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"If all that mattered was being the biggest, elephants would own the circus."

- Eike Batista, Brazilian Industrialist & Entrepreneur -

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Executive Summary

- Headwinds to the global economic recovery include higher energy and food costs, increasing geopolitical risks, lingering EZ sovereign debt risks, a US policy shift from one of stimulus to one of constraint, and finally Japanese aftershocks on the global supply chain.

- As a result, we expect global growth to slow in the second half of this year, particularly in developed economies. Fiscal austerity policies will begin to take effect and consumer spending will contract from the ill effects of higher food/energy prices.

- In our view, inflation, in both core and headline CPI, will subside by the end of the year. While commodity inflation will be the main factor in the short-term, low unit labor costs and productivity trends will control inflation over the longer term.

- Even so, the combination of improving unemployment figures along with real-term weakness in the US economy points to a topping-off of productivity, a development to be expected at this point in the cycle. Lower productivity from here on could dampen profit margins and mute corporate profits in the second half of the year.

- In the US, fiscal austerity, lower net exports and weakening consumption have translated into lower GDP growth in the first quarter of 2011, coming in at 1.8% relative to the much stronger showing in the fourth quarter of 2010. We expect consumer spending to slow even further in the second half of the year thanks to higher gas/food prices and the faltering housing market.

- Although unemployment has declined, it remains well above its historical average and will continue to weigh on consumer confidence. Moreover, lower unemployment prints have not been accompanied by meaningful increases in nominal wages. In fact, we are witnessing lower real wages, a datum which supports the tame inflationary outlook.

- Growth will be much weaker in the EZ this year than in the US. While business surveys suggest the EZ economy accelerated at the end of 2010 and in the first quarter of 2011 with the help of Germany, tighter fiscal/monetary policy, a stronger euro and weaker exports will dampen demand later in the year. Higher interest rates will also undermine demand in the housing sectors, especially in the periphery.

- Should we listen to economists or to credit rating agencies? First-quarter growth in the UK has come in much weaker than expected on the heels of major fiscal consolidation. These measures taken as a result of credit rating downgrades are clearly starting to have negative impact on the economy and consumer confidence.

- We remain concerned about the ongoing crisis in the periphery of the EZ. Portugal is following Greece and Ireland into a rescue bailout plan — and despite the core economies' dedication to the EZ and the EMU, their indulgence of further bailouts in the periphery is wearing thin. One or more peripheral governments, notably Greece, will most likely default as its sovereign debt costs swell while government revenues shrink. Doubts over the future of the EZ itself look likely to persist, if not escalate.

- The outlook is relatively brighter for EM economies, where growth may slow only slightly. Government data that we are getting augur a soft landing for China. The Chinese economy may be starting to slow, largely due to suspending the fiscal and monetary stimulus to slow inflation, but we still expect GDP to rise by ~ 8% in 2011. At the same time, headline inflation appears to be leveling off and should fall in the second half of this year, allowing an easing of monetary belt-tightening. Indeed, the last dial-reading showed food prices pulling back significantly.

- We expect robust growth to continue in the Pan-Asia economies. Inflation remains the key bogey, a consequence of rising commodity prices, high capital inflows and accommodative monetary policies. Central banks will respond with a mix of policies — higher interest rates to bridle inflation, higher reserve requirements and FX manipulation. The threat, as always, is overshooting, making for a too-restrictive environment and too much of foot-on-the-brake pedal action.

- GDP in Latin America will also rise by ~ 4% to 5% this year, with headline inflation buoyed by food and fuel prices and by various country-specific supply constraints. Central banks will tighten policy further and even introduce fiscal austerity measures. Rising real interest-rate differentials with developed economies will attract more capital to the region, further complicating monetary policy. Looking longer term, we see the region's greatest threat in a significant softening of commodity prices, although some cooling would be welcome.

- It will be important for governments to tighten fiscal policy in order to keep growth in balance. Brazil has taken steps in that direction this year, announcing fiscal cuts of over 1% of GDP and a reduction in off-balance-sheet subsidies.

- Prospects for the Middle East and North Africa (MENA) are also very different between countries which are resource rich (i.e., oil-exporting) and those that are resource poor (commodity-importing). Waves of democracy and political change in the latter are bringing turmoil, and the unrest is depressing tourism and foreign direct investment, with Egypt, Jordan and Lebanon specially affected. The economies of Saudi Arabia and Qatar, in contrast, are awash on high oil prices.

- With respect to the commodity complex, we remain bullish despite near-parabolic moves higher and stretched valuations for certain commodities. As long as the major countries' central banks stick with loose monetary policy, the global carry-trade landscape will funnel continued capital flows into these markets, pumping out more lucrative returns compared to markets in the Western economies. This is being exacerbated with the fall in value of the USD. From a higher vantage, however, a normalizing of policies and a slowdown in the second half, especially from the likes of China, could put a crimp on demand, whirling in a perfect storm for a major-league correction/consolidation, with industrial commodities particularly affected.

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I. Global Capital Markets | Introduction

The first quarter of 2011 saw two major exogenous shocks to the global markets: contagion-like social/political tensions in the Middle East and North Africa (MENA) and the natural disaster in Japan. Are these events likely to derail global economic activity? These are the key issues to monitor. On top of those concerns, political and sovereign debt challenges in the Eurozone (EZ) remain largely unresolved. However, global capital markets have become remarkably resilient, shrugging these issues aside and discounting only the most positive economic outcomes.

While global markets remain resilient, we do not. We believe one of the greatest threats to the sustainability of this recovery is the spike in the price of oil. Oil prices have spiked because of a confluence of factors such as a) fundamental demand-side responses to stronger global economic activity, b) supply-side shocks associated with fears of major oil disruptions in the MENA region and increased marginal costs of production, and c) central bank-linked financial liquidity such as QE2, breeding speculative fevers. These factors have created a very bullish supply/demand dynamic for oil. That in turn will necessarily squeeze real disposable incomes and as a result will depress consumption and growth patterns. An ancillary boost to this oil spike are inflation rumbles in Emerging Market (EM) economies, in the wake of rising food prices.

Responding to these inflation pressures, EM Central Banks have begun tightening the monetary noose, raising the risks of sharper slowdowns in activity in their respective economies. The ECB has also become the first among the Developed Markets (DM) economies to raise policy rates. This reflects the ECB's hawkish stance and its desire to signal to the periphery that the ECB will not be influenced by deteriorating economic conditions. But the move is likely to exacerbate the economic woes of the peripheral economies, already in the throes of severe fiscal austerity measures.

A special economic concern of ours is strictly home-based, and has to do with the end of the QE2 program and the fallout thereof for Wall Street — and Main Street. The current political make-up in Washington bodes ill for a possible QE3 in the event the US economy fails to gain sustainable economic velocity in the second half of the year. The hard-pressed spine of the Fed could be tested further by any signs of declining credit conditions and contracting monetary base, worsened by weaker housing and financial-asset prices. Political skirmishing in Washington DC would add another goblin or two to the nightmare.

Lastly, two major "firsts" confronted the world in the first quarter of 2011. The first and most obvious was the negative outlook put by Standard & Poor on our country's triple-A credit rating. However, we would argue that this downgrade could be a positive development if it gives sharper urgency to the fiscal austerity debate on Capitol Hill, and leads to a swifter proactive resolution. We can look to the UK downgrade for a salutary precedent. Once the UK's new coalition government announced widespread plans for fiscal consolidation, S&P upgraded its outlook back to stable.

The second, largely unreported "first" was the recent participation in military exercises of a Chinese warship off the coast of Libya. This is something unprecedented and portentous for a country that has abstained from any overt intrusion in other countries' sovereign affairs. Are we seeing here a symptom of China's need for resources to fuel future growth, and the need to protect its immense human and capital resources located overseas? Does this signal a change in China's role on the world stage? We shall see.

II. Global Macroeconomics & Capital Markets

Global Equity Market Characteristics & Valuation Analysis

Much has been written and continues to be written about the "cheapness" of current stock-market valuations. In this section, our aim is to demystify these global stock-market stats by using a different set of metrics. This will allow an alternate set of conclusions to crystallize out of the fog.

