portfolio construction forum

Outlook on the United States

Ronald Temple | Lazard Asset Management | 07 January 2014

The US economy made substantial progress in 2013. Five years after the Lehman Brothers bankruptcy, the recovery appeared to have enough momentum for the US Federal Reserve (the Fed) to announce that it is sufficiently confident in economic growth prospects to reduce the amount of monetary stimulus it will inject into the financial system. While we believe it would have been wise to delay the decision to taper large-scale asset purchases a few more months, recent events justify the Fed's decision. Below, we will review the key events of the year behind. We will then highlight the key events we expect in the year ahead, and summarise our expectations for key sectors of the market.

1. THE YEAR BEHIND

Reflecting on the year behind, we see many causes for optimism regarding the US economy and equity markets.

1.1 Tapering was announced for 2014

As 2013 wound to a close, the Fed announced the beginning of the end for extraordinary monetary policy in the form of large-scale asset purchases, more commonly referred to as QE3 (for the third set of quantitative easing measures). At the close of the Federal Open Market Committee meeting that concluded on 18 December, the Fed announced that beginning in January it would reduce its monthly purchases of mortgage-backed securities and Treasury purchases by US$5 billion apiece, to US$35 billion and US$40 billion each month, respectively.

1.2 Deficits reduced

In 2013, the US federal government slashed its fiscal deficit to "only" 4% of GDP. Compared to the 10% of GDP deficit only four years earlier, the pace of improvement has been propelled by higher tax revenue driven by the combination of a growing economy and narrowly targeted tax-rate increases, as well as spending reductions.

As importantly, the US federal debt-to-GDP ratio likely peaked in 2013 as nominal GDP grew approximately as much as did federal debt outstanding. If the debt is growing at about the same pace as GDP, then debt divided by GDP stabilises.

The decreasing deficit is critical to remove a major hurdle to normalised growth in the years ahead. It also is important as it will better position the United States to begin addressing entitlement cost increases that lie ahead due to demographic factors. The bipartisan agreement in mid-December on a two-year fiscal package has added to our confidence that the United States can avoid another debt debacle like those in August 2011, December 2012, and (most importantly) October 2013, when the federal government temporarily shut down operations and flirted with the idea of a dangerous default.

1.3 Household assets and net worth reached new records

Household assets topped US$90 trillion for the first time in the third quarter, bringing net worth to over US$77 trillion[1]. Household net worth is now 50% higher than it was in early 2009.

A critical driver of balance sheet conditions for most middle-class households is residential real estate. As of the Fed's latest triennial Survey of Consumer Finances in 2010, for the households ranked in the 25th to 75th percentiles of net worth, residential real estate (i.e., their home) comprised 62% of total assets for the average household. As a result, rising home values play a key role in creating a wealth effect and increasing perceived savings levels for these 56 million households. In 2013, house prices gained further ground, and have now recouped 44% of the value lost in the financial crisis. Since house prices bottomed at the end of 2011, the housing recovery has contributed about 20% of the increase in consumer assets[1].

Owners' equity in residential real estate has now rebounded to US$9.7 trillion, or about 12% of total net worth.[1] At the peak of the housing bubble, equity in residential real estate comprised 20% of household net worth. Importantly for consumer spending, the number of home owners who owe more than their house is worth has declined from as many as 17.0 million at the low point for home values, to approximately 6.4 million, according to CoreLogic (as of the third quarter of 2013). As these homeowners recover their equity, they should regain sufficient confidence to invest in their homes or other durable assets.

