



*“For every problem there is a solution  
which is simple, clean and wrong”*

- Henry Louis Mencken, American Journalist -

## QUARTERLY COMMENTARY | THIRD QUARTER, 2011

### Executive Summary

- Just as we had expected, the torrid pace of economic recovery that took hold after the March 2009 market lows has petered out. The Herculean stride of global deleveraging, undertaken mainly by the OECD countries, has and will continue to put a damper on economic growth for some time to come.
- We see the global economy making a wavering recovery in this post-financial-crisis world. The factors are straightforward. In a typical cyclical recession, recovery followed by a stimulus palliative tends to be quick and effective. But post-crisis recoveries are a different beast entirely. They can limp on for years with fragile growth and substantial output gaps.
- Many economists, in fact, have labeled the recent global slowdown a transient soft patch, believing that only further monetary and fiscal stimuli will provide the necessary escape velocity for the economy to reach sustainable growth. We believe that a more appropriate analysis of the post March 2009 lows will conclude that the recovery was a transient growth patch, making this recent “soft patch” the True Normal. Unlike our brethren at PIMCO, whose “New Normal” paradigm depicts the Emerging Markets, especially in the Asia Pacific region, as magically immune somehow from the structural ills of the globe’s latter-day crosscurrents and underpinnings, we believe that even the Emerging Markets are well advised to take notice.
- Global policymakers find themselves ill equipped to handle the new challenges of this global macroeconomic environment. They putter on in reactive mode, skirting politically unpopular proactive solutions, their thinking confined to short-term election cycles rather than spread-out structural trends.
- So we ask the question: With the US mired in public/private balance-sheet malaise, the Eurozone in debt malignancy, the globe itself in a trauma of imbalances, what can we expect from our policy solons? Solutions — or another left-tail crisis skulking around the corner?

- ***As we have written numerous times before, global imbalances and sovereign debt were not the problems, although they have become the problem. They are more a manifestation of the problem.*** The barely-there ghost of an institution that we call the International Monetary system is designed to breed these global imbalances and shocks and exogenous left-tail events that bring financial crises to the daily breakfast table.
- ***And so our clients rightly ask: How are we positioned for this uncertainty and increased volatility? Our watchword at TwinFocus is that crisis breeds opportunity — opportunity for the global investor who is both patient and well-positioned.***
- Our investment philosophy is to position for **multiple scenarios**, with strategic positions at the core, and satellite positions for opportunistic alpha exposure at the margin. Our bias, at least for the moment, is that headwinds will blow harder than tailwinds in the great global Tug-of-War, yet there is every reason to stick with global equities as long as growth vectors do not plummet.
- However, US presidential elections, the change of Chinese leadership in 2012, and the current stage of the US earnings cycle are likely to boost capital markets for another 12 to 18 months at least, since earnings will continue to be fairly positive as long as the global economy steers clear of a double dip, which we think it will.
- Our portfolios are thus oriented to overweight US Equities (enjoying the safety of large-caps multi-nationals in particular) and marginally underweight both International Developed and Emerging Markets.
- On the Credit and Fixed Income side of the portfolio equation, we hold ourselves apart from the consensus pack — and we feel ever more confident as events unfold. **While there are compelling reasons to believe that US Treasuries are grossly overvalued (from a historical perspective at least), we are firmly convinced that traditional bond concepts and calibrations bring misleading results when used to measure Treasury value.**
- We're parking ourselves on the cautious side when it comes to commodities, and industrial commodities in particular. Among our reasons are slower global growth, a cyclically stronger/stable USD, subdued inflation fears as central banks pare back monetary inflation, and the resolution of short-term supply issues. The one exception here is gold, based on our underlying premise that gold is no longer a real commodity, but functions more like a safe asset and reserve-currency alternative to fiat currency within the constraints of our International Monetary System. We therefore remain fully invested in gold and would look to add to precious metal related strategies upon valuation pullbacks.

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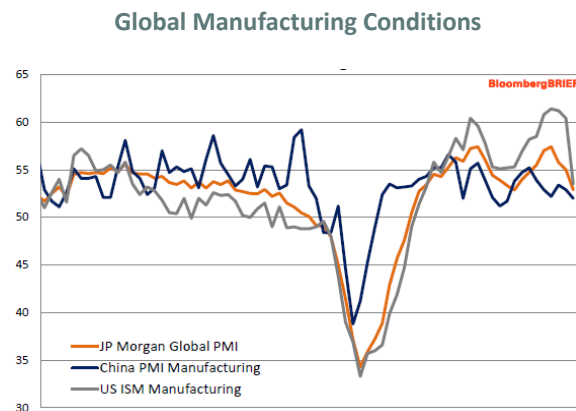
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## I. Global Capital Markets | Introduction

During the first quarter of 2011, we witnessed a strong recovering global economy, with robust growth going into the start of the second quarter. **However, things really slowed down as the second quarter came to a close.** The most recent economic releases point to a newly appearing *soft patch*, not just in the US, where housing, consumer confidence, employment and manufacturing are all trekking south, but in many other parts of the world as well. We’ve had negative surprises from countries as diverse as Korea, India and China, Spain and Norway, and even the sizzling export economy of Germany, where the ECB remains hawkish. As shown below, Chinese, US, and Global PMI readings have all veered sharply negative in recent weeks. While the three indicators are still above the all-important 50-level which divides growth from recession, the trends look like we may breach those levels very soon.



So we must ask ourselves *whether this soft patch is the first sign of a perfect storm brewing.* Are we facing headwinds that will converge simultaneously on the already-fragile global economy? Look at the debt ceiling and unemployment in the US, at Chinese inflation and potential slowdown, at Eurozone debt restructuring and bailouts, at increased commodity prices and stagnation in Japan. And then we have the end of QE2, which has been identified as a major catalyst for this massive risk-on rally since August of 2010.

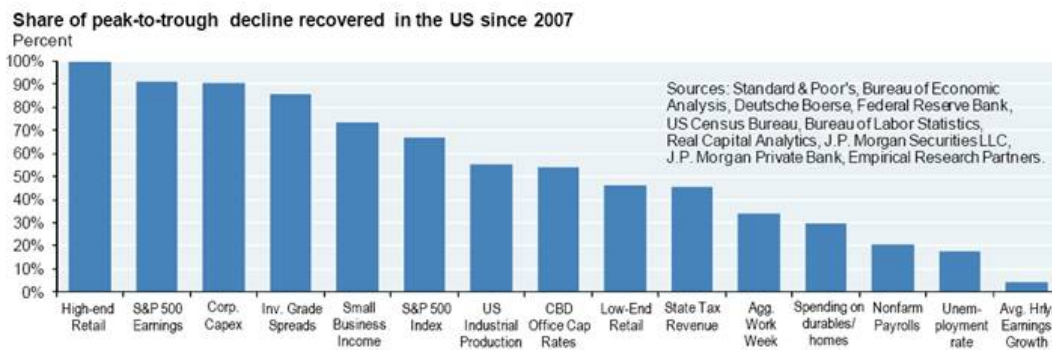
Yet despite the uncertainty still embedded in economies across the world, capital markets have been able to climb the wall of worry and stage a powerful bounce from the June lows in just the last week of the quarter. This was thanks to tailwinds like positive earnings from US companies, stopgap Greek sovereign-debt bailout measures, a shy but positive reversal in US manufacturing and employment data, China’s Premier Wen Jiabao signaling a

potential end to China’s tightening cycle, and a bit of last-minute window dressing from portfolio managers. And here are some of the catalysts that *could* keep the rally rolling on into the second half of the year:

- Finalization of the Greek bailout that will allow release of IMF funds and dissipate the threat of an immediate default, translating into temporary good news for the Eurozone banking sector;
- An all-important earning season that will provide for continued strong earnings growth momentum and positive forward-looking guidance;
- A Japanese economy that will avoid recession and resume growth;
- More positive US data prints on employment, manufacturing, retail sales and housing showing that June was a mere *soft patch* on the longer-term path of normalized growth;
- Pullback on oil, agricultural and other commodity prices, providing relief to the global economy;
- Evidence of a soft landing and tame inflation prints in China and other Emerging Markets; and
- Major elections in the US, together with Chinese political changes in 2012.

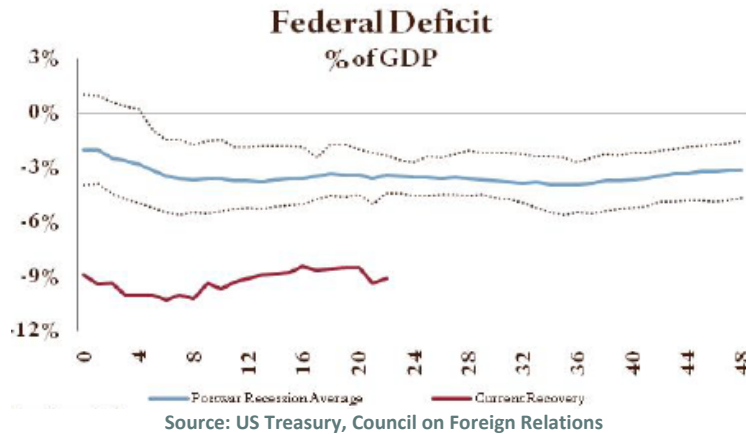
A confluence of these catalysts can fuel more risk taking and bring another powerful leg-up in risk assets. On the other hand, they could fail to materialize in the face of global headwinds that prove too powerful. For these reasons, we view the broad global macroeconomic environment as mercurial — uncertain and risky. What’s more, what makes prognosticating in this environment even more difficult are the fuzzy family resemblances between this period of economic recovery and previous post-recessionary periods. Before we declare that *it’s different this time*, or that we now dwell under a “*New Paradigm*,” it helps to compare some actual numbers.

If we line up this economic recovery with past recovery periods, a pattern sledgehammers out: this recovery has been a lot weaker and less robust. JP Morgan recently conducted research on how several items have recovered relative to their peak-to-trough declines since 2007.



Here we see that while high-end retail and the S&P earnings have captured most of their lost ground, important metrics such as wage growth, employment, state tax revenues and housing have far to go. And these are all factors that will weigh heavily on the sustainability of any recovery. ***Lastly we have to keep in mind that this anemic recovery was fueled by an unprecedented stimulus that doubled the federal debt/GDP since 2007.*** As the chart

below reveals, the current federal deficit (red line) is running almost 3x the average deficit (blue line) observed in previous post-war cases.



Here we're raising questions and conundrums about our economic environment — bullish *and* bearish alike — that only hint at the complexities, vacillations and uncertainties that face us as we look ahead. Have we merely hit a *soft patch*, or is this a clarion call of rougher times to come? In the pages that follow, we'll address these issues with their effect on investment portfolios in our sights, studying the immediate landscape while looking at the broader continent ahead.

## II. Global Macroeconomic Outlook | Executive Summary

### United States

- The slowdown in US economic activity progressed through the second quarter. There may be a modest jolt upwards in the second half from tailwinds blown by somewhat lower energy prices, recovered supply chains after the Japanese earthquake, and a potential political deal in the US debt/fiscal debacle in Washington. But over the longer term, we see domestic demand hovering below trend as households are squeezed by weak real wage growth, poor employment prospects, a deleveraging process still in its early stages, and by restrictive US fiscal policy.
- For these reasons, we expect US core and headline inflation to stay largely in check for the foreseeable future. Interest rates will remain low, as the Fed is likely to keep interest rates near zero in the months ahead. There may be a rebound in economic activity in the third quarter thanks to falling commodity prices, bringing about an uptick in jobs growth, but it won't be strong enough to ratchet down the unemployment rate in any way we can feel. In fact, such jobs growth may be curtailed by lower purchasing demand if the consumer confidence indicators we've seen are any crystal ball of things to come.

