



**Presentation to Economic Outlook and Revenue
Assessment Committee**

CAPITAL MARKET OUTLOOK

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OUTLINE OF PRESENTATION

■ **ECONOMIC AND CAPITAL MARKETS**

- Consensus has been generally correct past few years
- Next year expected to be similar
 - Subdued and stumbling growth, good equity markets, flat bond markets

■ **CENTRAL BANKS DRIVE TO NORMALIZE FINANCIAL CONDITIONS CENTRAL FEATURE OF RECENT MARKETS**

- Easy access to capital, low borrowing rates, encourages “risk” investing (e.g. equity), lower volatility
- Western financial conditions now back to “normal”

■ **MACRO THEMES TO WATCH**

- Future use of Potential Cash from Central Banks
 - Money isn’t printed until it is lent and spent
 - Hasn’t yet been either lent or spent – will it be inflation or reasonable growth?
 - Corporate and Personal deleveraging
 - European financial (re)integration
 - Shift to Developing World and global rebalancing
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2012 CLOSE TO FORECAST

- World Economies “Muddled Through”
 - Europe mild recession, avoided fiscal collapse
 - China cooled inflation, avoided hard landing
 - US kept on slow, stumbling growth path
 - Next year expected to be more of the same

 - Capital Markets Good
 - S&P 500 +15% vs expected +12%
 - Increase in PE ratio plus consensus earnings
 - Investment Grade bonds up 5% vs expected flat
 - Yields stayed low
 - Markets again expect 12% equity markets, flat bond markets
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BASIC CAPITAL MARKET CONCEPTS

■ EXPECTATIONS

- ❑ Not Current Conditions
- ❑ Current Economic Expectations Moderate

■ PROFITS

- ❑ Not general economy
- ❑ Good balance sheets, lean operating conditions, growth overseas (x Europe), little pressure on labor costs

■ RELATIVE VALUE

- ❑ Not absolute value in itself
 - ❑ What are people willing to pay for expected earnings
 - ❑ Current alternative – bonds -- unattractive
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ECONOMIC EXPECTATIONS

	Projected 2012	Actual 2012	Projected 2013
Real GDP	2.1%	2.2%	2.0%
Nominal GDP	3.9%	4.1%	3.9%
Real Consumption	1.9%	1.8%	1.8%
Real Business Spending	7.3%	7.2%	3.1%
Real Ind. Product	2.7%	3.6%	1.9%
Unemployment	8.7%	7.7%	7.7%
Housing Starts	680,000	770,000	980,000
Core CPI Inflation	2.1%	2.1%	1.9%
Europe Real GDP	0.25%	-0.5%	-0.1%
Europe Inflation	1.9%	2.5%	1.9%
China Real GDP	8.5%	7.7%	8.1%
China Inflation	3.5%	2.7%	3.2%

Expectations : Bonds “Dead Money”

- ❑ **Cash: Yields will rise from 0.2% to 0.4% for a +0.4% return**
 - ❑ **TIPS: Yields will remain at -0.8% real yield for a +1.1% return**
 - **Will get 1.9% for CPI Inflation**
 - ❑ **10Y Treasury: 1.7% Yield will go to 2.1%, for a negative -1.7% return**
 - ❑ **10Y Corporate “A”: Yields from 2.6% to 2.9%, +0.2% return**
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Expectations : Another Double Digit Equity Year

- ❑ **US Equities: +12% to +13%**
 - **Dividend at 2.3%**
 - **Expected Earnings Per Share Increase: 9.9%**
 - ❑ **Earnings increase : 7.7%**
 - **Around Historic Average of 7.5%**
 - ❑ **Net Share Repurchase: 2.2%**
 - **Assumes Current P/E stays around 14**

 - ❑ **EQUITY MARKETS BEING DRIVEN BY
RELATIVE VALUES AND FINANCIAL
CONDITIONS, NOT PROFIT POTENTIAL**
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PERSI TOTAL FUND RETURNS STARTING FY 2008
June 30, 2007 through December 25, 2012



