



Richard
Bernstein

Eleven Themes for 2011

December 7, 2010

Here are our eleven investment themes for 2011. Each of these is either specifically or generally embedded in our investment strategies.

1. The US Dollar Continues to Appreciate.

Despite all the talk about debasing the dollar, the DXY Index has actually risen about 2% so far in 2010.¹ In addition, most investors remain unaware that the dollar troughed in April... 2008! We expect the dollar to continue to appreciate in 2011.

2. The US Outperforms Emerging Markets.

Although the MSCI Emerging Market Index² has outperformed the S&P 500 so far in 2010 (15.9% vs. 11.9%), the gap is smaller than most investors expected at the beginning of the year. Perhaps more important, the S&P 500 has outperformed the BRIC countries (11.9% vs. 8.7%), which few people predicted. Emerging markets are now leading the world in negative earnings surprises and remain very expensive. We expect the US to outperform the broader emerging markets universe in 2011.

3. Stocks Outperform Bonds.

Stocks and bonds have performed quite similarly so far in 2010. The S&P 500's total return stands at 11.9%, compared with the 10.4% total return of the BofA Merrill Lynch 15+ Year US Treasury Index. We expect stocks to outperform bonds in 2011 as the US economy continues to expand and as normal upward pressure on longer-term interest rates becomes more apparent.

4. Gold Produces a Negative Return.

Gold seems to be in a pure momentum market these days. Momentum markets are exciting, and the media love them, but they have a nasty tendency to fall faster than they rose. The US dollar troughed in 2008, and inflation expectations are not rising in any meaningful way. We think that next year, gold's momentum market is likely to cede the spotlight to more fundamentally-based assets like stocks.

5. Longer-Term Treasury Rates Rise by More Than 150 Basis Points.

Our work suggests that the economy is just beginning to enter the mid-phase of the economic cycle. The early-cycle was notably anemic because early-cycle industries benefitted the most from the credit bubble, but investors should remember that there *is* a cycle. Our quick review of longer-term interest rates suggests that they typically increase during the mid-phase by between 200 and 300 basis points. Even assuming weaker-than-average growth next year, longer-term rates are likely to rise substantially.

¹ All performance data as of December 3, 2010.
² See "Index Descriptions" at end of document.

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6. Energy and Materials Sectors Outperform.

If the economy is indeed beginning to enter the mid-phase of the cycle, then energy and materials stocks begin to take leadership positions. We expect both global sectors to outperform in 2011.

7. US Consumer Stocks Outperform EM Consumer Stocks.

According to one fund-manager survey we recently saw, the emerging market consumer is the most popular investment theme among emerging-market fund managers. With inflation rising and monetary policies tightening in a growing number of emerging markets, it seems unlikely that this theme will meet expectations. We continue to believe that US employment will be stronger than most investors expect next year, which could produce positive surprises for US consumer stocks.

8. Small-Caps Continue to Dominate Large-Caps Around the World.

The MSCI AC World Small Cap Index has risen 21.7% so far in 2010, which is more than double the MSCI ACWI's +10.2%. And yet, investors have generally not warmed up to smaller companies. By our calculations, US smaller companies have been outperforming China for nearly three years, have twice the 2011 projected earnings growth of China, and have half the valuation.

9. Muni Bonds Outperform EM Non-Dollar Debt.

We find it curious that investors are so enamored of local-currency-denominated emerging-market debt, since this sector of the fixed-income markets has historically been the riskiest. At the other extreme, investors widely believe that US municipal bonds are extremely risky, when they have historically been a far more conservative investment. Investors clearly believe that "it will be different this time." We are not so sure.

10. Japan Outperforms China.

This is another performance comparison that runs counter to investors' expectations. Japan has outperformed China by more than 800 basis points so far in 2010. With expectations being so high for China and so low for Japan, we expect Japan's outperformance versus China to continue.

11. The Euro Survives. Europe Recovers.

We expect the Euro to remain intact, although talks about the "second reserve currency" now seem long behind us.

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On behalf of everyone at RBA, we wish you a Happy Holiday season.

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INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

Indices are not available for direct investment.

S&P 500: Standard & Poor's (S&P) 500 Index. The S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

ACWI: MSCI All Country World Index (ACWI). The MSCI ACWI is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of global developed and emerging markets.

MSCI AC World Small Cap: MSCI All Country World Small Cap Index. The MSCI AC World Small Cap Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the small-cap equity performance of global developed and emerging markets.

EM: MSCI Emerging Markets (EM) Index. The MSCI EM Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of emerging markets.

BRICs: MSCI BRIC Index. The MSCI BRIC Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of the following four emerging-market country indices: Brazil, Russia, India and China.

China: The CSI 300 Index. The CSI 300 Index is a free-float-adjusted, market-capitalization-weighted index that consists of 300 A-share stocks listed on the Shanghai or Shenzhen Stock Exchanges.

Japan: The Nikkei-225 Stock Average. The Nikkei-225 Stock Average is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

Gold: Gold Spot USD/oz Bloomberg GOLDS Commodity. The Gold Spot price is quoted as US Dollars per Troy Ounce.

DXY Index: IntercontinentalExchange (ICE) US Dollar Index. The ICE US Dollar Index, indicating the general international value of the USD, averages the exchange rates between the USD and six major world currencies using rates supplied by some 500 banks.

Long-Term Treasuries (15+ years): BofA Merrill Lynch 15+ Year US Treasury Index. The BofA Merrill Lynch 15+ Year US Treasury Index is an unmanaged index comprised of US Treasury securities, other than inflation-protected securities and STRIPS, with at least \$1 billion in outstanding face value and a remaining term to final maturity of at least 15 years.

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INDEX DESCRIPTIONS (cont'd):

Munis: BofA Merrill Lynch US Municipal Securities Index. The BofA Merrill Lynch US Municipal Securities Index tracks the performance of USD-denominated, investment-grade rated, tax-exempt debt publicly issued by US states and territories (and their political subdivisions) in the US domestic market. Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule, and an investment-grade rating (based on an average of Moody's, S&P and Fitch). Minimum-size requirements vary based on the initial term to final maturity at the time of issuance.

EM Non-Dollar Debt: BofA Merrill Lynch Local Debt Markets Plus Index. The BofA Merrill Lynch Local Debt Markets Plus Index tracks the performance of sovereign debt publicly issued and denominated in the issuer's own domestic market and currency, other than the more established top-tier sovereign markets. In order to be included in the Index, a country must have at least \$10 billion (USD-equivalent) outstanding face value of Index-qualifying debt and at least one readily available, transparent price source for its securities. In addition, the following countries are specifically excluded from the Index: G10 member states, Eurozone member states, and all countries with a foreign-currency long-term sovereign debt rating of AA3 or higher (based on an average of Moody's, S&P and Fitch).

Sectors/Industries: All sector/industry references in this report are in accordance with the Global Industry Classification Standard (GICS®) developed by MSCI Barra and Standard & Poor's. The GICS structure consists of 10 sectors, 24 industry groups, 68 industries, and 154 sub-industries.

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