## Europe

- Prospects for the Eurozone region, not surprisingly, are more dour than they are in the US. Even a cursory first look shows Eurozone growth easing, in stride with the slowdown in global trade generally. Even the German export powerhouse may not be able to keep the sluices flowing at their past rate. The strength of the euro only exacerbates the slowdown in export growth.
- Granted the relief of the recent Greek restructuring, there remains an increasing likelihood that other peripheral countries will need restructuring as well. The malaise may spread to core countries such as Italy and France, where we have seen a blowout in CDS spreads. Markets show increasing concern about Italy and Spain, and some market solons are even putting France on the endangered list.
- Meanwhile, growth in the core Eurozone countries, which was very strong in the first half thanks to stronger exports, appears to be slowing quickly. Even Germany's leading indicators have fallen off in the past few months. We see Eurozone growth falling below 1.0% in 2012 and 2013.
- Markets have been spooked by the ECB's aggressive tightening posture, which has put upward pressure on the euro. In the midst of the crisis, the ECB threatened to accept Greek debt as collateral, rejected QE, and has increased interest rates at the very time the region is going through debt deflation.

## Emerging Markets

- The outlook for Emerging Markets looks brighter than for Developed Markets, in part because of stronger domestic balance sheets. But even Emerging Markets will be showing slower growth, though with a softer touch on the brakes. Happily too, Emerging Market inflation should peak in the coming months, allowing central banks to ease up on their restrictive monetary policies.
- While growth in China has continued to slow, recent second quarter GDP data helped ease fears of an imminent hard landing. The slowdown stems partly from credit tightening over the last 18 months, which has brought weakened consumer spending. In fact, Caterpillar's recent earnings report stated flatly that China's slower growth had put a crimp on its bottom line.
- China's new Five-Year Plan, which seeks to tilt the economy towards more consumer spending and away from heavy investment and exports, is off to a slow start. The weakness in household spending seems a stubbornly endemic attribute of the Chinese economy. Indeed, China's trade surplus with Europe and the US continues to climb, and its ongoing reliance on investment spending raises the triple specter of over-capacity, capital misallocation, and the inevitable morning-after investment slowdown. Concerns over the high debt levels in Chinese banks and the borrowing demands of local governments and municipalities are likely to constrain loan creation going forward.
- Growth has also slowed in India, and inflation there remains more of a threat than it does in China. Yet while China and India appear to be slowing, many of Asia's smaller economies show little signs of deceleration. Stronger domestic demand should balance out weaknesses in export markets. Inflation is the key concern in these Southeast Asian countries; even so, the weaker global environment and falling commodity prices are likely to lower inflation in most countries in 2012.
- Growth in Central and Emerging Europe (CEE) is likely to be strong this year but may slow in 2012 as a result of contagion effects from the Eurozone. Turkey's rapid growth looks unsustainable, as the current account deficit could reach 10% this year, funded largely by short-term capital inflows. And Turkey is losing foreign reserves quickly, making it difficult to protect its currency against future shocks.

- Growth in Russia will be most likely be spurred by pre-election spending this year, but the long-run outlook may be dimmed by oil prices and government infrastructure spending. While Russia's induction into the WTO should come eventually, we now think it likely to be postponed until next year. We continue to believe that this will be a watershed event for Russia. Within the region, however, contagion effects from Eurozone debt crisis remain a major concern.
- In Latin America, demand and output have grown rapidly in this year to date, especially in the agricultural export sectors. The near-term outlook remains bright and we would expect it to outperform Developed Markets. However, inflation and widening macroeconomic imbalances in the form of current-account deficits are potential harbingers of unsustainability. Strong capital inflows continue to put upward pressure on currencies, resulting in increasing domestic demand, greater deficits, and financial-asset bubbles.
- Risks of overheating are visible in Brazil due to the ongoing surge in consumer spending. This has been fuelled by credit growth, which has spiked household debt servicing costs (as a percentage of disposable income) to a level more than twice that of the US. An unstable environment may prompt policymakers to take restrictive measures, lowering growth in the future. Still, we remain selectively bullish on Brazil, given its numerous untapped markets in many sectors, while acknowledging macro headwinds that advise a combined long/short strategy to balance these risks and opportunities.
- Hopes that stretches of the Middle East and North Africa might be heading for major market-oriented reforms have for the moment faded. However, the oil-rich Gulf States will be spending enormous sums on much-needed public projects, but will still maintain budget surpluses this year. As with Brazil, we remain selectively bullish on the region and prefer to access the space, where possible, with tactical managers who show the ability to maneuver opportunistically between long and short exposures.
- Our overarching fear with respect to Emerging Markets is that the irresistible force of capital inflows smacking into the immovable object of underdeveloped financial systems and weak regulatory infrastructure might bring about a variety of ills, such as excessive and debilitating lending, speculative asset bubbles, inflation, currency appreciation, capital misallocation and overinvestment. We foresee the same thing happening in many of these markets.

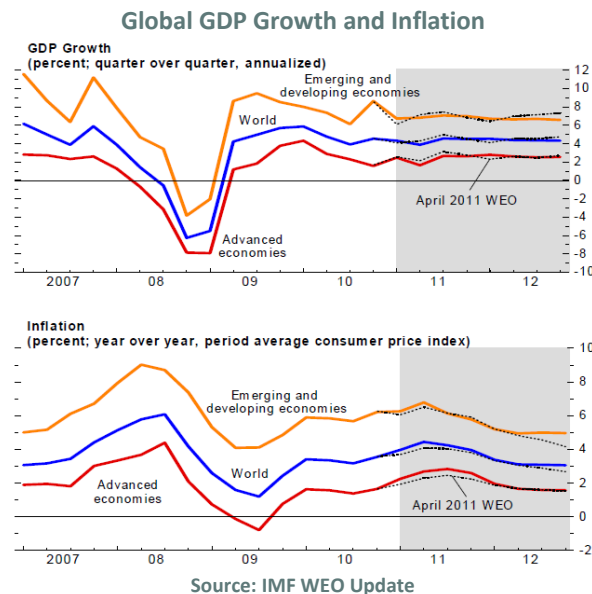
## Currencies

- With respect to fiat currencies, gold continues to outperform relative to all paper currencies with the exception of the Swiss franc. The franc has outperformed gold on a YTD basis and we continue to believe in further appreciation of the franc despite potential currency intervention and below-trend economic growth. We don't think that the franc's strength hails so much from Swiss economic strength as from the franc's status as a safe-haven bet against other currencies and risk assets.
- **The USD itself faces near-term tailwinds that could give it a strong bid. These include the termination of QE2, a contracting of spread differentials with other countries, relatively stronger economic growth with other OECD countries, safe-haven potential against any Eurozone contagion, and finally technical oversold factors.**

*To summarize, the global economy appears to be in a Tug-of-War between macro headwinds and macro tailwinds. Which of these tugging zephyrs will win in the short and the long term is our sleepless macro-meteorologists' big question right now.*

### III. Global Macroeconomic Overview & Outlook

Apart from a few negative surprises, global growth attained an annualized rate of 4.3% in the first quarter of 2011, according to IMF data. Growth generally was below expectations in the US, due to a myriad of cyclical and structural factors, including higher commodity prices, Japanese supply-chain disruptions to U.S. manufacturing, and lingering housing and unemployment woes. In contrast, upside growth poked through predictions in select Eurozone countries, powered by Germany. Growth in Emerging and Developing Market economies expanded as expected, but with much variation across regions.



***Despite the unexpected reversal in the US manufacturing PMI for June that helped fuel the stock market rally, further data point to slower global economic activity throughout the second quarter. Additionally, the forward-looking components of the US PMI augur little or no improvement in the coming months.***

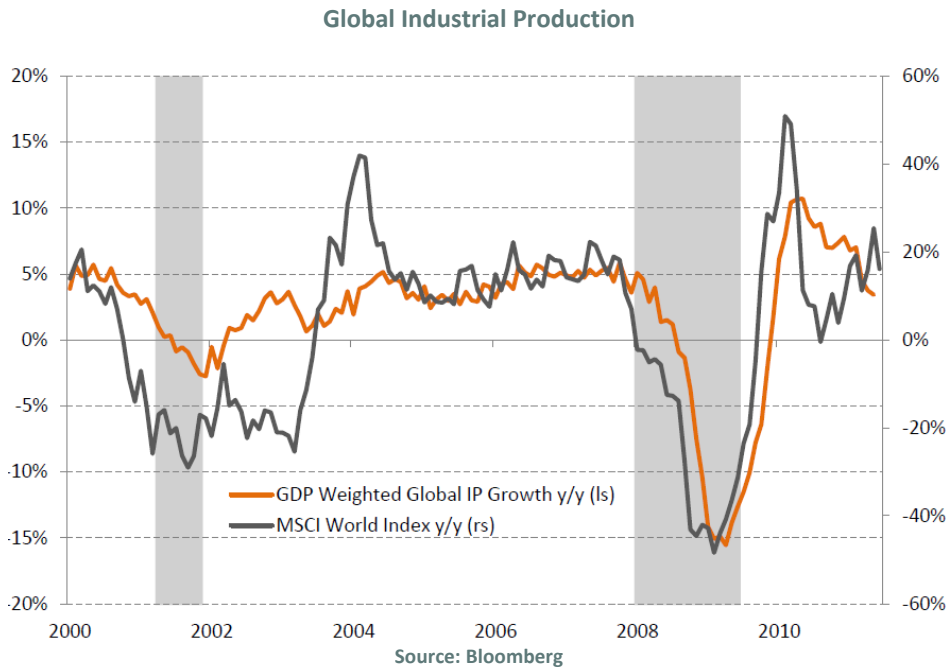
Moreover, evidence from surveys shows that the loss of momentum is a global phenomenon. Survey results from global purchasing managers, taken in June, fell for both the manufacturing and services sectors. The Global Manufacturing PMI has now fallen for four successive months and is at its lowest level since July 2009. That makes it lower than at any time during the recovery’s “soft patch” last summer. Composite PMIs declined in June in all the major economies apart from the Japan. The survey estimates for the Eurozone showed a particularly lurching slowdown, with the PMI falling by two points, now more than three points below its level in April. This adds to mounting evidence that growth is slowing in Europe, even in the red-hot German economy. The manufacturing PMI for China also fell in June, to a point only marginally above the 50-mark. This is consistent with evidence that China’s attempt to slow the economy and dampen inflationary pressures is working. Whether a hard landing can be avoided remains to be seen.

In our opinion, capital markets are failing to discount positive conclusions drawn from the bounce in last June’s US manufacturing PMI. In fact, the ISM is *far* from being the most reliable of economic indicators. It’s largely a measure of sentiment rather than an actual output number like the indices of industrial production or shipments.

Thus it tends to exaggerate the underlying strength of an economy. To demonstrate this point: in Friday's release, the ISM stated that the average PMI for January through June (58.8%) corresponds to a 5.7% increase in real gross domestic product (GDP). This result has proven concretely out to lunch.

