



QUARTERLY COMMENTARY | FOURTH QUARTER, 2011

It appears market sentiment is becoming increasingly gloomier and the outlook for the global economy less and less optimistic. As a natural extension to these observations, we only have to look at the dramatic sell-off in global equities, commodities and currencies as evidence. It has always been our view that robust global growth, as we know it, will not return for many years to come. Global growth has been suppressed by major tectonic shifts in global demand while dismissing any re-emergence of the Emerging Markets Decoupling Theory, acting as the primary source of growth going forward. Moreover, we believe the Financial Crisis of 2008 is a true misnomer as the crisis was not isolated to 2008, but has lingered as the trade and capital imbalances that eventually caused the global crisis, remain in place. Should we call it the Financial Crisis of 2008 through 20--?? We think so.

If we had to use two verbs to best describe the previous decade leading up to the crisis, the two that come to mind which led to an over-indebted economy are: borrow & consume. Of course, as a corollary to that, we could not have borrowers and over-consumers unless we have savers and over-producers. These stubbornly persistent imbalances have created large debts in developed markets which are suppressing growth due to the painful, but necessary deleveraging process. Additionally, many do not distinguish between public and private debts because both are believed to be equally toxic. As the private sector sheds debt, there is greater need for the public sector to step in to cushion the negative impact to aggregate demand. This is the main mechanism through which the debt problems in the early part of the decade, that was largely private sector-related, slowly transpired into sovereign debt issues.

In addition, for most of the post-World War II period, the only part of the economy which experienced any real dispersion in level of activity was the private sector. Economists and strategists were focused only on finding those factors and catalysts that influenced the private sector, while assuming the first derivative (rate of change, or delta) of the public sector trends remained unchanged. This approach, however, is no longer valid. We are now witnessing many countries' credit rating lower than corporate bonds domiciled in those countries. All sectors of the economy must now be under close scrutiny, with sovereigns facing increasingly precarious and unpredictable circumstances. The concept of a "risk-free" asset is debated constantly. While the dust settles, everyone continues to flock to the USD and US Treasuries until a viable alternative emerges.

Lastly, we hear the phrases "risk on" and "risk off" all the time describing investor actions and sentiment. We think these are gross misnomers of what is really underlying these capital markets. We would more

appropriately call market actions and volatility as “Cheater Trades.” We use these words because markets today are very analogous to a classroom full of students taking a test. If all the students look to their left and right to copy each other’s answers, the entire class will have the same answers. All the students will receive the same performance, beta; same with these markets. Traders and investors are looking to what the person next door is doing to do the same, regardless if it is the right or wrong decision or if it is based on fundamentals. This way, everyone presses the “buy” and/or “sell” button at the same time, creating purely beta-driven volatile markets, where the test scores are “highly correlated.” This, in turn, makes fundamental investing all the more difficult. But it does create market inefficiencies that will be rewarded when the market cheaters get caught – and eventually they all do.

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“Failure is simple the opportunity to begin again, this time more intelligently”

- Henry Ford -

I. Global Macroeconomic Overview & Outlook

Executive Summary

Over the next several quarters, global demand is likely to weaken for several reasons. First, fiscal policies, which are already restrictive, will tighten even further, causing larger fiscal drags. Second, private sector demand looks to disappoint as well because households, under pressure from deleveraging, remain burdened with high debt, and the unemployment remains well above pre-crisis levels. Falling asset values, including housing and world financial asset prices will further dampen household spending through the wealth effect. This is coinciding with falling sentiment in business confidence, pointing to continued slow investment and capital spending growth. Finally, we fully expect GDP output in the Eurozone to fall in the coming years, regardless of whether a banking/bailout package is implemented.

Nevertheless, Developed Market economies as a whole *should* avoid a “double dip” recession in the coming quarters. Low interest rates will assist, as there is a negligible risk of central banks’ tightening anywhere in the world, given that inflation is set to drop broadly as a result of weak demand, plummeting velocity of money measures, falling commodity prices and historically large spare capacity spreads. We would expect even further falling commodity prices, especially within the energy complex, to cushion the blow of any weakening global demand.

Prospects for emerging economies are comparatively brighter because they have much lower public and private debt levels. With the exception of Central and Emerging Europe, financial sectors in Emerging Markets have much less financial interconnectedness with those in the Eurozone. However, the Emerging Markets still remain heavily tethered to the slower Developed Markets through export channels. We therefore see growth even within the Emerging Markets to be dampened from previous levels, although they do have more room for policy stimulus in the short to intermediate term, especially as inflation sets to fall in 2012.

