiding the yard and making it difficult to inspect the perimeter of the building. Therefore, it would be more logical to compare this May's sales against the same month last year, rather than comparing them to this year's April. The fact that home sales in May 2009 vastly exceeded those in April 2009 does not necessarily mean that the U.S. housing market is having a boom.

Similarly, most news sources as well as investors are trying to interpret the latest statistics that tend to predict business cycle turning points—the so-called leading economic indicators. Two of these indicators are initial claims for unemployment insurance (a proxy for household income and labor demand) and new orders for nondefense capital goods excluding aircraft (a proxy for corporate capital expenditures).

These two variables move in opposite direction: initial unemployment claims tend to peak at the end of recessions, while new capital goods orders tend to bottom around the same time.

Two of the Main U.S. Leading Indicators



Source: FactSet

The statistics in the chart suggest that claims have peaked and started decreasing while new orders have bottomed (even if not necessarily resumed growth). Therefore, the recession appears to be losing its destructive power, but is unclear whether a new, expansion has started. Therefore, asset valuations are likely to be volatile until more solid indicators of an expansion emerge.

Soon the effects of expansionary economic policies should be visible. We will then see if the economic stimulus will have been sufficient to kick-start the economy, or if further measures will be needed.

Continental Europe

Unemployment and GDP growth remain gloomy in continental Europe. Real GDP growth projections from different sources for 2009 in the Euro zone estimate a loss of over 4 percent for the year (compared with an expected loss of less than 3 percent in the U.S. and 3.5 in the U.K.). One of the explanations is that several Euro countries, starting from Germany, rely heavily on exports for economic growth. When world trade drops as dramatically as it has recently, these countries bear the brunt of the world recession.

Looking at internal demand, car registration trends remain negative except for Germany where a government-sponsored scrapping bonus increased sales. This suggests that consumers remain cautious.

Spain, Ireland, and Iceland suffer from the decrease in global trade (e.g., tourism, a big export sector in Spain, is in a deep crisis) but also from the credit crisis, as their financial and housing sectors were in different ways bloated by the excess liquidity of the past. Banks must recapitalize while holding substantial amounts of real estate loans with quickly depreciating collateral and are unable to extend new credit.

Great Britain

Great Britain has taken advantage of having its own currency and devaluated the pound sterling to attenuate the effects of the international crisis, as confirmed by the GDP growth data in the previous section. Just like the rest of Western Europe, Britain has an outlook of feeble growth for 2010.

A continuous drip of scandals and public disagreements in the Brown administration are doing little to restore investors' trust during a difficult economic time. The fact that unemployment has increased by almost one-third since 2008 suggests that this is the time to find a common ground and focus on the bigger challenges.

Canada

The expected slowdown in Canadian economic growth and employment has occurred, due to decreasing trade with the U.S. and a drop in commodity prices. A big advantage for Canada is that there have been no major collapses in financial companies and therefore no bailouts were necessary.

By allowing the Canadian dollar to fluctuate, the Canadian central bank has taken advantage of automatic stabilizers that tamed the expansion while commodity prices were high and limited the recession that coincided with dropping commodity prices. In the meantime, energy prices have increased recently, bringing more revenues to Canadian exporters. It is not all roses, however, as the 2009 GDP contraction is expected to be in line with that of the U.S.

Japan

Exports are the major variable in determining Japanese GDP fluctuations. As a result, current forecasts for real GDP growth in Japan indicate a contraction near 6 or 7 percent—a dramatic loss. This is disheartening for the Japanese people, as around 2007 the country had recovered from its decade-long economic crisis thanks to exports.

In the meantime, the destabilizing presence of the currency carry trade (speculators borrowing in a currency with excessively low interest rates to invest in currencies with high interest rates) together with investment in local and international real estate has weakened the Japanese financial sector, which needs capital and is unable to lend. Trying to boost aggregate demand, the government has started a massive economic stimulus. Analogous fiscal expansion programs had limited success during the lost decade.