- The global stock market, as per the MSCI All Country World Index (ACWI), is trading at a discount based on the current forward P/E (12.1x) versus its 10-yr average (14.4x) — yet its dividend yield, its Price/Free Cash Flow, and its Price/Sales metrics all reveal that its trading is roughly in line with 10-year trends. This discrepancy in valuation is earnings-focused, and is based, in our opinion, on high corporate profit margins. But we see profits reverting to historic levels once cost pressures can no longer be passed on to end markets, and as productivity gains begin to wane. But the crystal ball can show a different picture. A good deal of positive news has already been pre-discounted in corporate earnings reports, so a continued flow of such news would be enough to rosy up the scenario.

- US equity markets and DM equities (EAFE) are trading at historic discounts of 18% and 20%, respectively, as measured by forward P/Es.

- At the same time, based on the Q-Ratio, US equities are trading at over 50% premiums to their 40-year averages. And if we calculate earnings based on the 10-year quarterly averaging method (Case-Schiller), we get overvaluations of 25% plus.

- Historically, EM stock markets, as represented by the MSCI EM Index, have traded at ~ 20% discounts to Global Equity Indices (as measured by 10-year average metrics), 20% discounts to the MSCI EAFE Index and 30% discount to US equities. (See our discussion on ***Emerging Markets*** for further discussion on this topic.)

    - Currently, EM equities are trading at an ~ 8% discount to parity with the ACWI, at parity with EAFE, and only a 16% discount to US markets. The reason for this relative valuation compression is not that EM valuations have become expensive on an absolute basis, but that DM equity markets have become cheaper than their 10-year average.

    - ***Nonetheless, relative to EM, DM equities are more attractively priced based on empirical trends, and this leads us to conclude that DM equity markets may outperform in the shorter term as valuation spreads revert to their historic relationships — unless structural imperatives result in permanent changes to relative valuations, a development that remains to be seen***.

- Within US equity markets, US Small Cap stocks, as measured by the 20-year average of the Russell 2000 P/E relative to P/Es of the Russell 1000 Index, are trading at over an 18% premium to 20-year averages. Similarly, Large Cap Growth stocks are trading at a 22% discount to their 20-year means.

- If we use the University of Michigan Consumer Sentiment figures as forecasting tools for predicting the path of future ***Forward P/Es, we see that the linear correlations between Consumer Sentiment and Forward P/Es is over 70%. Consumer Sentiment initially rose from its March 2009 lows, but has recently reversed course, even prior to reflecting the rise in commodity prices, and this fact could create P/E contraction going forward, especially in light of our forecast of lower margins and lower productivity as well as higher taxes.***

- The 40-year average for the University of Michigan Consumer Sentiment reading is 85.8. The current reading of 69 — well below historic averages, even this far into the so-called economic recovery, and despite unprecedented fiscal/monetary stimulus — shows, we would argue, that Consumer Sentiment has been a drag to the overall economic recovery. Accordingly, we are not surprised by the recent downturn, despite stronger than expected consumer spending in the first few months of the year, which is largely the result of temporary government transfer payments, lower private-sector savings rates and the wealth-effect mechanism from the QE2 program as designed by the Fed.

University of Michigan Consumer Sentiment Index
12.31.2002 thru 04.30.2011

Source: Bloomberg

- ***To summarize, we find relative value in the following equity themes***:

    - **Developed Markets over Emerging Markets** over the short to intermediate term as valuations of DM catch up;

    - **US Large Capitalization Equity** over smaller cap stocks because of:

    - Attractive relative valuations
    - Income-producing dividends, characterized by larger cap stocks in the current volatile environment, and
    - The multi-national nature of large caps as they gain exposure to high-growth global markets

  - **Growth over Value** in this environment, which sees investors seeking added risk premium for the sake of growth

III. Country/Region & Topical Analysis & Overview

United States

The Good, the Bad & the Potentially Ugly

US economic growth currently shows meaningful signs of recovery and a potential acceleration of growth. For example, a number of government statistics provide some bright light at the end of the proverbial tunnel. For example:

- The ISM Manufacturing PMI is at multi-year highs
- Corporate balance sheets are healthy, with ample cash reserves to increase maintenance and expansionary capital expenditures
- Employment figures are improving (although wages remain anemic)
- Financial asset price reflation is producing a wealth effect, increasing private-sector consumption along with large government wealth transfers
- Stimulative monetary and fiscal policies are in place
- A weakening USD should lead to improved net export prints and increased profits upon FX translation
- Overseas revenue growth from U.S. multinational companies is robust
- Productivity trends are healthy (but with indications that these trends are reversing)
- While ~ $554 bln of output was lost during the 2008 crisis, ~ $571 bln has since been recovered

Despite these positives, lingering remnants of the crisis are keeping the US economy from achieving sustainable growth and/or permanent escape velocity. The rebound in activity remains lackluster and anemic for this stage of the recovery. We therefore see the following threats to any recovery going forward:

- While private-sector activity has temporarily slowed down, we believe that the picture is far from complete. Increased consumption has been the direct result of the wealth effect from asset-price inflation following QE2, as well as public sector releveraging (bringing about record federal budget deficits), and a pop in disposable income due to lower taxes and higher government transfer payments;

- While the employment picture is improving, it still remains at 8.9% — and with the U-6 figure, which includes part-timers and discouraged workers, just under 16%. Labor participation rates are at a two-decade low despite consistent growth in the US population. In fact, the ratio of employed persons to total population has barely moved despite a 100bps improvement in the employment figure. The unemployment metric, at a 39-week average, is the highest it's been since the post-WWII period. Moreover, the GDP print of barely 2.5% makes for job creation barely large enough to absorb new entrants into the labor force. What's more, the recovery has managed to restore only ~20% of the jobs lost since the recession (1.7 mln of the 8.7 mln in lost jobs). ***At a very aggressive monthly rate of 250K new jobs (unrealistic at GDP prints of ~ 2.5%, but used for the sake of argument) which would include jobs for new entrants, it would take over 4.5 years, at a conservative estimate, to re-employ those who lost jobs during the previous recession***. We are more likely to enter another recession over the next 4.5 years, thereby adding to the toll of those needing re-employment.

- Housing appears headed straight for double-dip as sales, demand, prices, and new construction all dive toward new lows. Supplies seem to be piling up due to inventories of homes in the process of foreclosure. There are over 3.7 mln homes vacant or for sale, an additional 3.5 mln that are occupied but for sale, and 1.8 mln that are in distress;

- Rising oil and food commodity prices are taking a whack out of real disposable income and thus GDP growth. In fact, food/energy now eat up over 23% of US wages and salaries;

- While commodity price spikes increase headline inflation, the pass-through to core is still slowed by a significant slack in industrial capacity, labor, and housing stock. With limited pricing power to pass along increased input costs, profit margins, currently at historic highs, may droop as a result, triggering an equity market correction;

- Capex spending remains anemic, as capacity utilization is low and global macro uncertainties high; and

- The fiscal problems of state and local governments will require retrenchment and cutbacks, with further drags on economic growth end employment.

QE2 & Treasury Market Impact

This is has been a hotly debated topic ever since PIMCO's Bill Gross came out with his March 2011 ***Investment Outlook***, asking the question: Who will do the buying [of Treasuries] after the end of QE2? In fact, based on his outlook as described in this piece, PIMCO's Total Return Fund liquidated its Treasury position and even went net short on Treasuries. However, despite having such a big seller in the market, Treasuries have since appreciated, nose-thumbing PIMCO's outlook. They appreciated on the very day that S&P cut its outlook on US Treasuries. Go figure!

As for who will do the buying after QE2, we believe that there's a logical answer – all you've got to do is look at the empirical data. For a start, there's no clear causal link between the Fed's purchases of Treasuries and lower Treasury yields. With QE1, 10-year yields did drop by ~ 50bps in March 2009 when the Fed announced its first $300bn of Treasury purchases. But they soon reversed course and by the time QE1 was completed they were significantly higher. Similarly, yields have risen since QE2 was launched.[1] Based purely on empirical evidence, any Sherlock of the stats might well connect QE programs with higher yields.