Introduction

To provide greater granularity, in our opinion, volatility and uncertainty in global capital markets during the third quarter of 2011 were grounded primarily by three key developments.

First, the US and global macroeconomy remain on a slippery slope at a time when the burdens of exorbitant sovereign debt and the painful process of public/private deleveraging are putting further downward pressure on GDP growth trends, regardless of the amount of government stimulus imposed. US Treasuries suffered their first major credit rating downgrade while ironically still enjoying their rather robust rally, driving yields to postwar

record lows. We attribute this phenomenon to the global “fear trade” and the corresponding flight to safety, combined with an ancillary rally in the USD.

Second, the Eurozone sovereign debt crisis continues to manifest itself through deteriorating market sentiment, further driving down economic growth. With a Greek default all but certain, contagion has now spread from the periphery to the core countries of Italy and France. The financial and economic interconnectivity that has enveloped all Eurozone countries since the start of the Eurozone “experiment,” has facilitated the transmission of contagion effects through the under-capitalized European banking system, and financial institutions too big to save.

And third, we are also witnessing slowdowns in most of the systematically important Emerging Markets economies such as Brazil, Russia and China, which are widely considered to be the engines for global growth, regardless of the direction of developed markets under the guise of *global decoupling*. We are particularly concerned with the slowdown unfolding in China, which demonstrated completely incessant growth during the 2008 financial crisis and the recession that ensued. Associated externalities to the slowdown in emerging markets are: the pull-back in commodities and the complete breakdown in the Baltic Dry Goods Index, which we view as a reliable proxy for the health of the global economy.

How Did We Get Here?

Indeed, if we examine what has driven global growth during the past decade, several key ingredients come to mind:

1. In the US, a zealously accommodative Fed coupled with a US government willing to run massive fiscal deficits;
2. In Europe, a German government more than willing to provide artificially cheap China-like vendor financing (current account surpluses) to Eurozone periphery countries consuming beyond their means;
3. China and other Asian countries undertook an unprecedented reliance on export growth and a capital spending boom that had never been experienced before;
4. Excess reliance to debt-fueled public and private spending for growth in Western developed market economies;
5. Tolerance of prolonged triple deficits (current account, fiscal and trade deficits) during economic expansion; and
6. Commodity price boom that was the leading cause of this most recent downturn.

Unfortunately, this unsustainable party is now ending and the world is realizing that new growth models must be created. Equally important, it remains to be seen if the countries with unsustainable debt levels will experience Japanese-style debt *deflation*, or defaults coupled with *inflation*. Additionally, what was a **banking** crisis in 2008 became a **sovereign debt** crisis in 2009, and now appears to be morphing back into a banking crisis if government does not take proactive steps to stabilize the current situation.

Moreover, in the US, the Federal Reserve, Congress and the President all know very well that the interplay of previous monetary and fiscal policy are no longer effective or politically feasible, producing nothing fruitful in terms of economic growth and sustainability. In Europe, German taxpayers and the private sector in general appear to have reached their saturation points for lending to the periphery. This has cascaded from a previously private sector-led banking crisis to a sovereign credit crisis. The inevitable slowdown in the construction sector, empty housing and office buildings throughout the country and disgruntled trading partners around the world, from

groups as diverse as the US and Brazil, expressing their dissatisfaction with Chinese growth models, has definitely caused policymakers to be concerned about future growth initiatives.

What we now foresee is a radically different global macroeconomic environment than the one that evolved from the Bretton Woods post-war environment, with the abandonment of the Gold Standard in 1971, the revolutionary changes adopted by Deng Xiaoping after the death of Mao Zedong in 1977 and the fall of the Berlin Wall in 1989. In this regard, we do not think this prolonged slowdown is merely about lingering US unemployment, the Eurozone crisis or a likely China slowdown in fixed investments. It is more about transformational and highly disruptive macro undercurrents slowly auguring in a necessary change of leadership.

Global Downturn or Downright Recession?

How serious is this recent global slowdown and does it portend a global recession? September's government economic data support our view that, for now, the world economy is slowing, but not heading for an outright recession. Although the data does not suggest an outright negative global GDP growth, they are consistent with exceptionally low growth in most advanced countries, with the Eurozone already at risk of recession, and there are reasons to fear a more widespread slowdown.