Emerging Markets

Finally, signs of decoupling are appearing. As some of our readers may recall, the word decoupling is used as shorthand for the idea that business and financial market cycles in emerging countries have a remarkable prevalence of local factors and tend to move out of sync with those of industrialized countries, which are more closely integrated with one another. This was seen as a rationale for emerging market investing, but did not work well in 2008, when investors tried to liquidate all but the safest investments, thus causing dramatic losses in almost all markets.

U.S. Stock Market

The second quarter of 2009 returned the best advance for the S&P 500 Index since the fourth quarter of 1998 with a return of 15.9 percent. Since 1973, this is the ninth time that the S&P 500 Index return exceeded 15 percent for a calendar quarter (not annualized).

Quarter with High Return	Previous Quarter Return	High Return	Following Quarter Return	Notes
1975:Q1	9.38	22.94	15.36	NBER Recession ended in March 1975
1975:Q2	22.94	15.36	–10.95	
1982:Q4	11.46	18.14	10.05	NBER Recession ended in November 1982
1985:Q4	–4.05	17.18	14.07	
1987:Q1	5.4	21.33	5.14	
1997:Q2	2.62	17.49	7.52	
1998:Q4	–9.95	21.30	4.98	
2003:Q2	–3.15	15.40	2.64	
2009:Q2	–11.01	15.90	?	

Source: Morningstar

The table above summarizes what happened to the S&P 500 Index around those particularly high returns. The first row of data shows that in the first quarter of 1975 the total return (not annualized) was 22.94 percent, while in the previous quarter (fourth quarter of 1974) the return had been 9.38 percent and in the following quarter (second quarter of 1975) the return was 15.36 percent. Interestingly, a U.S. recession ended in during the first quarter of 1975, as mentioned in the Notes column.

In seven of the eight times the S&P 500 Index had returns above 15 percent in a calendar quarter from 1973 to 2008, the quarter was followed by another positive quarter—the exception being June 1975, which was followed by a negative quarter (but was preceded by another quarter with a return above 15 percent). Therefore, if history repeated itself mechanically, we could expect a positive return with almost certainty. But we know better than that and, given that the table above only reports eight observations, we encourage the reader to be skeptical about any generalizations.

In particular, while it is true that the market tends to rally near the end of recessions (a stock market index is a component of the Leading Economic Indicators Index), it is also true that no calendar quarter with a return exceeding 15 percent was observed at the end of the 1980, 1991, and 2001 recessions.

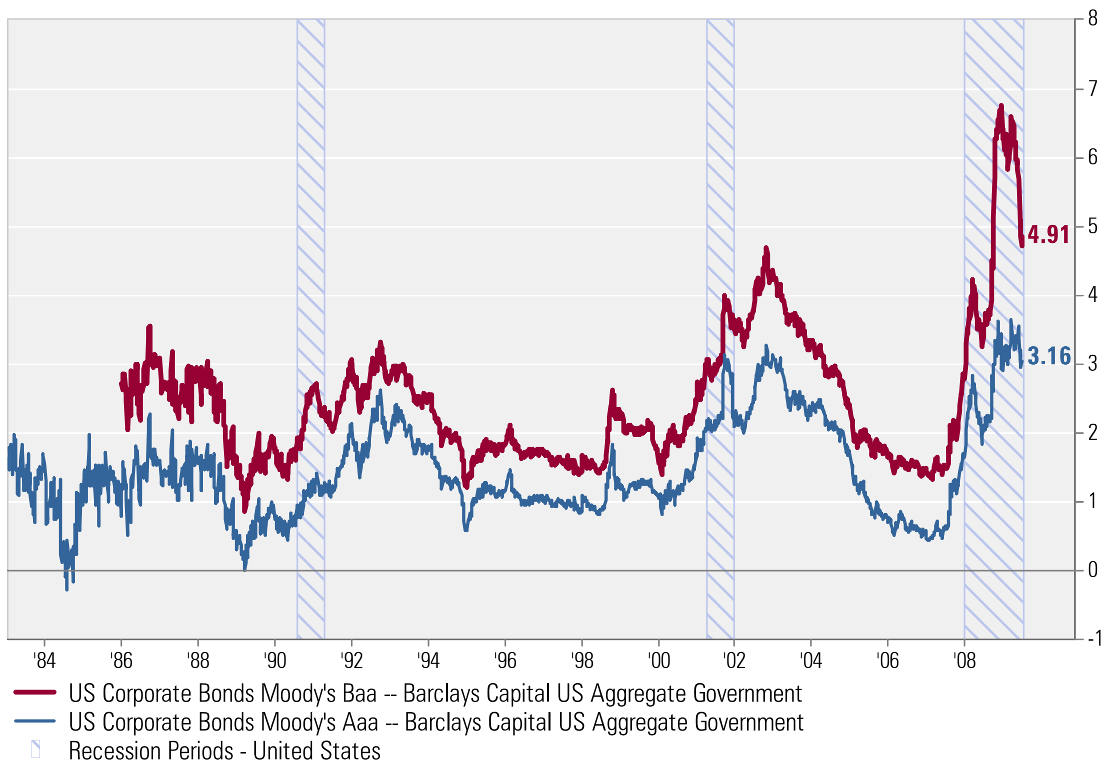
Financial stocks were the fastest-growing sector in the quarter, with an advance of 29.4 percent. In general, all stocks of leveraged companies, which had been battered heavily so far in the bear market, reported healthy gains as stock valuations incorporated decreasing interest rate spreads for riskier borrowers. To translate this into a more colorful and perhaps intuitive language that we started our piece with, the market experienced a "dash for trash" in the sense that less leveraged companies with more solid cash flows benefited less from this rally.

