

## **New Amsterdam Partners 4Q09 Market Outlook**

After the financial and economic turmoil that began in 2008, 2009 saw the US economy shrink by 2.5%. The stock market continued its fall until the beginning of March but then staged a sharp rally once signs of economic improvement appeared, producing the best calendar year return since 2003, while bringing to an end the worst decade on record for US stock performance. The “Great Recession” appears to be coming to an end and, although it involved a lot of pain, proved less dire than many had feared.

GDP growth turned positive in the second half of 2009, and we expect that trend to continue, with GDP growth of 2.5 – 3% in 2010. The continued recovery will be helped by increased demand from emerging markets, the rebuilding of inventories and an improvement in employment and personal incomes. The index of Leading Economic Indicators has moved up sharply while fiscal and monetary stimulus are working their way through the system. We believe that the unemployment rate has peaked and expect the economy to start adding jobs within the next few months. GDP per employee has now risen to the point where more hiring may be warranted. An increase in hiring along with the rebound in household net worth will produce a modest rise in personal incomes and spending.

The main threat to GDP growth lies in the private economy not recovering by the time the effect of the unprecedented fiscal and monetary stimulus wears off. Many states are in fiscal crisis and have been supported by federal stimulus money which is now going away. This may cause public sector employment cuts – a problem if the private sector cannot pick up the slack. Increases in taxation may also hamper the business sector, particularly small business which provides most of the nation’s employment. While the domestic real estate market has improved, there is still a shadow over the housing market due to high inventories and the commercial real estate market will continue to be distressed for a while. A major unknown, however, also lies in geo-political and global terror risks. Extremely adverse events could affect US and world economies and stock markets.

In the near term, inflation and interest rates are likely to stay low. Inflation will be subdued in the coming year due to low capacity utilization and modest employment cost increases. The Federal Reserve has stated its intention of keeping interest rates low for the foreseeable future, but we would expect them to start creeping up by year end. There is a longer term inflation threat if the huge amount of public debt becomes monetized, but so far the velocity of money has stayed low (due to banks’ reluctance to lend combined with some slack loan demand) and the Federal Reserve has laid out plans to remove liquidity from the system when the economy is back on track. It remains to be seen whether the political will exists to do so once a widespread recovery is underway.

With the exception of the financial sector, corporate America weathered the downturn relatively well, managing to maintain margins through astute cost control. A pick up in

top line growth from a reviving economy will allow profits to rise in the double digits. Since the market is trading around its long run average P/E of 15 (on forward earnings), we believe that the increase in profits will allow the US stock market to grow in the low double digits for 2010.

In the wake of a turbulent 2009 featuring volatile stock price moves on what we believe to be unsustainable factors, we expect the market environment in 2010 to be more favorable for our investment process. Low quality stocks led the recovery rally last year, and their returns relative to high quality stocks reached peaks similar to those last seen in 2003 and 1999. History suggests high quality stocks retaking leadership in 2010. Last year also saw a spike in stock price correlations, which proved a difficult environment for bottom-up stock selection processes like ours. Recently, stock price correlations have begun to drop, a factor which should make 2010 much more of a stock pickers market. In 2009, companies generating losses enjoyed the highest stock price returns, but as the business cycle moves forward cash flow generation is likely to be a much more important stock selection factor. We expect more normal stock market behavior going forward and stocks with better than average cash flow and profitability to outperform in 2010.