GROUNDHOG YEARS

GROUNDHOG YEARS

Spring Fiscal Crisis in Europe, Fall US Concerns, Early Winter Optimism

BLOOMBERG FINANCIAL CONDITIONS INDICES – UNITED STATES

33% MONEY MARKET

TED Spread
Commercial Paper/TBill
Libor/OIS

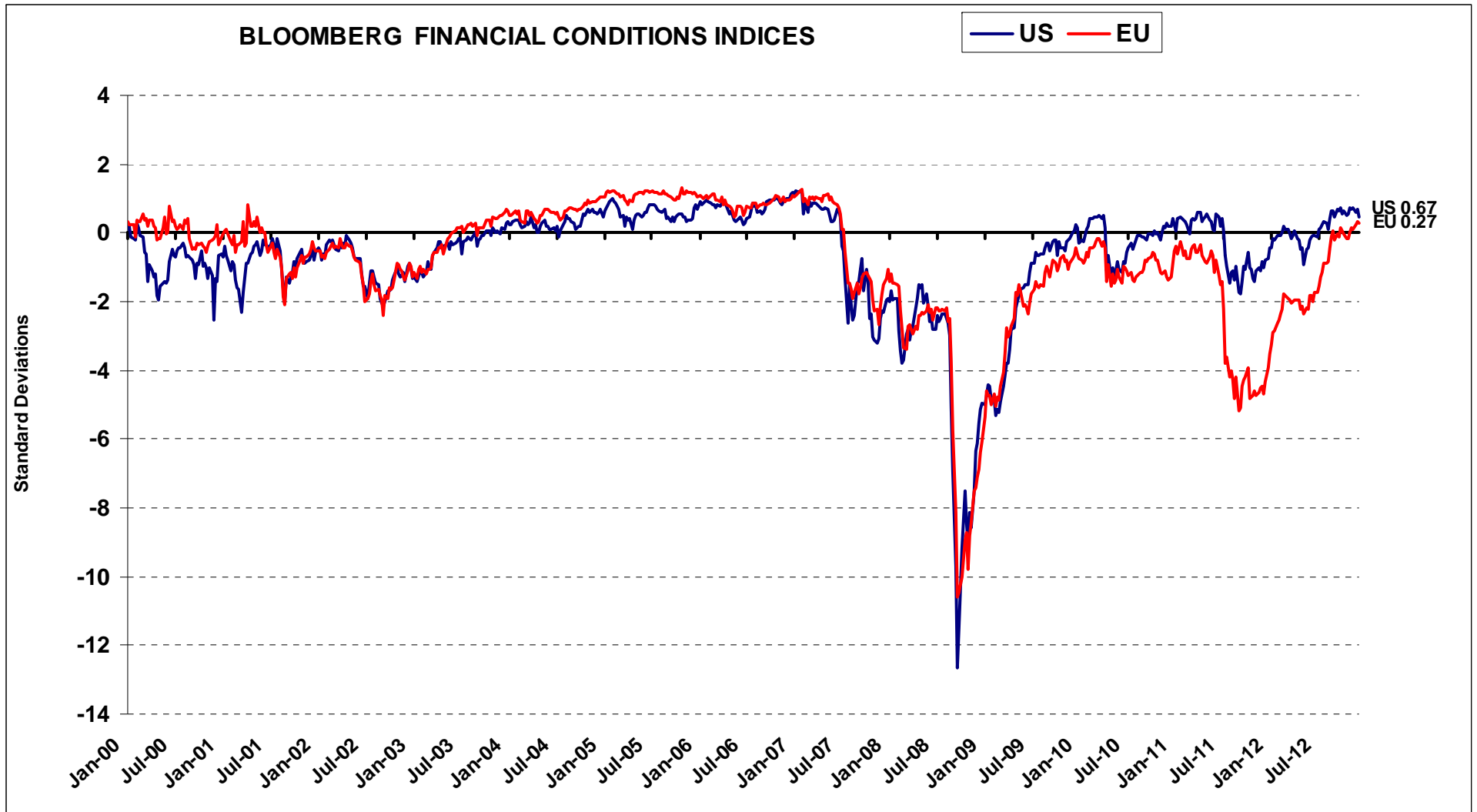
33% BOND MARKET

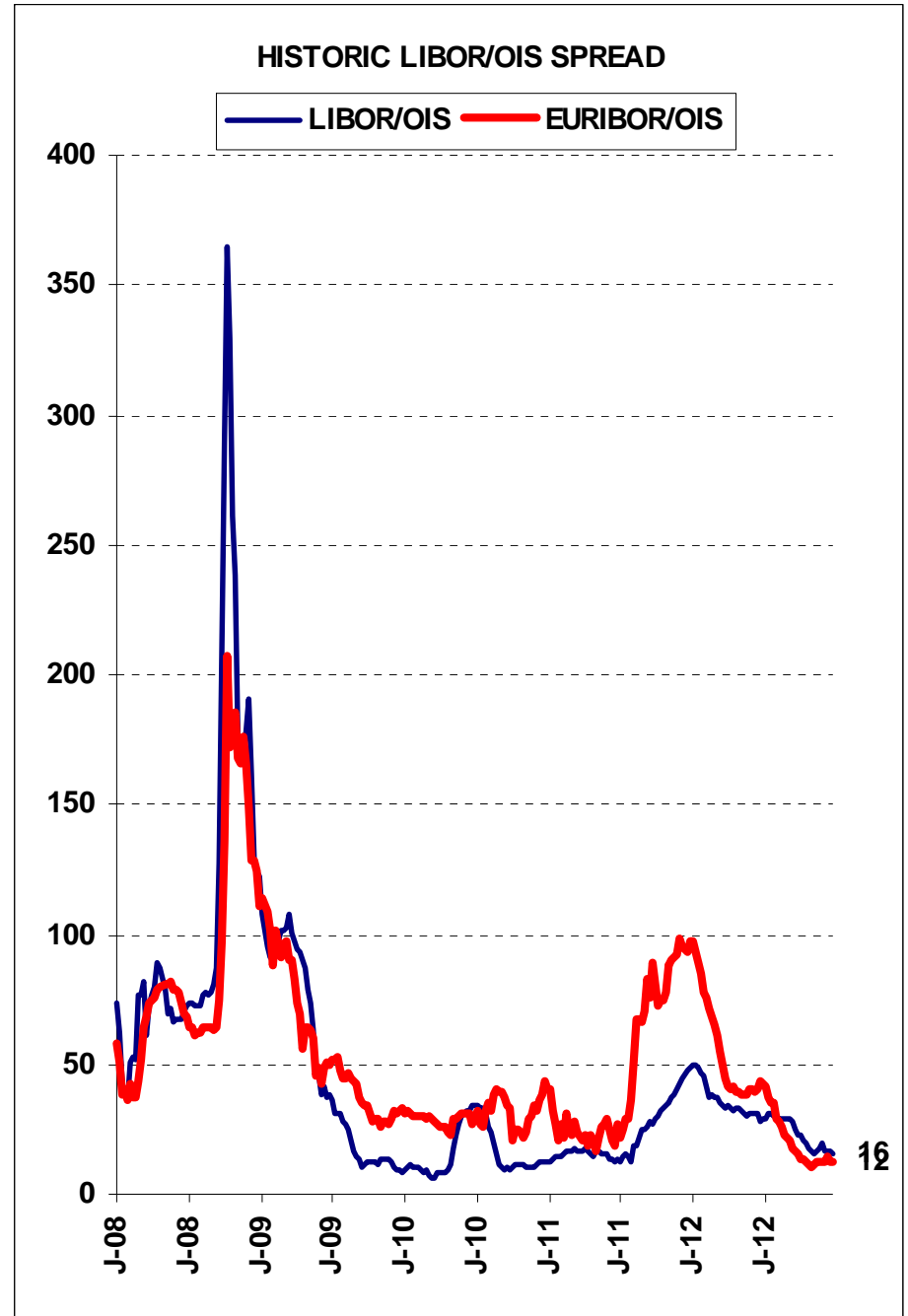
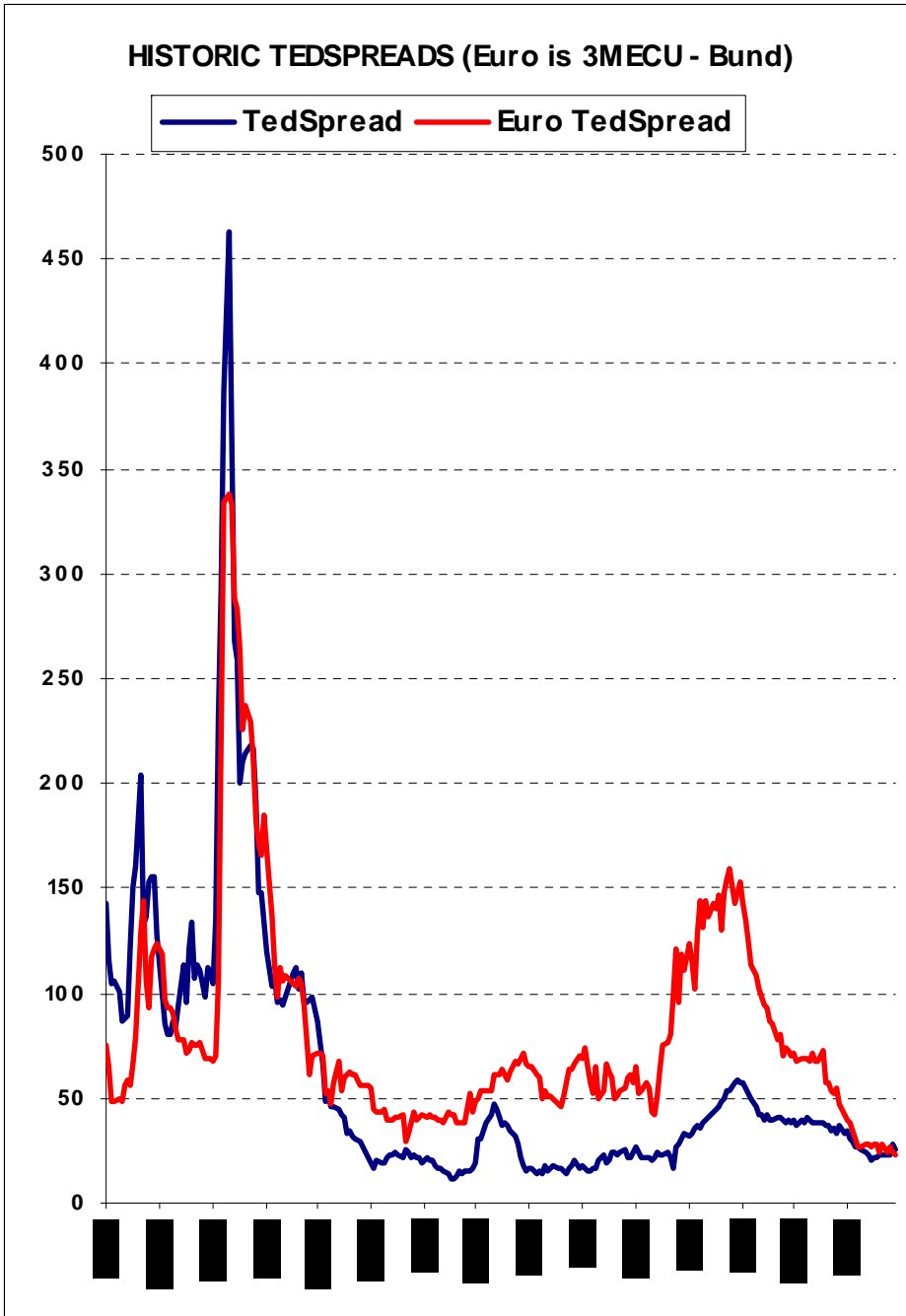
Corporate/Treasury
Muni/Treasury
Swaps/Treasury
High Yield/Treasury
Agency/Treasury