[1] After QE1, from April thru August, the Fed allowed its balance sheet to shrink by ~12% and contrary to the popular outlook, the yield on the 10-Yr Treasury plunged from 3.84% to 2.66%, along with a 16% correction in the S&P 500 and firming of the USD. In fact, the best days of the Treasury markets occurred after the end of QE1 and prior to the announcement of QE2, even with the Fed out of the buying picture.

From a supply/demand perspective, this isn't as illogical as it might seem. ***As the Fed buys government bonds and other assets from institutions, the proceeds eventually find their way into financial and risk assets, such as equities and commodities***. Banks and financial institutions with greater reserves can start increasing loans and overall credit. Such a rise in economic activity can make bonds look less attractive, especially if inflationary expectations begin to creep higher. At the end of the day, we believe, the impact on yields will largely depend on what happens to expectations in shorter-term credit markets (i.e., interest-rate SWAP rates of the equivalent maturities). If QE succeeds in achieving escape velocity to the US economy, bond yields may actually end up higher. Accordingly, the impact of the Fed's completed purchases will depend for the most part on whether they're interpreted as a sign that short rates will also be raised soon.

Moreover, QE is not the only factor that moves and influences interest rates. Treasury yields will move lower in the event that we continue to expect slower economic growth after June when QE2 ends and inflation fears in the US begin to subside. They will also be affected by any increased demands for safe-haven assets as shields against global macro problems. ***On the day that the S&P downgraded the triple-A credit rating of the US, the debt whose outlook was downgraded actually traded higher. What are the US credit markets telling us?***

Who will be the buyers after the Fed drops out of the demand picture? We say the traditional buyers, both institutional and retail, such as:

- Pension plans and insurance companies
- The US corporate sector with its unprecedented cash hoards
- The private sector (which is under-allocated in fixed income)
- Mutual funds and hedge funds
- Banks – commercial and money center
- Central banks (especially in EM economies with pegged FX rates to the USD as their foreign reserves continue to explode – the money has to go somewhere and it continues to find its way into the most liquid market on the planet – US Treasuries) and sovereign wealth funds
- Foreign private investors (for the lure of the safe haven)

Remember that the Fed has been the unconventional buyer during QE programs, and that the three-decade-long bull market in US Treasuries prior to that was sparked by outside buying, from non-Fed sources and funds. So it may make intuitive sense to ask who'll do the buying once the Fed stops, and the bloated supply of Treasuries crams the markets, and Congress continues to spend, there will be plenty of shoppers with buying capacity to step in, as they have in the past. This will be even more the case if we have a second-half economic slowdown, which looks increasingly likely. ***To emphasize, history has proven that the status of the Fed as a buyer is a very poor predictor of the directionality of Treasury markets***. ***In fact, the completion of the Fed's purchases of Treasuries could be a turning point for the price of assets such as equities, Treasuries and commodities. We will continue to focus on these events as they unfold.***

Before we move on to another subject, it's vital to address a related question. Why should foreigners continue financing our debt and investing in the US? We believe there are several reasons. First, the sheer size and liquidity of the US economy and capital markets make it hugely attractive. Second, property rights and other wealth-creating institutions make our economy uniquely successful. Third, despite structural headwinds and the ripeness of its wealth, the US economy exhibits the dynamism of a fresh entrant, in part because of positive demographics (we're one of the few DM countries where the population is actually increasing), and thanks in part to the innovation and flexibility of its movers, shakers, and tinkerers. Also, US markets have a comparative advantage over the rest of the world by being able to exchange low-risk debt for higher-risk equity.[2]

[2] We have to remember two vital facts about US Current Account Deficits and global imbalances as they pertain to the US. First, equity investment, both direct foreign investment and portfolio equities, make up a much larger US claim on the rest of the world (~ 60%) than foreign

US Corporate Profits-At-Risk (PAR) | US Profits Recovery Outpacing Economic Recovery

As we've mentioned in previous musings, this corporate profit boom remains quite unique – *it truly is different this time* - especially when we juxtapose the general level of US corporate profits with the anemic US economic growth rate. In fact, first quarter 2011 GDP prints have just been released, showing a meager 1.8% growth rate while corporate profits continue to flourish, albeit at a decelerating rate.

We attribute this profit boom against the backdrop of a weak economy to several factors:

- The continued proportion of profits generated in overseas markets, thus correlated more with global GDP than US GDP
- Positive translation effects of USD weakness compared to foreign-sourced profits
- Multi-decade low levels of labor costs plus other costs such as taxes and interest expenses
- Healthy productivity enhancements that have flowed down to shareholders.

In fact, research by JP Morgan reveals that from 1950 through 1985, post-recessions, profits recovered at 2.0x the rate of GDP growth. From the mid-1980s through the 2007 crisis, profits grew at a 4.0% clip (which we believe more closely reflects the natural and sustainable rate). Currently, the profits-to-GDP recovery is over an eye-popping 13x.[3] Moreover, adjusted, after-tax corporate profits (as a % of GDP) are currently 8.5% - versus the mean of 6.0%.[4] So we have to ask whether these trends in corporate profits and profit margins are sustainable. We believe that they are not. History has shown that corporate profit margins are one of the most mean-reverting statistics of all. If in fact they do revert to the mean (let's put aside the meager 1.8% GDP print for the time being), *ceteris paribus*, P/E ratios on the S&P would climb to over 25x simply from the contraction in the bottom line. This would hardly become a "cheap" market under such circumstances.

We base our conclusions of shrinking margins and lower corporate profits-at-risk (PAR) on several factors. First, since the introduction of QE2, the Fed has created real price pressure in the production pipeline that cannot always find its way through to finished goods. This is evidenced by the sudden increase in Producer Price Indices, mainly from basic commodities and energy. While companies have a bit of wiggle room to absorb some of the price increases, the effects of increased producer costs will ultimately flow to the bottom line.

Second, productivity trends also point to lower profit margins. The two necessary elements for a growing economy are growth in the labor/capital base *and* how productive this growth is. Stock markets prefer that most economic growth come from productivity enhancements because this tends to boost profit margins, profits that flow to shareholders and not to wages.[5] Growth through increase labor with sagging productivity sees more of the spoils going to employees and hence lowering profits. Recent government data point to a slightly improving employment picture with a weakening economy, indicating deterioration in productivity, and this, when coupled with surging raw material costs, will be sure to put pressure on profits over the coming quarters.

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investments in the US (~ 35%). In effect, the US is selling fixed claims and investing in equities – earning an equity risk premium from the rest of the world and very opportunistically participating in global growth. Second, most US assets located abroad are denominated in foreign FX while foreign assets held in the US are denominated in USD. Thus, with any depreciation of the USD, the US claims rise in value relative to foreign claims. This is made possible through the latent but deliberate use of the US' exorbitant privilege as the global reserve currency, buffering any possible negative externalities associated with current account deficits.

[3] *Eye on the Market*, Michael Cembalest, JP Morgan, 04.26.2011.

[4] "Guide to the Markets," *Market Insights*, Yuri Khalif & Greg Bell, 03.31.2011.

[5] "Breakfast with Dave," Gluskin Sheff, David Rosenberg, 04.01.2011.

The current consensus calls for earnings growth of over 14% coupled with top-line growth of over 13%. This translates into expected profit margins *increasing* from 8.5% to 9.0%, with every sector in the S&P outside of healthcare enjoying a boost to margins.[6] We haven't seen this type of top-line growth since the beginning of 2006 at the height of the bubble, when nominal GDP was running at 8.5% - a whopping 4.7x current growth rates. This begs the question of just how this degree of top-line boom can be achieved with such anemic general growth, and against the headwinds of shrinking profit margins.