1.4 Deleveraging continued

As nominal GDP continued to grow, debt-to-GDP ratios for the US private and public sector improved in 2013. Household deleveraging has been especially encouraging as the consumer debt-to-GDP ratio has declined from 95% of GDP at the end of the first quarter of 2009 to 77% in the third quarter of 2013[2]. (Prior-period ratios have been restated downward due to GDP revisions released this year.) Of the decline in the household leverage ratio, 78% of the decline resulted from higher GDP (i.e., the denominator grew) while the remainder was driven by reductions in debt outstanding[3]. Importantly, debt-to-GDP ratios only tell a small part of the debt sustainability story. We also need to consider the assets a consumer owns as well as income levels that cover monthly debt payments. As noted above, asset levels have never been higher, implying an even more substantial deleveraging. At current interest rates, it now appears to us that consumers might have reached the point where debt levels can be sustained. In fact, we might have reached a turning point in the third quarter of 2013 as household debt increased by US$116 billion, or about 0.8%[3]. This was the first meaningful increase since 2007. While we continue to expect consumer debt to grow at a pace less than nominal GDP, increases in the dollar amount of consumer debt outstanding, assuming the rise is at a reasonable pace, can be supportive of economic growth.

1.5 Exogenous tail risks continued to recede

Even while the core fundamentals in the United States strengthened, investors became much more confident in the economic outlook for the euro zone, Japan, and China. The key turning point for Europe was in July 2012 when Mario Draghi indicated the European Central Bank would do "whatever it takes" to preserve the monetary union. Since then, expectations for economic stabilisation have strengthened with the consensus view predicting real GDP growth in 2014. Abenomics gained steam in Japan through the year, with the July elections being a high point for Prime Minister Shinzō Abe's Liberal Democratic Party when it won a majority in the upper house of the Diet, cementing its control of government for the ensuing three years. Lastly, China held the Third Plenum of the Chinese Communist Party in November, and enthused investors by announcing wide-ranging economic, political, and social reforms, reinforcing confidence that China can avoid a hard economic landing in the near term.

1.6 Equity markets roared to new record levels

Amid these positive drivers, along with valuation expansion, the S&P 500 Index and other key indices reached new record highs in 2013. While we would not argue for further valuation increases for the market as a whole, we would assert that the current valuations appear reasonable considering the substantial decrease in macroeconomic and political risks that has occurred globally in the last 12 to 18 months. Moreover, relative to many fixed-income investments, equities continue to look more attractive from a risk/reward perspective.

2. THE YEAR AHEAD

2.1 Monetary policy

We continue to believe a self-governing feedback loop exists in which monetary policy affects markets for interest rates and other assets, which feed through to economic conditions, which then ultimately drive decisions about monetary policy. The decision to begin normalising monetary policy will likely reduce US growth in 2014. However, we are optimistic that the Fed struck the right balance in its statement, in terms of a gradual reduction in bond purchases alongside a pledge to keep the federal funds rate low well past the point when unemployment falls below 6.5%.

Our current expectation is that the Fed is likely to continue adding bonds to its balance sheet through 2014. We believe it will then begin to allow the balance sheet to shrink in the middle of 2015 by reducing the degree to which it reinvests proceeds from maturing bonds that it owns. Ultimately, we believe the Fed is unlikely to raise the federal funds target rate until late in 2016, after it has allowed the balance sheet to shrink and utilised reverse repurchase agreements and other tools at its disposal to reduce the amount of money supply in the financial system. At that point, it will be easier for the Fed to begin more forcefully applying brakes to monetary policy by raising interest rates.

Importantly, we believe the Fed's own expectations for economic growth have finally reached reasonably realistic levels. Since June the long-run real GDP growth forecast (defined as beyond 2015 for the June forecast, and beyond 2016 for September and December forecasts) from key Fed members has declined from a range of 2.0% to 3.0% to a range of 1.8% to 2.5%. We have long expressed our view that the three secular themes of deleveraging, re-regulation, and widening gaps in society were likely to lead to US economic growth ranging from 1.0% to 3.0% in any given quarter, with a central tendency of 2.0%. We consider this level of growth to be consistent with population growth of about 0.75% and productivity growth of 1.0% to 1.5%. To the extent we are correct, perhaps the Fed's forecasts of its own monetary policy are likely to be more dependable.