33% EQUITY MARKET

S&P 500 Prices
VIX Index

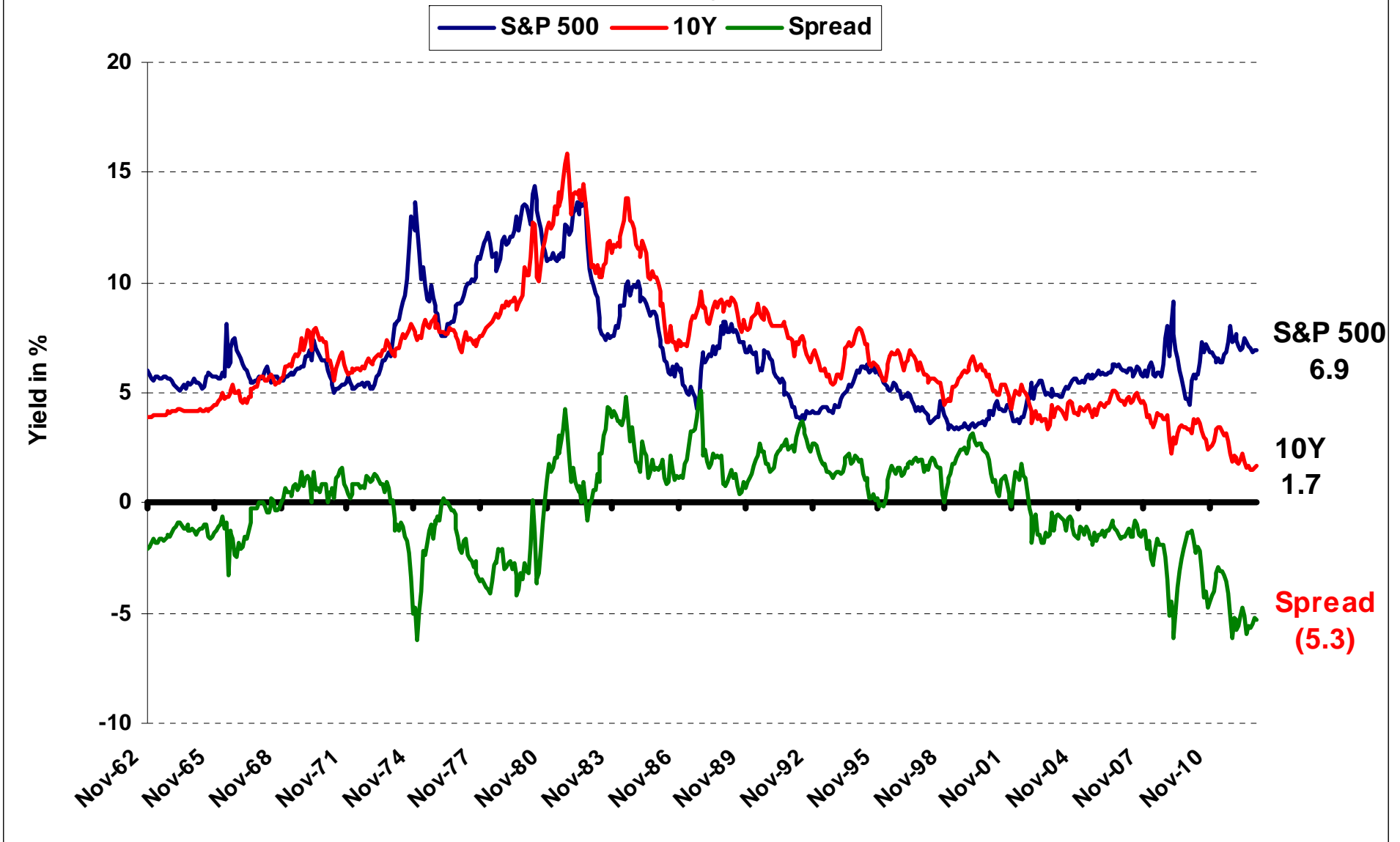
Z-Scores 1992- July 2008 Average





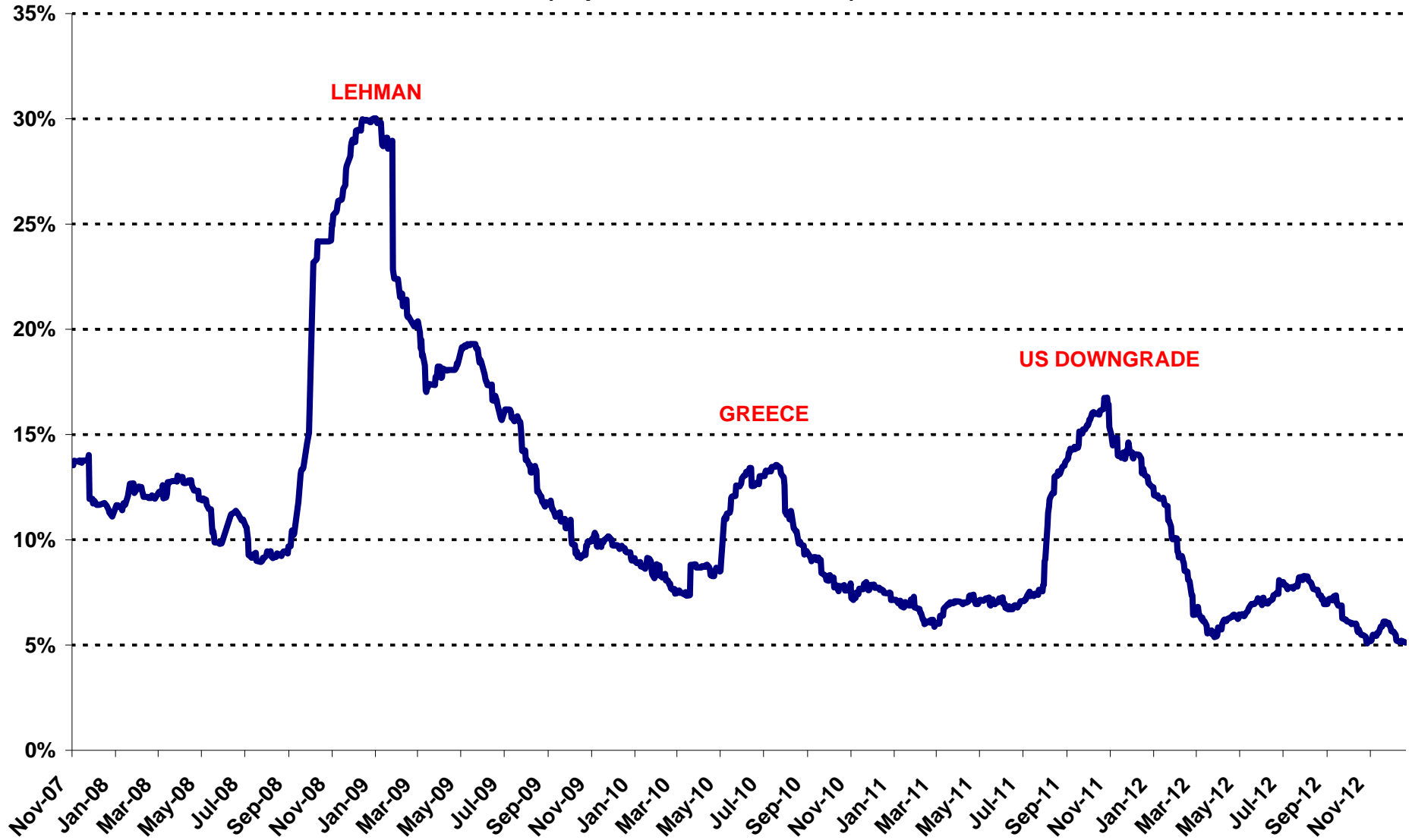
Capital Availability Increased and Borrowing Rates Lowered

Spread between S&P 500 Earnings Yield and 10Y Treasury Yield



Relative S&P Value vs Bonds Greatest since 1974

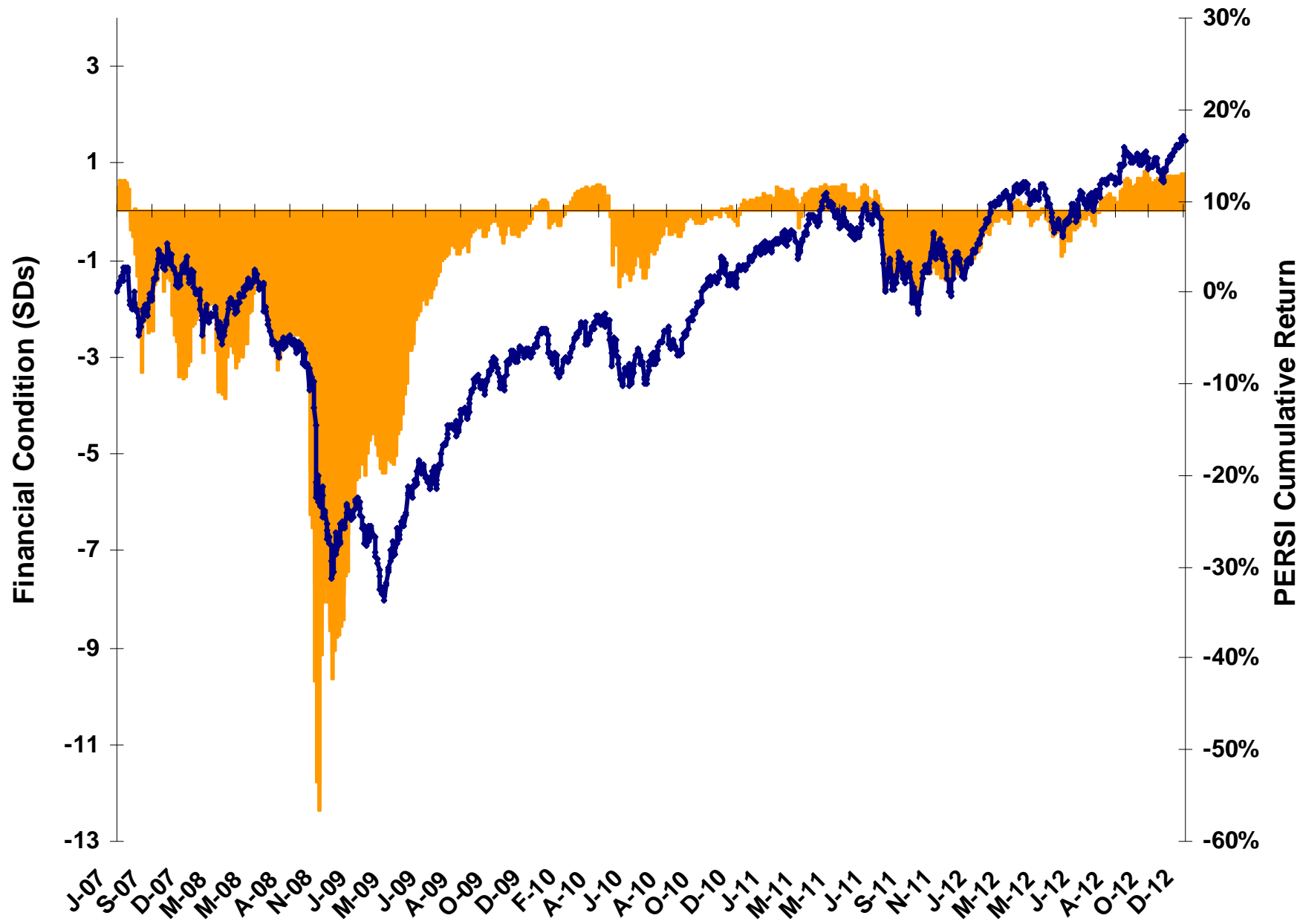
VOLATILITY
Three Month Standard Deviation (Annualized)
(Expected Normal is 13%)



