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Private Banking and Investment Group Chief Investment Officer

Private Banking and Investment Group

CIO Monthly Outlook

March 2009

In Summary

- Recent signs of better-than-expected economic news have put a positive tone to equity markets
- Ownership of cash and US Treasuries is crowded, and while safety is appealing now, strong supply is coming; we recommend diversifying fixed income exposures
- The value of asset allocation and diversification for equities has never been higher; we remain committed to portfolios that are diversified across a broad range of assets and strategies
- Japanese stocks have been underperformers since summer 2008; short term there may be more pain; the longer term investment story is intact
- Asset allocation: remain defensive with higher cash and fixed income allocations and shorter maturities in bonds; diversify fixed income exposure with high quality credit strategies
- As a proxy for economic recovery, commodities including gold are attractive additions to diversify equity portfolios

It's Still All About Diversification

Recent news on the economic front has not been as bad as expected despite corporations and policy makers continuing to beat the more-bad-news-is-coming drum. Thus the recent positive tone in equity markets has come as a welcome relief. At the beginning of the year, most investors expected newsflow to be negative for as far as the eye could see. Over the course of February, economic data worsened, bringing global equity markets to multi-decade lows. For their part, policy makers in Washington and around the world continue their quest to resolve the financial crisis, including expanding existing programs and most recently, reminding markets about the safety of US Treasuries, despite the very large supply that will be emerging over the next few years. Therefore, the most recent strength in equity markets has brought a respite from the chorus of bad news. As we have noted in previous Outlooks and continue to emphasize now, bear markets have rallies, some as great as 20% to 30%, but they should be used to reposition portfolios and assets to better reflect a world over the next few years of higher savings, lower spending and potentially lower returns.

The default position for most investors after the meltdown in 2008 and 2009 has been to put everything in cash and US Treasuries and "wait it out". We regard this view as something akin to Samuel Beckett's play, *Waiting for Godot*. While a casual read of the play reveals a story of hope despite the fact Godot never arrives, we think this is naïve and believe hope is never a good investment strategy. For example, according to the most recent Banc of America Securities-Merrill Lynch research, fund managers continue to be strongly overweight cash and bonds at the expense of equities (Chart 1 at the end of the month's Outlook). Given the market downdraft over the past seven months, these same managers did not position their portfolios defensively enough for the fall, and have let the market's course dictate their allocations – it seems "hope" is their strategy too. We continue to recommend investors take a broader view of high quality assets and consider diversifying their now overweighted fixed income allocations. Yields on high quality credit strategies and investments now approach the long-term total returns we expect from equities – attractive alternatives for investors with long-term income objectives and in keeping with our theme of being paid while we wait to add back to equity risks.

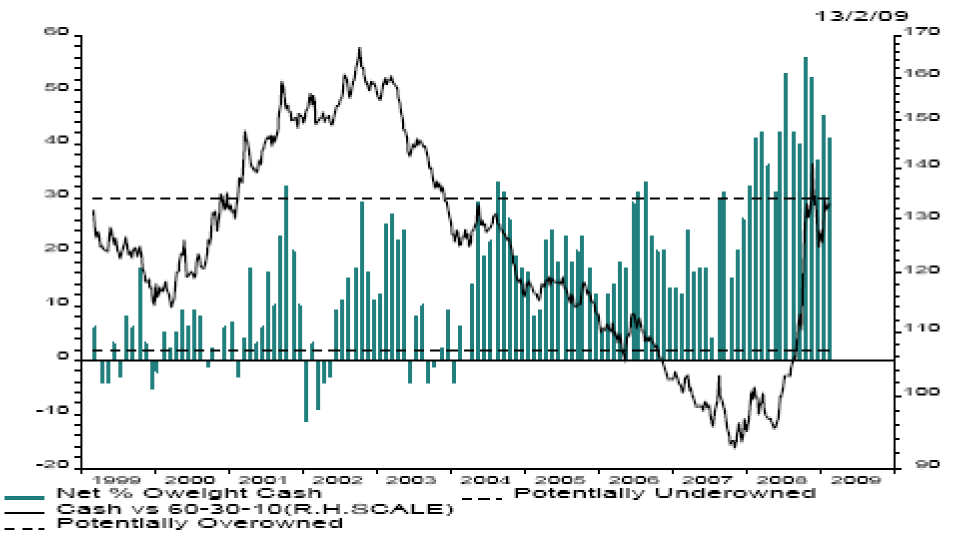
In the aftermath of the past seven months of markets crashing, investors have questioned the value of diversification as risky assets around the world fell in unison. We can appreciate the fact that many investors' views on diversification are now filled with scepticism. A chart at the end of this month's Outlook (Chart 2) from Banc of America Securities-Merrill Lynch Derivatives Research group illustrates the point. Over the past fifteen years, returns on stocks have become more correlated (the rising orange line) and for investors this feels like diversification is not working. We think an alternative view is worth considering: at current levels of +0.6, the correlations among stocks are already at high levels and may be headed **lower** over the next several years. This view hinges on the consolidation and financial protectionism trends identified by Banc America Securities-Merrill Lynch Chief Investment Strategist Richard Bernstein and the expectation they will play out in the near term. The world is awash in overcapacity and Berstein's view is that a long period of consolidation is ahead of us. We believe consolidation may not be the only recourse for reducing capacity; bankruptcy will be as well. These trends will by design start to shift correlations **lower** as winners and losers among stocks are sorted. Another factor that should serve to drive correlations **lower** over the next several years is financial protectionism. With most developed countries now looking **inward** to fix their domestic financial problems, we think global investors will allocate capital to countries and economies that show the strongest signs of transparency and success at combating their problems. In the short term, this means a flow of foreign capital coming to the United States and to US Treasuries as a safe haven should be strong. As the crisis passes and investors come to see signs of recovery we would expect this trend to reverse.