2.2 Fiscal policy

We expect the US deficit in 2014 to be less than 4% of GDP, while GDP is expected to grow by approximately 4.5% in nominal terms (nominal GDP is the appropriate comparison, as deficits are measured in nominal terms as well). As a result, we expect the federal debt-to-GDP ratio to decline in 2014 for the first time in over six years. Risks remain on the federal front as the debt ceiling will likely be reached in February of 2014, but we believe the very negative public reaction to the partial federal shutdown in October will likely preclude another similar drama.

We also expect the continued healing for state and local governments to be beneficial, as higher home prices lift property tax revenue, and improving growth adds to income and sales tax receipts. While the fortunes of state and local governments already turned in 2013, we believe they can aid job growth in 2014 as they re-hire personnel who had been terminated during the crisis.

2.3 Housing

As the year ends, the average conforming 30-year fixed mortgage stands at an interest rate of approximately 4.6%, or about half a percentage point above the average rate for 2013. Assuming rates stay in a range of 4.5% to 5.0% in 2014, we would expect mid- to high-single-digit home price appreciation, as measured by the S&P/Case-Shiller 20-City Composite Home Price Index (the home price index).

However, we would caution against assuming uniform price increases. We expect to see continued muted price increases in judicial foreclosure states with large backlogs of delinquencies that still need to be cleared. As a reminder, in a judicial foreclosure state a lender has to appear before a judge to foreclose on the property, whereas in other states the legal processes are generally much more expedited and handled by clerks (or even through automated processes). The worst states for backlogs include Florida (12.6% of loans are seriously delinquent [over 90 days past due] or in foreclosure), New Jersey (12.1% are seriously delinquent or in foreclosure) and New York (9.25% are seriously delinquent or in foreclosure)[4]. These three states are home to a substantial portion of home value in the United States (we would estimate approximately 25% of all value).

On the other extreme, there has been sharp price appreciation in many non-judicial states where prices overshot to the downside during the financial crisis. In these states, it was a quick process for lenders to foreclose and place homes on the market at the point when the demand for housing was weakest. This excess distressed supply led to an extreme decline in prices, much of which has now reversed. For California, in particular, home price index levels have recouped as much as 60% of the losses incurred in the crisis. In the most desirable areas, prices have actually reached new highs. We expect these price gains to decelerate substantially as affordability is becoming stretched in some markets. In addition, there are fewer distressed units on the market, and even fewer buyers of such units, as the economics of investing in distressed real estate have become less attractive.

In spite of the price deceleration, or perhaps even because of it, we expect increased construction activity in 2014. Population growth rates for non-institutionalized civilians continue to exceed household formation rates by a two-to-one margin[5]. To the extent job growth is sustained at recent levels, we would expect the pent-up demand for housing to be unleashed as recent college graduates seek their own apartments for rent and as other renters and home owners gradually develop the confidence to either make their first home purchase or to upgrade to a better home. We do not expect to see this pattern in the early part of the year, but would anticipate a ramp-up in household formation rates and demand for housing units in the second half of the year if current economic expectations prove correct. The National Association of Home Builders Housing Market Index confirms our expectation, with the index now at levels that are the highest since late 2005 when the housing boom was still in full swing. All components of the index (present sales, next-six-month sales, and prospective buyer traffic) remain very strong.

2.4 Job growth

Putting all of these factors together, we would expect to see job growth continue to improve in 2014. One area where we are confident is government employment. As recently as late 2011, state and local governments combined were shedding 30,000 employees each month, a substantial headwind to aggregate job growth. As we exit 2013, this figure has reversed to net gains of 9,000 employees each month (using a six month average).[6] We are encouraged by this shift as it removes a headwind to aggregate employment growth that had obscured private sector job gains in recent years.

