Investment Outlook: 2010

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Prior to joining Nicholas-Applegate in 2002, he was a managing director of Morgan Stanley Investment Management, London, responsible for developing and overseeing Global Core Equity and European tactical asset allocation programs.

Horacio was previously head of International Equity and asset allocation programs with Philadelphia-based Miller Anderson & Sherrerd. He started in the investment management industry with Credit Suisse First Boston, where he became the director and chief international investment strategist based in their London office.

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Massive amounts of government-supplied liquidity propped up asset prices worldwide in 2009, on the heels of the worst recession in many investors' lifetimes. Have government efforts succeeded? Are global markets on terra firma or will a retraction in liquidity tip security prices back into the pre-recovery red zone? With more than twenty years' experience assessing global markets and asset classes, Chief Investment Officer Horacio A. Valeiras, CFA, shares his perceptions on the macroeconomy and identifies asset classes, regions and sectors that are positioned to benefit from the liquidity infusion.

Last year was one for the history books in terms of the severity of the global recession. What were some of the key takeaways from your perspective?

The story of 2009 was the unprecedented massive amounts of liquidity that governments pumped into the market. The government-supplied liquidity acted as a floor to credit and propped up asset prices worldwide. Quantitative easing worked better than we thought it would. It gave investors confidence to move from non-risky to riskier assets, as witnessed by the market moves in 2009.

Have the government stimuli been effective?

The government responses to the crisis in the developed world have been successful in the short run in stemming the panic that emerged from the credit crunch; however, in the long term, these policies could lead to continued global imbalances. Look at the stimulus impact in the U.S. It is relatively small. Whether it created 600,000 or a million jobs is irrelevant given the 10.2% unemployment rate. Government spending stabilized the economy, but is it sustainable in the long run when the private sector is still cutting jobs? The government tax rebates and the "Cash for Clunkers" program largely provided one-time benefits.

Combine the lack of clarity surrounding the impact of the proposed 2011 budget with higher personal tax rates and continuing uncertainty over cap and trade and healthcare legislation, and it is likely the U.S. will experience a muted economic rebound compared to prior recessions. The situation is different in Asia, where economic recovery has been less dependent on government initiatives and more tied to fundamentals.

Will the U.S. economy grow in 2010?

We expect GDP growth on the order of 2% for the year. Growth rates could surprise on the upside because individuals will move activity forward to avoid higher tax rates in 2011. Continued growth also depends upon whether the Federal Reserve raises interest rates sooner rather than later.

What is the outlook for inflation in the U.S.?

As expected, inflation is picking up. Including the December numbers, consumer prices will rise 2.5-3% for 2010. We can expect higher prices for goods as retailers carry very low inventories.

Given expectations for higher inflation, when do you expect the Fed will raise rates?

Not before the mid-term elections! Cynicism aside, a rate hike could have a positive impact on growth. Remember that savers are getting zero interest on their savings, so a non-zero interest rate can stimulate the economy.

The yield curve is historically very steep, with high negative real rates at the short end. If this were a "normal" business cycle and we didn't have political pressures, the Fed would already have been raising rates.

What is the outlook for the U.S. dollar in this rate environment?

The recent rally in the dollar has been technical. The dollar had sold off to the point it was bound to reverse. Our bond managers foresee U.S Treasury issuance of historic proportions in 2010, which will continue to put a lid on dollar appreciation. We would not bet on a dramatic strengthening in the dollar.

Does the prospect for higher interest rates and tighter monetary policy cause concern for equity prices?

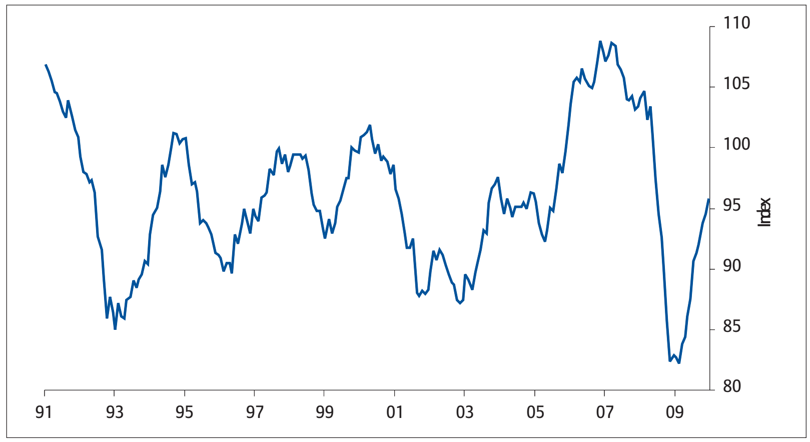
It depends upon the government's ability to make the correct decisions in removing liquidity from the system at the right times. We underestimated the amount of liquidity in the market a year ago, and expect liquidity will be abundant for longer than anticipated.

