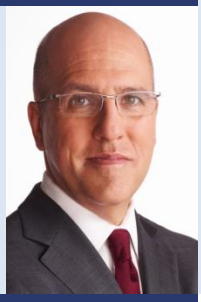

Richard Bernstein

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Everyone forgot the basic laws of economics

August 8, 2011

The consensus over the past month or so was that Washington would come to a last minute debt limit resolution and the equity markets would rally once the cloud of uncertainty regarding the US's finances was removed. Washington did come to its last minute resolution, but the markets have sold off. What happened?

It seems that investors got so caught up in Washington's political rhetoric that they forgot the basic laws of economics. The markets' selloff seems quite understandable if one is willing to accept those basic economic axioms.

The US was the only major country trying to stimulate its economy

Prior to the increase in the debt-ceiling and the associated austerity measures that will be put in place, the US was essentially the only major country in the world that was actively trying to stimulate its economy. As we have pointed out many times, the US's yield curve is the steepest in the world which indicated that monetary policy was at worst neutral. Although one could argue whether fiscal stimulus was being efficiently and effectively implemented, the fact is that the US government was indeed spending.

The US was alone in that both monetary and fiscal policies were focused on attempting to grow the US economy.

Europe's monetary and fiscal policies have been restrictive for some time. European fiscal policy has been focused on austerity as the cornerstone solution for the various sovereign debt problems. The European Central Bank previously tightened monetary policy, and now seems reluctant to even stay on hold despite European banking problems and restrained inflation expectations. The European debt problems' impact on the global stock markets has been exacerbated by these tight policies.

Monetary and fiscal policies in the major emerging markets seem conflicted. Because of their excessive credit and money growth, the BRIC nations have among the highest inflation rates in the world. As a result, their central banks have generally been raising interest rates. Emerging market fiscal policies, like those in Brazil, are actually trying to counteract the negative effects of tighter monetary policy.

The BRICs now seem to be in a tug-of-war between tight monetary and loose fiscal policy, which we view as a lose-lose situation. If tight monetary policies win the tug-of-war, then it is likely that unemployment will increase as the economy slows. That's probably not politically palatable. If loose fiscal policies win, then it is likely that inflation will increase. That's probably not politically palatable either.

So, Europe and the emerging markets already had anti-growth policies in place. It should be no surprise, therefore, that the markets are correcting as the sole "stimulator" of the world, the US, moves as well toward anti-growth policies. It's just basic economics.

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US corporations are now the key

To reiterate our view, the US currently has the strongest profits fundamentals in the world. As the following charts demonstrate, the US has the highest percentage of positive earnings and revenue surprises in the world. Although one might argue that it is simply global growth that is causing such strong profitability in the US, one should note that smaller US companies (i.e., those with little or no foreign exposure) are producing abundant surprises as well.

Chart 1:

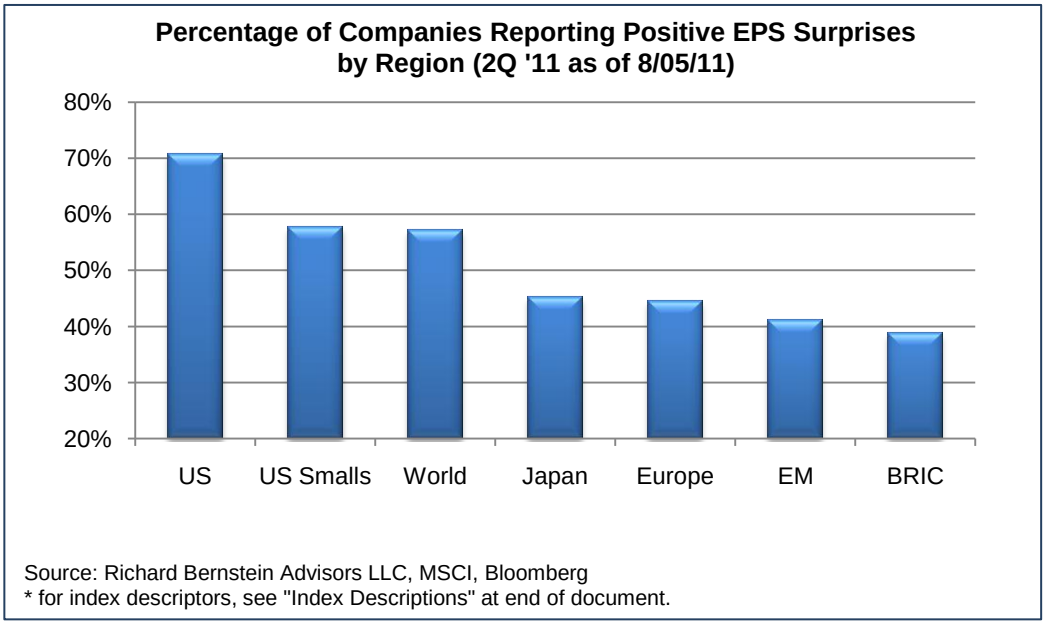
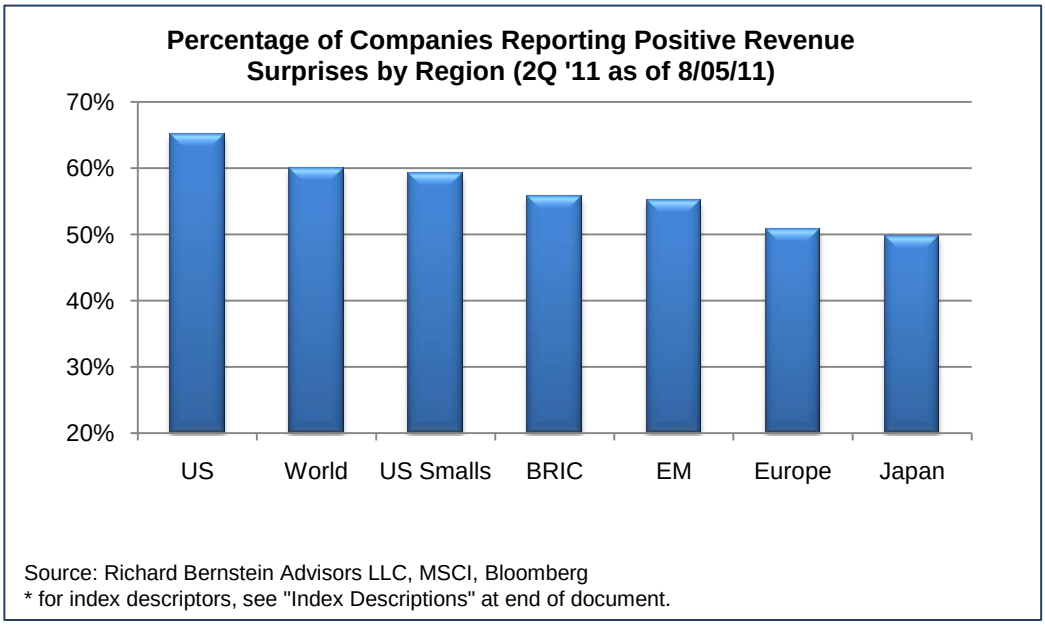


Chart 2:



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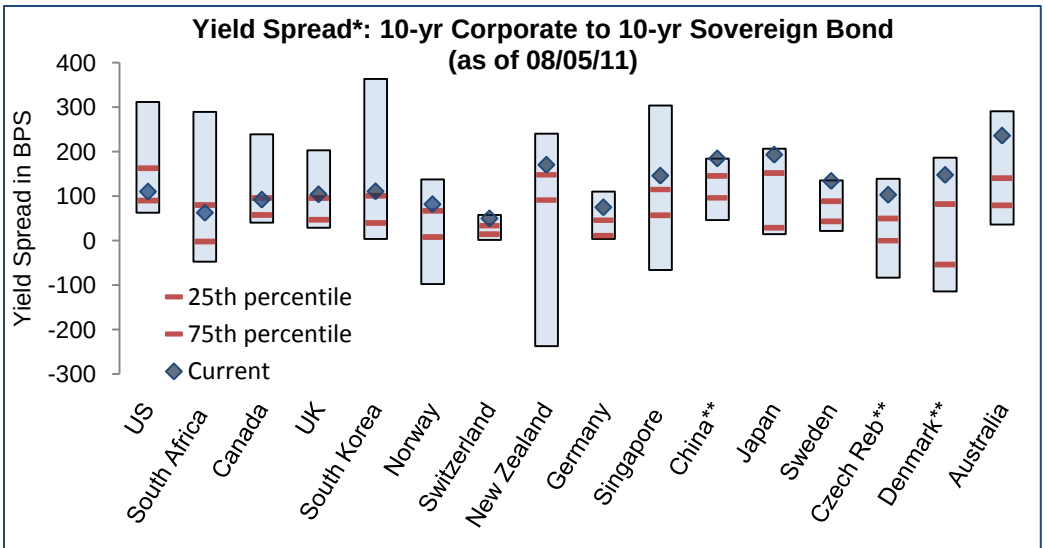
Corporate bond spreads are another potential sign that US profit fundamentals are the world's strongest. Chart 3 shows the historical range of corporate bond spreads in various countries. Each rectangle shows the historical range of corporate bond spreads in the particular country, and the diamond represents the recent spread.