Moving beyond government, we are also confident that construction-related employment should increase in 2014 as residential and non-residential building rates improve. There has already been a pickup of 400,000 construction jobs since early 2011 to 5.85 million employees, but total employment remains far below the 7.71 million peak in 2007.[6] We continue to believe job growth will ultimately jump-start a virtuous cycle in which increased employment allows people to consume more goods and services, which in itself creates more jobs and labor pricing power. Fortunately for the companies in which we invest, labor pricing power remains relatively weak, but we also believe we are nearing an inflection point at which higher wages that lead to better revenue growth outweigh the benefits of higher margins obtained from weak labor pricing power.

2.5 Healthcare utilisation and cost trends

The implementation of the Affordable Care Act (ACA) will clearly be a focal point of research for our health care team in 2014 as the implications are far-reaching across the sector. We also will focus on evolving trends in health care utilization and inflation, which have shifted over the last two to three years. These trends are independent of the act to a large degree, but the ACA might actually be accelerating them.

Based on the National Health Expenditure data from the Centers for Medicare & Medicaid Services, national health care spending has decreased substantially from an average rate of 7.1% from 2000 to 2008, to a rate of 3.9% from 2009 to 2011. More recently, there has been a substantial deceleration in the underlying inflation rate for medical care services as reported by the Bureau of Labor Statistics in the monthly Consumer Price Index releases. As of November 2013, the medical care services year-on-year inflation rate has decreased to 2.6%, the lowest level in over 40 years, as consumers decreased their consumption of medical services. There are certainly some cyclical elements to this reduction as the unemployed or underemployed might not have enough money for a co-payment for services, and hence delay treatment. If we are correct in our expectation of strengthening job growth, we should see the pent-up demand for these services be satisfied.

However, we believe there is an important structural change underway in the American medical system. On the demand side, more employees are choosing to enroll in high-deductible health insurance programs (more formally known as consumer-driven health plans). To the extent consumers are becoming more aware of and accountable for the cost of medical care, we would anticipate a sustained reduction in the growth rate of medical care usage, especially as it relates to discretionary services. On the supply side, more health care providers are adopting a compensation model in which they are paid for comprehensive care rather than on a fee-for-service basis. This shift to fee-for-value arrangements disincentivises excessive utilisation of services, and is likely to cumulatively lower spending on care over time. On the Aon Hewitt private active employee exchange, when employees had the choice to select their own health plan, 39% of employees enrolled in high-deductible programs versus only 12% of employees who did not have the same range of choices off of an exchange. While the Aon Hewitt analysis includes only approximately 100,000 individuals, and hence is not as comprehensive as we would like, it could be an early indication of the structural change we are hoping for.

The implications of a change in healthcare inflation and utilisation would reverberate through the entire US economy. For employers in the private sector, lower health care utilisation and inflation would directly reduce an expense that has grown at a multiple of the overall Consumer Price Index for several decades. This competitive disadvantage for American companies is substantial as US spending on health care is 50% to 150% higher per person than in other developed countries, implying a relatively large expense disadvantage for employing American labor in the production of goods and services[7]. The combination of savings in the private sector, and decreased inflation and utilization should reduce the long-term entitlement burden on the federal government as Medicare and Medicaid would benefit from a reduction in future price increases. We believe this emerging trend is a significant and underappreciated potential tailwind for future US economic growth, federal deficit reduction, and profitability for American companies.

2.6 Broad sector strength

If we look at 2014 through the lens of industries, we have consistently optimistic, albeit perhaps a bit muted, expectations. It is always important to remember that over 30% of S&P 500 Index revenue is not derived from US activities. As such, the continued economic lethargy in Europe is a drag on growth, and the decelerating growth of emerging markets is also a relative headwind. That said, we continue to expect mid-single-digit growth in revenue for the US investment universe. Following are our high-level observations for each sector, based on thoughts from our US analysts.