This will be a positive for equity prices. In addition, corporate earnings growth will be critical to supporting equity prices, and moving forward, that will depend more on revenue growth than cost cutting.

German Business Climate

German business sentiment has recovered rapidly, according to a survey of the manufacturing, wholesale, retail and construction industries. The IFO index has posted ten consecutive months of gains since crashing at a more than twenty-eight-year low last March.

German Business Survey

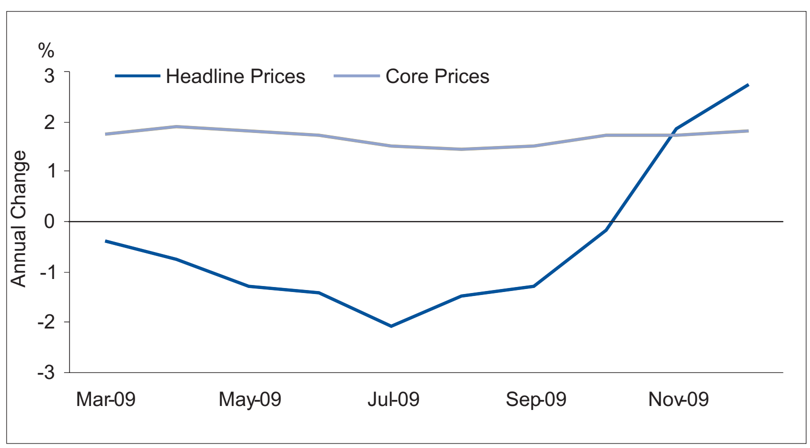


Source: IFO National Institute of Research; Nicholas-Applegate; see additional disclosure
As of 31-Jan-10

Consumer Prices

Price pressures have increased recently, pulling the U.S. out from deflation. Gains may moderate in the near-term, but further out, we expect renewed upward pressure.

U.S. (CPI)

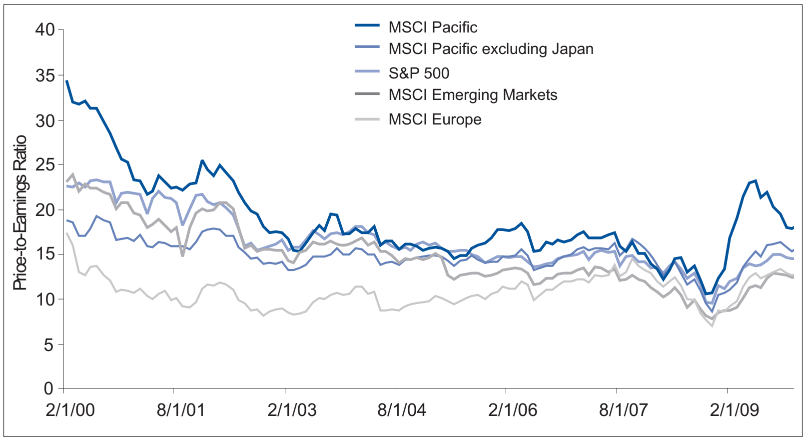


Source: FactSet; Nicholas-Applegate; see additional disclosure
As of 31-Dec-09

Global Forward Price-to-Earnings

Despite the 2009 rally, equity valuations look reasonable. Through January, P/E ratios in Asia, Europe and the U.S. were below both last year's highs and ten-year averages. Emerging markets are an exception.