Moreover, there are several reasons why growth could slow further in 2012. First, over-indebted governments in advanced economies have to undergo comprehensive and widespread fiscal contraction next year. Material fiscal drag will come from the US, even if President Obama passes his stimulus proposals, from the UK and the Eurozone as well as many Latin American countries.

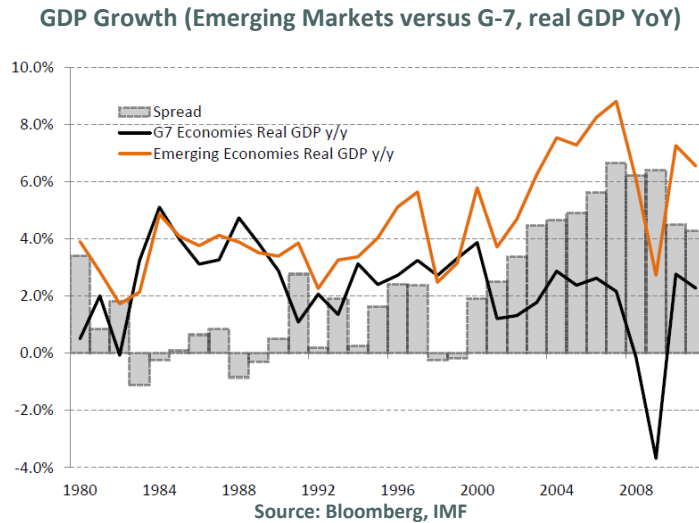
Second, the Eurozone crisis only looks to proceed down one path and intensify further. Given the political brinkmanship posed by many Eurozone governments, it may require a larger banking crisis, which could lead to contagion to the more systematic core countries considered *too big to save*, before the Eurozone political apparatus definitive decides what action is required. However, we have to ask ourselves whether there is another financial crisis looming, as governments and central banks do not possess the policy tools to mount another monetary or fiscal bailout on the scale they managed in 2008/09. Third and final, ***while most market participants believe that Emerging Market economies will remain resilient and unscathed from this malaise, we think they too will be affected.*** (See further discussion below.)

Against this cautious backdrop, we see several factors that could provide some support to global demand. First, the recovery of Japanese supply chains could provide a much-wanted boost to the manufacturing base. Second, the recent fall in commodities and natural resources (particularly oil) should help producers and consumers. The recent fall in oil prices should transfer some funds from high-saving oil producers (Middle East) to oil consumers (the West), stimulating consumer spending.

While the current slowdown does not look entirely like the economic quagmire we faced with the Lehman collapse in 2007-2008, the landscape is still fraught with potential landmines. Anemic growth is to be expected in most developed economies with growing risks of outright economic contraction in the Eurozone. ***To summarize, we do not expect a global recession in the later part of 2011, pending the absence of any disaster emanating from the Eurozone or a much larger slowdown in China and Brazil than is currently expected. The major determinant to the growth trajectory for the global economy remains within the future prospects of the Emerging Markets.***

Emerging Markets & Developed Markets: Economic Divergence or Convergence

It is quite apparent that most Emerging Market economies are growing significantly faster than their developed market counterparts. *The question in our minds remains whether this divergence will remain intact or will a new set of global macro dynamics provide the groundwork for convergence going forward. In fact, as the chart below shows in the shaded areas, we are already starting to see this happening.*



While Emerging Markets were able to avoid the 2008 recession that plagued most Developed Markets, a repeat performance appears more unlikely to engineer without significant help from governments worldwide. EM economies such as China continued to grow right through the 2008 recession for primarily two reasons. First, they plowed an unprecedented RMB 4.0 trillion into their economy in the form of fixed investments to boost demand. Second, globalization and free trade played and continue to play a very large part to their success. As emerging markets open their commerce to the rest of the world, their economies converge. We attribute this emphasis on globalization and free market openness on several factors:

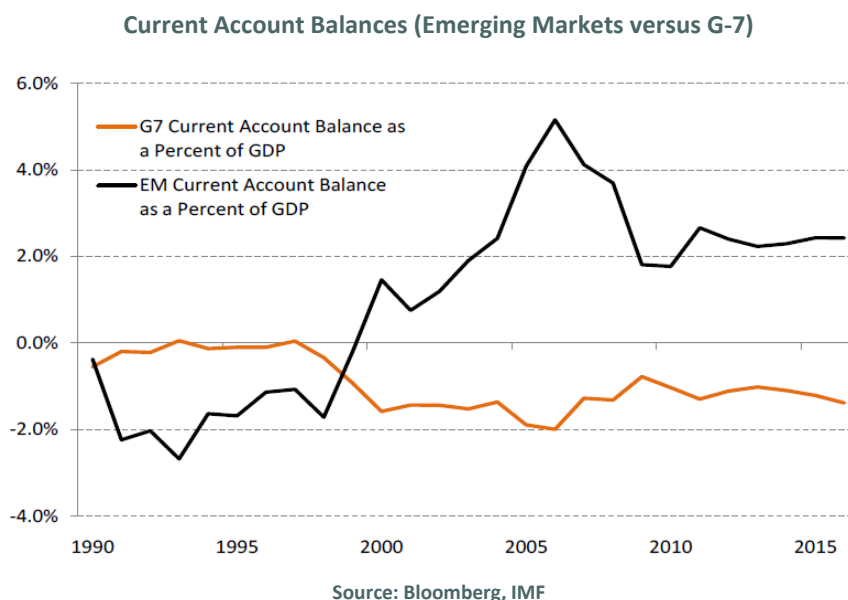
- The fall of the Soviet Union and the realization that free market capitalism was the only successful economic model;
- The Asian Debt Crisis in the late 1990s that caused Emerging Markets, and China in particular, to rethink and reformulate their development strategy through currency manipulation;
- Accommodative monetary and fiscal policy in the US as a result of the Tech Bubble and 9/11 Terrorist attacks; and
- China's accession into the WTO.

Over the previous decade, a confluence of the above factors caused developing markets' real GDP growth to outpace G-7 real GDP growth by ~ 5%. Let's focus on China. China's growth has been fueled over the past decade

by a trade surplus. In the aftermath of the Asian debt crisis of the late 1990's¹, China amassed over \$3.0 trillion in foreign reserves in order to act as insurance from external shocks. Over two thirds of that total is invested in dollar-based assets, mostly US Treasuries and agency securities. As a result, China surpassed Japan in late 2008 as the largest foreign owner of US financial assets. These surpluses, however, have reached politically unsustainable levels. This is quite evident given the clarion calls of lurking trade wars against China's mercantilist practices from the likes of Brazil, the US and China's neighboring Asian countries.

Will China reform? We think not, and we only have to look at the numbers to see why. For example, one solution to this situation is to allow the RMB to freely float or appreciate against the USD. If the RMB appreciated, the Chinese central bank would not need to purchase large quantities of Treasuries to control the RMB/USD currency rate. While such a textbook move looks ideal from a global economic perspective, as a matter of Chinese policy it could prove devastating to Chinese economic growth. Between 2001 when China entered the WTO and 2008, export growth grew to over 40% of China's aggregate economic growth. China's GDP growth rate would shrink by ~ 4% if it lost its export model of growth and development. Moreover, a study by the China Center for Economic Research concluded that 20% appreciation of the RMB against the dollar would result in a loss of more than 20 million jobs.

Moreover, if we look at current imbalances that these growth policies have fostered we see something quite dramatic. G-7 countries have been running consistent deficits while EM countries have been running large surpluses.



Sustained growth of this magnitude generally requires much more than globalization and traditional macroeconomics. It requires proactive economic policies that foster economic diversification; pulling once unproductive rural farmers into productive activities focused on the tradable goods sectors (i.e., export markets). This structural transformation does not happen strictly with market forces.² It is typically the result of

¹ We would further argue that the same policies of FX manipulation that have created the current imbalances created the Asian debt crisis in the late 1990s. As China manipulated its FX relative to its Asian neighbors, their economies became noncompetitive, causing their economies to shrink. Their debt levels eventually became unbearable. The same scenario as this has caused the current Eurozone challenges, as the German economy has become too competitive compared to the periphery without the ability of intra-European exchange rates allowed to adjust to offset this noncompetitiveness.

² "The Future of Economic Convergence", Harvard University, Dani Rodrik, August 20th, 2011.

governmental policy interventions, ranging from public fixed asset investment to government subsidies and currency manipulation. Few countries, especially democratic ones, have managed such disciplined industrial policies with any level of perfection. The notable exception is China, aided by its authoritarian regime with complete control over its population. Whether such policies are sustainable remain in question.