MARKETS GENERALLY CALMER THAN NORMAL SINCE COLLAPSE

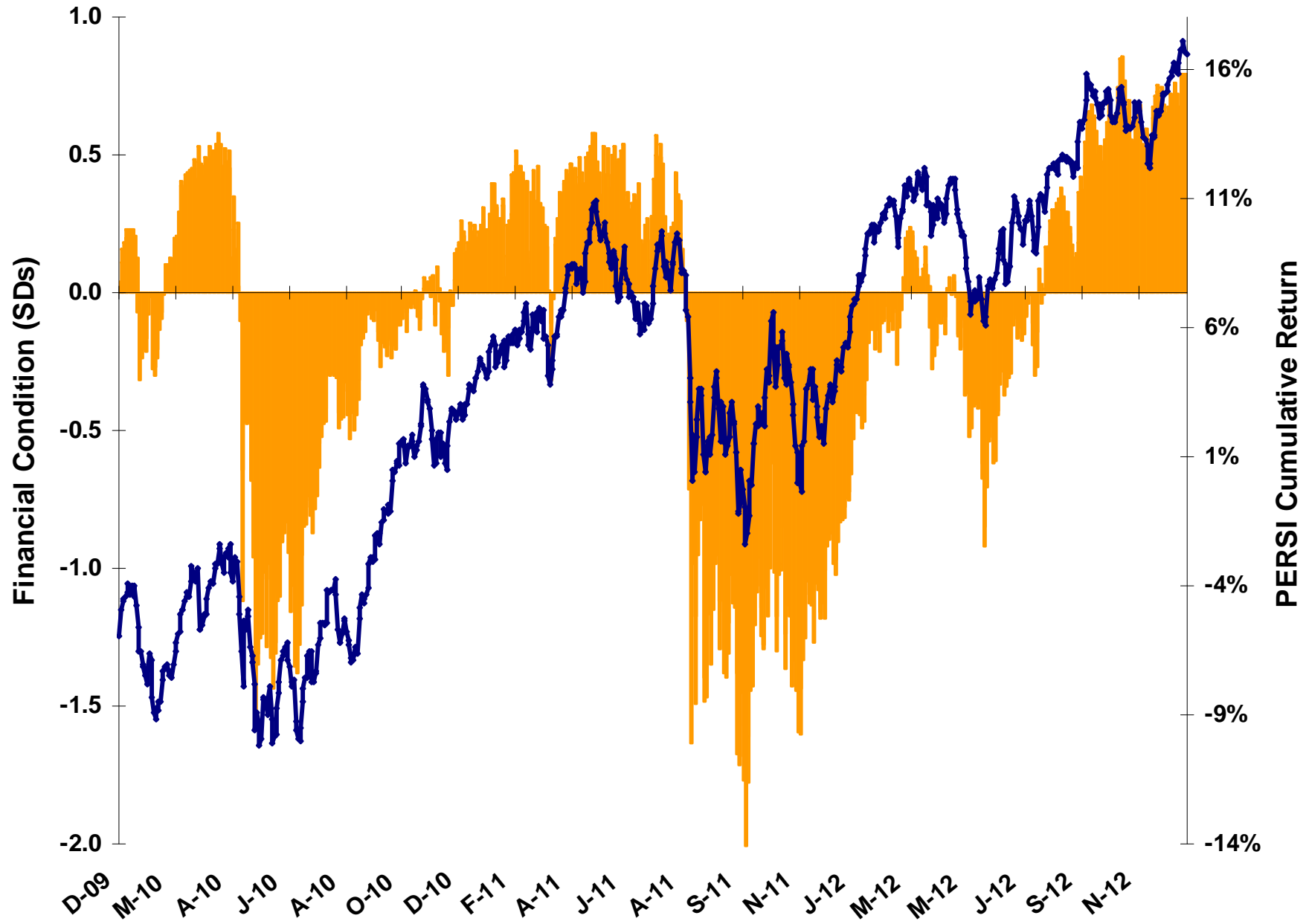
Financial Conditions and PERSI Returns Since June 30, 2007