Further, while the June number was stronger than consensus estimates, it followed a massive slump in the previous month, ushering in snap-back distortions in subsequent months. In fact, the US manufacturing PMI for June, at 55.3, was well below ISM figures of over 60 in each of the first four months of the year. Moreover, data released today show the US ISM survey of non-manufacturing purchasing managers fell from 54.6 in May to 53.3 in June. This is more consistent with other evidence that the US economic recovery remains lackluster and has been slowing. On a global level, a look at some of the components of the PMIs suggests still further slowdowns. Overall, the PMIs paint a picture of a global recovery that is running out of steam, with inflationary pressures generally declining across the world economy.

Consistent with weak global PMIs is global industrial production that indicates an equally prolonged slowdown. The *Bloomberg* Brief GDP-weighted Global Industrial Production Index grew in May at its slowest pace since December of 2009.<sup>1</sup> The index is likely to fall further as more countries report, reinforcing the conclusion that global production is slowing. June manufacturing surveys show such weakness persisting, bringing the threat that industrial growth could turn negative and increase the likelihood of another recession.



For emerging and developing economies, the financial environment remains largely accommodative, but with considerable variation across countries. Some of the larger economies are witnessing rapid credit growth, propelled by congenial macroeconomic conditions and capital inflows. In others, credit growth has decelerated under the persistent tightening of monetary policy.

<sup>1</sup> "Bloomberg Brief Industrial Production Index" *Bloomberg Economist*, Michael McDonough, June 22nd 2011. The Index consists of 17 countries whose monthly industrial production figures are averaged and weighted according to the size of each economy based on GDP.

## Interpretation of the Capital Markets Correction

We have two complementary explanations for the most recent US and global market correction that came in the second quarter:

1. Transient reasons include the headline geopolitical events of the last months: rising commodity prices, the Japanese earthquake, Middle East turmoil, Eurozone concerns and political dithering in the US on debt and fiscal issues; and alongside these:
2. More structural factors that may lead to prolonged recession in some advanced economies. In that case, the equity-market correction and increase in credit spreads will most likely become more acute, eventually bringing negative effects to the economy. Policymakers in Developed Markets are simply running out of tools, and their ability to counter such economic weakness is becoming more difficult to muster.

*Looking at the year in review, global capital markets, especially equity markets, seem surprisingly resilient in the face of these potential left-tail events that are bringing turmoil to the global economy, aside from a few fairly minor and benign pullbacks.* The year started with rising commodity prices, sparking global inflation fears, followed by widespread unrest in the Middle East that drove oil prices still higher. Then a terrible earthquake struck Japan, severely damaging its economy and a good deal of the globe's production/manufacturing by supply-chain disruptions. After that, Eurozone debt predicaments erupted, and Portugal, following in the footsteps of Greece and Ireland, lost market access and required an IMF-EU bailout package. Greece then followed suit, its initial bailout having roused a heated debate about the survival of the EMU and whether to allow Greece another official bailout or let private creditors take a haircut. Finally, angst about the unsustainable US fiscal deficit triggered off a political fight on spending cuts that almost brought a government shutdown. Another stalemate, this time on the debt ceiling, is now in the works, potentially forcing a technical default on U.S. public debt sometime in late summer. This has provoked the threat of a downgrade in the US credit rating by Moody's.

To summarize, the headwinds in 2011 that blew in heightened risk, uncertainty, and volatility have adversely impacted growth in Developed Market economies. These had already been growing anemically due to ongoing deleveraging that required a slowdown of private/public spending. The slowdown is occurring at a time when the double punch from monetary and fiscal stimulus is under phaseout, leading to monetary and fiscal drag. Accommodative monetary policies are likely to end in the coming months. Global growth dynamics are sharing center stage with US fiscal woes, deterring central banks from any further tightening and in some cases even obliging them to switch gears, as with China and the ECB. So — if the headwinds get the victory in the **Global Tug-of-War** with the tailwinds, we could see further equity-market corrections and a widening of credit spreads, thus choking off growth even further through negative wealth effects on consumer demand. Uncertainty is king right now, uncertainty over the direction of global growth and of US growth in particular. Here's our gloves-off summary of headwinds and tailwinds as we're feeling the blasts right now:

### Headwinds | imbalances, imbalances, imbalances . . .

- Totally disappointing June employment data across all fronts;
- Anemic growth observed in many advanced economies;
- An unresolved debt ceiling;
- Structural unemployment in the United States and stagnant real wages;

- Eurozone debt restructuring/bailouts and related contagion effects;
- Evidence of a hard landing and more aggressive inflation prints in China and other Emerging Markets;
- Persistently increasing commodity prices (i.e., oil and food);
- Economic stagnation in Japan and renewed slowdown in Germany;
- Increased risk of a U-shaped recovery in a weaker version, a growth recession in which expansion in DMs falls to a pace that is consistent with rising (rather than slowly falling) unemployment;
- US housing market in a prolonged double-dip; and
- Lack of robust growth in EM economies due to an over-tightening credit policy and an export slowdown from slower OECD countries.

### Tailwinds | Earnings, earnings, earnings . . .

- Historically strong US corporate balance sheets and cash balances supporting M&A, share buy-backs and CapEx;
- A finalization of the Greek bailout that will allow release of IMF funds and will dissipate the threat of an immediate default, translating into good news for the Eurozone banking sector;
- An earning season that will provide for strong earnings growth momentum and positive guidance;
- A Japanese economy that will avoid recession and resume growth;
- More positive US data prints on employment, manufacturing, retail sales and housing — showing that June was merely a *soft patch* on the longer-term path of normalized growth;
- A pullback on oil, agricultural and other commodity prices, providing relief to the global economy and a spur to consumption;
- China Premier Wen Jiabao's signal of a potential end to China's tightening cycle;
- Commodity prices remain elevated, but below demand-destruction levels, supporting favorable terms of trade and export revenues; and
- Weaker government data, giving birth to a QE3, and translating into another leg up in risk assets.

### US Economic Outlook

US growth is slowing once again. The June employment tally was incredibly disappointing, and it incorporated downward revisions to the May and April numbers as well. Cynically, the only good piece of news is that the government sector is shrinking. Aside from the June PMI reading, which we believe is far from the best measure of

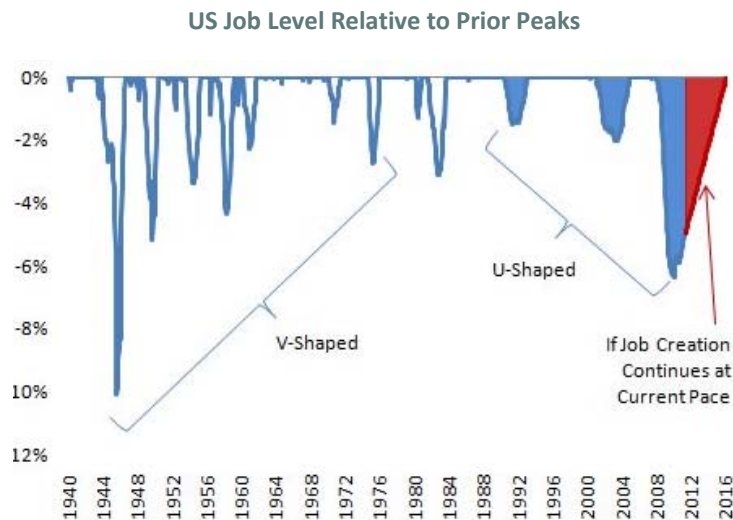
actual industrial production and manufacturing, most of the government data is disheartening. We expect US GDP to grow at less than 2.0% in the second half of 2011, causing unemployment to rise further.

A peak in productivity may support some level of expansion in private-sector employment through the second half of the year. But with global industrial activity waning and downward pressure being felt on US manufacturing, the broader economy will be drawn increasingly into the witches' brew. This will cause consumer confidence, already in recession blahs, to tumble yet further, will bring smaller trade improvements, and most importantly, will make for delays in capital-expenditure plans despite many companies' ability to finance capex. And all this apart from the erosion of the housing market, still lofty gasoline prices, additional deleveraging and finally the drag of federal/state/local government fiscal tightening.

On housing, we have seen a surge in construction starts but sales are disappointingly slower. This toxic mix of swelling supply and shrinking demand does not bode well for pricing power and the housing market in general. And while corporate earnings are coming in strong once again, we are seeing more and more justification for cost cutting including job cuts, with top-line growth remaining anemic for this stage of the recovery and business cycle. Yet while job growth stagnates and consumer confidence sinks, exports have climbed in the past two years and accounted for a record 13.4% of GDP in the first quarter of 2011, compared with a decade low of 9.2% in the second quarter of 2003.<sup>2</sup> Many economists see this as the cure-all for structural weaknesses in the US economy, we don't think the export renaissance will be strong enough to put our national growth accounts in the black.

### US Recovery & Employment: A New Paradigm

From the 1940s through the 1970s, US labor markets exhibited V-shaped sharp declines and rapid recoveries, as seen in the chart below. Labor markets recovered very quickly from prior recessions. However, by the 1990s the labor recoveries took on a U-shape, signifying longer, persistent unemployment. This most recent recovery, indicated in red, could most likely take years for a full recovery.



Source: Bureau of Labor Statistics, Council on Foreign Relations

<sup>2</sup> Bloomberg, *Economist*, 7.18.2011.

The reasons, of course, are more structural than transient, as the US economy has become more service oriented, with most new jobs since the 1990s arising from the non-tradable-goods sector. Meanwhile, jobs in the tradable sector, which produces goods that can be consumed anywhere, barely grew at all. On top of this, US manufacturing jobs continue to be lost to Emerging Markets. Here lies the rub. ***As the US economy produces fewer jobs in the tradable sector, employment problems accelerate in a vicious cycle, since the non-tradable goods sector always lags behind the pace required for full employment, ever widening the gap. If this structural shift does not “re-shift” back towards tradable goods, we will slog through systemic unemployment in the US for long periods, consistent with the graph above.*** But why this structural shift in the first place, and how did we get here?

The economic record of the past three decades shows the US exporting a material portion of its tradable goods sector (manufacturing, etc.) to the Emerging Markets, a development facilitated by the international monetary system and its various exchange-rate mechanisms — but due above all to the role that the US has played since WWII under the various Bretton Woods regimes. Without going into laborious detail, and as the economist Charles Kindleberger has convincingly argued, the global economy can only remain open and functional in the long run ***“if one country is willing to provide leadership — to be the supplier of capital when others are in a panic, to keep its markets open in the face of protectionist pressure, and to act countercyclically as an economic locomotive for the world.”*** Because the US has become the *de facto* global reserve country and the USD the global reserve currency, whenever a financial crisis has hit or the world economy has been about to slide into stagnation, the US has acted and will most likely continue to act as the lender/consumer of last resort, ensuring free global trade and sustaining global aggregate demand through increased domestic consumption. The US has played this role since the post-war period.