Forward P/E Ratio - Next 12 Months Estimate (monthly data)

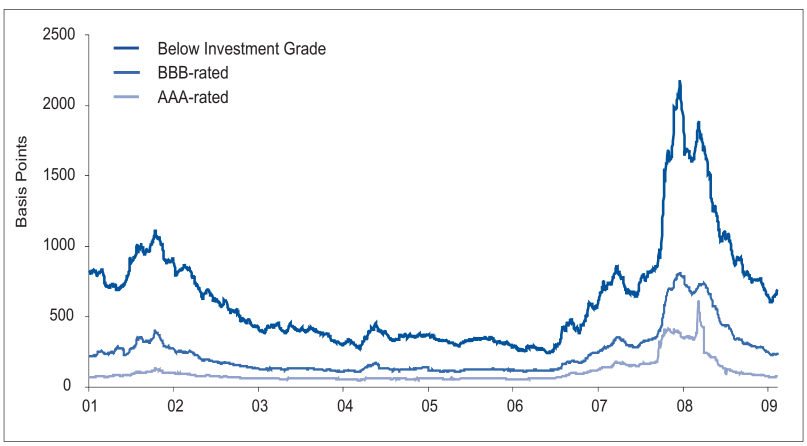


Source: IBES; MSCI; Standard and Poor's; Nicholas-Applegate; see additional disclosure
As of 14-Jan-10

Corporate Debt Spreads

Spreads have tightened substantially from historic levels, but remain elevated. When spreads reached comparable levels in the early 1990s and 2000s, high yield investors experienced positive returns. Access to capital has been good.

Corporate Debt Spreads*



*Debt spreads are equal to yield-to-worst less comparable U.S. Treasuries
Source: Bank of America - Merrill Lynch; Nicholas-Applegate; see additional disclosure
As of 9-Feb-10

What is the outlook for corporate earnings in the U.S.?

History reveals that price/earnings multiples compress following liquidity rallies, so higher equity prices have to be driven by earnings growth. Analysts are predicting 25% earnings growth for U.S. companies in 2010.

If earnings grow by 25%, then the equity market could rise by 15-20% based on the normal cycle. That seems too optimistic. A more likely percentage gain in earnings would be 10-15%, because corporate profits in the U.S. are still largely being driven by cost-cutting rather than revenue growth.

With multiple compressions, equities would be up about 10% for the year. Liquidity is the wild card. Too much money chasing too few assets — what we saw in 2009 — could drive equity prices significantly higher.

How are you structuring asset allocation portfolios?

In our asset allocation portfolios, we are overweight stocks versus fixed income and cash equivalents. We favor Asian equities over U.S. and European. In Asia, we prefer the dollar plays — Hong Kong, Singapore, China — over Japan. As long as liquidity is abundant, we are equal weight U.S. and European equities, and overweight emerging markets.

Within Europe, we favor German industrials and Swiss shares and are underweight France, the U.K. and the countries under scrutiny for meeting debt obligations — Spain, Ireland, Greece. In emerging markets, we hold select stocks in Brazil, emerging Asia and the Middle East and are avoiding Eastern European securities.

On the fixed income side, U.S. high yield bonds still represent good value in that we expect continued spread compression, but investors shouldn't expect the high double-digit return levels of 2009. We anticipate high yield investors will get the coupon of 10% plus some spread, so returns around 13%.

We are steering away from government bonds and feel an allocation to TIPS is warranted, given the prospects for higher inflation longer term.

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Given the strong run-up in the Russell 2000 relative to the Russell 1000, what are your thoughts about relative performance along the market-cap spectrum in 2010?

We would expect free cash-flow generating companies to do relatively well, without regard to capitalization. In addition, companies that export or have significant operations overseas should outperform based on our outlook.

What economic sectors should benefit from this market environment?

In general, technology is likely to benefit from a rebound in capital spending. Financials should do well in the steep yield curve environment. Global consumer product providers benefit from both a weak dollar and non-U.S. operations.

Conversely, consumer discretionary companies will have a tough go as consumers in the recession-hit economies opt to rebuild balance sheets over spending for discretionary items.

Can the U.S. economy truly gain traction until real estate recovers? What is your take on the status of commercial and residential real estate?

Residential real estate has stabilized, not recovered. There is too much supply to support a strong recovery. Prime foreclosures are still on the increase, and the question is how much of that market can Fannie Mae and Freddie Mac take up?

You could see weakness in the $500,000 - $1 million home price tag range that Fannie and Freddie can't restructure. Commercial real estate is likely to take a hit in 2010, although the overall impact on the economy should be small relative to residential housing.

Horacio, thank you for sharing your insights.