HUSIC CAPITAL MANAGEMENT

INVESTMENT OUTLOOK Q3 2009

Emerging Markets Lead the Economic Recovery: Update

There have been numerous material developments that fit with our world view of an economic recovery, led by emerging markets, that includes the U.S. economy recovering at a more robust pace than the consensus view. These include:

1. Australia raised interest rates, which we cite as evidence of strong growth in emerging countries.
2. Gold is trading at a new all-time high and oil prices are strong, evidence of a world awash with liquidity and improving commodity demand. This liquidity is on an unprecedented scale, which will have implications for many different assets around the world, including equities.
3. Employment has increased in 12 countries outside the U.S., which we believe will occur soon in the U.S.

Profits are being propelled at rates ahead of most expectations fueled by global growth, steeply pitched yield curves, tight credit spreads and high productivity driven by lower labor cuts. In our last quarterly, we took note of the return to positive GDP growth in a number of emerging economies. These trends have continued with many anecdotal pieces of evidence, including auto sales of 1.3 million units in China and record gaming revenues in Macau.

Fallout From The Credit Crisis: Demand Shock Turns Into Supply Shock

We may discover that the credit crunch was more of a supply shock than a demand shock. In the last up cycle, corporations were significant beneficiaries of the abundant supply and low cost of credit. In fact for many, the cost of capital was negligible. This enabled producers to extend credit to their customers via vendor financing. This came to an abrupt end as companies globally were shocked by developments in last year's third and fourth quarters, especially with the bankruptcy of Lehman Brothers.

During the crisis, corporations' cost of capital, if available, skyrocketed. This in turn, led to drastic cuts, including layoffs and production shutdowns, to preserve cash. The Lehman bankruptcy triggered a supply chain contraction as inventories were liquidated and capital expenditures were aborted.

The rapid pace and depth of the decline has been followed by an equally startling recovery. In only six months, real GDP has rebounded 10% from a 6.5% decline in the first quarter to a 3.5% increase in the third quarter. Corporate cuts have been of such magnitude that we are now hearing news of shortages appearing in many industries. We believe this is setting the stage for more powerful growth than most expect as firms struggle to make up for shortages. As we have seen, corporate profits will continue to expand in that environment.

There is the potential that the credit crunch caused excessive corporate cutbacks. If so, the available capacity in the economy may be less than expected. Rehiring could happen more rapidly than expected, turning the jobless recovery into one that creates jobs.

Outlook

The Fed has signaled that it intends to keep monetary conditions loose and short rates low for the foreseeable future. We believe this monetary backdrop is positive for equities. The monetary environment also implies that the dollar carry trade will continue unabated. Longer term, it is unclear how this will play out, however in the interim it suggests buoyant conditions for risky assets including commodities and cyclically-oriented industries.

The last 10-year returns on equities are among the poorest in history. In fact, they are exceeded only by the decades of the 1850s and the 1930s. Both of those decades were followed by extended periods of strong positive returns.

Clearly the market has staged a robust recovery since early March. Why should we believe it can continue? Indeed in bull markets, a 10% correction can happen at any time. To date the largest dip has been 7.1%. That being said, the market, as we discussed in our last quarterly *Outlook,* put in a constructive inverse head-and-shoulders bottom, which established a 1250 S&P 500 target. Following the recent shallow correction, there are many indicators of the market entering a new up-leg.

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First, AMG Data Services has announced large net outflows from equity mutual funds and ETFs in the recent week. This is a contrarian indicator as most market bottoms occur when there are large weekly equity outflows. Second, sentiment continues to be very negative. Recently, the American Association of Individual Investors reported 56% bears and 22% bulls, or a net 34% bears. The last time the percentages resembled this was in March of this year when the market made its low for the decade. Third, the 10-day average TRIN Index reading reached 1.5, which is a buy signal in bull markets. Lastly, contrarian odd-lot selling has been quite high.

Mergers and acquisitions activity has been reignited. Broad-based in nature, participating sectors include technology, health care, consumer discretionary and transportation. Many of these deals are being done for cash. This is a positive for equities because it infers that the buyer believes their stock is undervalued so they are willing to pay cash for their purchases. Corporate balance sheets are in great condition and once again there is access to capital markets.

Sectors we find attractive include those that are cyclical – economically sensitive sectors that would benefit from a better-than-consensus recovery. These include consumer discretionary, basic materials, industrials, technology and financials. Consumer cyclical stocks benefit from the economic recovery and lack of inventory available, positively impacting margins. Consumer wealth increases, with equity and housing market gains combined with improved confidence of future employment outlook, translates into improved spending. In turn, these companies will show outsized earnings gains. Industrials will benefit from a revival in new business orders which should continue for several quarters.

Firms in the materials sector have tremendous operating leverage. Emerging markets' thirst for basic materials drives commodity prices higher as their economies grow. With high fixed costs, the incremental dollar of revenue will fall disproportionately to earnings. Financials benefit from a steep yield curve – paying low interest rates on deposits and lending those deposits at higher rates to earn the spread. Charge-off rates peaked last quarter and loan demand may recover soon, and there is potential for write-ups of previously written-down assets. Improvement in corporate cash flows will unleash capital spending which has often been good for technology investors. Technology is a productivity-enhancing endeavor which corporations crave following dramatic labor reductions.

With most companies having reported earnings, 80% of the S&P 500 exceeded estimates. Though there were early signs of top-line revenue growth, questions remain regarding how much of that was already priced into the market. The recession has ended and company profits can respond powerfully to the turn in the economy. Our focus will be on progress from making earnings on cost cutting to renewed focus on revenue growth. The hurdles strategy will help us cull weak performers from the portfolio.

As discussed previously, we expect a more robust recovery than the consensus. Though this view is adding some followers, it is still a minority view. So we took particular note that the "perma-bear" Jim Grant, of the eponymous *Grant's Interest Rate Observer*, is now bullish. In his Wall Street Journal essay dated September 19, 2009, he argues that the deeper decline will equate to a steeper recovery. In the post-World War II era, he notes the government's fiscal and monetary stimulus has combined for a 2.9% countercyclical lift of GDP. This time out, the combination is 10% fiscal and 9.5% monetary for a total 19.5% lift of GDP. That should provide for strong economic growth into 2010.

Conclusion: A New Theme

With this outlook we begin a discussion of what may be the most important and pivotal theme we have developed in the 23-year history of our firm. This theme is the return of inflation after almost three decades of disinflation/deflation. We recall that in the early 1980s fiscal and monetary policies were adopted that were aimed at ending the inflationary trends that emerged in the 1970s. At that time our view that inflation was ending was greeted with great disbelief. No doubt our view that inflation is now preparing to return may seem at least as improbable. The exact timing of this return is difficult to predict but we believe it will emerge before the end of 2010. The impact of this change will dramatically alter the global economic terrain and create a whole new set of winners and losers. We plan to address this change in more detail in future pieces.

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