The confusion on valuation continues. If we include negative earnings, the P/E for the S&P 500 Index is above 120 (note that the height of the technology bubble saw the same measure around 44, so this is major). As a matter of fact, the S&P indexes for mid-cap and small-cap stocks have negative earnings (source: Standard & Poor's web site). If we exclude negative earnings, the market is not extremely cheap as prices are 13.6 times earnings (compared to 9.4 in February of this year). The truth is probably somewhere in the middle with considerable uncertainty about where we stand—just like the macroeconomic statistics suggest.

U.S. Bond Market

For U.S. Government bonds, the quarter brought a steepening of the yield curve. Short-term issue continued to have low returns, while longer-term yields moved closer to where they were a year ago—before the Lehman crisis. Some observers interpreted this as an expectation of inflation over the next five to ten years, which led investors to require higher yields for bonds spanning years where higher inflation is expected. Another explanation is that Government borrowing is expected to increase over the years, and therefore yields reflect the future excess supply of bonds.

Spreads from US Treasury Yields: Corporate Aaa and Baa



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A combination of the two explanations given so far is an expectation of future weakness of the dollar, and therefore expectation that yields will need to increase (because of inflation or high government borrowing) to attract foreign lenders. A third explanation is that investors are forecasting an increase in the productivity of capital in the future, and therefore yields show the expectation that firms will be able to pay higher interest rates to borrow money (this is a rationale of why the slope of the yield curve is a component of the Leading Economic Indicators Index).

U.S. corporate bonds had a very positive quarter, particularly for issues with lower credit quality. The decrease in spreads has been substantial. For example, top-rated AAA bonds had a yield spread from the Barclays Capital U.S. Aggregate Government Index of 3.41 percent at the beginning of the quarter, while BBB bonds (the lowest rung of investment-grade bonds) had a spread of 6.41 percent. At the end of the quarter, the spreads were 3.01 percent and 4.81 percent, respectively (see picture above). Therefore, not only did both yields decrease, but also the difference among the two suggests that panic in the bond market has been receding. This view is confirmed by high yield bond spreads, which followed a similar path.

U.S. REITs

The ongoing excess supply of commercial real estate (CRE) in the U.S. is accompanied by falling occupancy in hotels and shopping malls. The CRE sector is overly leveraged. However, REITs have less leverage than private owners. With defaults increasing, banks are still reluctant to lend against CRE collateral unless the value of the property clearly exceeds the amount of the loan, with most banks apparently financing only up to half the current market value of the property.