Consumer Staples

- We expect 4% organic sales growth across the US consumer staples sector in 2014, with significant variance across companies.
- In beverages, we anticipate volume improvement from 2013 levels and continued strong price and marketing mix, particularly for beer. In food, we look for a volume recovery, but more muted pricing given little-to-no increases of input costs. For household and personal care (HPC), the outlook is very company specific, but broadly there is a more difficult pricing environment partially offset by volume improvement.
- For operating margins we expect 30 to 50 basis points (bps) of margin expansion for the sector. This is largely driven by packaged food companies, which should have a

jump in gross margins due to lower input costs and efficiency programs. Beer companies in particular should also benefit from improved volumes, stronger pricing, and minimal input cost increases. HPC companies will have a more difficult time expanding margins, given the competitive environment and no tailwinds for input costs.

- We believe earnings per share (EPS) for the sector should grow 8% to 10% in 2014, driven by the 4% organic sales growth, margin expansion, and debt pay-downs and share repurchases. We anticipate earnings growth slightly short of consensus expectation, which is just below 10%.

Consumer Discretionary

- We expect revenue for the sector to grow at least in the low single digits, with significant variance across the various sub-sectors.
- Media should continue to benefit as long as overall economic growth is moderate and companies are forced to fight for share through marketing initiatives.
- Sales growth is likely to continue accelerating for hardline consumer producers at the expense of softlines as a category. There have been many years of underspending with regard to hard goods ranging from renovations and other home improvements to auto purchases. We expect this pent-up demand to be unleashed as home price recovery translates into higher consumer confidence and willingness to spend.
- The fundamentals for softlines look unfavorable, in our opinion. We are especially concerned about apparel manufacturers who have increased prices for multiple years now, and it is unclear if revenue will grow at a pace consistent with recent history if volume growth does not improve from current levels.
- We expect margins to be modestly higher, which should lead to earnings growth of high single digits when combined with a fair amount of company share repurchases.
- Consensus expectations are for earnings to increase in the mid-teens. We believe this number is too aggressive relative to our expectations, and believe that consensus extrapolates too favorably from prior top-line growth rates.

Financials

- Consensus revenue growth is approximately 2% for the entire sector, with earnings growth of 7% to 8%. We believe these expectations are reasonable, though underlying macroeconomic assumptions behind the consensus are difficult to validate.
- For money center banks/major brokers, expectations of 21% net income growth and 2% revenue growth are in line with our expectations. The major divergence between the revenue and earnings growth is largely related to lower litigation expenses and continued decreases in credit costs (which include reserve releases and lower net

charge-offs in some cases).

- Commercial banks are likely to squeeze out 1% revenue growth, 2% to 3% net income growth, and 3% to 5% EPS growth in 2014. The critical assumption underlying this forecast is that the Fed does not raise interest rates in 2014, and that loan growth remains lower than nominal GDP growth as consumers deleverage. EPS growth is higher than net income, as we assume regulators will continue allowing banks to return more capital to shareholders through buybacks.
- Insurance prospects diverge between non-life and life companies. In non-life, we expect revenue to grow slightly and net income to decline by 4% amid more normal catastrophe losses. For life insurance companies, we expect 3% revenue growth and 7% net income growth due to benefits from equity market appreciation and slightly higher yields on debt assets due to tapering.
- We believe real estate investment trusts (REITs) should deliver 7% revenue growth and 7% growth in funds from operations (FFO). Commercial real estate fundamentals are still recovering, and supply remains at historically low levels. To the extent supply increases, expectations could be at risk. Additionally, higher rates could dampen fundamentals, but we feel that this is not a fiscal year 2014 issue.
- We expect consumer finance companies to deliver 2% revenue growth and a 2% to 3% decline in net income. Revenue growth is driven by only modest balance sheet expansion as consumers continue to deleverage. Net income expectations are lower relative to those for fiscal year 2013 due to significantly lower credit reserve release assumptions.

