

## A RETURN TO “NORMAL”

This past September marked the one-year anniversary of the financial crisis. An array of articles and news segments took a look back at the events of that chaotic period, which worsened the downward turn of the equity markets and intensified an already serious recession.

Given the fears that prevailed at that time, it's actually quite gratifying to consider where we are today. Government intervention, while costly, appears to have helped avert economic collapse and the credit markets, once dysfunctional, have essentially returned to normal. Indeed, it seems that we may have already emerged from the recession with most forecasters expecting positive GDP growth for the third quarter. Meanwhile, the stock market, after dropping to March lows, has regained substantial ground, although remaining well below 2007 market highs.

At Neuberger Berman, our portfolio managers relied on experience and investment discipline to weather the chaos of the last year and position client portfolios for a recovery. Today, as an independent, employee-controlled investment management firm, our mission is clear and straightforward: to partner with you to achieve your investment objectives. This means adhering to investment processes, paying careful attention to risk and providing the highest level of client service. Although less turbulent times have arrived, we understand the trust you have placed in us and will remain vigilant as we seek opportunities on your behalf.

### MARKET RECOVERY CONTINUES

Last quarter, we described a dramatic change in market sentiment as investors moved from panic about the potential for economic collapse to relief that disaster had been averted. The result of this changing sentiment was a sharp two-month rally of 37% in the S&P 500 off the March 9 low. Following the initial rally, the S&P 500 maintained a tight trading range for nearly three months, which included a slight retrenchment in late June and early July. Equities continued their upward movement in July, this time a reflection of improving fundamentals and signs of a broad economic recovery. Since July 10, the S&P 500 has risen over 20% and now stands 17% higher from the start of the year.<sup>1</sup>

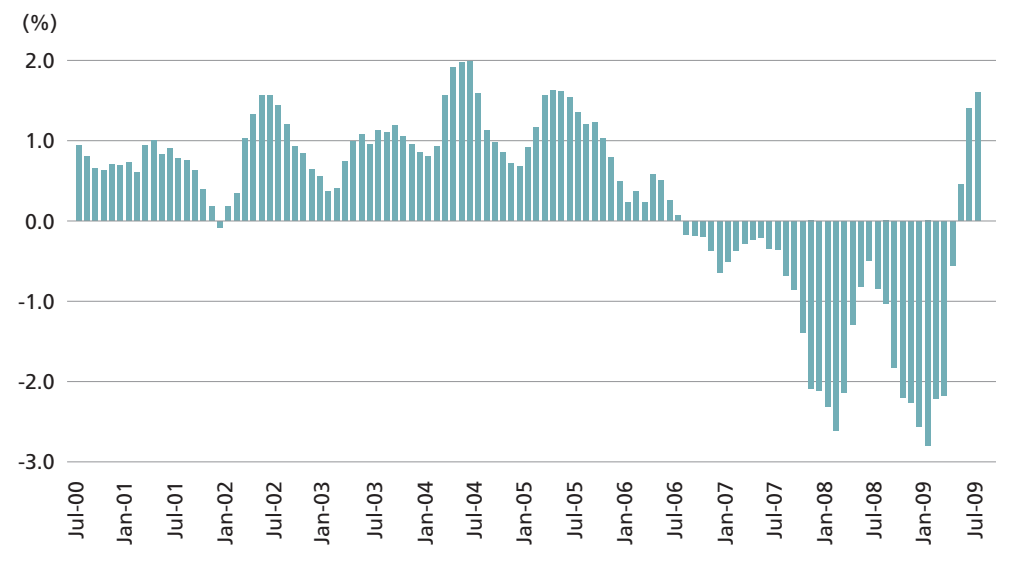
In the past, there have been periods of market strength that appeared unjustified by economic fundamentals, and those rallies ultimately failed. However, we believe that support for recent gains and continued upward movement in equities comes from numerous sources:

**Manufacturing trends**—The U.S. manufacturing sector, as measured by the Institute for Supply Management's (ISM) manufacturing composite, is now expanding for the first time in 19 months. According to ISM, New Orders far exceed Inventories, which bodes well for an increase in production for the remainder of 2009 and 2010.

<sup>1</sup> As of September 30, 2009.

**FIGURE 1 — U.S. RESIDENTIAL REAL ESTATE SHOWING SIGNS OF A RECOVERY**

Case-Shiller Home Price Index: Month-over-Month % Change



Source: Standard and Poor's. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

**Improving real estate market**—The real estate sector is showing moderate improvement, as reflected in three straight monthly increases in residential home prices in May, June and July—something that has not occurred since 2006. New sales volumes have also been on the rise for five consecutive months through August while mortgage rates remain near historic lows.

**Stabilizing labor market**—Although the unemployment rate remains high, job losses continue to slow, averaging 256,000 per month in the third quarter compared with 428,000 in the second and 691,000 in the first.

**Positive leading indicators**—The leading economic indicators developed by the Economic Cycle Research Institute (ECRI) currently show pervasive, rapid growth, with the Institute's long-leading indicator index hitting a 26-year high.

**Favorable supply/demand for equities**—The second quarter saw the highest volume of equity issuance in 19 years—roughly \$92 billion, much of it from financial companies seeking to improve their balance sheets. Despite the large number, however, issuance was well absorbed into the market as investors increased their equity exposure. Given our expectation for relatively low issuance moving forward, we believe that supply/demand for stocks should remain healthy.