The Chinese example is a textbook illustration. China has been industrializing and growing much faster than the US by exporting and selling more and more to the US. When a country such as China “imports” US demand by subsidizing its own exports to the US, the US economy, in order to maintain the global balance, responds in one of two ways. Either American unemployment rises as demand is diverted abroad, or else Americans must counteract the employment impact by increasing domestic consumption (or investment) to keep GDP steady. However, with little incentive for ***private*** domestic investment, the capital inflows into the US through positive capital accounts have not gone into productive investment projects such as building up the US infrastructure and the industrial base, which would boost the tradable goods sector. Quite the contrary, capital was and is funneled into unproductive uses, additional consumption, larger houses, etc. (investment in the non-tradable goods sector). ***Therefore, within this current global economic landscape, the US must choose a mix of higher unemployment as US demand is exported, or higher debt, and/or higher consumption.*** Thus far, Fed policies clearly indicate a preference for higher debt as a move towards full employment. The global economic landscape, coupled with the our ability to borrow at low rates through what our Gallic friends, with caustic tongue, have deemed our ***“exorbitant privilege,”*** has allowed us to stockpile debt to a level that now hovers at crisis proportions — and this circumstance has spawned the great gladiatorial debates of the day, in Congress, in the press, on the streetcorner, and in the world’s chancelleries. We at TwinFocus are stoutly convinced that the stockpile of US debt is not *the* problem (although it has become *a* problem) — but is a manifestation of the ***real*** underlying problem.

***Right now we find ourselves unable to consume and take on debt at the rates that we have been able to do in the past. As a result, our non-tradable-goods sector will suffer and so too will the jobs generated in that sector. We need to shift to the tradable-goods sector and begin manufacturing things in the US that we can sell to the rest of the world, especially those parts of the world that are growing steadily. This is our structural employment dilemma. While one can look at the employment reports from month to month, this strikes us as a futile exercise. We need to look at policy initiatives that will yield long-term progress.***

## QE2 & Its Effects

Fed Chairman Bernanke confirmed that he was in no rush to raise rates or trim the Fed's balance sheet, even *after* QE2 expires. We interpret this to mean that the "Bernanke put" is alive and well. That makes his message loud and clear: **Please buy stocks and other risk assets at the expense of the dollar.** We believe that from a fundamental perspective, the Fed's QE program has done very little that positively impacts real business activity in any meaningful manner.

The major impact of QE has been the rapid escalation of excess reserves within the banking system. In fact, the net increase in the Fed's balance sheet has been exactly matched by net gains of excess reserves in the US commercial banking system. This means that the high-powered money created by the Fed has been locked into the banking system, while failing to stop credit contraction, which started at the end of 2008 and has continued until today. This is especially the case with smaller businesses that would otherwise lack access to low-cost capital, unlike larger corporations with easy access to low rates offered by the global credit markets.

Additionally, QE2 played an indirect role in impacting the economy through a weakening of the USD rather than through balance-sheet effects and credit conditions. The QE programs created a market expectation that short rates in the US would stay at zero for extended periods, and that Fed policy would always lag behind other major central banks. This has effectively created an incentive to sell the USD merely from interest-rate differential spreads. Since the crisis, the Fed has wasted no time driving down the USD. So far, the strategy has worked:

- A falling USD has helped stock prices by improving corporate profits through currency translations — especially given that almost half of US earnings come from overseas markets;
- A weakened USD has revived the export sector, speeding up a much-needed recovery in manufacturing;
- A weakened USD has prevented deflation expectations from taking hold. In fact, inflation expectations, as proxied by break-even TIPS spreads, recovered most of the ground lost by the crisis.

The decline in the USD and the end of QE2 has not even caused tension in fixed-income markets, despite rhetoric from the likes of Bill Gross and others. To the contrary, the Treasury market has stayed serenely calm, and bond yields have actually fallen, much as we predicted.

The only unintended negative externalities of QE2 and weakening USD have included:

- **Rising Commodity Prices:** However, productivity gains have absorbed most of the inflationary impact from increased materials and energy costs, allowing core inflation to stay low. In addition, ephemeral supply constraints have eased. In any case, we cannot put the entire blame for a weaker USD on rising commodity prices, since commodities have risen in almost all currencies;
- **Emerging Market Asset Price Bubbles:** Liquidity from QE2 and other central-bank monetary easing have been funneled to higher-returning markets, creating potential asset-price bubbles, although here too, external factors have facilitated overinvestment in certain asset classes.

The bottom line is that we do not expect much of a negative impact issuing from the end of QE2. Interest rates in our opinion will actually benefit to the **downside** as inflation fears reside and other traditional buyers of Treasuries step in.

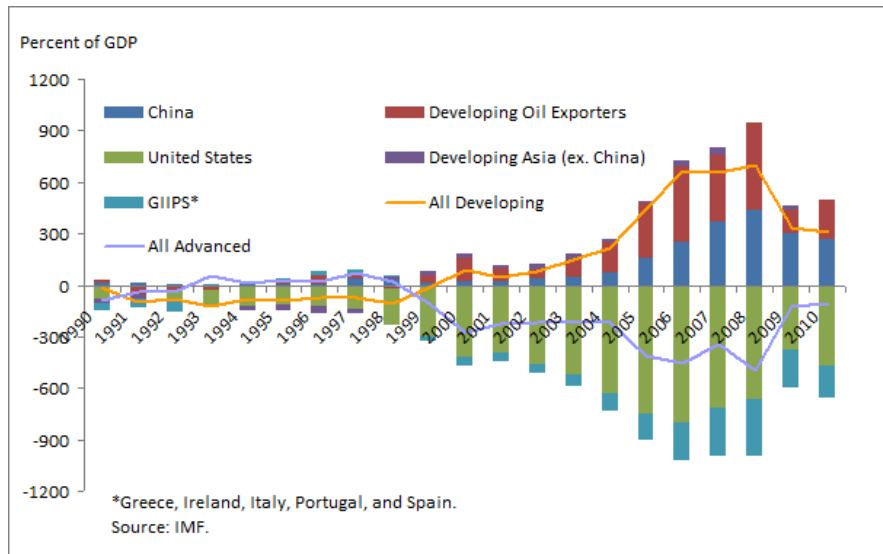
## US Deficit & Debt Levels | Washington Impasses & Possible Credit Ratings Downgrades

We are often asked about possible portfolio implications if our policymakers fail to reach timely agreement and the US loses its venerable triple-A rating. We believe that the purported downgrading of US government debt needn't be as destructive for Treasuries or the USD as many would think, once the financial noise dissipates over the intermediate to longer term. The downgrading would simply magnify the risks associated with our current unsustainable macro environment and its global imbalances. Any deficit-reduction agreement must provide for meaningful debt reduction of at least \$3.0 trillion over the next decade. Anything short of that could cause a credit-agency reduction of the US triple-A status. But even the loss of this status could prove only temporary, as was the case for Australia and Canada.

If the US government were no longer rated AAA, the lower credit rating would probably translate into higher borrowing costs, *ceteris paribus*. But there are other factors that influence the level of interest rates above and beyond credit ratings. These include expectations for short-term rates, inflation, growth prospects, and the increasing probability that international shocks that would renew the safe-haven status of US Treasuries. Just look at Japan, which lost its triple-A rating over a decade ago: its government-bond yields are ~ 1.0% and the yen is much stronger. While the US depends much more than Japan on foreigners to purchase Treasuries, making us much more susceptible to capital-outflow potential, we must remember that the US remains the global reserve currency, and that there is no other credible alternative.

To conclude on this point, we believe that when the financial noise settles on the potential credit-rating downgrade, Treasury rates will remain largely unchanged, as other factors will dominate the directionality of US Treasury rates going forward. A downgrade from triple-A to double-A will become more of a formality.

## Conclusion | US Structural Problems Remain



Some pictures can say even more than a thousand words. As the chart above shows, the US economy has steadily been borrowing its way to consistent nominal growth, using credit-card debt from the likes of China, oil exporters and other current-account surplus countries. While the basis for these trends is beyond the scope of this commentary (and one that we have explored in a previous whitepaper), the burden of this debt has now reached a

fulcrum point where the US will find it difficult to grow by simply borrowing more to consume. Our tradable-goods sector has deteriorated during the past two decades on the heels of the “*exorbitant privilege*” enjoyed by the US as a global reserve currency. This will create more and more volatility and uncertainty, making it increasingly imprudent for companies to deploy capital expenditures and rehire unemployed workers.

Our traditional business cycles are re-formulating themselves, while the Fed finds itself ill-equipped to fulfill its mandate of full employment. Its policy tools — traditional and unconventional — remain sidelined and impotent. Oceans of liquidity slosh down the economic food chain, and interest rates fall to negative numbers, yet all this fails to stimulate activity as it has in the past. Meanwhile, our fiscal policies provide little room for relief, caught as we are in a classic Catch-22. More fiscal stimulus increases Keynesian demand temporarily, but also puts us in a bigger debt hole, making long-term prospects worse — while opting for fiscal austerity, on the other hand, would shrink GDP at a time when our economy is in first gear when it should be in fourth.

Deleveraging is going at a much slower pace, and the burden of further balance-sheet repair will only make for headwinds to US growth. Lower interest rates appear to have eased the direct costs of this debt, but the policies that have brought these lower rates have simply shifted the indirect costs from the debtors to the savers — the investors and taxpayers. The true costs haven’t decreased, they’ve just been shifted: that’s it in a nutshell. Savers, exhilarated and a bit tizzy, are incentivized to cast about for plummier yields, taking on more risk than they would have done cold sober.

Where do we find ourselves now? As Professors Rogoff and Reinhart have stated in their seminal research on sovereign debt dynamics (*This Time is Different*), we are fast approaching our debt limit, and short-term options for growth are coming from sources increasingly beyond our control. These include increased exports to the likes of China, lower commodity prices, and global stability. Unless our policies pursue timely structural changes, we are destined to keep riding the same merry-go-round, which will whirl faster and faster and land us in dangerous, possibly fatal territory. It’s still not too late, but time is running out and the cliff looms ahead.

***While the US may lag behind in physical infrastructure, compared to other Developed Markets and the advanced Emerging Markets, we are light years ahead in institutional infrastructure, an asset we shouldn’t take for granted but should manipulate to our advantage. Bridges can be rebuilt, but it’s far more difficult to put in place the institutional framework that builds the bridges. If you have any doubt about this, take a look at Russia, or better yet, drive its roads.***

## European Economic Outlook

***“The chief cause of problems is solutions”***

- Eric Sevareid, *Journalist*

### Introduction

For the first time in the history of the European Union and the EMU, the very rationale of the European experiment has been put in question. But instead of facing up to their current dilemmas, the EU’s leading member states have been indecisive and wavering, owing to national self-interest, vanity, and a conspicuous absence of leadership. The complex political economy of the European Union, comprising as it does a gaggle of 17 governments and the bureaucracies of the European Commission and European Central Bank, has failed to demonstrate the political vision and guidance needed to resolve these intractable issues. So what went wrong with the Eurozone in the first place?

## In the Beginning . . .

The sovereign debt crisis has been magnified by recent events in Greece. Greece is the poster child of a sovereign nation that has consumed far more than it has earned, wallowing in debt levels which all markets recognize as unsustainable and a mock to any hope of making Greece self-supporting. The cruel irony here is that Greece is a member of the EU — a monetary institution designed for the muscular and fit, which finds itself singularly ill-equipped to handle the sickly and underfed. Greece flounders and the EU flounders.