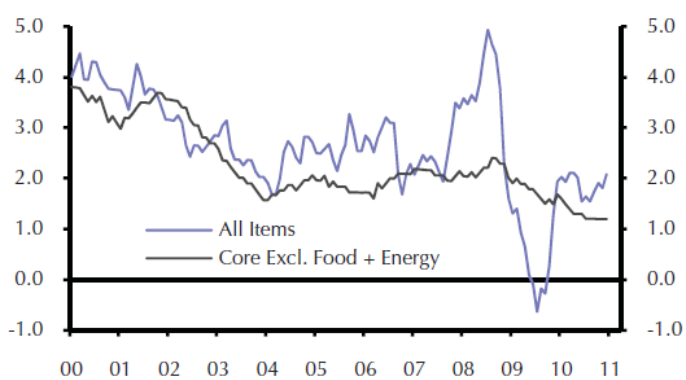
Inflation, Stagflation or Deflation | Select Topics

Current Environment

The recent surge in global commodity prices, most notably in food and energy, has raised the specter of inflation fears around the world. The EZ, where headline inflation is flirting higher than its long-term targets, has started to take action and raise policy rates. Additionally, the major EM countries (i.e., BRICs) have also proactively instituted a variety of tourniquets to contain the problem. In this section, we'll analyze the extent of inflation as a problem, and the factors that ***must*** be monitored to determine if the Medusa of inflation will truly rear its ugly head.

Most recent government data from around the world suggest that underlying inflation remains very subdued in DM economies. Headline inflation has inched its way higher, creating inflation fears in some countries and even central bank tightening in others, notably in the EZ. But the mean headline OECD inflation is only marginally above 2%, well below historic rates. What's more, core inflation, which is a better and more stable metric over the longer term, has shown no sign of rising. What are the markets telling us yet again?

OECD Consumer Price Indices (%, YoY)
2000 thru Q1 2011



Source: Capital Economics

Domestically, to provide some historical color on CPI figures, US headline CPI has averaged 4.1% over the past 50 years, but currently stands at 2.7%. Ex-energy and food, core CPI has also averaged 4.1% over the past 50 years while it only exhibits a 1.2% print currently, and this incorporates abundant food and energy effects that pervade the economy. Higher gas/food prices should soon push headline CPI inflation over 3.0%. But we believe that these

[6] "Breakfast with Dave," Gluskin Sheff, David Rosenberg, 04.12.2011.

moves will be temporary, especially since longer-term inflation expectations and wage growth are unlikely to rise in a recovery that will prove unsustainable in the second half of this year, when policy stimulus fades and fiscal consolidation begins, especially in the EZ.

What's more, there still appears no evidence that recent commodity inflation and/or a weaker USD will lead to permanent inflationary environment — and the reason is that the key to inflation is not commodities but labor. During the 1970s, for example, while commodities did play a part, it was strong labor unions, higher wages and poor productivity that fueled inflation. Institutionally-driven cost-of-living wage adjustments, poor productivity, and their joint impact on profit margins had greater effect than resource sectors on elevating the levels of inflation. The picture today, with wage growth stagnating nominally and deflating in real terms while productivity streams at 2.0%, is a different beast indeed from those times.

As we stated earlier, while there has been some improvement in the employment picture, the underlying dynamics are far from healthy. Most of the new jobs are in relatively low-paid service, leisure and retail areas, and the proportion of part-time work has increased markedly. What's more, the dip in unemployment has not come with a corresponding increase in the labor participation rate, a likely sign of widespread dropouts from the labor force due to unattractive lower wages and a dearth of suitable work. ***As the chart below shows, unit labor costs in the US continue their downward negative trend, despite apparent improvements in employment. We would note that unit labor costs have a ~ 90% correlation with aggregate inflation rates. During the hyperinflationary period of the 1970s, unlike the situation today, unit labor costs did not decline for any single quarter***.

US Nonfarm Business Sector Unit Labor costs (%, seasonally adjusted, YoY)
12.31.1961 thru 12.31.2010

Source: Bloomberg

The employment landscape for the EZ is even dimmer and gloomier. Average EZ unemployment was over 10% at the end of last year, but the disparity between employment in the Northern states and peripheral states is an eye-opener. Employment is running below 4.0% in the Netherlands but north of 18% in Spain. In Germany, unemployment is likely to fall even further than it is, yet Consumer Sentiment may not translate into much higher spending.

To be sustainable, any commodity-led inflation footprint *must* be accompanied by such confluent factors as:

- Credit expansion
- Healthy housing turnaround
- Real wage expansion with material rise in unit labor costs
- Capacity over-utilization
- Materially lower productivity
- Positive money velocity and multiplier growth
- Material service-sector inflation (where raw material inflation has little impact)

None of these other factors is currently present, leading to our view that this is a very tempered commodity-led inflation and is cyclical in nature. In fact, very little Producer Price Inflation (PPI) is finding its way to end markets, further supporting our thesis that corporate profit margins will revert to their mean and that earnings will come under pressure in the months and quarters to come.

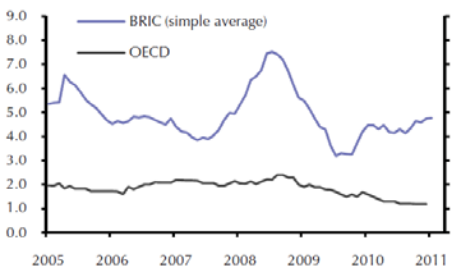
Similarly, lingering spare capacity, high unemployment levels from the recession, the ongoing housing malaise and the continued pressure for public and private sector deleveraging are all likely to keep the lid on inflation firmly clamped for some time to come. Higher commodity prices (oil and food especially) might support inflation expectations in the short term, but as supply-and-demand dynamics work their way through these short-term commodity issues, the threat of disinflation or deflation could become a very real story in the US before too long.

Moreover, while concerns are felt over debt levels and bond issuance from fiscal indulgence, inflation remains the most important factor in determining the directionality of long-term interest rates. Until we see concrete evidence of inflation, we remain believers that the bull market story in bonds has not reached the last chapter. That said, the only logical conclusion is that 2011 should remain volatile for interest rates as credit markets work to absorb and discount conflicting data points on the strengths and weaknesses of the national economy and the lasting consequences of the QE2 termination. We remain dubious that the current year will bring us to the fulcrum point where interest rates reverse the bull market enjoyed since 1981. However, we are prepared for the unexpected as we gradually adjust our portfolios to capitalize on the potential for a higher interest-rate environment.

Emerging Markets & Inflation

Inflationary pressures are greater in EM, especially where food accounts for a much larger share of consumption baskets. When it comes to slack in the economy, we find much less spare capacity in EM economies than in the DM economies, as the latter still suffer from negative output gaps. The risks of “second round” effects in EM are also greater since most of them are now operating at (or above) full employment. Nonetheless, while a number of EMs, including Brazil, are likely to overshoot their inflation targets this year, the risk that inflation will spiral out of control remains low. In most cases, inflation can be brought in check by a mix of higher interest rates, quantitative tightening, higher reserve requirements, capital controls, and faster currency appreciation, all without doing much damage to economic growth. Inflation in EM is a greater hazard because their capital and manufacturing-based economies are much more susceptible to commodity-based inflation than a service-based economy like the US would be. These distinctions are clearly reflected in core CPI prints of BRICs over DM economies as seen in the chart below.

OECD & BRIC Core CPI Inflation Rates (%)
2005 thru Present



Source: Capital Economics

One final point with respect to inflation and EM economies: As we mentioned above, an economy cannot sustain a high inflation rate without high credit growth that stimulates abnormal demand.[7] In fact, large credit and money-supply growth in the BRIC countries have been stoking uncomfortable levels of inflation, exactly as textbooks would suggest. Monetary growth during the past 12 months in Brazil, Russia, India and China now ranges between 15% to 30% — easily the highest such growth rates among the world's major economies. Very loose credit conditions have boosted excess demand above natural levels, and without commensurate levels of fixed investment growth, which has led to significant and rising rates of inflation.