Financial Conditions PERSI



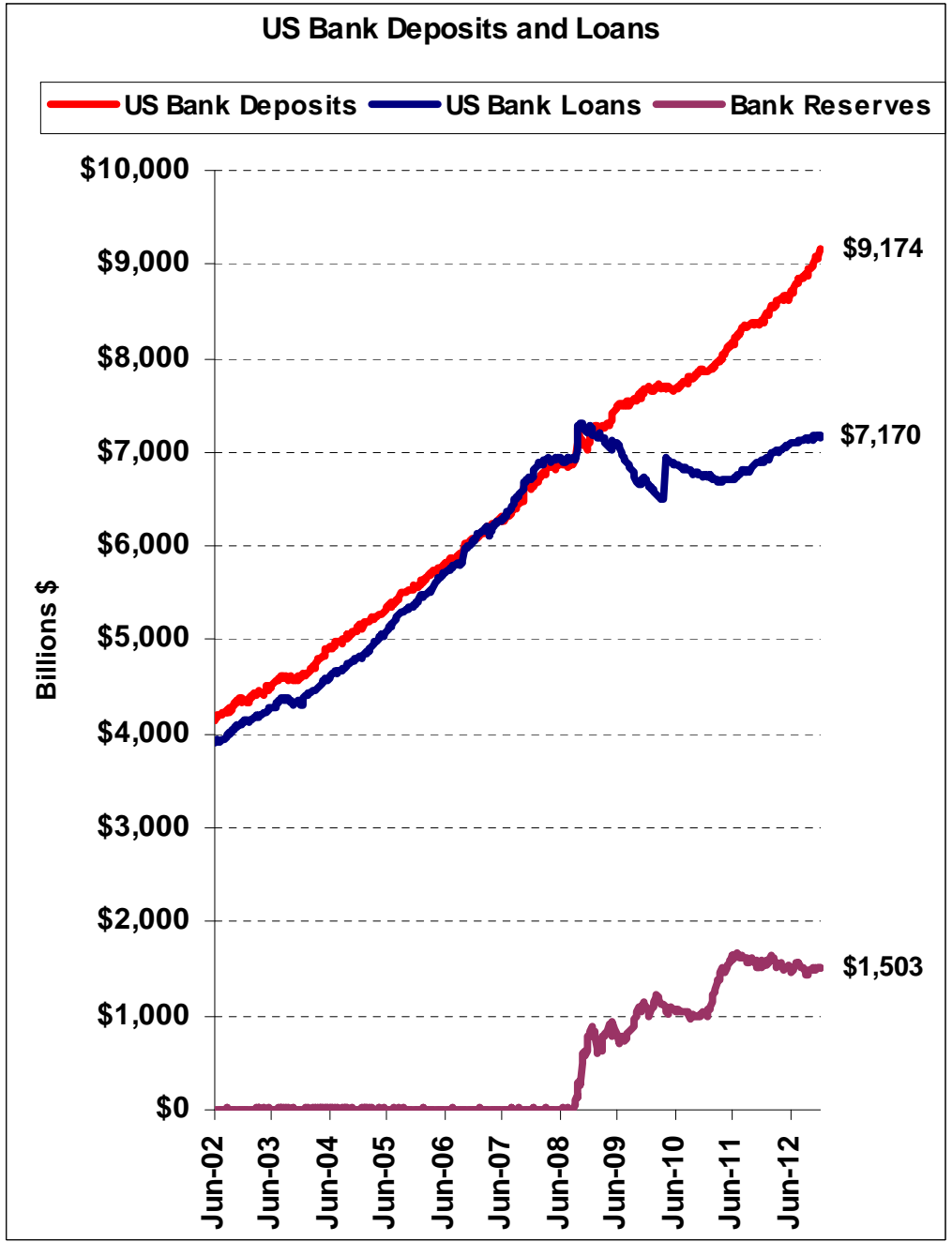
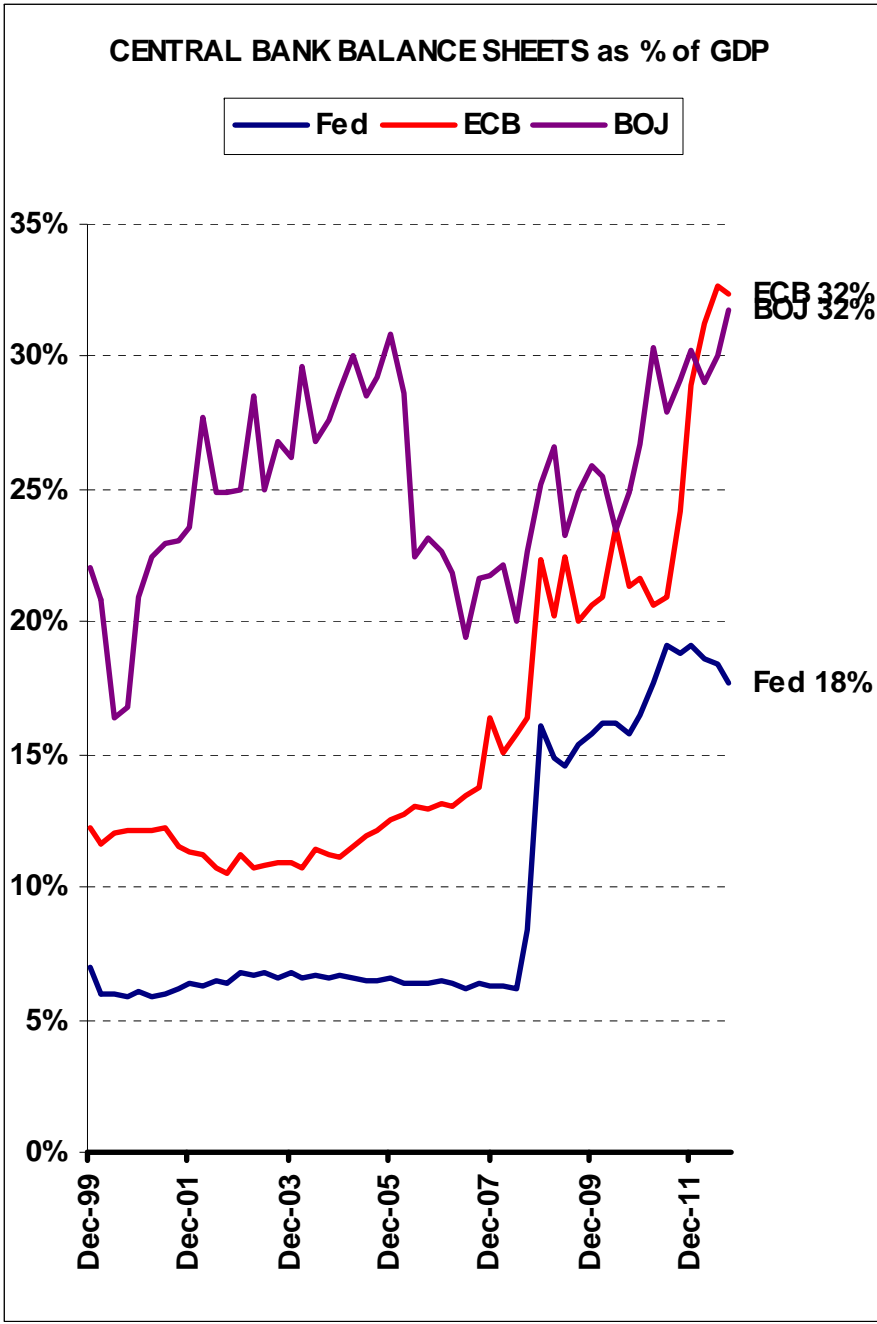
Financial Conditions and PERSI Returns Since Jan 1 2010