As it functions today, the Eurozone and the EMU is not even the monetary union it proclaims itself to be, but a quasi-fixed-exchange-rate system. The system was premised on two conditions: a) a stable euro, guaranteed by the European Central Bank under a clear mandate to maintain price stability, and b) good fiscal housekeeping on the part of each member state. However, history has proven that any effective currency requires a central bank **and** treasury, each playing a vital role in times of crisis. The central bank provides the liquidity, while the treasury provides solvency and crisis management. This means that the EU's fiscal federalism could work only if a treasury-like institution, mandated by the EU constitution, was able to function across borders, languages, and cultures. But sadly, in working fact the EU today is neither a fiscal nor a political union, but a jerry-built collection of bureaucracies that works in fits and starts — when sufficiently prodded by crises. Bets are being taken whether the fiscal nightmare facing Greece and other peripheral EU countries might prove the quicksand that swallows up the very viability of the EU.

By its very constitution, the EU is a no-wealth-transfer community of sovereign states. Because its single monetary system is administered by the European Central Bank, it is the responsibility of each individual sovereign to adjust its own economic and fiscal policies to the collective monetary regime. This loose framework allowed Greece, at its time of entry, to evade its commitment to reduce public debt levels, and instead to waste potential savings in a spending frenzy fanned by political corruption. Its current crisis is the blighted fruit of bad policies — or rather *no* consistent policies — which it has drifted into over many years. We may be seeing the last chance that Greece and the other EU periphery countries will have to adopt a regime of stable, independent money backed by a transparent and enforced public policy. ***We are convinced that the EU's greatest need is for a crisis-resolution mechanism to handle the members' internal fiscal predicaments, along with a procedure to resolve internal economic imbalances, which are partially to blame for these predicaments.***

Given the extreme current-account imbalances and the lack of any central mechanism for bail-out and fiscal redistribution, this monetary union of such a diverse group of countries might not be sustainable. It would be unreasonable to ask a country like Germany to raise wages or cut exports to other EU member states, yet there are legitimate concerns about Germany's lack of domestic demand — not indeed like that of China. At the root of these problems is the fact that prices and wages in the periphery countries have risen much faster than those of Germany and other Eurozone members, making the peripheries largely uncompetitive in their export markets. In prior Commentaries, we opined on this EU sovereign issue as it applies to Spain<sup>3</sup>:

One of the underlying difficulties in trying to solve this problem is a policy divergence between France, Spain, Italy, Portugal and Greece on one side, and Germany, Finland, Austria, and the Netherlands on the other — with the policy divide between France and Germany the most damaging. The crisis has demonstrated that political leaders treat the Eurozone not as a true economic union but merely as a single currency arrangement that is comprised of sovereign states with not much else in common.

On the other side of the fence is a country such as Spain. When the euro was adopted, the ECB's lending rates were below Spain's rate of inflation for many years, so Spanish households and businesses had a huge incentive to borrow, which they did with a vengeance. Spanish private sector debt peaked above

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<sup>3</sup> The caption above could apply just as well to the other periphery countries. While in most other periphery countries, the debt problems originated with the private sector, in Greece it was the bloated public sector that brewed up the debt mess.

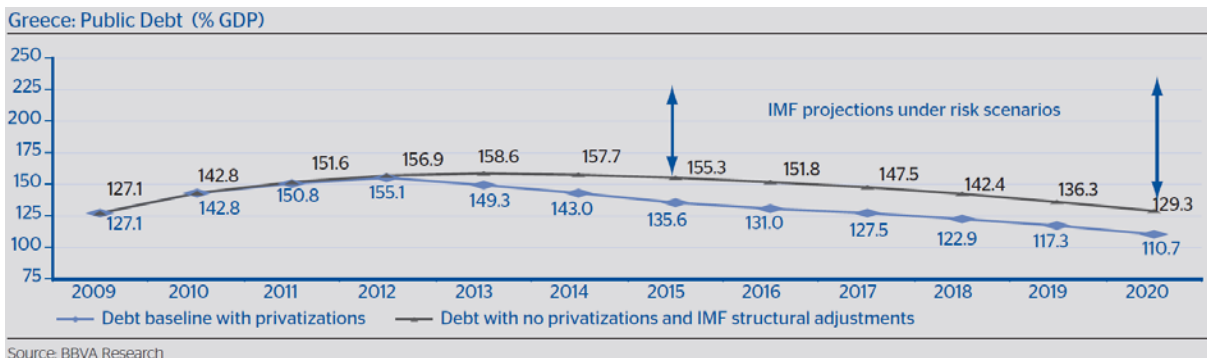
130% of disposable income in 2007, while consumption boomed. With a debt-fueled construction sector in overdrive, Spain was briefly propelled to being the world's ninth-largest economy. Wages rose at almost twice the rate as those in the rest of the Eurozone, making Spaniards richer. The downside was rising costs for Spanish businesses, making them lose competitiveness and productivity against other countries in the Eurozone such as Germany. Once the euro turned the corner and began to appreciate, Spain found it tougher to export to the rest of the world. The result is an economy still contracting while others have shown signs of stabilization. Spain's experience illustrates the difficulties of running a monetary policy for 16 countries with separate governments, different propensities to save, consume and invest, and widely varying economies. Exacerbating this arrangement for the euro is the large trade imbalances within the currency union. Countries like Spain, Italy and Greece have built up huge trade deficits while Germany and the Netherlands have vast surpluses. Unless both sides rebalance their economies, with Germany absorbing more exports and boosting domestic demand, and countries like Spain and Italy taking steps to improve competitiveness, the weakest Eurozone countries could struggle with heavy government and private-sector debts down the line.

In summary, the German economy and its relative competitiveness is the direct beneficiary of trade deficits on the part of EU member states, especially at a time of global crisis, and this fact has cushioned Germany's own economic contraction. An expanded EU area remains in Germany's direct interest — and that of the US (a topic for another day). ***Whatever measures the EU does adopt and decides for Greece, one thing we believe is certain — that Greece will not be the last or the greatest sovereign challenge facing the EU in the years (even months) ahead.***

### Beware of Greeks Baring Bonds

Greece has a debt-to-GDP ratio of over 150%, a current account deficit of over 8% of GDP, and a fiscal deficit of over 8% of GDP as well. Given the structural dynamics of Greece, these data points complete the puzzle picture of a Greece that is a bankrupt ward of the Eurozone and IMF.

We can confirm such a conclusion by a little back-of-the-envelope arithmetic. Greece's current cost of capital is ~5.0%. If it were to go to market for refinancing, at say 10%, it would take 15% of GDP just to swing the finance costs. That is 15% of GDP and not tax revenue. Greece would have to grow at north of 15% per annum to generate tax revenues for paying interest costs and necessary social services to survive as a civilized country. Unhappily, the country lacks the infrastructure and industry in tradable goods to reach these GDP growth levels, so our back-of-the-envelope conclusion is pretty summary.



We therefore take the view that the measures recently announced by Eurozone officials are a Potemkin village covering up the inevitable. This second bailout deal reflects a ~ 21% reduction in the net present value of debt owed to bondholders, which constitutes about ~ 70% of Greece's total public debt. This translates into a reduction of ~ 14% in total public debt, which would bring it down from ~155% to ~ 133% of GDP. We agree with the consensus in this instance that there needs to be a debt reduction greater than 50%, making this agreement unlikely to ensure debt sustainability, even if Greece fully implements their fiscal plan just voted and they sell public assets at fair prices. It will still leave Greece with a debt/GDP level above 100%, with no solution to the underlying problem or even a feint or two in that direction. Greece's problem is its lack of growth, caused by its sclerotic bureaucracy, its consequent non-competitiveness, its bloated public sector (pumped to gaseous levels by endemic corruption), and the opportunistic policies of surplus countries.

Here's a quickie review of the ballyhooed stopgap measures for Greece. The agreement offers an orderly exchange of the entire public debt of Greece, coming to maturity between 2012 and 2020. The agreement includes two par-bond options and two discount-bond options. More precisely, investors will be offered four new instruments in addition to the chance to participate in a debt buyback program established by the Greek government in consultation with the official sector. The instruments are structured to attract a wide range of voluntary investors. The four instruments involve:

1. **A Par-Bond Exchange into a 30-year instrument, the principal to be collateralized by 30-year zero-coupon AAA-rated bonds.** The zero-coupon bonds are purchased using EFSF funds. Greece pays the funding costs to the EFSF. The principal is repaid to the investor using the proceeds of the maturity of the zero-coupon bonds.
2. **A Par-Bond offer involving rolling-over maturing Greek government bonds into 30-year instruments.** (The principal is collateralized using the same mechanism as for instrument 1.)
3. **A Discount-Bond Exchange into a 30-year instrument offered at 80% of par into a new 30-year instrument.** (The principal is collateralized using the same mechanism as for instrument 1.)
4. **A Discount-Bond Exchange into a 15-year instrument offered at 80% of par value.** The principal is partially collateralized with 80% of losses which are covered up to a maximum of 40% of the notional value of the new instrument. The collateral is provided by funds held in escrow. These funds are borrowed by Greece from the EFSF. The EFSF funding costs are covered by the interest earned on the funds in the escrow account, so there is no funding cost to Greece of this collateral. The funds in escrow are returned to the EFSF on maturity, if not used, and the principal on the bond is repaid by Greece.

The coupon on the par bonds (Alternatives #1 and #2) will be 4.0% during the first five years, 4.5% during the next five years, and 5.0% for years 2011-2030. The other two alternatives — one for 15 years and the other for 30 — would pay higher coupons of 5.9% - 6.8% as compensation for taking an upfront 20 per cent haircut on the value of the bond. Credit enhancements will be used: these new bonds will be collateralized by 30-yr zero-coupon triple-A bonds.

Lastly, the Eurozone also agreed to an expansion of its €440 billion bailout fund. That vehicle, once restricted to countries near the brink of collapse, can now buy Eurozone bonds in secondary markets to move prices and lend directly to countries even before they lose access to private funding. That could include lending money to finance bank recapitalizations.

The new plan for Greece will work as follows: The Eurozone's bailout fund and the IMF will lend the country roughly €109 billion over the next three years at around 3.5% interest. Private creditors who hold Greek debt that matures in the coming 10 years will *voluntarily* turn in their bonds and accept new ones that have much longer maturities. The European banks, especially those in Germany and France, will be allowed to swap into new 30-year or 15-year

Greek bonds. The offer includes a menu of four different selections of bonds with varying coupons and types of credit enhancement — some backed by triple-A-rated collateral, some bringing a 20% discount to principal. The nature of the Private Sector Involvement (PSI) — and how it is calculated — remains uncertain. It appears that a relatively small portion of it would come from bondholders outrightly forgiving principal owed. The larger part would come from accepting a late repayment at lower interest rates.

The main caveat to this solution is that private creditors are expected to accept PSI in exchange for a credit enhancement that increases the coupon rate on the new bonds relative to the risk-free rate, even if the overall yields will be lower than the current high and unsustainable market rates. The credit enhancement will in effect reduce, significantly, the net-present-value debt reduction for Greece to only 21% (average haircut) — a level that we believe may prove insufficient to restore debt sustainability to Greece over the long term, especially given that country's productivity profile.

Two remaining points. Firstly, the drafters of the agreement made it clear that the bondholder program would be limited to Greece, which they called “an exceptional and unique solution.” Theoretically, the program could not extend to another periphery country, although you can guess how blue-sky this assurance sounds. Second, the International Swaps & Derivatives Association (ISDA), the organization that sets legal and policy initiatives for CDS, has declared that this agreement will not trigger CDS protection because it will not be considered, for CDS purposes, a default or a restructuring.