Health Care

- We expect low-to-mid single-digit revenue growth for the sector, driven by easing comparable sales from the continuing roll-off of drug patent expirations, growth from new product innovations, and growth from newly insured Americans entering the healthcare system under the ACA.
- Among biotechnology, pharmaceutical, and medical device companies, there is a reasonably wide variance in revenue and EPS growth rates. For example, we expect large-cap biotechnology companies to post the most robust growth amid new product introductions. We anticipate consensus expectations for strong double-digit growth might actually be too low for these companies. In comparison, mature pharmaceutical companies are likely to generate low-single-digit revenue growth, as patent expirations partially offset the positive impact of new product introductions. The bigger driver of stock performance among these companies is likely to be based on capital deployment strategies, coupled with continued improvement in research-and-development productivity. For medical device companies, expectations for low-to-mid single-digit revenue growth are likely to be met, as the broader healthcare

utilization environment remains relatively tepid. Prudent capital deployment remains a key lever for shareholder value creation in this subsector. Companies most impacted by the ACA are healthcare services (e.g., hospitals, managed care, pharmacy benefit managers, etc.) and medical device companies. Growth expectations in these subsectors have the greatest potential for variation from expectations given the uncertainty around healthcare reform implementation. In the managed care group, we expect high-single-digit revenue growth as the industry benefits from coverage expansion under the ACA, but low-single-digit earnings growth as margins contract from increased regulations and negative product mix shift. For the PBM industry, we expect low-single-digit revenue growth and high-single-digit earnings growth as the increase in generic drug introductions drives incremental profitability. For healthcare providers (hospitals, labs, and other providers), we expect mid-to-high single-digit revenue growth and mid-single-digit earnings growth, as ACA-related benefits (e.g., coverage expansion) are offset by deteriorating underlying fundamentals (such as weak volumes and reimbursement pressure).

Industrials and Materials

- For industrials, there is a wide range of dispersion in the sector overall. In aggregate, we expect organic revenue growth of 3% to 4%, with improvements in the United States and Europe, and continued growth in the emerging markets. We expect margins to expand modestly from already high levels with volume, leverage, and productivity as positives, price versus input costs neutral to slightly positive, and mix negative. Finally, we expect 10% underlying earnings growth plus approximately a 2% benefit from capital allocation (i.e., share repurchases and acquisitions). Our view of 12% earnings growth is generally in line with consensus. For materials, we expect organic revenue growth that varies by industry (chemicals, paper, and metals), but is generally between 3% to 5%. We believe earnings will grow at a mid-single-digit pace, and some may benefit from capital allocation (i.e., share repurchases and acquisitions), equating to 4% to 7% earnings growth. Our view is lower than consensus, likely because we assume there will be no change in commodity prices while others expect commodity price increases.

Energy

- The consensus view of 10% to 15% EPS sector growth looks reasonable to us as a base case. We expect slightly lower oil prices and slightly higher US gas prices to translate to a slight decline in revenues. There is potential for a more negative oil price scenario if North American production continues to grow and Libyan and Iranian volumes return to the market. Subsector outlooks will differ significantly.
- Integrated oils are likely to have small production gains. Downstream profits in the United States are likely to be good due to wide price differentials, but weak outside the country due to overcapacity. Overall, we expect limited revenue growth and some

margin pressure due to cost inflation.

- Exploration and production (E&P) companies are likely to have strong revenue growth due to rising US production, as well as margin expansion. In particular, shale-focused E&Ps are expected to have high volume growth (20% to 30%), driving revenues and cash flow. That said, there are downside risks to oil prices that could throttle back revenue and cash flow growth.

- For oil services, we would expect high-single-digit revenue growth and modest margin expansion as US activity rebounds. E&P capital expenditure growth is the key driver, and is expected to be close to 10% growth in 2014; oil services revenue growth should be relatively in line with that pace. Earnings growth expectations for most of the big companies are high at 20% to 40% next year due to continued recovery off of depressed utilization in the United States, higher margin leverage from deepwater rigs coming online next year, and international growth, particularly offshore Middle East gas drilling.