Financial Conditions PERSI

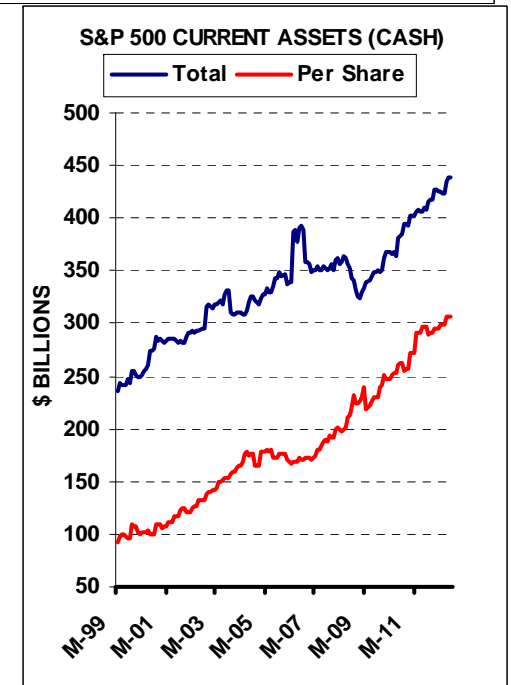
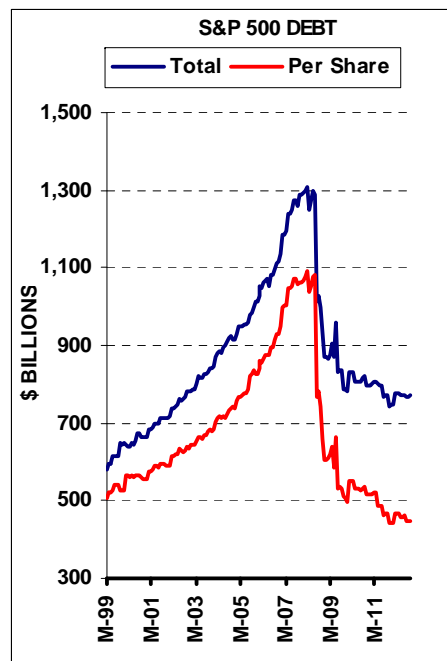
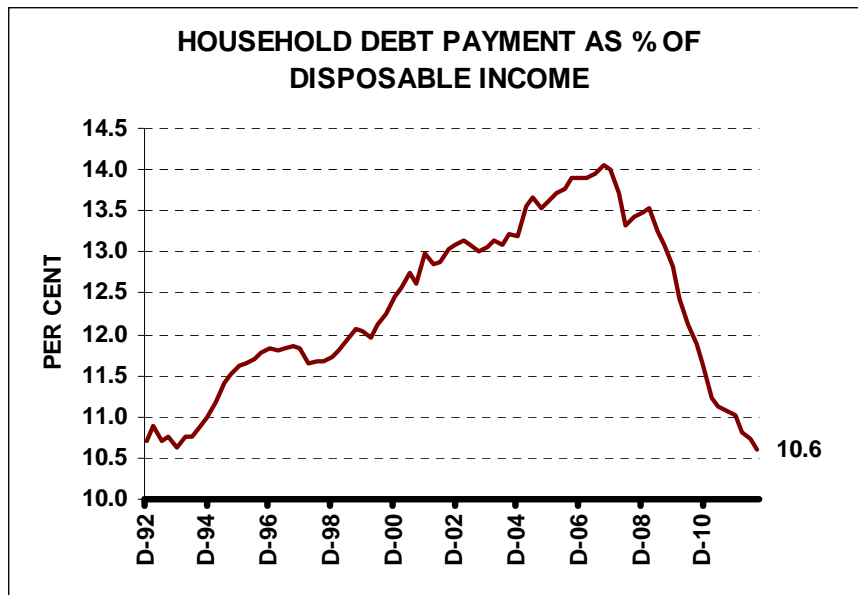
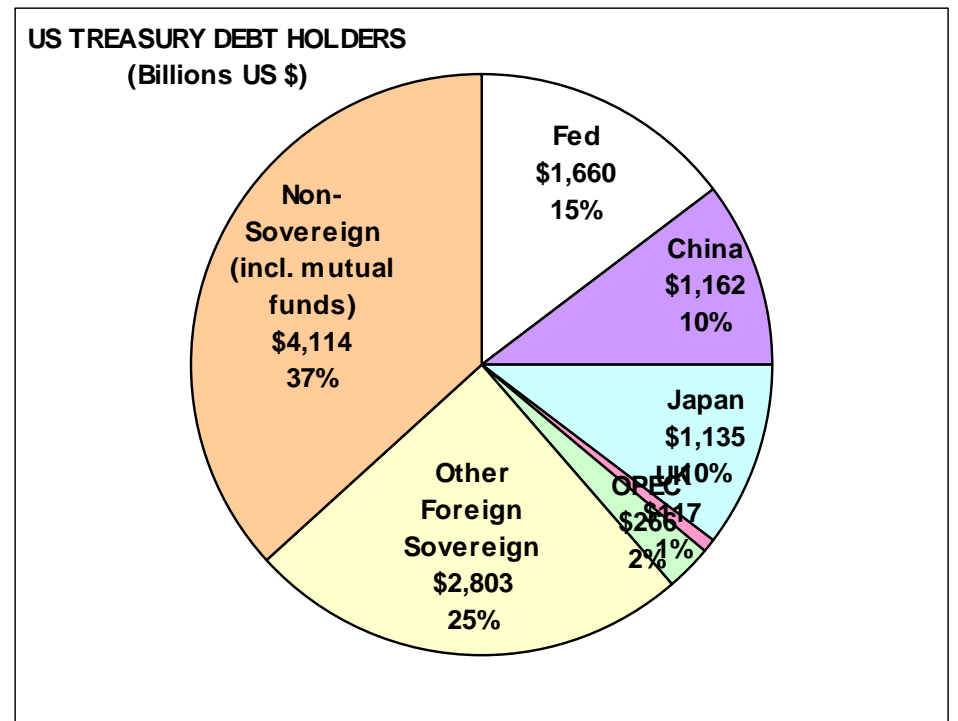
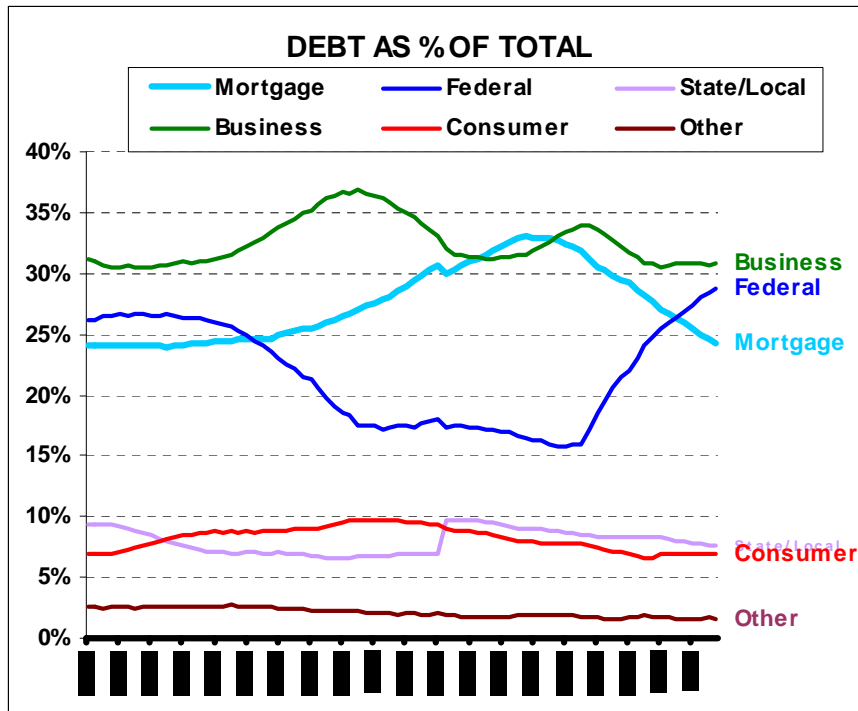


MACRO LONG TERM THEMES

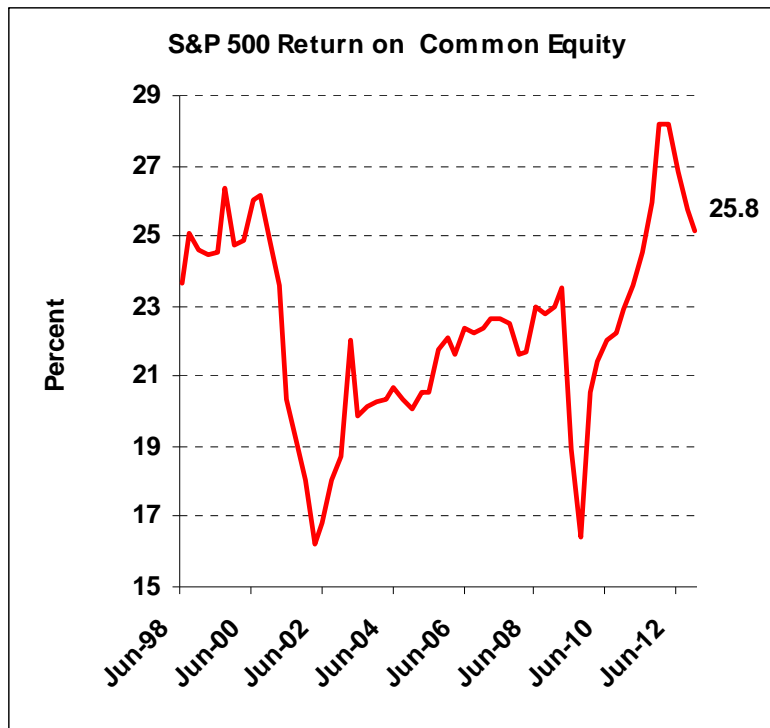
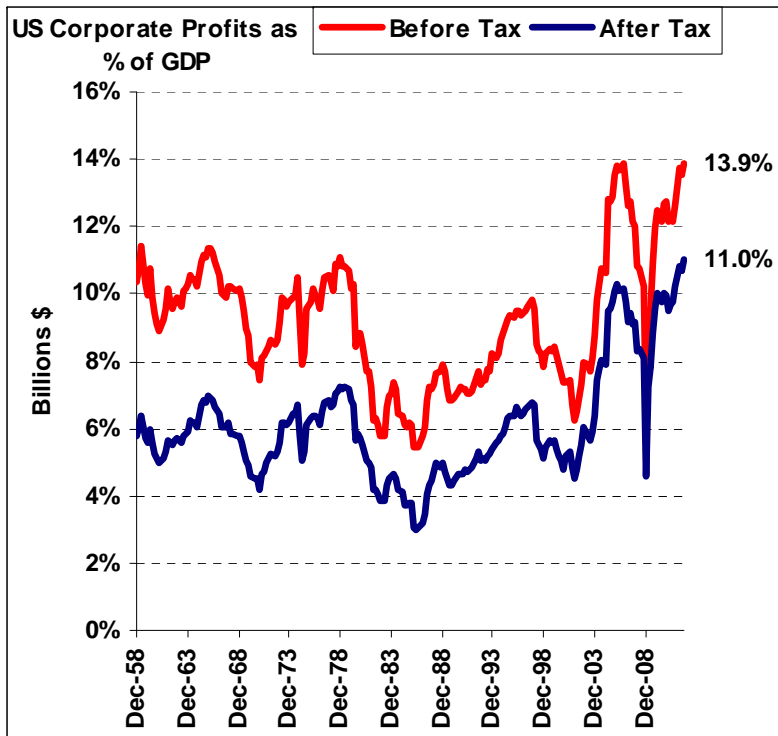
- Huge Amounts of **Potential** Cash from Central Banks
 - Currently “buried in the mattress”
 - Banks aren’t lending, corporations aren’t spending
 - US Corporate and Personal Deleveraging
 - Corporations profits and returns on equity at all time highs
 - Costs are low
 - Balance Sheets strong
 - European project to integrate financially
 - Shift from Developed West to Developing World and Asia
 - Shift in China from Export to Internal Spending
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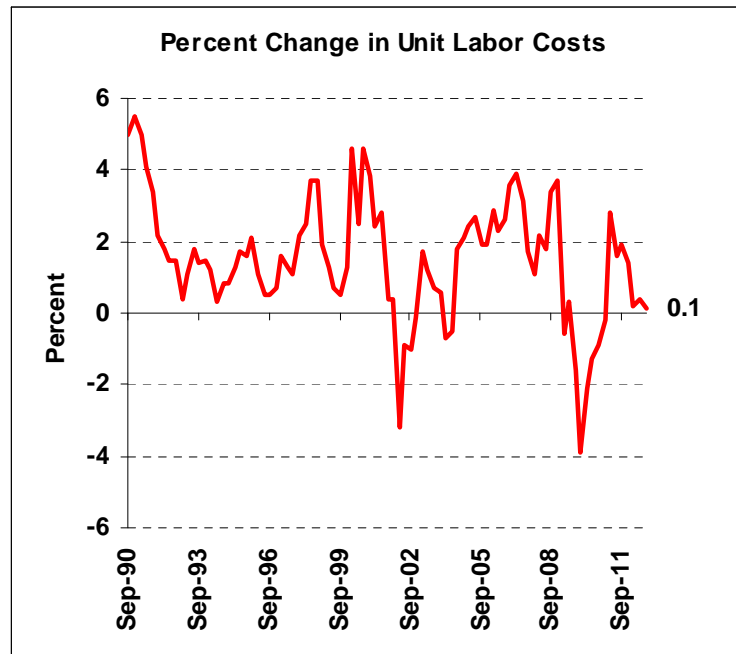
MONEY ISN'T PRINTED UNTIL IT IS LENT AND SPENT