To summarize, we think that Greece will not be the only periphery country either to default or to need further bailout assistance. Spain, Portugal, Ireland, Italy, Belgium, much of Eastern Europe, and even Cyprus will also face severe financial distress and remain potential default candidates. While this agreement represents a temporary stopgap measure, it does not address the true underlying problems. ***This is where we believe that the recent announcement of a Greek bailout portends more dire conditions than the markets are discounting.***

We believe that the European banking system cannot survive even the smallest stress-test restructuring scenario. As a result, these countries are headed for several years of tough economic adjustments while the markets and the EU authorities pretend that these countries can work off their debt burdens. What they really aim to accomplish behind closed doors is for European banks aggressively to rebuild their capital bases, with the unwilling help of local taxpayers and the household sector, until they are strong and well enough capitalized to begin writing off losses. At that point, markets will come to grips with the fact that some of these periphery countries cannot repay their total outstanding debts, even after restructuring. ***More importantly, countries such as Greece and even Spain will be forced to choose between giving up sovereignty to the Eurozone's Germany-centered core, languishing under extremely low rates of growth for several years, or giving up the euro and taking the Latin American approach.***

## Is China the Eurozone's White Knight?

Despite pleasantries and initial interest of support from China's leaders and Premier Wen in particular, we see little reason to believe that China has the ability (and the willingness) to solve the Eurozone's debt crisis.<sup>4</sup> Just for example, it is estimated that China has already bought more than €40 bln of euro-denominated assets in 2011 from many of the periphery economies, yet the crisis intensifies with time. Where is the Chinese relief?

China does have a major stake in solving Europe's troubles. First, by presenting itself as a white knight, China portrays itself as a responsible and proactive global participant, especially in the Mediterranean where it has had little historical presence. It will be able presumably in the future to exert more leverage over global issues that it is sensitive to. Second, China has a tremendous interest in limiting foreign exchange volatility, given that its economy

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<sup>4</sup> Global Markets Update, *Capital Economics*, “Can China solve the euro-zone's problems?”, Mark Williams, June 27, 2011.

is still vastly dependent on exports to the likes of the US and EU, where exchange-rate levels are key to its competitiveness.<sup>5</sup> Lastly, China may want to take advantage of higher yields available on sovereign debt from peripheral Eurozone countries in order to diversify gradually into the euro.

That said, we're not holding our breath waiting for the Chinese to make themselves a major catalyst in the geopolitics and geo-economics of the Eurozone. China may talk loudly, but its actions will likely fall short of what it eventually promises.

We don't believe that China would purchase the debt of a bankrupt state or become a debt buyer of last resort for a country close to default. China's officialdom does not want to lose money on foreign investments that could lower its people's living standards. It is already taking heat for purchasing US Treasuries yielding only 3.0%. On the flip side, China does have a vested interest in the stability of the Eurozone economy and financial system. On the other hand, if the Eurozone proves unable to control its long-term destiny, and some form of EU break-up looks inevitable, China would not stand in the way. In any case, the Eurozone's structural problems are far deeper and more involved than merely finding purchasers of sovereign debt. Chinese funds will do little to solve intra-Eurozone imbalances and competitive divergencies that have fractured the core from the periphery.

In conclusion, we perceive a Tug-of-War among Eurozone interests regarding Chinese influence in the area. While the periphery countries seem unfazed as the Chinese scoop up assets at bargain prices, they still struggle to get a handle on China's burgeoning international influence. They know that the issue can only be addressed by a unified Europe that includes France and Germany — yet they see France and Germany fixed exclusively on their own national interests. The picture is muddy and conflicted: the periphery is for sale on the cheap, while China shows but nugatory interest in solving the problems that put the periphery on the auction block in the first place.

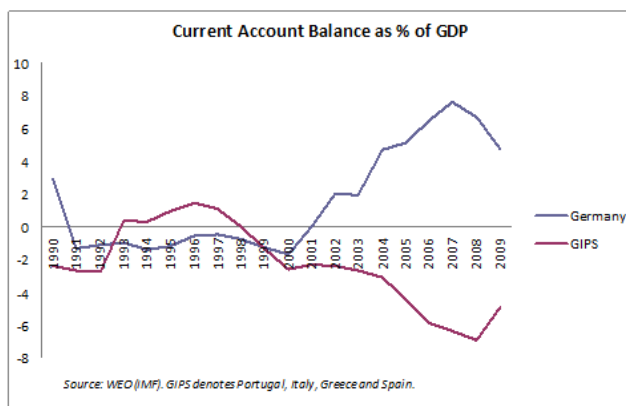
## Concluding Remarks: Greek Default & Eurozone Contagion

The sovereign debt crisis engulfing the Eurozone is not the real problem but a manifestation of the problem. Nor are the credit-rating agencies, derivatives, Credit Default Swaps, or speculators the problem. Our view is that the root problem and the source of all externalities within the Eurozone is twofold:

- ***A monetary system in which individual countries refuse to soft-pedal their sovereign self-interest in order to integrate EU institutions into a true fiscal/federal union***
- ***The growing orthodoxy that the periphery countries are the profligate villains, piling up mountainous debt, while ignoring the domestic largesse of the surplus countries, which is just as much to blame. The surplus countries have suppressed domestic consumption by reducing wages, while at the same time subsidizing industry and holding interest rates artificially low. This nectar-for-the-grabbing has guaranteed that the periphery countries would lap it up, running the huge trade and current-account deficits that have ushered in the current crisis. (See chart below)***

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<sup>5</sup> There are several reasons why China would be interested in the euro markets. For one, China may be buying the Euro in a slow and strategic diversification out of the USD. Another possible motive to purchase euros is to use currency manipulation to forestall revaluation of the Chinese RMB against the USD should the USD appreciate against the euro. That would help China gain in competitiveness against Europe what it may lose against the US.



Unless we get a firm fix on the problems that have brought Europe to its present pass, the necessary solutions will escape us as well . . . and indeed they have. The markets have made it clear that simple austerity measures won't work because they serve only to reduce revenue and thereby worsen debt/GDP ratios. Just before the recent Greek agreement, the markets spoke loud and clear that deeper measures were needed. The contagion spread from the periphery to the core to Spain and Italy.

If Greece does default on its loans even after the current proposal is implemented, will the Eurozone be in for a "Lehman Crisis"? The Lehman Contagion Argument certainly acknowledges that problems relating to intra-Eurozone trade and the integration of financial and goods-and-services markets are a major precipitant of the current crisis. But the panicky core of the argument rests on the fear that markets might cease to weigh the fundamentals of borrowers and instead just sell off whatever looks, tastes, and smells "European", which by self-fulfilling prophecy would bring about another liquidity crisis and a sharp depreciation of the euro.

It's the "shoot now and ask questions later" mentality. This would lead to a flight to safety in the USD, causing a surge in the USD and a rise in LIBOR rates. It would also cause Eurozone banks to realize large losses, hitting their already weakened balance sheets and emaciating the ECB's balance sheet as well. It would make spreads and risk premia for peripheral countries blow out even further, adding heavy avoirdupois to debt burdens. The CDS markets, if CDS protection is triggered, could show unsuspected strains among certain market participants even though the aggregate exposure of buyers and sellers within CDS markets should net out across the financial system. Lastly, default could cause bank runs as depositors pull money out at more alarming rates.

When the founders of the European Union and the EMU created this regional experiment, they knew very well that it would be an incomplete integration, and as one crisis unfolded after another, future leadership would find the solutions on an ad-hoc basis. They were very well aware that no monetary union in history had been successful without the backing of a political union. Unhappily, that's not exactly how the string unwound. The euro had other latent deficiencies which even its architects couldn't have predicted. They were guided by the assumption that capital markets could correct public-sector excesses. They built risk-management solutions into the Maastricht Rules, but the process proved futile, as the whole membership was violating the very rules that were supposed to bring stability. Hopes had rested on the benefits to flow from a large, pan-European market and from the members' commitment to keep fiscal deficits, public debt, and inflation under control by waving the magic wand of Maastricht. But even the core Eurozone failed to live up to these mandates. A major imbalance surfaced: Ireland, Portugal and Spain showed budget surpluses and relatively low and healthy debt-to-GDP ratios, but both France and Germany ran government debt/GDP levels much higher than those of the periphery (Greece excepted).

The data subsequently showed that the excesses that developed in the periphery were not in the public sector but in the over-levered private sector.<sup>6</sup> Interest-rate convergences and the disappearance of risk premia throughout the Eurozone generated tremendous misallocations of capital, and this ultimately brought economic diffraction. In weaker periphery countries, low interest rates made for over-consumption, higher inflation, housing bubbles and a lowered competitive position. On the other side of the fence, in strong core countries such as Germany under the leadership of Gerhard Schröder, costs were reined in and reforms instituted following German reunification. Its global competitive position exploded.<sup>7</sup>

The strength of the German economy in recent years has stemmed mainly from its export success. Germany's lusty current-account surpluses — the fruit of domestic policies that dampened domestic demand while subsidizing export production — have come at the price of large current-account deficits in the periphery countries. Absent this Eurozone imbalance, the euro would have surged, making German exports less competitive. Low interest rates in the euro area allowed the periphery countries to finance their large current-account deficits. ***The funding of periphery borrowing by German banks was a necessary part of scheme, oiling Germany's export machine while aggravating the sovereign-debt problems of the periphery.*** Blame goes equally to the deficit and the surplus countries, so responsibility for fixing the Eurozone debt problem must fall squarely on both shoulders.

What we have now is a ***multi-speed Eurozone***, with debtor nations sinking under the weight of their liabilities, and surplus countries sailing high. With Germany the raptor in the room, the largest creditor and the European Union's only growth engine, it can dictate the terms of bailout assistance, which tend to be punitive and socially unpopular, braking economic growth even more sharply in the periphery. Authorities try to buy time, stalling through measures that will only make the final medicine more bitter. ***This only increases diffraction among the different speedometers of Europe, and it could lead to a disorderly breakup and potential disaster. The multi-speed economy of the Eurozone needs an alternate approach if the inevitable is to be delayed or tempered. Wise heads know that institutions are inherently imperfect, and the inevitable is the inevitable. What is key is preparation for the change.***

All functioning retinas perceive that the Eurozone's current institutional frame can neither foresee nor manage fiscal problems effectively. Many are asking why the Eurozone's political establishment didn't police Greece's economy and debt inflammation before the crisis. A hefty and final solution to the debt woes of Greece (and other areas of the Eurozone) will hinge on an ***accurate*** analysis of the underlying problems. The Eurozone's monetary union ***must*** be turned into a fully integrated economic union as well. But first must come the unpalatable medicine. Surplus countries must recognize that their domestic policies are as much at fault for the periphery nightmare as the latter countries themselves. It can't be a coincidence that *all* the periphery countries are in fiscal trouble. Alas, the Eurozone experiment has no modern precedent for solutions. These will require out-of-the-box thinking and political guts.

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<sup>6</sup> In fact, the public sector of many of the periphery countries, such as Portugal and Ireland, were much leaner than those of Germany and even China. As we mentioned above, Greece was the exception, most of the damage there flowing from the public sector. Ireland, Portugal and Spain ran government debt/GDP levels as low as 25%, 49%, and 36%, respectively, while debt levels in Germany and France averaged well over 60% of GDP during the previous decade.

<sup>7</sup> The topic of Germany's role within the Eurozone is a precarious one and will be left for future editions of our commentary. But one further point to be made on Germany is that its competitive position vis-à-vis the periphery received a direct boost from the EMU, because the periphery's crisis kept the euro well below where the deutsche mark would have been. We're convinced that if the euro ever disappeared, Germany's currency would appreciate significantly, evaporating its colossal trade advantage over other countries, especially in Asia.

