HUSIC CAPITAL MANAGEMENT

INVESTMENT OUTLOOK Q4 2009

The World Is Torn By Opposing Forces

Since our last *Outlook*, we have seen the world torn by opposing forces. On one hand, we see positive reinforcement of our long-held view about a more robust recovery than most expect. Reasons are what we have discussed before. Strong growth in emerging countries and dramatic cutbacks by companies have generated almost unbelievable productivity numbers – greater than 6% for the last three quarters of 2009.

In addition, GDP grew 2.2% in the third quarter and surprised everyone in the fourth quarter with 5.7%. Some have written off these strong numbers as merely inventory restocking. There may be some of this, but it is growth nonetheless, and is the beginning of what we need for a sustainable recovery. Unemployment has fallen to under 10%, temporary help is up again and we expect positive job growth in February.

Along with higher than expected GDP and progress on the employment front, we expect corporate profits to exceed most estimates substantially. Year-to-date about 75% of companies in the S&P 500 are reporting greater than expected earnings, and 70% are reporting greater than expected revenues. As we speak with companies, we find they are experiencing strong demand conditions, in some cases constrained by shortages. Some industries displaying this are semiconductors along with materials such as steel and copper.

On the other hand, the macro picture has been muddled by some new concerns:

1. Prospect of sovereign debt contagion in the PIIGS (Portugal, Italy, Ireland, Greece and Spain)
2. Continued weak loan growth – banks trying to get liquid
3. Pending financial and health care regulation
4. Implications of tightening measures in China

First, the sovereign debt question: Will this be our sub-prime situation, or the next Thai baht situation? The contagion fear is fueled by the subsequent issues of one country's debt defaulting followed by others. Because the rest of the PIIGS will also require a bail-out if Germany bails out Greece, we don't believe a bail-out will occur. We think Greece will get some sort of resolution short of the dissolution of the European Common Union. As part of the restructuring, there will be some strings attached that will push Greece to be more fiscally responsible. Countries don't file bankruptcy and the population does not go work in another country – they simply restructure their debts. Unlike the period leading up to the Lehman bankruptcy, short-term and corporate spreads have not spiked higher. We see this as an aftershock and not a new systemic risk.

Second, there are concerns about continued weak loan growth – banks trying to get liquid. Following financial crises, the Federal Reserve engineers a steep yield curve to enable the banks to earn their way out of their problems. The Fed has recently engineered one of the steepest yield curves in history.

Many are concerned that banks are not lending to companies. The banks can avoid credit and default risk by simply purchasing government-backed debt, but they still have exposure to interest rate risk. Though credit standards have been tightened, others believe that companies are too scared to borrow. As the economy recovers and growth becomes self-sustaining this concern will fade. Importantly, there has been $1.4 trillion in corporate credit issuance, so credit is flowing and continues to flow to businesses.

Third, there are concerns over regulation. Financial services regulation will be softer than expected. We view the Scott Brown Senate victory in Massachusetts as the roadmap. The Obama administration spent a great deal of political capital on health care reform. The Brown victory showed that gridlock will rule for the foreseeable future with little, if any, progress on health care reform.

The administration's knee-jerk reaction to the Brown victory was to pull Federal Reserve ex-Chairman Paul Volcker to the center stage to make a push to revamp financial services and banking regulation. After the initial market sell-off, investors realized that it is very difficult to get all the opposing forces to agree to anything. Unfortunately, much of the financial services laws that are in place, if properly enforced, could have softened the blow of the crisis.

Fourth, there are concerns of China tightening monetary policy. We view China's tightening as necessary to prevent the economy from overheating. Though rate hikes may be targeted at reducing bubbles, the jobs of the people in power depend on creating jobs. In reaction to the policy change, sectors sensitive to China GDP – such as energy, base metals and agricultural sectors – declined about ten percent in January. From a stock perspective it is a buying opportunity. Global economic fundamentals are still intact and continue to improve. China's PMI for January was 57.4, an all-time high, which indicates that industrial output is continuing to accelerate in 2010. The IMF has raised its growth estimates and now expects 3.9% global growth in 2010, accelerating to 4.3% in 2011. This is good news for commodity demand. Below are two examples that illustrate the continued commodity demand.

Iron ore prices declined from a peak that was 50% above last year's contract prices. Not only could this be a buying opportunity for investors but also for those buyers entering their annual contract pricing negotiations. Given China's insatiable demand for resources, slowing growth expectations provides a great opportunity to buy resources on the cheap – similar to what occurred at the bottom of the 2008-2009 downturn.

Another example: Oil prices have the potential to hit a new all-time high. For the first time in history, 2009 unit car sales in China exceeded the U.S. This translates directly to an increased demand for oil. OPEC's spare capacity peaked at over 25% in the mid-1980s and fell to 2% of global production when oil traded at $150 in 2008. As global economies continue to recover, demand for oil continues to grow and will drive the price of oil higher.

Conclusion

It is our view that these macro issues will be resolved positively in the next two to three months. Our view is that the incredible productivity numbers will drive strong earnings, which will lead companies to hire more labor, resulting in a self-sustaining and more robust recovery than the consensus view.

Outlook

As we predicted, the emerging markets continue to lead this recovery. In the last downturn, despite the economic turmoil in the developed markets, emerging market growth remained positive. We now have a new emerging world market to sell to. Before 2007, trade regularly subtracted 0.5% from GDP growth annually. Since 2007, it has added about 1% to GDP growth. We believe U.S. GDP growth will be at least 4% in 2010.

There has been much discussion that high unemployment is a big problem to the stock market. Quite the contrary has been the case historically. Since 1950, there has been a strong positive correlation between unemployment over 7% and real GDP growth over the subsequent five years. In each case – the late 1950s, 1975, 1982 and the early 1990s – real GDP grew at an annualized pace over 4%. It was also positive for equities. In 1982 and 1990, the last time unemployment exceeded 9%, the following five-year annualized stock market return was at least 10%. Turning an unproductive worker into an income producer generates strong benefits.

Since 1950, history shows that peak-to-peak earnings have grown on average over 50%. The recent peak in S&P 500 earnings was $85 which, if history holds, will translate to peak earnings of $130 in this cycle. With a reasonable multiple, we believe the market could hit new highs and achieve strong annualized equity returns during this recovery.

Following a 65% rally in the equity market from the March 2009 lows, a correction is inevitable though the timing is difficult to predict. We see this as a health-restoring correction and remain constructive on equities. We believe cyclical sectors of the market will benefit the most from this environment – sectors such as consumer discretionary, basic material, industrials, technology and financials. We will use our hurdles strategy to navigate our course and position the portfolio to take advantage of this environment.

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