Eaton Vance Investment Managers

Eaton Vance Viewpoint October 1, 2009

Market Insight

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"Healing is a matter of time, but it is sometimes also an opportunity."
– Hippocrates

On the heels of a strong second quarter, U.S. equities showed further signs of life in the third quarter of 2009, registering positive returns across investment styles and market capitalizations. The Standard & Poor's 500 Index[1] gained roughly 14%—the first time in two years that the S&P 500 posted back-to-back quarterly increases. After a disastrous start to 2009, the S&P 500 is now up nearly 18% on a year-to-date basis and 55% since its March 9 low. The stock market continued to advance in synch with positive trends in the credit markets but, from here, gains in all markets may be harder to come by.

In light of the equity market's vigorous rebound, some may assume the economy is well along the path to full recovery. Recent vital signs are better: Household net worth rose for the first time since the second quarter of 2007; U.S. retail sales and producer prices came in better than expected; and housing and unemployment data have stabilized. **But**, these numbers are only better because our government and the world's central banks have taken creative and extraordinary means to breathe life into the financial system and reverse the sickening slide of earlier this year. While Eaton Vance agrees that the U.S. economy is out of the emergency room, we are not yet convinced it has emerged from intensive care, and we are far from being ambulatory.

Our concern is this: What happens as we wean the patient from the artificial support stimulus? Businesses, consumers and investors have all pulled back to an unprecedented degree during this recession. Beyond an inevitable rebuilding of inventory, will there be follow-through of end market demand, or will the economy relapse into a double-dip recession? We face a tricky transition over the next several quarters. The near-term course of the economy is unknowable at present and heavily dependent on future policy actions. We try to assess "policy risk" in our fundamental analysis of industries by paying close attention to Washington and developing earnings scenarios for individual companies.

For instance, the government's involvement in financials, health care and energy is at unprecedented levels. Collectively, these three sectors amount to a considerable percentage of gross domestic product (GDP). Any further policy actions could have a tremendous influence on the earnings power of companies in these industries—and on the market as a whole. In our view, the potential for bad policy decisions (and thus continued volatility) has never been higher. We feel fortunate in this environment to have retained a talented team of research analysts who can help us find attractive investment opportunities and attempt to use the market's volatility to our clients' advantage.

Eaton Vance remains cautiously optimistic that both the market and economy are on the road to recovery. While the healing process may be slow and involve some setbacks, we are seeing many attractively valued companies for longer-term investment.

Sector Outlook

Currently, we're finding some of what we believe to be the best growth prospects and risk/reward ratios in the **technology** sector. Demonstrating they learned their lesson from the tech crash early in this decade, tech companies responded aggressively to the latest market downturn—conserving cash, spending capital on investments, and right-sizing their workforce. This could set the stage for tremendous earnings leverage if the recovery does take hold. There are further reasons for optimism as well. It's been almost a decade since the first real corporate rejuvenation of technology infrastructure. The potential for a new corporate spending cycle on tech and low "policy risk" makes us optimistic about the sector.

We're less sanguine about the longer-term prospects for **financial services**. Unfavorable capital ratios, solvency issues, and future known write-downs are just some of the negatives. Additionally, we believe new regulations will almost certainly lower the amount of allowed leverage, thus reducing rates of return. While the sector has made a recovery off its death bed, there is, in our view, a definite need to be selective here.

In **energy**, we favor some of the larger, more-established energy companies for their cash flows and dividend-paying characteristics. Near term, the companies have solid fundamentals supported by what we believe is likely to be a secular rise in the price of the underlying commodities. Alternative energy is an interesting area to look into; however, there is a danger that faddishness gets ahead of fundamentals in new, emerging industries that are supported by government programs and financing that can change with a stroke of the pen. One has to be careful with valuations, but for those with a higher risk tolerance and for small- and mid-cap investors, we believe there are opportunities to be found in alternative energy.

Although the stock prices seem to be reflecting a worst-case government overhaul, we believe the **health care** sector has some compelling opportunities. In its favor is an undeniable demographic that we believe, over time, should continue to drive revenues upward. The industry has relatively high profitability and tremendously strong cash flows—a key driver of a company's ability to deliver both earnings and dividends. Recent merger activity in the sector suggests that further consolidation and cost cutting lie ahead, potentially creating upside earnings surprises from currently low expectations.

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Eaton Vance Approach

Regardless of the near term economic outlook, we will continue to adhere to Eaton Vance's time-tested, disciplined principles of investing. We will continue to follow our disciplined investment process—constructing our equity portfolios one stock at a time, basing our investment selections on fundamental proprietary research, and seeking to avoid unnecessary risk. Above all, whatever the short-term economic environment, we will remain firmly focused on the essential tenet of our equity investing philosophy, that we will best serve our clients by seeking to deliver consistent returns with reduced risk over the long term.

Sincerely,

Duncan Richardson, CFA, Chief Equity Investment Officer

[1]The Standard & Poor's 500 Index is a broad-based, unmanaged market index of common stocks commonly used to measure the performance of the U.S. stock market.