



RICHARD BERNSTEIN ON THE US

Heart, brains and valour needed as wicked witch of West's economy melts

Hail Dorothy, the wicked witch is dead! In the classic movie, the *Wizard of Oz*, this is the ending of one era and entering of another.

However, in contrast to Dorothy, who was going to return to Kansas, 21st century investors in this real-time, debt-laden world are not likely to return to the halcyon days of lower credit cost and unlimited availability that drove much of the last 25 years' growth in America. For most of today's investors, their investment framework was simple and reliable: economy gets in trouble, consumer spending plummets, Fed drops borrowing costs, buy stocks. Then wait a few years until the next crisis and repeat.

In the early 1980s with a discount rate of around 9%-10%, the discount rate was driven to almost zero and put household debt ratios in an unsustainable position.

Bull and Bear points

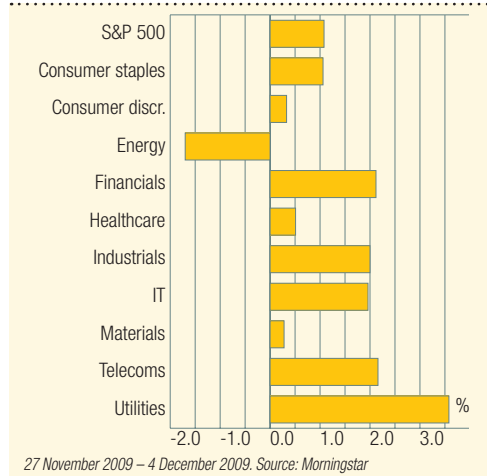
Generous liquidity policies continue to fuel rally in equity markets

Dollar depreciation policy devolves to a dollar crisis

Weak dollar benefits American exports

Goods/services inflation accelerates while housing assets stagnate

S&P 500 sector returns



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(IMA) North America: over three years

| Top 5 | 3yr % Chg | Rank | Volatility (monthly) | Fund size (m) (£) | Morningstar Rating™ |
|--------------------------------------|--------------|-----------|----------------------|-------------------|---------------------|
| Neptune US Opportunities A | 30.9 | 1 | 5.27 | 377.14 | ★★★★★ |
| Schroder US Mid Cap Acc | 14.99 | 2 | 5.39 | 291.22 | ★★★★★ |
| Jupiter North American Income Inc | 14.8 | 3 | 4.77 | 236.84 | ★★★★ |
| Allianz RCM US Equity A | 13.98 | 4 | 5.68 | 21.99 | ★★★★ |
| Gartmore US Growth R | 12.74 | 5 | 4.88 | 217.41 | ★★★★★ |
| Bottom 5 | | | | | |
| IP US Equity | -16.45 | 62 | 5.25 | 346.4 | ★ |
| L&G (Barclays) MM US Alpha (2) A Inc | -17.05 | 63 | 5.82 | 127.56 | ★ |
| M&G North American Value A Inc | -19.27 | 64 | 7.77 | 87.66 | ★★ |
| Franklin Mutual Shares OEIC A Acc £ | -26.55 | 65 | 6.22 | 15.12 | ★ |
| Legg Mason US Equity A | -36.36 | 66 | 7.38 | 109.1 | ★ |
| Sector average | -1.97 | 66 | 5.55 | 187.75 | |

Performances calculated bid to bid, net income re-invested, GBP to 4/12/09. Data Source: © 2009 Morningstar, Inc. All Rights Reserved.

In our view, Ben Bernanke had two choices, neither of which were very appealing: one would mean years of difficult times and the second would risk a period of considerable inflation. For many reasons, it appears the second route is the most likely and this, we believe, has material implications for equity investors. For most of the dis-inflationary period of the last 25 years, lower discount rates, rising household debt and valuations, made it hard not to make money in most equities. The framework is about to shift to one where making money in equities is much more selective.

While the timing is uncertain, we believe a period of rising inflation is on the way. Unprecedented governmental stimulus will be the driver of this change.

The total stimulus commitments for this recession top more than 29% GDP.

Equities have not been the only recipients of immense government largesse. Quantitative easing programmes have ploughed massive amounts of liquidity into the global financial system. Many fear this liquidity has been responsible for the major bull market in virtually every conceivable asset class, save the debts of Dubai World or condos on the Las Vegas strip.

At some point, there is a probability this type of asset inflation will find its way into goods and services inflation, perhaps in a manner less controllable than assumed.

As this situation develops, it will become clear not all industries or firms have the same capacity to manage higher nominal prices. In gross terms, it will probably be a period more like the 1970s – a time where the equity market had a large spread between winners and losers.

Finally, we believe absolute valuation will matter a lot more. Although an inflationary period will support solid nominal sales and earnings growth for many companies, without the support of declining interest rates, market valuations could be lower several years from now, especially if inflation and interest rates are at unexpected levels. Having a low starting valuation should be an important margin of safety as we head back to Kansas.

Richard Bernstein is CFA, manager of the Brown Advisory US Equity Value fund