Investment Commentary

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Richard
Bernstein

Mid-Year Review

Last December, we issued our 10 predictions for 2010. As it is now mid-year, it's time to review those predictions and see how they have fared so far.

•**Stock and bond returns will again be positive**. So far, the bond prediction is doing very well, but the stock prediction is not. Treasuries with a maturity of 15 years or more were up 14.3% (all performance data are through June 30), but the S&P 500 was down 6.7%.

•**The US dollar is likely to meaningfully appreciate once market-driven, short-term rates begin to rise.** The US dollar has certainly appreciated much more than most expected this year (+10.5% when measured using the DXY Index), but short-term rates have obviously not risen. We were correct regarding risk increasing, but the perception of faltering, rather than excessive, growth is the source of risk.

•**US dollar "carry trades" could get killed as 2010 progresses and the US dollar appreciates**. So far, this has proven correct. Commodities, as measured by the CRB Index, are down more than 9% in the first six months of the year. Other so-called carry trades from six months ago have similarly underperformed, and hedge fund performance has been mediocre at best.

•**The Fed will spend the second half of the year trying to catch up to, and flatten, the yield curve.** We were much too optimistic on the economic recovery. This might still happen during the next six months, but the odds do not look too favorable. The curve is indeed flattening, but for the opposite reason from our expectations.

•**Corporate profits are likely to explode to the upside during 2010**. We suggested that S&P 500 reported earnings growth would exceed 100%, and that has indeed happened.

•**Employment in the US will probably continue to improve**. This was true for much of the first half of the year, but recent weakness in the employment data is starting to make this forecast seem optimistic.

•**Treasuries will probably underperform stocks**. Although we have consistently emphasized long-term Treasuries as a core asset allocation holding, we have been too optimistic about the relative performance of stocks.

•**Small cap value will be the US's best performing size/style segment**. This prediction has so far proven correct. The Russell 2000 Value Index (-1.6%) has outperformed the Russell 2000 Growth Index (-2.3%), the Russell 1000 Growth Index (-7.6%), and the Russell 1000 Value Index (-5.1%). Emerging market equities were down 6.1%.

•**Financial regulation will progress, but the bull market will probably aid politicians "forgetfulness."** This is a work in progress. Much of the original strictness within proposed regulations has indeed been watered down. This, unfortunately, fits our prediction. We would view a weakened "Fin Reg" as a secularly bearish development. Much like labor in the late-1970s and early-1980s, the financial sector seems bloated and dysfunctional . From our perspective, the financial sector needs significant restructuring for the long-term health of the US and global economies.

•**The Democrats will do better in the 2010 mid-term elections than people currently think.** As of now, this looks like a very poor forecast. The Democrats' poor ratings from late last fall have simply deteriorated further.

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Second Half Outlook

Our favorite economic indicator, weekly initial jobless claims, will probably determine the path of the financial markets during the second half of the year. We have suggested for several years that jobless claims was the most important economic indicator because it is a leading indicator of the economy, a leading indicator of most other employment statistics, and an early-warning radar for the health of the household sector's cash flow. Because we do not believe in the so-called "de-coupling" theories of the emerging markets, we view US household cash flow as the key to global performance.

The cyclical improvement in initial jobless claims stalled in February, and the US stock market subsequently peaked in April. The financial markets' performance is likely to continue to suffer until jobless claims start to improve again.

Our strategies continue to balance economic sensitivity with long-term Treasury bonds. As we have repeatedly emphasized, Treasuries are the only major asset class today that has negative correlation to equities. The correlation between most other asset classes and the S&P 500 continues to be high or is increasing.

For secular equity exposure, we continue to favor US small cap value stocks. US small cap value is one of the few segments of the global markets that is starved for capital, and remains largely out of favor despite that it has been outperforming more popular investments such as China and commodities. One should realize that small cap value is highly economically-sensitive, and is unlikely to perform well if the economy re-enters recession. We nonetheless continue to emphasize this market segment because we think the secular opportunity is very attractive. We are counterbalancing the economic risks associated with small cap value by maintaining significant exposures to Treasuries.

Although past performance is certainly not indicative of future investment results, our strategy for 2010 has worked well so far. Treasuries are up 14.3% (as measured using BofA Merrill Lynch US Treasuries +15 years) and 30-year zero-coupon bonds are up a whopping 22.2%. Small cap value has been the best-performing size/style segment of the equity markets. The table below highlights small cap value's performance versus those of other global investments.

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Year-to-Date Total Return as of 6/30/10	
Small Cap Value	-1.6%
Small Cap Growth	-2.3%
Large Cap Value	-5.1%
Large Cap Growth	-7.6%
Emerging Markets	-6.1%
Commodities (CRY)	-8.8%
Oil	-4.7%
Gold	+13.7%
Treasuries (15+ Years)	+14.3%
30-Year Zero Coupon Bonds	+22.2%
Source: Richard Bernstein Advisors LLC, Bloomberg, MSCI	

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

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