Information Technology

- In technology, revenues and EPS should grow more rapidly in 2014 than in 2013. Performance in 2013 was poor due to pockets of weakness in emerging markets and government.

- We believe revenue growth will be driven by both developed and developing markets, although developing markets will still grow at a multiple of developed markets. We expect choppy growth from hardware and semiconductor companies, and more positive growth (mid-to-high single digits) for software and Internet companies.

- We expect margins to be flat or slightly higher depending on the sub-sector, but overall cost discipline will remain. Within the over-capitalized larger-cap companies, cash continues to be used for buybacks and dividends, while smaller companies may continue to pursue mergers and acquisitions. With greater cost discipline and more stock buybacks, we do see the prospect for mid-to-high single-digit EPS growth at a minimum.

3. OUTLOOK

In summary, the economic outlook for 2014 appears promising at this point, with only exogenous risk factors and the potential for another debt ceiling disruption standing out as meaningful near-term risks. We acknowledge that the risks that are most dangerous are often the ones that surprise investors, but at this point we are quite optimistic that the operating backdrop for companies should continue to improve in 2014.

Clearly, the equity market has appreciated substantially in 2013, with a 32% gain for the S&P 500 Index, implying that we are not the only investors with positive expectations. That being said, we believe the market can continue to appreciate from current levels given earnings growth driven by moderate revenue growth, strong expense controls, and disciplined capital management. While we continue to believe the three secular themes of deleveraging, re-regulation, and widening gaps in society are headwinds to growth, it appears that economic and company fundamentals are strong enough to overwhelm these challenges. We continue to seek investments with strong balance sheets, robust organic cash flow, and operational flexibility to capitalise on the economic growth we foresee, and we remain enthusiastic about the range of choices available to investors today in the US equity market.

ENDNOTES

1. Source: US Federal Reserve, Financial Accounts of the United States, as of September 30, 2013.

2. Source: US Federal Reserve, Bureau of Economic Analysis, and Haver Analytics. As of September 30, 2013.

3. Source: US Federal Reserve, Bureau of Economic Analysis, Haver Analytics, and Lazard. As of September 30, 2013.

4. Source: Mortgage Bankers Association and Haver Analytics, as of September 30, 2013.

5. Source: US Census Bureau, Haver Analytics, and Lazard.

6. Source: Bureau of Labor Statistics and Haver Analytics.

7. Source: Organization for Economic Co-operation and Development, The Commonwealth Fund, and Kaiser Family Foundation. As of 2011.

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Outlook In summary, the economic outlook for 2014 appears promising at this point, with only exogenous risk factors and the potential for another debt ceiling disruption standing out as meaningful near-term risks. We acknowledge that the risks that are most dangerous are often the ones that surprise investors, but at this point we are quite optimistic that the operating backdrop for companies should continue to improve in 2014. Clearly, the equity market has appreciated substantially in 2013, with a 32% gain for the S&P 500 Index, implying that we are not the only investors with positive expectations. That being said, we believe the market can continue to appreciate from current levels given earnings growth driven by moderate revenue growth, strong expense controls, and disciplined capital management. 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As of September 30, 2013. 4 Source: Mortgage Bankers Association and Haver Analytics, as of September 30, 2013. 5 Source: US Census Bureau, Haver Analytics, and Lazard. 6 Source: Bureau of Labor Statistics and Haver Analytics. 7 Source: Organization for Economic Co-operation and Development, The Commonwealth Fund, and Kaiser Family Foundation. As of 2011. Important Information Published on 7 January 2014. This report is being provided for informational purposes only. It is not intended to be, and does not constitute, an offer to enter into any contract or investment agreement with respect to any product offered by Lazard Asset Management, and should not be considered as an offer or solicitation with respect to any product, security, or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited. 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