Non-Government Debt Burdens Lower

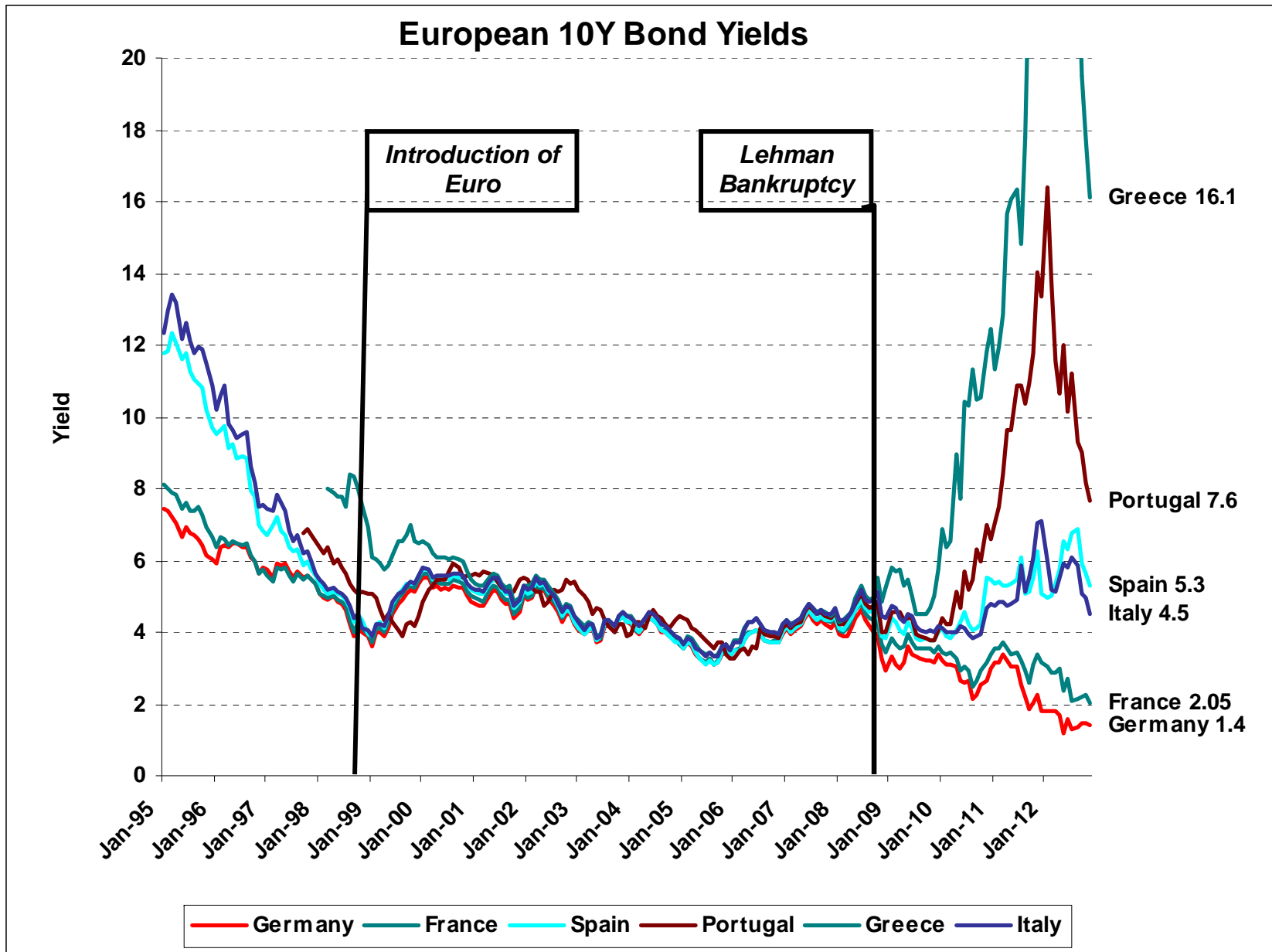


Corporate Profits and Return High



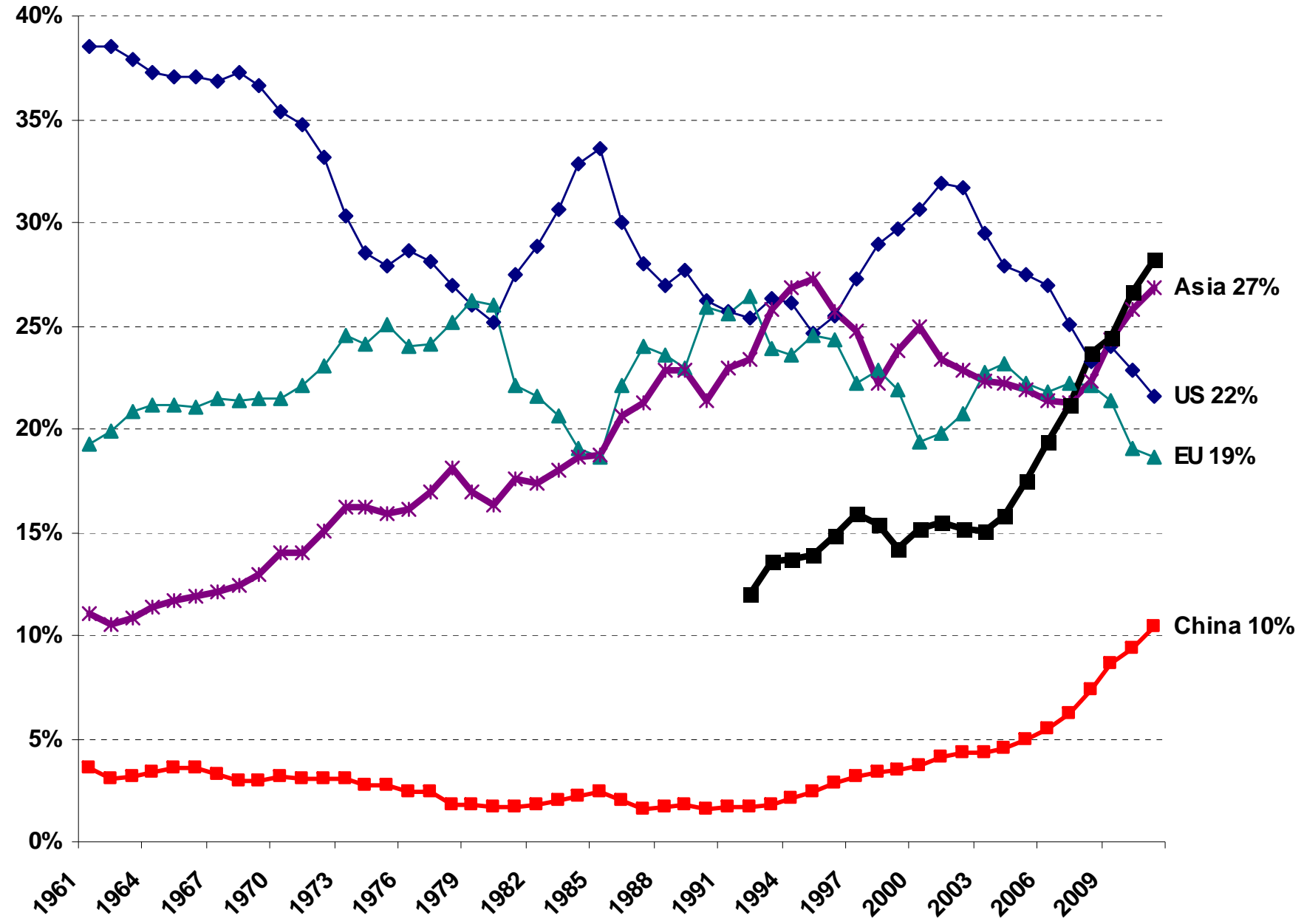
Labor Costs Are Low

Cash High Debt Low

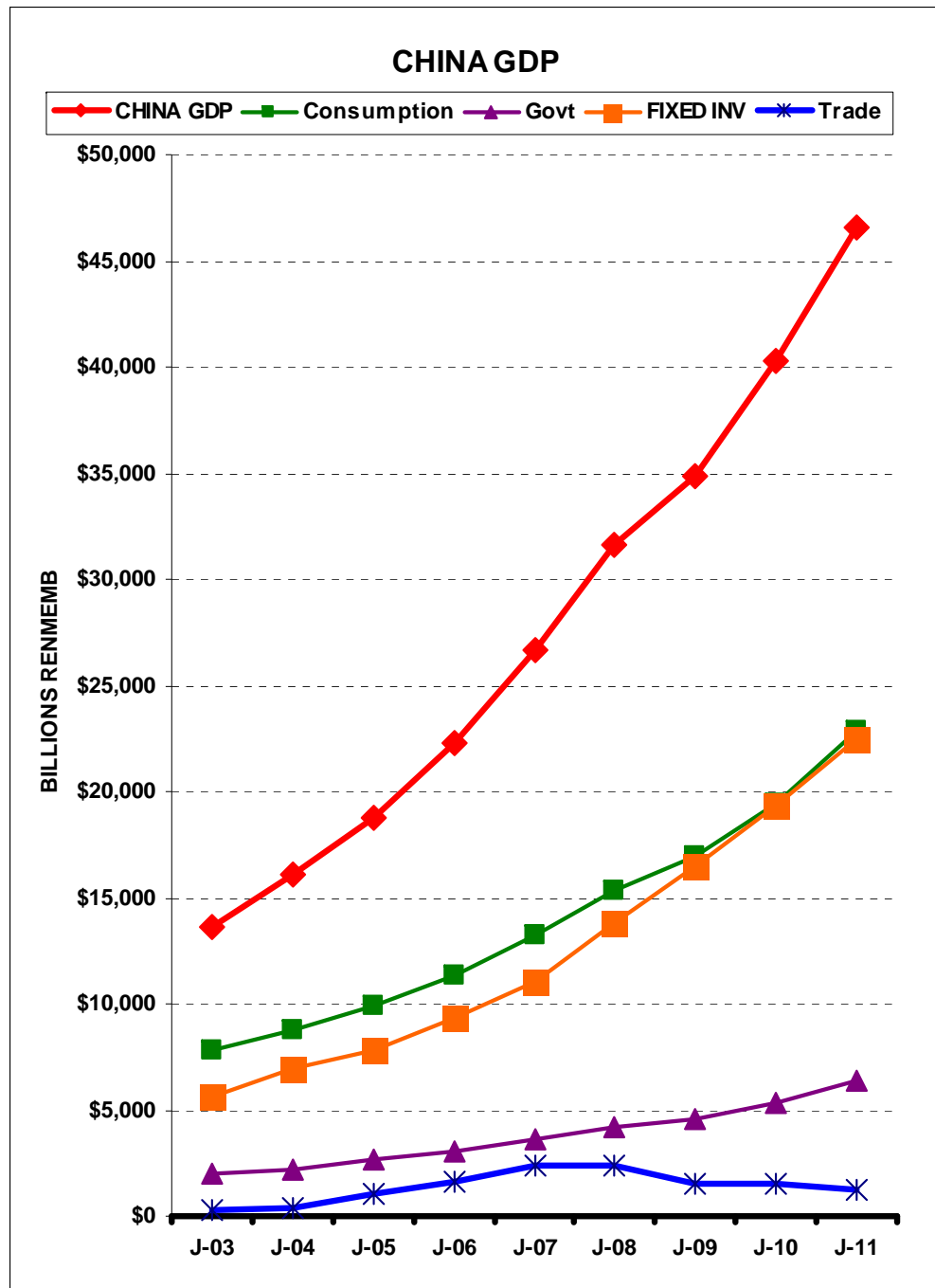