EM central banks have been contracting monetary growth and curtailing credit growth to slow aggregate demand: one avenue to curb inflation. If successful, this measure may ratchet down the recent uptrend in commodity prices. It has been widely believed that the incremental demand for commodities over the past decade has originated from EM economies, especially China, fueled in part by loose money and credit growth. Accordingly, any evidence that these trends are reversing and demand slowing can bode ill for commodities, at least for the short to intermediate term. And speaking of monetary policy . . .

Monetary Policy & Inflation

Numerous central banks around the world are pursuing loose monetary polices to spur activity. However, accommodative monetary policy can stimulate economic growth only if certain conditions are present. If, for example, the Fed introduces QE programs into an economy that suffers from large output gaps as a result of structural non-competitiveness at the hands of EM economies (creating large pools of the unemployed who require retraining), then this excess liquidity will find its way to the path of highest yields and returns. At the moment, this is the situation in EM countries where investment opportunities are more lucrative. The result is asset bubbles and destabilization of global capital markets. Moreover, it doesn't stimulate the US economy in any way, because no meaningful increase in fixed investment spending occurs in the US to increase productivity. What does occur are massive liquidity/capital inflows, creating demand shocks in countries/regions that do not need it, raising the drum beat of "currency wars" and a protectionist reaction that could devastate any global recovery.

What's more, as we mentioned above, the increased liquidity from Fed programs has not landed new state-of-the-art factories in the US but two carry trades instead — financial assets in EM markets and in commodities. These carry trades involve borrowing for very short periods of time in the US and Japan, where short-term rates are practically zero, and investing in EM equities, fixed income and FX, and now in commodities, especially in gold and oil. Because these investments are highly tactical — i.e., short term in nature — they do nothing to boost productivity in any country, but only serve to distort the short-term price of assets. Lastly, because EM countries

[7] "EM central banks are doing Fed's dirty work," *Financial Times*, Richard Bernstein, 04.26.2011. Monetary theory states that high levels of inflation require abnormal levels of credit growth.

have largely followed a pegged FX regime (against the USD) to serve as their guiding development strategy, this has further facilitated the export of US monetary policy into EM countries.

Further, when last year's draughts shrank the supply of food inventories, investors migrated to the agriculture carry trade. Similarly, when political tensions emerged in the Middle East, carry-trade funds moved into oil markets. At a time when political instability, the Japanese natural disaster, and lingering concerns of the EZ sovereign debt malaise have underlined the need for tail-risk insurance, the carry trade has continued into gold. More importantly, as the carry trade has pumped prices of hard assets higher and higher, creating the specter of inflation, the demand for gold has risen even more, funneling more liquidity into that asset.

What has become apparent is that an expansive monetary policy — by conventional and unconventional means — has put us in a Catch-22 situation. The increased liquidity has flowed into carry-trade assets such as commodities, but without any jump in economic activity.[8] On the contrary, increased prices of food, energy and other industrial commodities has become a major threat to the sustainability of this recovery. Any signs of further weakness will force the Fed to try further monetary loosening, increasing the carry trade, raising commodity prices again and making matters worse. ***This spiral will stop only when we address the underlying problems within the US (and other DM economies) economy, which are structural challenges arising from competitive EM economies. We need to retool our factories and retrain our work force rather than chase the mirage of an easy way out through inflation***.

Can an Inflation Tax Solve the US Debt Problem?

It is widely believed that creating inflation by paying debt through money creation, and with it inflation, can lower the debt burden of a sovereign — an ideal textbook script. However, our view is that the US is not in a textbook situation where we can float our debt burden away by inflation, given the nature of the debt.

There are several obstacles to trying it. First, while higher inflation will raise tax revenues, it will also raise government spending by the same token, and on a real basis. Second, higher inflation distorts real economic growth. For instance, if we assume that the US economy can grow by a nominal rate of 5.0% annually, a higher inflation rate will contract the real growth component. Third, if a material portion of US debt is inflation linked, any increase in inflation indices will automatically ratchet up interest and principal payments, solving nothing in real terms. Fourth, increased inflation will raise the cost of new deficit spending and new borrowing, making it even more expensive to run deficits and roll over or re-finance existing debt. If market participants sniff sustainably higher inflation even before it appears, investors will demand current compensation by means of higher risk premiums for uncertainty about inflation. An inflation tax is a grand tail-chase.

An inflation tax can ease a government's existing debt burdens and benefit the economy ***only*** if:

- It has little to no inflation-linked debt (TIPs)
- It has long-term outstanding debt
- It is currently running a surplus or a balanced budget, not needing new borrowings
- There are no distortive real effects on the underlying economy

[8] Actually, this is not quite correct. We believe that the Fed's main intent in the QE2 program was to create financial asset inflation. As US equity markets and other risk-asset prices increase, Americans feel "wealthier" as their equity investments expand, and as a result they spend more, boosting aggregate demand. Whether this temporary spending binge will result in a sustainable recovery is far from clear. What definitely results from these negative interest rates are major distortions in asset prices that may not end well.

Even if inflation does benefit government debt burdens, we need to consider other negative externalities. First, inflation through increased monetary policies can create asset-price booms and busts and non-fundamentally-driven credit expansion, such as the housing boom during this past decade. Second, it has undesirable distributional consequences by punishing savers and benefiting borrowers, especially if interest costs are locked. Third, once inflation is created, it could be difficult to bring down. It took a severe recession in the early 1980s through Paul Volcker's tight monetary policy to rein in the 1970s-triggered inflation binge. Lastly, it kicks the proverbial "can down the road" by creating less incentive for needed fiscal discipline.

So, will an inflation tax ease the US debt burden? Probably not by much because of where we stand with respect to:

- High levels of Inflation-linked debt
- Our fairly short-dated debt, with maturities averaging slightly over 4 years
- The current deficits we continue to run, with our expected deficit in 2011 approaching over 8% of GDP

Emerging Markets

Overview

In many EM economies, output has already regained pre-crisis levels and unemployment is under control, suggesting that recovery is well under way. With the DM economies still recovering from the financial crisis, the global economy has become increasingly dependent on EMs to drive growth. Machine manufacturers, energy suppliers, and raw-materials producers alike look to China and other fast-growing EM economies as the key source of marginal demand.

But there is a rub. As we mentioned earlier, headline inflation now exceeds 6.0%, up from 5% in January of 2010. Over the same period, core inflation increased from about 2% to 3¾ percent, suggesting that inflation pressure is broadening. In a number of the larger economies (BRIC), headline inflation is running well above central bank targets. Furthermore, some economies, notably Brazil and China, are in the midst of a credit boom that the government is trying to rein in.[9]

EM Equity Valuations

Since the third quarter of 2010, EM equities have underperformed DM equities, and in some cases have underperformed significantly. While we still see a period of relatively better performance for DM, we do not think it will last for a prolonged period, especially with emerging Asian equities. ***Admittedly, EM equities are still less attractively valued based on empirical data versus their developed brethren, but not overvalued on an absolute basis***.[10]

Looking back, EM equities have had a tremendous run. Since 2001, they have returned over 13%, annualized in USD. By contrast, the annual average total return from DM equities in USD has been ~ 2.0% during this interval. The attribution of the vast majority of this outperformance has come from a relative shift in P/E ratios, rather than from

[9] International Monetary Fund, *World Economic Outlook*, April 2011
[10] "Will emerging markets outperform," *Financial Times,* Gavyn Davies, 04.10.2011.

relatively faster earnings growth or higher dividend yields. While the P/E ratio for DM equities has fallen since 2001, the P/E ratio for EM equities has *risen or remained flat* since then.

Admittedly, the valuation discount of EM equities relative to DM equities has averaged ~ 20% since 2001, compared to a current level of less than half of that (in the case of the EAFE Index, P/Es are at parity). But many developments have occurred in the past decade that could explain this relative reorientation. Many EM economies have undergone enormous transformations, making them far less risky, such as a build-up of large foreign reserves and fiscal prudence. What's more, as we mentioned in previous sections, most of the shift in relative valuations has come about as a result of lower valuations for DM equities rather than higher valuations for EM equities. Finally, on a historical basis, EM equity valuations have not been capped by DM equity market valuations on the upside, since EM equities traded at premiums to DM equities before the financial crisis struck.