Corporate bond spreads are an indicator of the perceived relative risk of a country's corporate sector. Presently, corporate bond spreads are "normal" in the US, South Africa, and Canada. In most countries, bond spreads are relatively wide which suggests that investors perceive there to be more risk than normal in those countries' corporate bonds. This seems to indicate that the markets perceive US corporate cash flows to be relatively more stable than are those of most other countries' corporations.

Chart 3:



Source: Richard Bernstein Advisors LLC, Bloomberg
*For Yield Spread descriptors, see "Index Descriptions" at end of document.
**10-yr data was unavailable for these countries, additional maturity details at end of document.

If US corporations put their cash to productive use (i.e., hiring and investing in capital equipment), then the stock markets are likely to begin to recover. If corporations hire and invest within the domestic United States, the US economic story could be quite a robust one.

In retrospect, it is pretty clear that US monetary and fiscal policy was driving the global markets. The US fiscal picture has changed, and the markets are reacting accordingly. Although the markets may get temporarily excited over changes in central bank policies or currency intervention, it now appears that it will be US corporations and their strong balance sheets that will determine the fundamental course of the financial markets.

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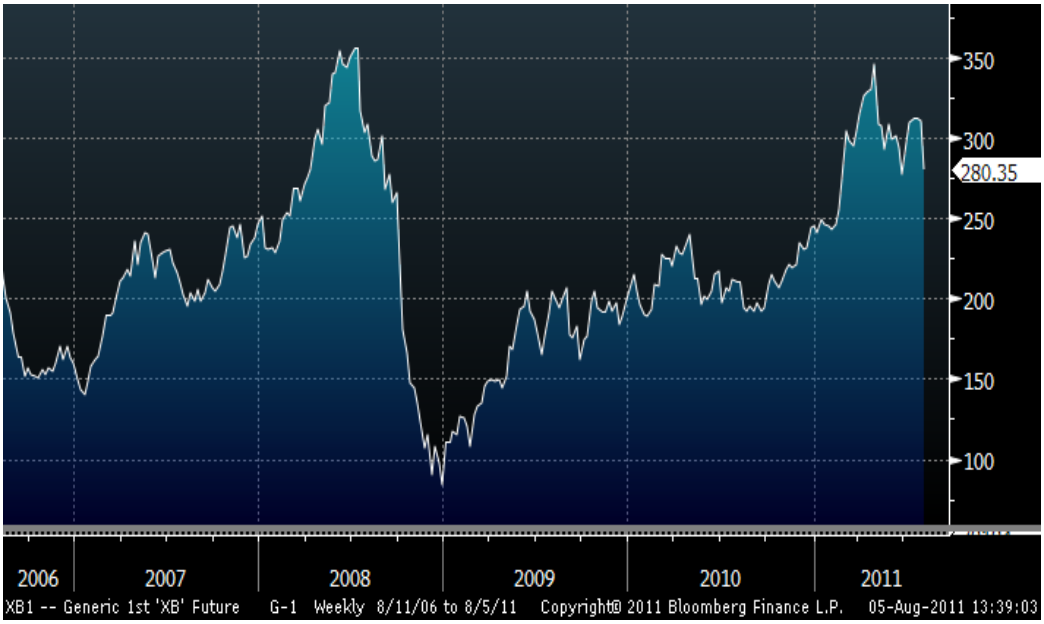
If employment remains stable, falling commodity prices are a positive

We have argued for some time that a slowdown in emerging market economies, which seems inevitable to us, would likely cause commodity prices to fall. Falling commodity prices would, in turn, be a positive for the US economy.

If US employment stabilizes (and some might consider that a big "if"), then falling commodity prices might indeed benefit the US economy. It is hard to believe that under such circumstances falling gasoline prices, for example, would not buoy consumer confidence. The latest set of employment data, such as weekly initial jobless claims and payroll employment, seem to suggest that employment is remaining stable and not deteriorating.