More importantly, policymakers in the US, Latin America and Europe have recently started to view development policies based on unfair subsidies and currency manipulation, all in the name of aiding exports, with much skepticism. With lingering high unemployment, stagnant economies and political elections around the corner, they are likely to become more tenacious in opposing such policies. We think the policies that fueled this growth in Emerging Markets will inevitably disappear as these unsustainable global imbalances will have to rebalance. This will definitively eliminate exports as a major growth driver for Emerging Markets, with an eventual elimination of fixed asset investment as well.

To summarize, the status quo is no longer tenable for reliable growth within EM economies. Their growth and development model is becoming quickly antiquated within the new global order marked by global imbalances and concomitant private and public sector debt. They will have to look for internal sources such as domestic consumer demand. Again, such transformational structural change does not occur overnight. When it does happen, as the economy slowly transforms from one dominated by tradable goods to one dominated by non-tradable goods (i.e., the US economy), economic growth will inevitably slowdown. What this means for global equity markets is a **convergence in market performance as well**. With Emerging Market multiples largely converged to those of Developed Markets and with earnings expected to level off, we do not foresee the structural outperformance EM once enjoyed. ***That is not to say that there will be times where Emerging Markets will enjoy greater returns than other equity markets. What we are saying is that Emerging Markets will no longer be the long term outperformers they once enjoyed being during this past decade. In essence their strength has become their weakness.***

Regardless of their future growth, however, it is undeniable that the growth of the Emerging Markets during the past decade has permanently altered the geopolitical and geo-economic landscape, catapulting these countries into a more multi-polar world. And while we maintain that the US and the West will be the dominant force for decades to come, we can no longer ignore the Rise of the Rest in our outlook; doing so would be perilous.

We have one last comment on global imbalances. Disputes over the currency manipulation of Emerging economies and loose monetary policies in developed markets increasingly emphasize the need for elimination of current pegging policies of the large Emerging Markets. We believe and emphasize the current international monetary arrangements are incapable of delivering not only domestic harmony for each individual country, but also global economic and financial stability. The current International Monetary System, implemented through a series of *de facto* rules and initiatives, cannot effectively accompany the transformation of the global economy and the rising economic power within the Emerging Markets. ***The status quo is no longer a viable option as the structural flaws in the current International Monetary System are likely to become more incisive as time progresses and governments around the world will have to agree upon coordinated multilateral policy initiatives to reflect an increasingly multi-polar world.***

US Economic Outlook

Overview

US government data continues to reinforce our outlook that any economic recovery will be anemic for many years to come. While some rebalancing through deleveraging has occurred, as private debt levels have come down sharply and balance sheets have improved, we still have a long way to go. We expect this will lead to weak

consumption growth coupled with high levels of unemployment for several years. **Unfortunately, there is very little that policymakers can do to boost aggregate demand.** The Fed's policy tools have proven inadequate, creating unwanted externalities that do more harm than good, such as asset price bubbles in commodities that only serve to dampen demand. Congress is equally constrained, as their checking account is empty and borrowing is becoming increasingly untenable. In fact, the projected contraction in Federal discretionary spending will compound the ongoing stress at the state, local and municipal level. Let's take a slightly deeper dive:

Consumption: There is good news and bad news. Consumption is set to decelerate significantly into the future. In fact, never before since the post-war period have American consumers been so weak for so long, especially after our unprecedented government stimulus programs. With consumption comprising over 70% of the US economy, it is little wonder why this one metric represents a major component of the economic malaise we are enduring. **Only recently are Washington policymakers becoming aware that US consumers are unlikely to return to their risky ways of over-consuming and spending again. The futile barrage of monetary and fiscal stimulus is wasted on attempts to short-circuit both the processes of deleveraging and much-needed balance sheet repair.**

Lastly, no other global economy is able to fill the US' shoes as consumer of last resort and offset shortfalls in US consumption. Neither Europe nor Japan is in an economic position to fill the consumption void. Additionally, Emerging Markets such as China are unable to tap their domestic consumption sectors in such a short timeframe.³ Therefore, US consumption weakness will no doubt translate into pressure on the growth of export-led Emerging Markets. The one bright spot is that this will force Emerging Markets to implement rebalancing strategies aimed at stimulating domestic consumer demand. This will in turn alleviate the global imbalances that are the roots of all our problems, but it will take time.