Some REITs that entered the crisis with limited debt are now in a dominant position and have been able to refinance their debt. The news of refinancing taking place sent U.S. REITs indexes up 30 percent in April, suggesting that investors expected all REITs to be able to find lenders (or vulture buyers).

An interesting development is that many REITs, including the top players, have been paying dividends in a mix of stocks and cash. The IRS allows this practice, which allows REITs to avoid increasing their debt burden, instead using cash flows to pay off debt. Less leveraged REITs are using this trick to increase their cash reserves so they can buy at distressed prices from less fortunate ones.

Commodities

Oil prices kept their steady growth path during the quarter, reaching in June spot prices near $70 per barrel, which had not been seen since October 2008. This fueled speculation that demand was restarting thanks to emerging economies, such as China, which had not directly suffered from financial system crises. Since the IEA, an international body providing forecasts of energy markets, reduced its estimate of energy demand for 2010, the oil price rally is puzzling.

At the same time, a rapid increase in the cost of shipping (as measured by the Baltic Dry Index, a measure of the cost of sea transportation for dry goods) has taken place while newspapers were printing stories about large numbers of merchant ships docked off Asian ports, waiting empty and idle for a return of demand. Clearly, the stories about idle ships contradict the logic of an increase in freight costs.

An outlook for commodities appears therefore particularly uncertain, as demand from rich countries falters and may or may not be replaced by emerging country demand.

Non-U.S. Equity Markets

Non-U.S. equity markets posted large advances in the quarter, with emerging markets nearing a 35 percent gain. Commodity producers, including Canada and Russia, fared particularly well. The MSCI EAFE Index of developed country stock markets in Europe, Australasia, and Far East returned 25.4 percent with most markets from Britain to Japan posting gains in the mid-twenties.

Most industrialized markets (excluding Ireland, Germany, and Switzerland) are in the black on a year-to-date basis according to MSCI. The recent gains have not yet made up for the substantial losses posted in 2008, however. Some emerging markets have seen gains over 50 percent year to date, including Brazil, Chile, India and Indonesia, thus leading some observers to suggest that a new asset bubble may be born. Other observers however explained that most emerging countries have no need for bank bailouts and can direct government expenditure to infrastructure spending, which is likely to increase future productivity thus justifying higher stock valuations.

Given the rather gloomy macroeconomic picture that still remains present, observers have started wondering whether the second quarter rally is justified and if the current valuations will remain or markets will retrace to a lower level.

Non-U.S. Bond Markets

The U.S. dollar lost some terrain to the euro and the yen during the quarter, but still non-U.S. bonds posted positive returns in U.S. dollars during the quarter. The JP Morgan Global Government Bond ex U.S. Index advanced about 5 percent, while the JP Morgan EMBI Global Index of emerging market sovereign bonds advanced almost 11 percent.

Rumors about credit rating downgrades of the United Kingdom caused little change on spreads for gilts, suggesting that investors trust Britain more than they trust bond rating agencies.

Non-U.S. REITs

Non-U.S. REITs according to the EPRA/NAREIT Global ex U.S. Index returned near 39 percent in the quarter.

From conversations with sector experts we gather that REITs in several non-U.S. markets have strict limits to leverage, and therefore might be expected to be suffering less from the current restrictive credit market. Currently, dividend yields of non-U.S. REITs appear in line with those paid by U.S. REITs. The difference, as we mention above, is that several U.S. REITs pay dividends partially in stock, while we have not heard of the practice outside the U.S. This may be a concern for yield-seeking investors.