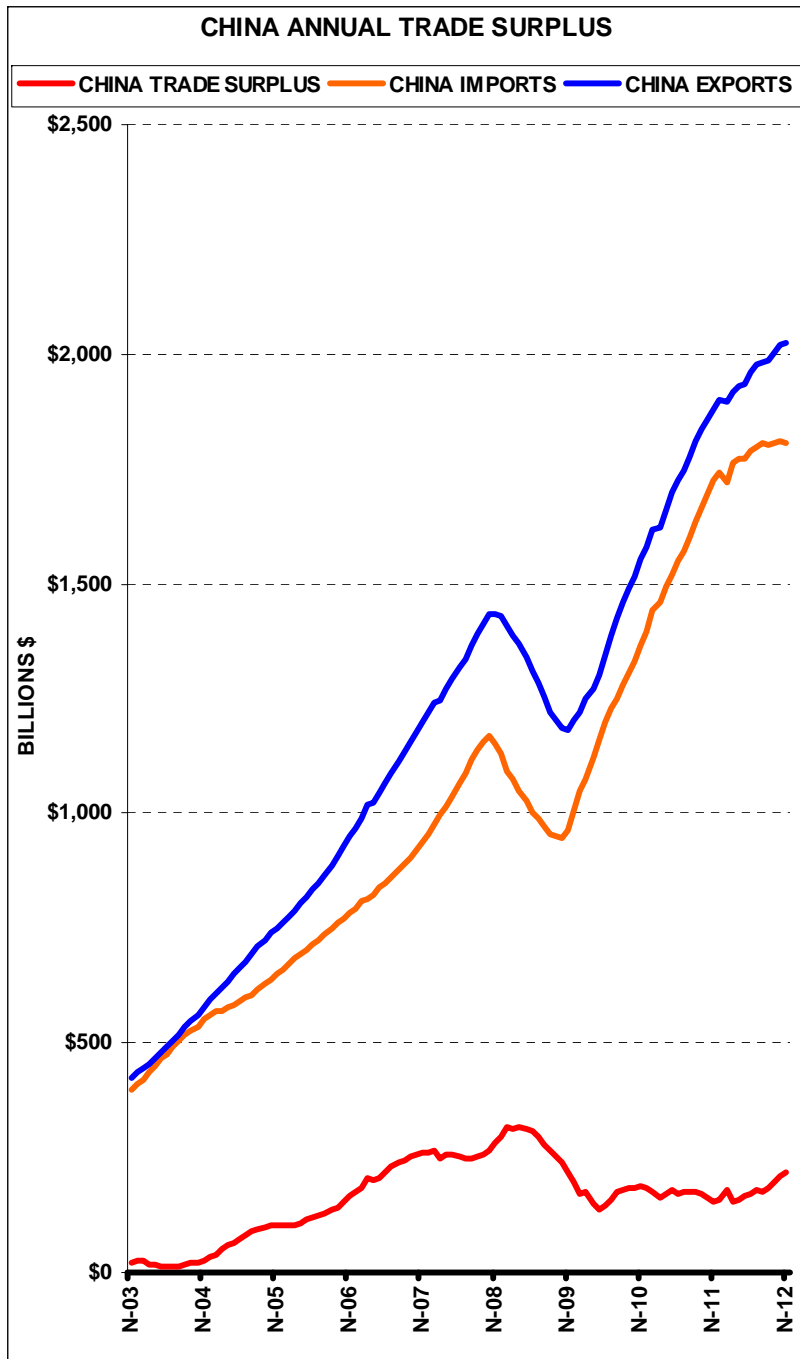


Europe financial integration beginning to recover – still have long way to go

Percent of World GDP



Developing World, Led By China, Increasing Share of World GDP Since 2003



CHINA ECONOMY REBALANCING TO INTERNAL SPENDING

QUESTIONS?