**Normalizing credit markets**—The absence of credit was a huge pressure on many companies in the wake of the financial crisis. Today, the credit markets are far more accommodating. Prices for high yield securities have increased to 90% of par (face value), compared with 55% last December, and the difference in yield between investment-grade bonds and Treasuries has returned to pre-credit crisis levels. Given the price gains that bonds have realized, we are seeing relative value in the equity markets.

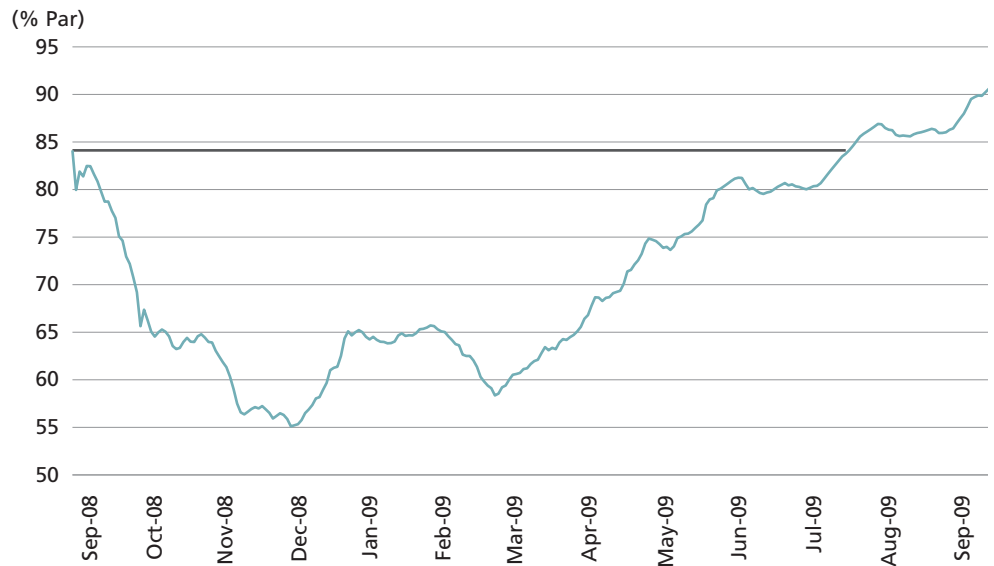
Overall, we agree with consensus estimates that the third quarter will see positive economic growth—the first time that has happened since the second quarter of 2008. Moreover, the latest quarterly earnings season indicates to us that earnings have

**FIGURE 2 — CREDIT MARKETS BACK TO PRE-CREDIT CRISIS LEVELS**

**Baa Spreads Over U.S. Treasuries**



**High Yield Average Prices**



Source: Barclays Capital. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

troughed, and that many companies are well positioned to benefit as the economic environment improves. During the economic downturn, companies were aggressive in cutting costs and reducing inventories. As a result, we believe there is considerable operating leverage (with additional revenues generating higher growth in operating income) and, thus, the potential for higher profit margins moving forward.

Despite all these positive trends, we are not anticipating an economic boom by any means. As we've said in the past, the withdrawal of cheap credit and losses in the real estate and financial markets have severely hindered the spending power of consumers. And although the labor market is stabilizing, unemployment will probably remain high as job growth lags in our current economic recovery.

As such, we anticipate that consumers will go through an extended period of "deleveraging" as they mend household balance sheets. Recent statistics are not encouraging. For example, consumer credit outstanding plunged by a record \$21.6 billion in July—the sixth consecutive decline—following a \$15.5 billion drop in June. Of course, increased savings will help households replenish their nest eggs but, from a growth standpoint, represents a long-term negative offset to the economic benefits of government stimulus.

### INVESTING FOR RECOVERY

Given the pressures faced by domestic consumers, we believe that the current recovery is most likely to benefit cyclical business sectors such as energy, technology, industrials and materials. Companies with exposure to foreign markets, recovering commodity prices and stimulus infrastructure spending should be particularly well positioned. In our opinion, consumer discretionary businesses will have a difficult time, suggesting that consumer staples companies (which sell goods needed even during times of weakness) are a more secure alternative. Still, it bears noting that emerging market populations are far less debt-laden than their established market counterparts, potentially benefiting global firms with greater exposure to emerging market consumers.

In terms of asset allocation, recent share price gains have come from across the equity markets, but the most pronounced strength domestically, as of late, has been in value and small-cap stocks. On the fixed income side, high yield bonds have been standouts. These are areas that traditionally outperform early in an economic recovery, and we believe that they will continue to show leadership for the near future. Although individual portfolios may vary depending on the investment needs of the client, we think it makes sense to maintain exposure to these areas within a diversified portfolio.

Overall, we believe this is a good time to be an equity investor. Equity markets have experienced substantial gains since March as the real estate, labor and credit markets stabilized and investors recognized the beginning of an economic recovery. Although valuations have crept up, we believe that they are reasonable when taking into account earnings projections for next year. Our portfolio managers are finding what they consider to be compelling investment opportunities in the current environment. Still, no one can predict the short-term swings of the market, so we believe that maintaining a long-term perspective, aligned closely with individual investment goals, continues to be crucially important.

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