Investment Spending: While business investment has been a bright spot to an otherwise disappointing recovery, most recently the growth rate of capital spending has slowed significantly. This spending is now runs barely at pace with corporate depreciation levels. It appears companies are only spending enough to replace worn equipment. Only when companies begin expanding their capital base do they need to take on additional employees. While companies have taken advantage of these low rates to increase their borrowing in commercial paper, they appear to be using these funds to add liquidity, increase dividends, fund buybacks, and effectuate mergers rather than for capital expenditures. Lastly, while business investment has staged a meager recovery since the crisis, residential investment remains at depression levels, with no light at the end of the tunnel.

Exports & External Demand: The crisis in Europe and a more widespread slowdown in global demand will not allow US exports to offset weakness in other parts of the economy. In fact, the recent global slowdown caused deceleration in US exports from 8% in the first quarter to 3% in the second quarter, with expectations of further weakness, especially as the trade-weighted value of the USD firms.

In terms of actual numbers, Europe represents just fewer than 15% of total US exports, with less than 3% going to the periphery Eurozone countries. The bulk of US export demand originates from Mexico, Canada and Asia, which are expected to ease as well.

This will no doubt cause US current account and trade deficits to widen in the coming years. At a time when unemployment remains high and US GDP growth still weak, large current account deficits may lead to more pronounced demands for protectionist measures, especially against China. The US runs a larger trade deficit with China than with all other trading partners in the aggregate.

Labor & Unemployment: Outside of a slightly better employment number for September, it appears that employment creation has ground to a halt. The decline in the unemployment rate was not due from an increase in the number of net new jobs but a decrease in the workforce. The all-important barometer of this trend is the

³ "One Number Says it All", *Project Syndicate*, Stephen Roach, August 25th 2011.

employment-to-population ratio that steadily trends downward, hitting a multi-decade low. Productivity also acts as a double-edged sword; when productivity increases, it means that employers are successful at reducing headcount while keeping production level. When productivity decreases, this often leads to more layoffs to prop productivity back up. Finally, although the economy is producing 80K to 100K of jobs per month, we need a minimum of ~ 125K in new job creation merely to keep up with new job entrants. Additionally, with all this political uncertainty from Washington on deficit issues and tax policy, it is little wonder companies are reluctant to increase hiring until they have greater clarity about the future direction of the economy.

Inflation: We expect headline inflation and core inflation to peak in the coming quarters, with the potential for core inflation to trend below 1% by 2013. Core inflation is difficult to explain given the current level of spare capacity in the economy and an output gap of more than 6% of GDP. We think either the output gap is smaller than the numbers seem to suggest or it will take longer for the disinflationary effects to flow through to prices. We could attribute a portion of this discrepancy to a rise in commodity prices and the fall of the USD during the second quarter of 2011. Finally, the recent drop in energy prices has led to a corresponding drop in inflation expectations, similar to what happened in 2009.

While we can see from the different economic components highlighted above that the current weakness in the US economy appears to be more structural in nature. The dawn of a new era has emerged where we are realizing the US can no longer borrow and spend beyond her means, and the global imbalances that have been amassed during the previous three decades on both sides of the Atlantic and Pacific are not only unsustainable, but must be reversed. That said, it is not hard to make a strong case for a short term, cyclical market rally in US risk assets. For instance, while consumer spending has been lackluster, it has not been as grim as consumer confidence would indicate. As commodity prices retreat and energy prices correct, we could soon witness an unexpectedly strong rebound in consumer spending, albeit a temporary one at that. Additionally, while we have seen some disappointing manufacturing data for August, we should soon get a boost to manufacturing activity as Japanese supply chain disruptions from the earthquake earlier in the year finally dissipate through the system.

Operation Twist (& Shout)

The Fed has recently announced that it will re-align its current balance sheet by increasing the proportion of long-term bonds relative to current holdings and short-term bonds. Currently, the balance sheet is predominantly positioned on the short end (less than 5 years). By increasing holdings on the long end, it plans to lower yields on the long end, while keeping the short end anchored to current levels, not necessarily flattening the yield curve but twisting it lower. It will accomplish this in either one of two ways:

1. In a sterilized manner by selling current short-term bonds in the market place and buying existing long-term paper, thus keeping the size of the Fed's balance sheet level; or
2. Monetize existing debt by buying more long-term debt going forward with freshly printed money, increasing the long-term debt holdings through the denominator effect and increasing the size of the Fed's balance sheet in the interim⁴.