Total Returns to Select Indexes for the Second Quarter of 2009

U.S. Stock Indexes (Total Return)		**Non-U.S. Stock Indexes (Total Return in U.S.$)**	
Russell 3000	16.8%	MSCI EAFE	25.4%
Russell 3000 Growth	16.8%	MSCI Europe	25.3%
Russell 3000 Value	16.8%	MSCI Japan	23.1%
Russell Top 200	14.9%	MSCI Canada	30.5%
Russell Top 200 Growth	14.7%	MSCI Emerging Markets	34.7%
Russell Top 200 Value	15.1%	MSCI EM Emerging Europe	40.6%
S&P 500	15.9%	MSCI EM Emerging Latin America	38.5%
Russell Mid Cap	20.8%	FTSE EPRA/NAREIT Developed x US REITs	25.7%
Russell Mid Cap Growth	20.7%		
Russell Mid Cap Value	20.9%	**U.S. Bond Indexes (Total Return)**	
Russell 2000	20.7%	Barclays Capital U.S. Aggregate	1.8%
Russell 2000 Growth	23.4%	Barclays Cap U.S. Government Long	-6.7%
Russell 2000 Value	18.0%	Barclays Cap U.S. Government 1–3 Yr	0.1%
Morningstar U.S. Stock Sectors		Barclays Cap U.S. Corporate High Yield	23.5%
Morningstar / Financials	29.4%	Barclays Cap 1–3 Month Treasury Bill	0.0%
Morningstar / Telecom.	4.1%		
FTSE NAREIT All REIT	27.5%	**Non-U.S. Bond Indexes (Total Return in U.S.$)**	
FTSE NAREIT Equity REITs	28.9%	JP Morgan GBI Global ex U.S.	5.1%

Source: Morningstar, Inc.

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Appendix: Index Definitions

Citigroup Non-U.S. 1+ Year Government BIG Index: Index representing sovereign bonds issued by non-U.S. industrialized countries with maturity of at least one year.
EPRA/NAREIT Global ex US REITs Index: Capitalization-weighted index representing the full universe of publicly traded REITs outside the United States.
FTSE NAREIT All REIT Index: Capitalization-weighted index representing the full universe of publicly traded U.S. REITs, including those companies that do not meet the minimum size rule, liquidity criteria, or free float adjustments.
FTSE NAREIT Equity REIT Index: Market-capitalization-weighted index that includes healthcare and net lease REITs but excludes real estate operating companies. There is no minimum size or liquidity requirement for an equity REIT to be included in this index.
FactSet U.S. Real Estate Investment Trusts Aggregate: Market-capitalization-weighted index of U.S. REITs stocks, not limited to equity REITs but including mortgage and hybrid REITs as well.
JP Morgan Government Bond Index (GBI) Global ex U.S.: Total return index (with dividends reinvested) of traded international debt issues from a sample of industrialized countries. The return for this index is calculated from prices quoted in U.S. dollars.
Morningstar U.S. Market Index: Diversified broad market index that targets 97% market capitalization coverage of the investable universe.
Morningstar U.S. Large Cap Index: Diversified index that targets the top 70% market capitalization coverage of the investable universe.
Morningstar U.S. Small Cap Index: Diversified index that targets the fourth through the 10th percentiles of market capitalization coverage within the U.S. investable universe.
Morningstar U.S. / Financial Services Index: Capitalization-weighted index measuring the performance of companies within the Morningstar U.S. Market Index that are classified in the Financial Services sector.
Morningstar U.S. / Telecommunications Index: Capitalization-weighted index measuring the performance of companies within the Morningstar U.S. Market Index that are classified in the Telecommunications sector.
MSCI EAFE Index: This index tracks non-U.S. stock funds (EAFE refers to Europe, Australasia, and Far East). The EAFE Index is an aggregate of 21 individual country indexes that collectively represent many of the world's major markets.
MSCI EAFE Growth Index: Capitalization-weighted index tracking companies within the MSCI EAFE index classified by MSCI/BARRA as growth.
MSCI EAFE Value Index: Capitalization-weighted index tracking companies within the MSCI EAFE index classified by MSCI/BARRA as value.
MSCI Emerging Markets Index: Capitalization-weighted index measuring the total returns of stocks from a number of emerging markets across the world.