Despite all the talk that the US today represents Japan in the early nineties, our Japanese economists are comparing Japan to the US Great Depression to understand the surprise falloff in exports. The surprise negative news on exports has caused a rush by economists to forecast a recession for the Japanese economy in 2009; recalling most economists had predicted growth as recently as two months ago. Exports were down **more than 45% on a year over year basis in January, the fastest pace in 40 years** and the data was a complete surprise to most economists. Banc America Securities-Merrill Lynch Research Japan Economist Masayuki Kichikawa recently published a report titled "Thinking the Unthinkable" in which he compares Japan to the US Great Depression and to Iraq in 2004 – uncommon times call for uncommon thinking! The report concludes that neither example is a fitting analogy for Japan in its current state; although Kichikawa's expectation for GDP growth in 2009 is -4.2%, he sees risks to the downside. For long term investors the "risks to the downside" may not be fully priced into markets, and a more patient strategy will be necessary before adding more Japanese equities to global portfolios.

We maintain our recommendation to stay defensive in asset allocations and in portfolio construction. In prior Outlooks, we have noted an intermediate term trend towards higher savings rates and potentially lower growth and lower returns. In that kind of environment, we believe a patient and disciplined strategy of adding risk (stocks) back to portfolios is the most prudent. While waiting, we suggest investors diversify their fixed income exposures to raise the quality of their fixed income portfolios and to earn more than the zero they are earning in cash. With many investors now "upside-down" in their asset allocations (for example a traditional 40% in bonds, 60% in equity account may now be 60% in bonds and cash and 40% in equity); a re-evaluation is in order. We think investors can consider many high quality bonds that have yields greater than 5% as attractive. In addition, we have noted that some riskier credit strategies have higher yields. For equity portfolios, we resist the siren song of trying to time the market and to thus add strategies that will give investors market-like returns when we pick the bottom. We do not have that skill and have instead suggested investors consider a broader range of "equities" including investments in strategies that do not follow benchmarks, convertible bonds and hedge funds that have dynamic market exposure such as long/short strategies and event-driven strategies to own in this kind of environment.

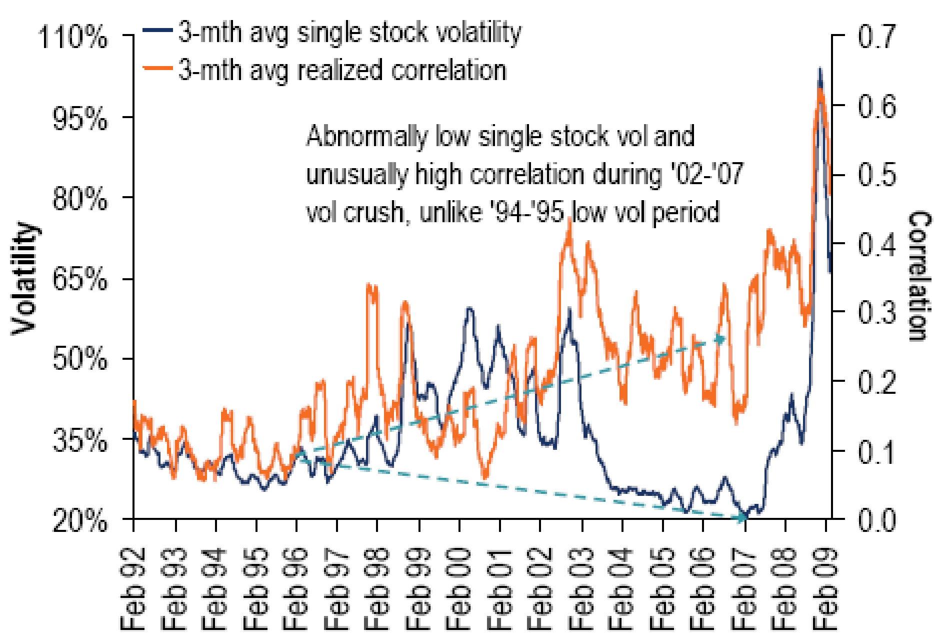
We think positioning for a recovery does not require a large allocation to stocks. A working hypothesis we have employed is: An economic recovery would likely see the demand for commodities (and potentially other risky assets like stocks) rise strongly as the world ship rights itself. In other words, we expect an economic recovery would benefit many asset classes (including commodities), and not just stocks. In addition we observe that many commodity producers, because times are difficult **now**, are shutting capacity to produce copper, lead, tin, diamonds and gold among others. This is setting the stage for potential supply/demand imbalances such as our Banc of America Securities-Merrill Lynch Research Commodity Analyst Francisco Blanch has noted in recent reports. For clients considering a turn in economic growth in 2009, we suggest an allocation to commodities would capture that growth.

Chart 1: Cash position of Fund Managers and Relative performance of Cash (Black line)



Source: Banc of America Securities-Merrill Lynch Global Fund Manager Survey

Chart 2: 3-month average S&P500 single stock realized Correlation (Orange line) and Volatility (Navy line)



Source: Banc of America Securities-Merrill Lynch Derivatives Research

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