Chart 4:

Gasoline Futures – Nearby Contract Price



Murky, but optimism is likely to win

The economic data remain remarkably mixed, but do not suggest that a recession is imminent. Valuation, sentiment, corporate profits, and a broad range of economic data are not typical of that seen prior to a recession. Prior to recessions, valuations are typically very unattractive, corporate profits' growth is slowing dramatically, investors are ebullient, and leading indicators are negative. None of those conditions exist today.

Our sentiment indicator, which is based on Wall Street's consensus recommended equity allocation, shows a marked difference between the investors' current sentiment toward stocks and the sentiment that existed at the end of 2007. According to this model, equities were the asset class of choice in 2007, i.e., Wall Street recommended overweighting equities. Today, Wall Street is recommending underweighting equities.

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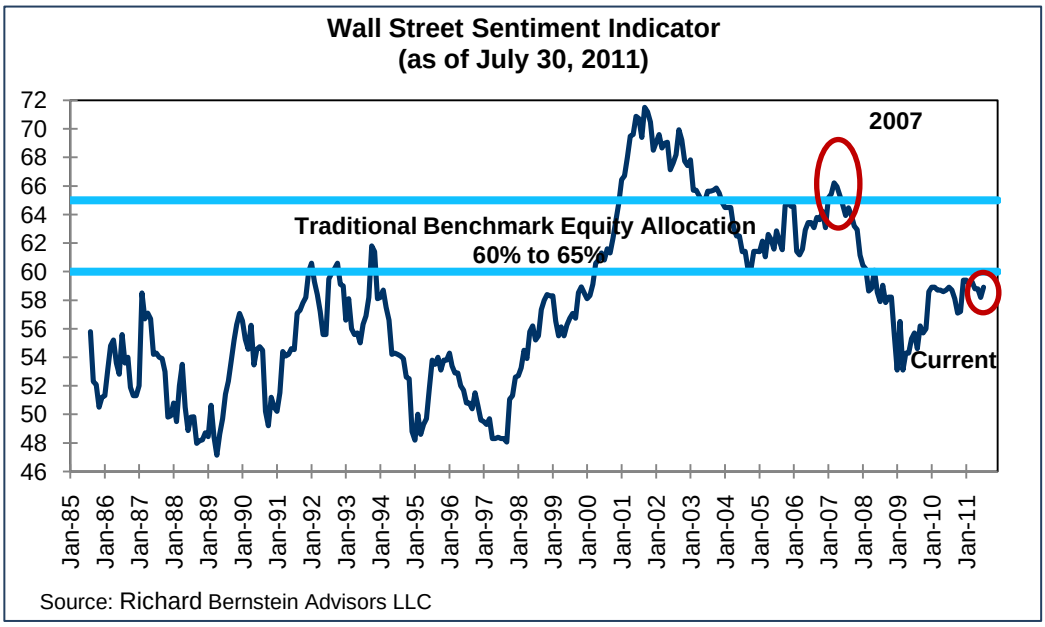
It's indicators such as this one that lead us to believe that the markets' recent volatility is not indicating a full-blown recession is around the corner. We will continue to protect our portfolios in the near-term, but believe that our longer-term optimism will be rewarded.

Chart 5:



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INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

Indices are not available for direct investment.

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

BRICs: MSCI BRIC Index. The MSCI BRIC Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of the following four emerging-market country indices: Brazil, Russia, India, and China.

Gasoline Futures: 1st Generic "XB" Future of the New York Mercantile Exchange with a Contract Size of 42,000 U.S. gallons, priced in USd/gal. Contracts: Roll method is relative to expiration.

Yield Spread: 10-yr Corporate to 10-yr Sovereign Bond. The 10-yr Corporate to 10-yr Sovereign bond spread is defined as each countries' 10-year Bloomberg Fair Value (BFV) corporate bond index *minus* each countries'10-year Sovereign bond, except countries where data for the 10-year maturities were unavailable to the firm. For these countries, the longest available maturity was used. Denmark (8-yr substituted), Czech Republic (7-yr substituted), and China (7-10 yr substituted). Additionally, there was not a BFV comparable index available for China so the BofA Merrill Lynch 7-10 Year China Corporate Index was substituted.

Richard Bernstein is chief executive officer of Richard Bernstein Advisors LLC.

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