Regardless, based on these structural shifts in the global economy, we could very well see EM equities trade in line with DM equities for some time, or even permanently for several reasons. First, we do not foresee DM equities plummeting, creating multiple contractions to any significant extent. Additionally, we do not see EM economic growth stalling in any material way. Further, we think inflationary fears are a bit excessive: inflation in many cases is most likely close to peaking. While there are many global headwinds that could potentially derail this thesis, we believe that international investors will continue to allocate to EM assets once greater clarity on economic conditions is forthcoming in the second half of 2011.

China

While no discussion of EM is complete without some mention of China, and while we could write volumes on this subject, we'll limit our lucubrations here to one brief issue: whether China can continue to grow at the historically torrid pace it has been maintaining. As Premier Wen Jiabao stated in his new-minted 5-Year Plan, we believe China is in for a period of slower growth (~ 8% to 9%), and for the reasons we'll give.

China has been able to keep up rapid growth by shifting large numbers of underemployed workers from agriculture to manufacturing. But China's labor force may be peaking. The flow of workers from agriculture to manufacturing and services is slowing as the pool of surplus workers is drying up. The low-hanging fruit easily plucked as the labor force moved from rice paddies to factories has largely played itself out.

Moreover, China has been able to use its vast foreign reserves to gear up its extraordinarily high investment rate, on the order of 45% of GDP, at a virtual finger snap whenever required to boost GDP. A close analysis of GDP figures during the crisis reveals that the growth lost from global exports (~ 9%) was replaced with increased domestic fixed investment, which was boosted from 42% of GDP to 49% of GDP in 2009 alone. No country, especially an authoritarian one with a state-run economy, can be productive enough to take over 45% of GDP and reinvest it into new capital stock without incurring massive overcapacity and a staggering nonperforming loan problem.[11] We are fearful that China is suffering from overinvestment in physical capital and infrastructure. One sees this in new empty airports, bullet trains, highways to nowhere, massive new government buildings, new towns completely vacant, and spanking new aluminum smelters kept closed to prevent global prices from plunging.[12]

[11] "China's Unbalanced, Uncoordinated, and Unsustainable Growth Model," Nouriel Roubini, Roubini Global Economics, 04.05.2011. As China accumulates FX reserves, it needs to increase its monetary base to acquire them. In turn, to prevent inflation, it raises reserve requirements, institutes capital controls and partially sterilizes the monetary base through bond sales that produce a negative carry (as China earns a very low interest on its Treasury holdings relative to what it pays to its bond holders), making sterilization expensive.

[12] "China's Unbalanced, Uncoordinated, and Unsustainable Growth Model," Nouriel Roubini, Roubini Global Economics, 04.05.2011. "Several Chinese policies have led to a massive transfer of income from politically weak households to the politically powerful corporates: a weak currency makes imports expensive, low interest rates on deposits and low lending rates for corporates and developers amount to a tax on savings and labor repression has caused wages to grow much less than productivity."

Lastly, China's main development model in the past has been the Bretton Woods II Model, which we have written about in previous reports. Basically, China has been able to stimulate export demand by maintaining what is by any measure an undervalued currency. As the US continues buying Chinese goods, the Chinese turn around and finance the US purchases by buying US Treasuries, keeping US interest rates low, building up China's foreign reserves and pegging the RMB to an artificially low level versus the USD, to boost exports. This "vendor financing" scheme worked well enough until the credit bubble collapsed in the US. That made the resulting global imbalances, indeed China's whole development model, unsustainable.

Thus, in response to both domestic and foreign pressure, China will have to abandon the Bretton Woods II development model and transform/rebalance its economy, placing less emphasis on manufacturing and exports and more on services and domestic spending and consumption. Additionally, Chinese workers will start demanding higher wages and shorter workweeks, with additional social safety nets becoming necessary to decrease domestic savings and boost consumption. What's more, added consumption will mean less investment. All of this implies slower growth.[13] But this will create a potential global externality. In shifting to a more consumption-led dynamic, China will reduce its surplus saving and have less left over to fund the ongoing savings deficits of countries like the US.[14]

Therefore, we believe the true question to be, not *if* Chinese growth will slow, but *when* it will slow. Studies have shown that fast-growing economies begin to show significant and persistent slowdowns in growth when they reach per capita incomes of $10K.[15] This is expected to occur in China in 2014, assuming 10% GDP growth rates. Moreover, there is evidence that this slowdown could come sooner in China because of China's:

- Increased life expectancy and the one-child policy implemented in the 1970's
- Large manufacturing sector, which grabs more than 20% of employment; it will become necessary to shift workers into services, where productivity growth slows considerably
- Undervalued currency, making China more vulnerable to external shocks

To us, these factors crystal-ball a slowdown in China's growth rate, most likely over the next few years. However, China's large global bank account (in the form of FX reserves) can cushion any short-term volatility by merely ratcheting up fixed investment spending. That policy, though, is creating large misallocations of resources and reducing China's net wealth. For all these reasons, we remain bullish in the very short term, but see potentially rough waters on the horizon as China transitions. Our investment approach here is to allocate to broad-based EM exposure with satellite positions, where applicable, in hedged and tail-risk strategies. Such strategies are designed to benefit from China's future structural growth trends and from any actual turbulence this transition causes to global capital markets.

Latin America & Brazil | Balance Between Growth & Inflation

As with other EM economies, the Latin American region weathered the global recession well. But their policymakers must now contend with two strong tailwinds — high commodity prices and strong capital inflows,

[13] "Slowing China," Project Syndicate, Barry Eichengreen, 03.09.2011.

[14] "China's Turning Point," Morgan Stanley, Stephen Roach, 04.18.2011. "But the emphasis on the Chinese consumer is likely to be the new Plan's defining feature—sufficient, in my opinion, to boost private consumption as a share of Chinese GDP from its current rock-bottom reading of around 36% to somewhere in the 42–45% range by 2015. While still low by international standards, that would nonetheless represent a critical step for China on the road to rebalancing."

[15] "Slowing China," Project Syndicate, Barry Eichengreen, 03.09.2011.

both exerting inflationary pressures on the domestic economy. In most LatAm economies, the baseline forecast is for more tempered rates of growth than those seen in 2010, and a level of output more in line with each country's supply constraints.[16]

We expect the aggregate economies of Latin America to expand by 4% to 5% in 2011. One key risk is a precipitous drop in commodity prices, bound to affect any region that is a large net exporter of natural resources. For now, however, the priority for policymakers is to guard against bad credit/loan practices and inflationary pressures. The challenge is to cool domestic demand without attracting uncontrollable capital inflows and so exacerbating the problem of unbalanced growth. A range of different measures will likely be attempted, including further interest rate hikes, sterilized FX purchases and so-called macroprudential measures, such as higher bank reserve requirements. In the end, the countries which tighten fiscal policy, such as Brazil, will likely have the most success. LatAm's financial system is still in good shape, especially compared to that of the DM economies. But lending and credit growth have accelerated noticeably throughout the region, and default rates, in Brazil especially, are accelerating.

- In Brazil, GDP growth above 4% could stoke inflation. This is due to a lack of aggregate supply caused by fixed investment constraints. Fixed investment growth should reach levels of 25% to 30% of GDP, vs. the current ~15% levels. Supply-side initiatives, such as Infrastructure and other investment spending, are needed to increase aggregate supply. But a bulge in current-account deficits must be avoided, since domestic national savings is not large enough to satisfy increased investment.

    - The real problem is that government spending, which makes up 35% of GDP, is crowding out private-sector spending through gulping tax rates. Government spending is being poured mainly into wealth-transfer programs such as pensions and other social-welfare devices.

    - Less than 10% of government spending goes into infrastructure and other direct investments that would enhance productivity. The other 90% goes for wealth-transfer programs.

    - Lula's *Bolsa Familia* was a wealth-transfer program, but it came with a *quid pro quo* and, more importantly, was highly cost effective, accruing a load of less than 0.5% on GDP, and brought positive effects for income equality.