As part of this program, the Fed has reiterated its zero-interest-rate-policy (ZIRP) which should anchor the short end of the yield curve while the long end is pivoted down. As the long end of the curve comes down and yields decrease, we would expect an increase of mortgage refinancing which should hurt the value of mortgage backed securities (MBS) with any increase in prepayments. To alleviate this hit to the Fed's balance sheet, it plans on reinvesting MBS and agency debt coming due into more MBS, which should push more buyers into MBS.

⁴ The Fed has indicated an inclination to sterilize their purchases of long-term bonds so as not to expand its balance sheet further.

Additionally, any positive news on the housing front should be positive for agency fixed income securities and the lower level of interest rates should boost values of fixed income securities in general. ***By announcing its support of the long end of the yield curve and its decision to reinvest proceeds back into MBS, the Fed is not only trying to lower rates but motivate investors to buy corporate bonds and MBS.*** Even if the Fed fails to lower rates, this investor action could indirectly lower borrowing costs for corporations and homeowners and stimulate the economy. ***If anything, the Fed would like to reverse the widening of credit spreads as corporate bond prices decreased while Treasuries appreciated. This should provide significant alpha-generating opportunities for US domestic fixed income in the corporate sectors, especially in the lower investment grade and higher quality high-yield credits, where credit spreads are well above normal levels.***

To summarize, we find the US economy facing another soft patch in growth and declining inflation expectations. As a result, the Fed has once again made a move to counter this downturn. Operation Twist is a significant announcement, as is a 2-year commitment to a ZIRP policy and the decision to reinvest in MBS. However, we have not seen any significant rebound in growth or inflation expectations. Nominal US Treasury yields are near multi-decade lows because people do not think Operation Twist will be successful in reviving growth. We agree with the markets here, that it will take much more than Operation Twist to solve the long-term structural problems of the US.

S&P's Downgrade of US Treasury Debt: Two B or not Two B, that is the Rating

This past quarter, Standard & Poors downgraded the credit ratings of US Treasury debt only to cause a rally in the debt it downgraded. As part of their credit process, S&P has a different methodology of its analysis and places much more weight on political factors, not to mention a potential \$2.0 trillion mistake on its future expenditure growth assumptions.

Despite such downgrade to double-A, Treasuries are triple-A rated for all Barclays indices. If history is any guide, we would also note that with prior downgrades to Japan, Canada or Australia, credit markets put much more weight to the domestic economic and inflation developments than they do to credit downgrades that are incorrect, inconsistent, arbitrary and non-uniform. ***If the US is truly a double-A, can France and Germany seriously sport a triple-A rating with all the excess baggage they will need to carry for many years to come?***

We maintain that what guides demand for Treasuries is far more complicated than analyzing what comes out of Standard & Poor's. During precarious times such as these, in an environment where the USD remains the sole global reserve currency and the International Monetary System remains largely an informal and uncoordinated set of *de facto* rules that very few follow, there will always be a demand for Treasuries. This will especially be the case if over 70% of global transactions are conducted in USD and the largest Emerging Market economy continues to peg its currency to the USD to command export superiority, financing its exports with Treasury purchases. Until this changes, don't count Treasuries out – it's that simple.

Municipal Bond Market Developments: Proposal to Limit Municipal Tax Exemption

In September of 2011, President Obama sent the *American Jobs Act of 2011* to Congress for consideration. In this bill he proposes specific tax deductions and spending programs that would purportedly create jobs and put Americans back to work. Part of this program included an increase of tax on the wealthy. According to the proposal beginning in tax year 2013, holders of all outstanding municipal bonds who meet certain income criteria will have the exemption on their municipal bond income capped at 28%. This means that an investor who is in the 35% tax bracket would be paying 7% surtax on the income generated by his/her bonds. Furthermore, if the Bush tax cuts

are not extended at the end of 2012, the top rate will jump back to 39.6%, increasing the marginal tax rate on bondholders to 11.6%.