MSCI EM Emerging Europe Index: Capitalization-weighted index measuring the stock market's performance in mainly Eastern European emerging markets.
MSCI EM Emerging Latin America Index: Capitalization-weighted index measuring the performance of the stock market in Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
MSCI Nordic Countries Index: Capitalization-weighted index of Scandinavian stock markets.
Russell 3000 Index: Market-capitalization-weighted index that includes the 3,000 largest U.S. companies based on total market capitalization. The Russell 3000 Index represents 98% of the investable U.S. equity market.
Russell 3000 Growth Index: Market-weighted total return index that measures the performance of companies within the Russell 3000 Index having higher price-to-book ratios and higher forecasted growth values.
Russell 3000 Value Index: Market-weighted total return index that measures the performance of companies within the Russell 3000 Index having lower price-to-book ratios and lower forecasted growth values.
Russell Top 200 Growth Index: Market-weighted total return index that measures the performance of companies within the Russell 200 Index having higher price-to-book ratios and higher forecasted growth values.
Russell Top 200 Index: includes the 200 firms from the Russell 3000 Index with the largest market capitalizations.
Russell Top 200 Value Index: Market-weighted total return index that measures the performance of companies within the Russell 200 Index having lower price-to-book ratios and lower forecasted growth values.
Russell Mid Cap Growth Index: Market-weighted total return index that measures the performance of companies within the Russell Mid Cap Index having higher price-to-book ratios and higher forecasted growth values.
Russell Mid Cap Index: Capitalization-weighted index including firms 201 through 1000, based on market capitalization, from the Russell 3000 Index.
Russell Mid Cap Value Index: Market-weighted total return index that measures the performance of companies within the Russell Mid Cap Index having lower price-to-book ratios and lower forecasted growth values.
Russell 2000 Index: A capitalization-weighted index including the 2000 firms from the Russell 3000 Index with the smallest market capitalizations.
Russell 2000 Growth Index: Market-weighted total return index that measures the performance of companies within the Russell 2000 Index having higher price-to-book ratios and higher forecasted growth values.
Russell 2000 Value Index: Market-weighted total return index that measures the performance of companies within the Russell 2000 Index having lower price-to-book ratios and lower forecasted growth values.
Standard & Poor's 500 Index: Market-capitalization-weighted index of 500 widely held stocks. Member companies are chosen based on market size, liquidity, and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies.
Barclays Capital Aggregate Index: Market-value-weighted performance benchmark for investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities, with maturities of at least one year.
Barclays Capital U.S. Aggregate Government Long Index: Serves as a measure of total return of all public-issued nonconvertible investment-grade corporate debts that have a maturity of 10 years or more.
Barclays Capital 1–3 Month Treasury Bill Index: Market-value weighted index of very short-term U.S. Treasury securities. We use it as a proxy of money market investments.
Barclays Capital U.S. Aggregate Government 1-3 Yr Index: Total returns index comprised of both the Treasury Bond Index (all public obligations of the U.S. Treasury, excluding flower bonds and foreign-targeted issues) and the Agency Bond Index (all publicly issued debt of U.S. Government agencies and quasi-federal corporations and corporate-debt guaranteed by the U.S. Government). These bonds must have maturities of one to three years.
Barclays Capital U.S. Corporate High Yield Index: Index measuring returns of the high yield bond market. The Index includes issues rated BB and below by S&P or Moody's.
Barclays U.S. TIPS Index: the Barclays US Government Inflation-linked bond index (US TIPS) measures the performance of the TIPS market. Inflation-linked indices include only capital indexed U.S. government bonds with a remaining maturity of one year or more.
Barclays Capital Emerging Markets Bond Index (U.S. Dollar Issues): Index measuring the performance of emerging market sovereign bonds denominated in U.S. dollars.
LIBOR: London Inter-Bank Offered Rate. Besides being an interbank short-term lending rate, it is one of the most common benchmark interest rate indexes used to determine the variable rate of adjustable rate mortgages.
3 Month T-Bill Index: Represents the average of T-bill rates for each of the prior three months.
JP Morgan EMBI+ is an index of external-currency-denominated bonds from emerging markets.
Return on equity (ROE): Ratio of total net earnings (profits) to shareholders' equity. It measures the profitability of a company.