    - To combat inflationary pressures, Rousseff is relying on macroprudential measures without using the real as a policy tool. These include credit controls with higher reserve requirements, making stabs at reining in government spending, thus reducing Keynesian expansionary fiscal deficits, and boosting taxes to disincentivize consumer credit. The likely outcome of these policies looks uncertain for the approaching re-election years, when fiscal belt-tightening is not likely to be the voters' favorite digestif.

- Capital inflows remained strong despite attempts to control and limit them. Foreign investment is offsetting a savings deficit, and is also propping up domestic demand. But the associated appreciation of real FX rates will squeeze exporters even though only account for a smaller share of the Brazilian economy. The result is that growth among the region's best performers is likely to become increasingly unbalanced.

- This will complicate the fight against rising inflation. While food and energy hikes should start to moderate, diminishing spare capacity means that core inflation is likely to pick up. The upshot we project for this year and next is for inflation to remain above target for most of the region. In Brazil in particular,

[16] International Monetary Fund, *World Economic Outlook* , April 2011.

lowered investment has led to insufficient supply capacity, and we see this inducing inflationary pressures, creating a sensitive scenario for the newly-elected Rousseff administration, which will have to decide on socially unpopular austerity measures already in the pipeline.

- ***The problem is that foreign capital is going into financial assets, not infrastructure investments that increase capacity and productivity – two sound disinflationary forces***.

- Consumer credit has become a hot and widely debated topic in Brazil, and no wonder. It is viewed as a cautionary tale, as all eyes are riveted on the fact that it has approximately doubled as a percentage of GDP over the past 5-year period. With average interest costs at ~ 40%, debt service could choke off future consumer spending. Indeed, debt service already gobbles up over 25% of disposable income. While the region's banks are strong, warning voices are getting louder that the pace of lending is unsustainable and downright hazardous to the nation's health. These metrics, however, are distorted:
  - Firstly, because credit growth there springs from a very low base. LatAm consumers, Brazilians in particular, were highly under-leveraged to begin with.
  - Second, it isn't the amount of debt that drives the debt service/GDP ratio out of whack but a) high interest costs (implied inflation in Brazil is ~ 6.3%, based on the most recent Brazilian type of TIPs); real interest rates could sail north of 15% for certain types of loans, and b) the fact that maturities are very short, making monthly debt service much higher for such shorter-term debt.
  - Third, Brazil's aggregate mortgages/GDP is only 4% compared to 20% in other EM and over 50% in most DM economies. Additionally, mortgage rates are most often lower than government bond rates. Currently, mortgage rates stand at ~ 12%.
  - Thus, in the aggregate, debt in the Brazilian economy, as in many other LatAm countries, is low in both absolute and relative terms. Brazil in particular is sitting pretty, its terms of trade improving thanks to rising exports, despite a rising real.

MENA | Democracy & Regional Stability

A strong economic performance in the Middle East and North Africa (MENA) region in 2010 did not ease tensions in 2011. It might even have made matters worse, having sharpened a widespread sense that the new prosperity has not been spread evenly. Many in the region have failed to realize any benefits at all from this commodity-led expansion. A number of countries in the region, such as Egypt and Bahrain, have seen key economic sectors hit particularly hard by this regional instability.

This bifurcation of economic performance has spawned growing social unrest. In MENA's resource-poor (net commodity-importer) countries, the short-term economic prospects look fairly daunting. There has been a steady drop in tourism revenues, foreign investments and fund repatriations/worker remittances, and these have hit Egypt, Morocco, Tunisia, Lebanon and Jordan particularly hard. In these net-importing countries, the slowdown in growth is likely to be accompanied by rising budget deficits as governments increase spending on ameliorative social programs. Additionally, the cost of price subsidies and debt servicing will worsen fiscal pressures. For Egypt and Tunisia, the turmoil in neighboring Libya and slowdowns in the EZ periphery will make matters worse, especially for the tourist trade. On the other hand, high oil prices and record government spending in the resource-rich GCC countries (mainly Saudi Arabia and Qatar) should usher in a flush performance this year – excepting Bahrain, where civic unrest remains a major drawback. (See below for additional comments on Bahrain.)

Europe & the Eurozone

Overview

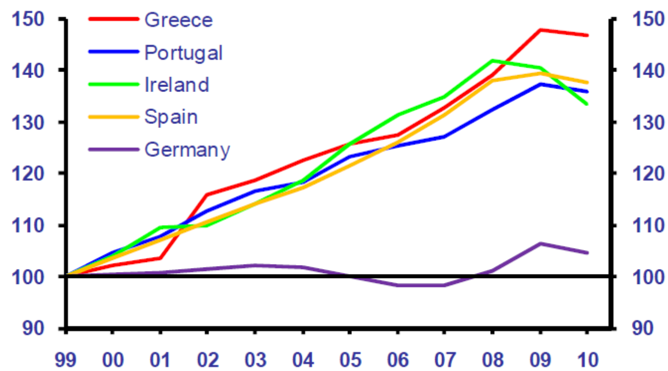
In Europe, economic recovery lopes along anemically. Real economic activity is stuck below its potential level and unemployment is still high. But it remains a tale of two regions, the North and the South, with wild swings from economy to economy. Economic slack is larger in the periphery of the EZ than in the core, while the powerhouse economies of European EM already operate at or above capacity.[17] Meanwhile, the challenges of EZ sovereign debt remain unsolved. In the following section, we'll review the cyclical and structural challenges facing the EZ, to see how much light we can glimmer at the end of the tunnel, and whether the EZ will survive unscathed.

Close analysis of the recession shows that 50% of the 2009 economic slowdown consisted of a pullback in fixed investments, making it as much of a supply shock as a demand shock. Government revenues and spending trends were highly linear, while revenues closely followed GDP, slacking in 2009 with the recession and foisting a metastasis on state deficits.[18] As the private sector retrenched, the public sector stepped in to prevent further economic slide, but creating ballooning deficits in the process. This corresponded to widening CDS spreads, tallying the true risk of underlying sovereign debt. Moreover, as we have written in prior commentaries, private-sector borrowing has also become a major issue in the EZ. Prior to the crisis, public-debt levels in many of the PIIGs countries were lower than those in Germany. It was only when the crisis hit and governments had to step in that public debt swelled to match private debt.

So why did this debt explosion and intra-EZ imbalance happen? We believe that it was due to a major misallocation of resources. Interest rates were not prudently aligned to reflect the correct risk premia in each of the individual countries. Each country's borrowing costs reflected those of Germany's. Interest rates were too high relative to the Taylor Rule for core countries, restraining their capacity and forcing them to become more productive. On the other hand, borrowing costs were too *loose* in the periphery countries, creating incentives to borrow and spend, pushing up inflation rates and wage rates, making labor forces unproductive. ***If we had to summarize one of the major woes of the EZ currently, we would use the chart below to depict it; it shows the extent of the productivity gap between the core German economy and the periphery.[19] It is simply amazing how distortions from low interest rates over the past decade have impacted the structural dynamics of the EZ***. Since the crisis, the interest rate environment has turned. The search for higher yields within the EZ has pushed German yields lower, to the point where they are below what the Taylor Rule would dictate (by a spread of over ~ 250bps).

[17] International Monetary Fund, World Economic Outlook, April 2011.
[18] ***While budget deficits have begun to improve, we notice that in France they continue to deteriorate, making them a factor in need of close monitoring to determine the long-term viability of the EZ***.
[19] Germany's competitiveness was aided by major wage and social welfare cuts/reforms as well as deregulation.

Eurozone Unit Labor Costs (1999 = 100)
1999 thru Q2 2011



Source: OECD, Capital Economic

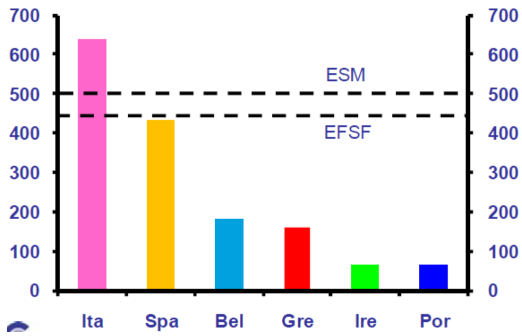
As we have pointed out, all this doesn't even approach the major structural problem bedeviling the EZ. That, in our opinion, is the lack of a fiscal union, or a federal-level Treasury which can act as an automatic stabilizer of last resort. Even Jean Monet, one of the architects of the European Union, understood that the EZ, bereft of a fiscal union, will likely be forced into multiple crises and eventually become the sum of these crises.