## IV. Capital Markets Overview & Outlook

In our view, investors will most likely face a challenging investment landscape. Portfolio returns on risky assets will be compressed by historical standards, the product of a global slowdown and monetary tightening by key countries and regions. Nonetheless, the current environment does not counsel mandatory and hasty evacuation from risk assets. Quite the contrary. A case remains for global equities and other asset classes, but with meticulous selectivity and discipline in making strategic asset allocations. We maintain our view that equities will face some consolidation in the second half of 2011. For the time being, we expect the cyclical uptrend in global equities to be extended into 2012, when election hoopla should keep the good times going in equity markets.

Other strategic decisions will concern the allocation between the US and international equities. We have reiterated repeatedly our commitment to internationally diversified portfolios: Mean Variance Portfolio (MPT) optimization has proven time and again that adding international exposure to an equity portfolio heightens returns for the same amount of risk. We remain invested in global equities, with an overweight allocation to US Equities and underweights to International Equities.

***The US stock market has a better risk-reward profile than most other OECD capital markets. A weaker USD (allowing for accretive foreign currency translation), plenty of liquidity and low interest rates will continue to subsidize corporate profits for those large, well-placed multinationals that have trimmed the fat from their cost structures and accumulated large cash balances.*** As long as earnings don't disappoint and profit margins show signs of stabilization, the US stock market should be a great place to hide. These days, we don't expect multiple expansion any more than we expect equity risk premia to contract any time soon. Under such circumstances, we would emphasize larger-capitalization stocks as safe havens for our equity allocations, buffered from volatility by their high dividend payouts and stable business models.

And as we stated earlier in the year, relative and absolute valuations for Emerging Markets are no longer so compelling, as they have been natural feeding grounds for global liquidity and capital inflows, attracting those searching for higher growth and yield. At such levels, despite underperformance on a year-to-date basis, their valuations remain historically rich and prices topky.

Our key short-term risk concern in Emerging Market stocks, apart from valuations, is the inflation outlook. If Emerging markets are indeed on the verge of major inflation trends, EM equities will most likely underperform, since central banks will have to tighten much more, raising the specter of potential overshooting and a hard landing. We think that the inflation landscape in key Emerging Market economies is being distorted by transient factors such as rising food and energy prices. It's most likely that food prices have already peaked, as evidenced by Chinese wholesale prices and collapsing vegetable prices.

***We remain committed to our capital-markets outlook in our global equity allocations, tactically overweighting domestic equities at the margin and underweighting Emerging Markets.*** We believe that the cyclical undertones in stocks, which began in March of 2009, should extend further into the election cycle. That said, we have not changed our baseline scenario for anemic growth in the US, extending into the foreseeable future, as the public/private deleveraging process weighs down on GDP growth. Moreover, this most recent *soft patch* in US and global growth data may serve as a warning signal that investors will be faced with further disappointment as they read the economic releases.

### **Its all about earnings . . . and multiples**

Thus, while our equity outlook, and our surface economic outlook may seem contradictory, they are not. So far, the U.S. stock market has been in a bit of a sweet spot in the earnings business cycle, seeing strong profit growth, muted economic expansion, huge productivity gains, easy monetary policy, low interest and inflation rates, and

non-existent wage pressure. ***Our take is that as long as the world economy does not spin into reverse, S&P earnings should grow and so too should stock prices. That is the basis for our being cautiously constructive regarding equities.*** Our course, we are fully cognizant of the Global Tug-of-War, and we do agree that there are too many risks and uncertainties that may have propagated a larger risk premium on equities than would traditionally be the case, keeping multiples compressed and valuations low for extended periods of time. Looking through the rear-view mirror, we see the rally in stocks since March 2009 as unlikely to be repeated. On the same note, we anticipate profit growth for the S&P 500 in the single digits rather than the double digits we saw following the March 2009 lows. And thus far, we are seeing just that — second quarter earnings still respectable on a historical basis, but not growing as rapidly as they have during the past two years.

Well, what about multiples? If we take the consensus of \$98 for forward 2011 operating earnings, with the S&P at ~ 1330, we are trading at a Price/Earnings ratio of 13.6x, which is arguably within the fair value realm for this type of environment. However, if we use a different P/E metric, as espoused by Robert Shiller, which uses the 1-year average trailing earnings<sup>8</sup> to smooth out the earnings cycle, we are currently as much as 30% overvalued. So why the discrepancy? Are the markets telling us something about the global economy that makes this current business/earnings cycle illusory?

We know that globalization and trade have exploded during the past decade, and with it the share of S&P revenues and earnings originating abroad, especially from Emerging Markets. So we must ask if it's still reasonable to try forecasting S&P earnings mainly from US GDP and other indicators biased by US economic conditions, such as Shiller P/Es that reflect previous US earning cycles. Can we assume that equity markets have gotten it right this time by discounting previous US earnings cycles as largely irrelevant? And with the increasingly internationalization of US earnings comes the distorting effects of the USD fluctuation — as with recent USD weakness, which has lifted S&P earnings thanks to currency translation.

So it's imperative to stress today's disconnect between corporate profits and GDP growth. Logic teaches us that earnings should follow GDP growth, but there are key reasons why hitching top-down earnings forecasting to GDP growth forecasting could yield misleading results:

1. **Cost cutting:** Maximizing shareholder value by aggressive labor conservation;
2. **Productivity:** Technological advancements that can substitute capital for labor;
3. **Globalization & Global Growth:** Export outsourcing and sales in overseas growth areas;
4. **USD Translations:** Weaker USD that brings a currency translation of overseas profits; and
5. **Low Interest Rates:** Lower cost financing that shrinks the overall cost of capital.

Global tailwinds have allowed American companies to prosper in overseas markets, benefiting from an ever widening global footprint. At the same time, global headwinds have forced these same companies to cut costs in this uncertain environment by pruning their headcount and cutting back on capital layouts. Such savings have all coursed to the bottom line, creating a near-ideal condition for US earnings growth. The headwinds, however, did negatively impact multiples paid for these earnings. Historically, when inflation is within the 1.0% to 2.0% range as it is now, P/E multiples go as high as 18x. The multiples are considerably lower today, reflecting the negatives in the economy.

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<sup>8</sup> It is important to note that Forward P/Es are based on operating earnings, which remove one-time items and other potential distortions, whereas Shiller P/Es include GAAP measures which incorporate all items. This tends to depress earnings shown by Shiller calculations and produces overvaluation more easily.

## Global Fixed Income

Fixed Income & Credit remains attractive to us for a variety of reasons. While many have predicted that US Treasury rates would trend significantly higher, especially after the end of QE2, we strongly disagreed and have thus far been proven correct, with most fixed-income sectors outperforming equities.

***The likeliest threat that we see boosting interest rates on a sustained basis is a dramatic and prolonged increase in economic activity. This would reduce the output gap and absorb excess capacity, especially in labor markets. Rising labor costs would start inflation climbing and cause the Fed to tighten money.*** Such developments, especially if accompanied by stagnant productivity growth, would make us shy away from fixed income. But with employment/population ratios still at multi-decade lows, we think this whole scenario of an economic zoom highly unlikely. The tea leaves we read show the global Tug-of-War more heavily tilted towards headwinds, not tailwinds.

***So our outlook continues strongly thumbs-up to Fixed Income and Credit across all sub-asset classes. We put in this group domestic, including government, corporate and municipal (where appropriate), as well as global/international, an environment in which a broader opportunity set provides management a plethora of fertile alpha generation, and at lower cross-correlations to other fixed-income exposures.***

US Treasuries continue to trend lower, as we have expected, much to the chagrin of even the largest bond managers. Since the end of QE2, the 10-Yr Treasury has lost almost 30bps and is now trading below 2.9%. From a global perspective, Treasuries outperformed all G-7 debt in the first half of 2011. Treasuries returned 2.09%, while the UK returned 1.78%, Italy 1.68, Canada 1.79%, Japan 0.6% and only 0.7% for government bonds worldwide.<sup>9</sup> Bond dealers are betting that the second half of the year will be different for Treasuries, with the US economy firming and the Fed winding down its QE2. In fact, the 20 primary bond dealers have a -\$44.5 billion position in Treasury notes and bonds, compared with an -\$11 billion average over the last three years, showing their expectation that prices will fall.<sup>10</sup> Additionally, all hedge funds we've talked to are bearish on credits — either short or holding no positions. ***This makes us even more bullish, possibly setting up for a short squeeze. We believe that when all is said and done, we could see the 10-yr Treasury trade at levels well below 2.5% and even down to 2.0%.***

### US Municipal Bond Market Update

There are increasing concerns about the ~ \$3 tln US municipal bond market. Although issuers of US municipal bonds are coping with the lingering effects of the recession, we believe that most of these fears are overdone. Issues do remain, but we don't think that municipal bonds will be the next Black Swan that rocks the financial markets. They'll shimmy and shake on the media stage for awhile, increasing their volatility, but this will allow the patient investor better opportunities to scale into positions.

There's evidence of a turnaround in state finances. In nearly every state in the nation, revenue is up, YoY, as municipalities have begun to reduce expenses. With most other municipal expenses subordinated to municipal bond interest, we are fairly comfortable that municipal defaults and bankruptcies will remain a non-issue as long as the overall economy continues sidestepping a flat-out double-dip recession.

Still, state and local government revenues have been badly affected by the recession. Even with the bounce of the economy, tax and other receipts, though rising, remain well below 2008 levels. Despite states' efforts to close budget gaps by higher taxes and fees, they've suffered shortfalls that required a dip into reserve funds. Even federal aid, which softened the initial blow, has tapered off substantially as the federal government puts the broom to its own fiscal mess. But on the brighter side, while states wriggle through financing gaps, interest rates are rock

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<sup>9</sup> Bloomberg, *Economist*, 07.06.2011.

<sup>10</sup> Bloomberg, *Economist*, 07.06.2011.

bottom and account for little more than 5.0% of overall state expenditures. Municipal interest payments are higher up on the state debt capital structure, making their remittance quite secure.

Meanwhile, state/local unfunded pension liabilities loom as a bigger issue. Even if state and local governments solve their shortfalls, they'll have to increase taxes or cut spending drastically in order to meet pension liabilities while complying with constitutional balanced budget requirements. But even though the pension problem is very dire, time may be on the side of state and local governments. They may have to fund their pensions with larger budget allocations, but at present that share of the budget is very small compared to other categories of expenditure. And they have the power to discount those future liabilities.

To summarize, investors may continue cautious about the fixed-income credit class, but we believe that such fears are overblown. Investors will have ample opportunity to capture safe and stable tax-free returns as default fears dissipate.