Reforms and Actions Taken

A few major actions have been taken by the EZ government and by individual states to address some of these structural problems in an endeavor to close the gap between the periphery and the core. First, major austerity programs have been instituted at national levels, following the Grand Bargain programs and Euro Plus Pact. These have narrowed divergences in competitiveness and unit labor costs among countries. With respect to intra-EZ current-account imbalances, it's worth pointing out that the German economy was once comprised of 45% exports, with 60% of those exports going to the PIIGs. It has since taken major steps to diversify its export base to Asian countries, allowing the EZ to run current-account surpluses at the aggregate level.

Second, the European Commission and the ECB have instituted a number of bailouts to stabilize the current situation. For instance, the EU and IMF have extended bailouts to Greece, Ireland and Portugal to the tune of €110 bln, €85 bln, and €80 bln, respectively. Much of this assistance (along with the aid of the IMF) was expedited through the European Financial Stability Facility (EFSF), which is due to be replaced by the European Stability Mechanism in 2013. ***The goal is to allow time for European banks that own large amounts of government debt to recapitalize by 2013 and thus be able to absorb the potentially large losses***. But the bigger, longer-term goal is to make sure that the likes of Spain and Italy do not land in the same bailout swamp wallowed in by Greece, Portugal and Ireland. The chart below demonstrates why. A default by Spain plus any other periphery country will be enough to flatten the total funding capacity of the EFSF and the ESM in 2013.

**Eurozone | Gross Financing Needs
by 12.2013 (€, bln)**



Source: Bloomberg, Capital Economics

One note on these bailouts. It appears that potential solvency problems are being treated as temporary liquidity hitches. It will be interesting to see what the combination of even higher debt, prohibitively high interest rates and fiscal austerity will be likely to have on already weak economies. While these countries painfully work through their debt problems, the ECB increases rates to dampen growth, responding to what is likely to be a temporary case of commodity-based inflation. Amidst these attempts to prolong the status quo until banks re-capitalize, we think it highly uncertain whether such bailouts will work on the first go-around, and that further bailouts might be required. Credit markets seem to agree with our assessment, since interest rates continue to soar despite government backstops and bailouts. Markets are clearly pricing against increased risks of default, and this will become a self-fulfilling prophecy as borrowing costs continue to increase. This procrastination might well continue indefinitely until the periphery economies collapse under their debt burden, at which point the inevitable defaults will be much messier, costlier, and more uncertain.

Greece and its Default

Many now believe that a default and restructuring of Greek government debt is simply unavoidable. Regardless of the small size of any bailout, Germany is no longer willing to provide a blank check on Greece's behalf. Believing that restructuring is all but assured and priced into the markets, the Germans no longer find it justifiable to burden their taxpayers to relieve banks and private creditors by extending loans to the Greek government. The IMF likewise believes that the current rescue measures for Greece will no longer be successful. The IMF had previously opposed the idea of debt restructuring for Greece, but is now pushing to reduce Athens' debt burden, currently at ~ 150% GDP. The potential restructuring options include: a) having holders of Greek debt take a haircut, b) extending maturities, and/or c) reducing interest rates.

These positions are in stark contrast to ECB president Trichet's belief that any Greek restructuring will jeopardize the confidence of the EZ, so that the EMU and the EZ could ultimately face a crisis of confidence. However, Trichet could also be wanting to protect the overall profits of the ECB. As part of ECB measures to bolster Greece's financial condition, the ECB bought billions of euros worth of Greek sovereign debt. Being one of Greece's creditors, it would be affected by any Greek debt restructuring. The ensuing write-downs would impact the ECB's bottom line and profits. For this reason, Trichet's dissenters want him to come up with a plausible plan for Greece to pay its debt service costs and to refinance via hostile public markets as early as 2012, at a time when Greece's 2-yr Treasury rates are at over 24%.

What do we think? Simply doing the math does not look good for Greece, and default looks all but assured. There is little possibility that Greece could successfully go to market in 2012 with current rates where they are. The economy is worsening, and IMF bailouts will only exacerbate matters in the short run. The question comes down to whether the Germans will be willing to bail Greece out permanently. One can argue that with Greece's small size and the EZ having lots to lose by a default, the benefits of a bailout might outweigh the costs. But moral hazard can be very expensive, and public unwillingness is hardening against such a move. If Germany bails out the smallest and most marginal of the EZ countries, would it not be necessary then to bail out Portugal or Ireland? With a sigh, we acknowledge that Greek debt restructuring — whatever the shape and size of it, and whether the rationale be candid or cobbled up — is probably just a function of time. Once the other countries have recovered a firmer fiscal footing and the banks a fluffier capital cushion, Greece will be forced willy-nilly to restructure.

IV. Concluding Remarks and Market Outlooks

Economic Outlook

We continue to see a multi-speed economy, in which our baseline scenario predicts a ~ 4% annual growth for the global economy, with advanced economies growing at 2%-3% and EMs at 5%-6%, despite the recent exogenous events. Within EM economies, we see a further bifurcation, with one group growing north of 8% (i.e., India and China) and the other group between 4% and 5% (LatAm and Brazil, EMEA and Russia, and MENA). Downside risks include further financial contagion in the EZ, renewed economic weakness in the US, EM policy missteps breeding inflation, capital inflows and FX appreciation, and lastly, increased global geopolitical risks. Our projected upside factors include increased economic activity in developed markets, increased momentum for a manufacturing and capital boom in the US, and the solution by the EMs of their policy dilemmas.

- We continue to like US equity markets over overseas markets, and we prefer large cap over small cap and have a slight bias of growth over value.
- We continue to see EZ danger signs, simply because we do not think that enough corrective action has been taken.
- We continue to favor EM markets and equities over the longer term as valuations catch up to DM valuations.
- Despite the fabulous run that commodities have had, we continue to believe they will do well only as long as the Fed is willing to flood the markets with liquidity. When increased liquidity refuses to go into Western economies, it will continue to deploy itself in fertile sectors such as commodities, oil and gold in particular — it is as simple as that.
    - We will change our outlook once the Fed turns restrictive and the global economy, China in particular, shows signs of major slowing. Under such conditions, we could see the commodity complex correcting and prices approaching their mean reverting marginal cost of production levels.
- We continue to nestle ourselves in the contrarian seat of fixed income, viewing tame interest rates ahead for the time being. Our economy will coast along in a lower gear than our interest-rate Cassandras are

doomsaying these days. Numerous opportunities still lurk in municipals, corporates (both investment grade and high yield) and in international/global credits.

But caution remains the watchword among our band of solons here at TwinFocus. We continue to believe that global financial asset prices have been driven more by government-assisted liquidity than by robust fundamentals. The latter determinants have a better proven track record for accuracy and dependability. We are also convinced that to take significant overweight directional risk in the current market environment is not prudent: risk and return profiles at these levels are not advantageous. We prefer to position around our long-term themes and conviction ideas, relying on non-correlated tail-risk hedges in various forms to protect against significant market corrections and exogenous events. In the face of a globe gripped by economic/market uncertainty, it remains an Everest-climb to settle on conviction investment ideas and to pinpoint opportunistic investment strategies. But that's our job here — to sift through the scramble of economic data, remove the "financial noise," determine and evaluate the eventual casualties, and find those areas that will outperform. We do this by maintaining a globally diversified portfolio, emphasizing our Top-Down approach that is aligned to capitalize during investment landscapes ***under multiple scenarios and various secular global trends.***

Thank you for your continued trust and confidence in our ability to navigate paths expected — and unexpected.

Respectfully,

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