Our positive outlook about municipal bonds is based on the following factors:

- Tougher transparency/disclosure requirements by the SEC for municipal bond issuers
- Interest payments that are given precedence over other budgetary items
- Bonds backed by underlying assets that are easily determined
- A steady investor base — mostly high net-worth US retail investors who hold them for income and not for trading
- Constitutional balanced-budget mandates that help state and local government stay fiscally sturdy
- Recovering tax revenues and cost cutting that should prove beneficial as long as the national economy does not double dip

## Commodities

The performance of commodities was strong during the first quarter of 2011, and the renewed bullish case made for them was based on two arguments. The first was a further fear of USD debasement. The second was based on China's growth, which would spark a new supply/demand tail-chase, causing strains on global commodity supply chains. We find weaknesses in both arguments. First, commodities increased not only against the USD, but against all major currencies, negating the argument that commodity rallies were based on a weak USD. Second, we have yet to see a big spike in global demand. In fact, the second quarter has brought renewed economic weakness not only in the OECD countries but in Emerging Markets and even China. China's insatiable demand for materials like copper will trail off in the coming years with the deceleration of housing construction, which is inevitable, due as much to the laws of large numbers as to property restrictions, over-leverage and tighter monetary policy.<sup>11</sup> We also see weak economic prints in Chinese industrial activity, thus further debilitating industrial commodities in the coming quarters.<sup>12</sup>

To summarize, some of the factors we see bringing a soft patch to commodities are:

- Demand destruction caused by previously elevated prices;
- In the shorter term, supplies recovering from temporary shocks — draughts, rain, etc.;
- A general tightening in the Emerging Markets, leading to economic slowdowns;

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<sup>11</sup> GaveKal Five Corners, "Commodity Bulls Fight History and Slowing China", Warwick Simons, May 23, 2011.

<sup>12</sup> Chinese demand for industrial metals such as copper and aluminum has already fallen double digits (year-over-year).

- Short-term oversupplies and inventory building; and
- Potential USD strengthening as a result of lingering Eurozone problems, causing a flight to safety.

The implications of our short-to-intermediate-term commodities outlook is quite straightforward:

- Falling inflation expectations and interest rates;
- ECB and EM central banks likely to stop raising policy rates; and
- Less hawkish Fed and lower resulting interest rates.

Despite our cautious outlook for commodities over the short to intermediate period, our longer-term view remains more sanguine, unless we see these cyclical weaknesses in the global economy becoming more systemic, and unless we see the natural supply constraints that have evolved over the past few years resolved by technological innovation, substitution and the like.

Herewith a few comments on specific commodities that have grabbed the national media attention and/or on which we have bullish biases.

## Gold & Precious Metals

Gold entered 2011 on a weak note, as reduced safe-haven demand outweighed the lure of gold arising from inflation fears sparked by commodity prices. In April and May 2010, gold prices surged as investors sought a safe haven from risk — in particular from paper currencies — and from the Eurozone’s sovereign debt crises, long-term fears about the USD and economic weakness elsewhere. After another brief respite in the second quarter, July has thus far proven very bullish for gold, amidst angst that the Eurozone contagion might spread to the core countries. Despite receding fears of inflation, we believe that the price of gold will continue to climb, spurred chiefly by worries about the health of the global economy and sovereign debt. We see gold rising to over \$2,000 in 2012, whether or not the Fed opts for QE3.

We have several reasons for expecting the long bull market in gold to continue into the foreseeable future:

1. Weaknesses in the global economy should keep interest rates low, translating into very low or zero negative carry on gold, which is very bullish for gold;
2. Worries about sovereign debt are likely to enhance gold’s status as a safe haven. Within the Eurozone, these worries have already led to unprecedented demand for physical bars and coins. EMU break-up fears will persist;
3. Central banks around the world, after net-selling gold for three decades, have become net purchasers during the past two years. The factors responsible include the demand for safe assets, diversification away from the USD, and growing interest from the Emerging Economies’ central banks. This trend shows no sign of ending;
4. Chinese private-sector demand for gold increases appreciably, boosted by limited high-quality alternatives for savers and the increased availability of investment vehicles for gold, including access for the first time to overseas ETFs in precious metals.

Even with the easing of Middle East concerns, it is not difficult to anticipate further economic and financial shocks that could drive the price of gold significantly higher, say the fallout from a fiscal crisis in Japan, the threat of a US-China trade war, doubts over the future of the euro.

***We therefore reiterate our bullish outlook for gold and gold equities. The bull market in gold has legs to run.***

## Crude

***We expect oil prices to remain at current levels and even trend a bit lower for the rest of the year. Our reasons are:***

1. A weakness of demand, given a slowing global economy. (We're not prepared to state that oil's falling price will be relieving factor strong enough to rekindle growth. For that, oil prices would have to fall significantly lower);
2. A world economy that still remains susceptible to exogenous shocks;
3. A firming of the USD over the short term; and
4. Current high inventory levels

One of the major events of the last quarter that affected the energy complex was the International Energy Agency's (IEA) announcement of a release of 60 mln barrels from strategic petroleum reserves, of which around 50% would come from the United States. Additionally, to prevent an OECD recession caused by oil, Saudi Arabia continues to increase its oil output to push prices down. While the announcement about the petroleum reserve was totally unexpected, the amount of oil to be released was not large enough to change the longer-term outlook for prices. ***The longer-term prospect for oil prices continues to hinge on demand, and more importantly, whether Emerging Markets will continue to demand oil at the current torrid pace, and on geopolitical risks in the Middle East and the resulting supply shocks, plus negative developments in financial markets — and last but not least, the value of the USD.***

***To summarize, while we remain favorable to the energy sector over the longer term and expect continued volatility in the shorter, this volatility has enabled us to establish positions at lower price points while maintaining core positions.***

## V. Concluding Remarks

Just as we had expected, the torrid pace of economic recovery that took hold after the March 2009 market lows has petered out. The Herculean stride of global deleveraging, undertaken mainly by the OECD countries, has and will continue to put a damper on economic growth for some time to come. We see the global economy making a wavering recovery in this post-financial-crisis world. The factors are straightforward. In a typical cyclical recession, recovery followed by a stimulus palliative tends to be quick and effective. But post-crisis recoveries are a different beast entirely. They can limp on for years with fragile growth and substantial output gaps.

The externality of financial crisis followed by output gaps brings with it a narrow margin of safety for future exogenous shocks — Japanese natural disasters, Eurozone sovereign debt, Middle East geopolitical tremors,

commodity supply disruptions, US housing pathologies . . . Iranian nuclear threats. Any one of these may not quite be a dispositive down-and-out for the global economy, but a confluence of such factors may do the trick.

**Many economists, in fact, have labeled the recent global slowdown a transient soft patch, believing that further monetary and fiscal stimuli can rev up the necessary escape velocity. We believe that a more appropriate analysis of the post March 2009 lows will conclude that the recovery was a transient growth patch, making this recent “soft patch” the True Normal.** Unlike our brethren at PIMCO, whose “New Normal” paradigm depicts the Emerging Markets, especially in the Asia Pacific region, as magically immune somehow from the structural ills of the globe’s latter-day crosscurrents and underpinnings, we believe that even the Emerging Markets are well advised to take notice.

Despite their hare-like growth leadership in this **multi-speed** economy, Emerging Markets must not forget that their development strategies are still oriented largely towards exports, facilitated by our uncoordinated international monetary system and the legacy of Bretton Woods. No matter our fond belief that China has turned the corner and now follows a tale of domestic consumption, that tale is still a Midsummer Night’s Dream. Any sneezing by the US and the Eurozone and the Chinese will catch catarrh – just ask Caterpillar. The dials of China’s industrial activity remain closely correlated to G-3 growth patterns. The Chinese will respond to perturbations by tapping their piggy bank — i.e., foreign reserves — and letting the fixed investments tinkle out, regardless whether or not their economy needs the transfusion. But this tale must wait to be told another day.

Our policymakers find themselves ill equipped to handle the new challenges of this global macroeconomic environment. They putter on in reactive mode, skirting politically unpopular proactive solutions, their thinking confined to short-term election cycles rather than spread-out structural trends. We saw this vividly in the recent QE programs, which brought exiguous results for positive fundamentals, such as job growth, housing resuscitation, or the reorienting of our economy from jobs in non-tradable goods to jobs in high-value tradable goods that bring meaningful and sustained results. Liquidity injections in these cases do little more than foment asset-price bubbles. All countries seem hot to pump up their economies at any cost, to themselves or to their neighbors, oblivious of downstream repercussions.

**So we ask the question: With the US mired in public/private balance-sheet malaise, the Eurozone in debt malignancy, the globe itself in a trauma of imbalances, what can we expect from our policy solons? Solutions — or another left-tail crisis skulking around the corner?**

The current approach of cranking up the fiat-money printing press to dole out short-term relief to bankrupt nations is merely putting off the Cod Liver oil, waving off a serious diagnosis of the underlying disease. Despite this, we detect a salutary changeover from traditional welfare-state Keynesianism to fiscal reform on the German model, keynoted by Gerhard Schröder and Swedish supply-side economics. **And as we have written numerous times before, global imbalances and sovereign debt are not the problem although they have become a problem. They are the rash the problem has broken out in.** The barely-there ghost of an institution that we call the International Monetary system is designed to breed these global imbalances and shocks and exogenous left-tail events that bring financial crises to the daily breakfast table. Weak-kneed responses and flaccid political will only magnify the impact, making the left tails fatter — i.e., more likely to occur, and with more frequency. It’s slim satisfaction to us that the recent soft patch and the potential downgrading of US debt have brought to pass the gloomy prognostications we’d already been making.

**And so our clients rightly ask: How are we positioned for this uncertainty and increased volatility? Our watchword at TwinFocus is that crisis breeds opportunity — opportunity for the global investor who is both patient and well-positioned.** Our investment philosophy is to position for **multiple scenarios**, with strategic positions at the core, and tactical maneuvering through market volatility at the margin. Our bias, at least for the moment, is that headwinds will blow harder than tailwinds in the great global Tug-of-War, yet there is every reason to stick with global equities as long as growth vectors do not plummet. Our economic Fortuna is a fickle goddess,

and we wouldn't want to miss rallies that one can't possibly time to perfection. Our portfolios are oriented to overweight US Equities (enjoying the safety of large-caps multi-nationals in particular) and marginally to underweight both International Developed and Emerging Markets. We do the latter for these markets' safety profile and their dual exposure — to innovations in the US economy, and to the faster growth of Emerging Markets, a bonus being potential alpha generation through currency translation (i.e., a weaker USD). The strategy has worked out well for our clients, as US Equities continue to outperform their International brethren.

On the fixed-income side of the portfolio equation, we hold ourselves apart from the consensus pack — and we feel ever more confident as events unfold. **While there are compelling reasons to believe that US Treasuries are grossly overvalued (from a historical perspective at least), we are firmly convinced that traditional bond concepts and calibrations bring misleading results when used to measure Treasury value.** We've seen a ringing demonstration of this point year-to-date, as US government debt has performed the best of all global sovereign debt by a significant margin. While this topic alone would warrant a whole whitepaper, we don't believe that the 10-year Treasury should be made a ouija board for interest rates over the next ten years. It should be seen more as a "global safety blanket" and risk-free asset that central bankers need to buy. Domestic corporate and global fixed income also remain exciting allocations to us for the reasons we stated above, and we don't see our convictions changing soon unless major moves higher mandate a pairing of back positions on valuations.

Lastly, on Alternative Investments and Commodities, we're parking ourselves on the cautious side when it comes to commodities, and industrial commodities in particular. Among our reasons are slower global growth, a stronger USD, subdued inflation fears as central banks pare back monetary inflation, and the resolution of short-term supply issues. The one exception here is gold, based on our underlying premise that gold is no longer a real commodity, but functions more like a safe asset and reserve-currency alternative to the USD within the constraints of our International Monetary System. We therefore remain fully invested in gold and would look to add to commodity positions upon valuation pullbacks.

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