In brief, we do not think this legislation will pass in its current form for one specific reason. The major disruptive force in the act is the fact that it will apply retroactively to existing bonds trading on secondary markets. For new issue, interest rates will simply recalibrate and municipal bond investors will remain unaffected. It will be the actual municipalities that will feel the major brunt of the legislation as they will now have to pay higher costs for debt financing. For existing bonds, while their price may fall as a result of higher municipal bond rates, especially along the longer end of the yield curve, they will be paper losses that will pay par upon maturity. Also, as prices fall, new investors will step in to buy these bonds at opportunistic prices in order to search for higher yield. This will create a floor on how low prices will fall. Lastly, because municipal bonds are currently trading at premiums to Treasuries (~120% to corresponding US Treasuries), the potential price deterioration from interest rate increases as a result of passage of this bill would only suppress this premium, creating very little impact to bond prices at the end of the day.

As noted above, the most bothersome aspect of this proposal is not the impact of the new tax on market yields *but the retroactive nature of this legislation to existing issue*. For the first time, the proposed municipal legislation would affect not only future issuance but existing bonds as well, with no apparent benefits of a grandfather clause, which is usually the case with this type of disruptive legislation. The credit markets have always operated under the assumption that any changes to the treatment of municipal tax exemption would include a grandfather provision for previously issued bonds. At a minimum, this proposal has now increased the tax risk premium discounted into municipal bonds, as evidenced by this premium to their respective Treasury securities, making such a risk now a tangible component of municipal bond prices, regardless if this new proposal actually passes. However, we think at the end of the day, not much will change for municipals in terms of final demand for such bonds. Markets will clear at slightly higher rates and retail investor demand will still be there because investors demand municipals for non-tax reasons such as credit quality, diversification and other market risk exposures not found in other segments of the credit markets.

Additionally, from an investment point of view, if the proposal moves forward as stated, it is reasonable to expect the current relationship between municipals and Treasuries will result in a higher municipal/Treasury yield ratio, translating into marginally higher municipal yields over time to reflect this new tax premium.⁵ From an investor's perspective, this may mean a rethinking of the allocation between federally taxable and federally tax-exempt investments at the margin, but will not result in a material shift in investment strategy and allocation.

To summarize from a tax perspective, if the proposal were to pass in its current form, the municipal market would continue to provide high quality tax-advantaged credit products for both current income and capital preservation, but calibrated to new rate levels relative to taxable bonds, due to the new tax rate and potential future uncertainty of other tax legislation. Additionally, municipal issuers would have to pay a premium to access the markets, and the derivative effect would be that all taxpayers would pay higher income tax, sales tax and property tax to offset the cost of services supported at the state and local level. From an investment perspective, we continue to believe municipal bonds remain one of the most attractive asset classes for ultra-high net worth taxable clients, regardless of whether this Bill passes.

Conclusion: Structural vs. Cyclical Slowdown in the US

The US can no longer generate trend GDP growth rates and employment without alteration in the mix of the economy's non-tradable domestic and export-oriented tradable goods components. This will require structural

⁵ Again, because municipals are trading with a sizable premium to Treasuries, any interest rate compression will only serve to compress this cushion, limiting the downside to municipals.

change and greater competitiveness in an expanded tradable sector. For a few decades prior to the 2008 crisis, the US and most of the global economy was fueled with excessive consumption, funded by foreign leverage in the form of current account deficits, mainly with China. Household sector savings declined as low interest rates led to over-leveraging, an asset bubble and an artificial increase in wealth. Meanwhile, US economists dismissed warning signs by arguing Americans were in fact saving and growing their assets because of their ever-increasing housing prices even though such prices were boosted artificially and unsustainably.

The private sector was not only the only culprit here. The public sector also dis-saved by running fiscal deficits. In the aggregate, the US economy expended more than it produced in income, running a trade, current-account, and fiscal deficit, borrowing the difference from abroad. Both household and government spending patterns in relation to income were unsustainable. While GDP grew more than other OECD countries, the consumption component of GDP consisted of foreign borrowing and not domestic savings. Thus, even though the economy was growing, we were not getting richer.

The financial crisis that began in 2008 was the clarion call for a halt to the unsustainable consumption components. As asset prices fell wiping out balance sheet wealth, households began the much-needed deleveraging process as savings rose and government could no longer make up the difference, as its sovereign debt levels now came under scrutiny as well, slowly falling into a Japanese-style debt trap. ***The net result is domestic consumption is significantly lower and no other GDP component can pick up the void, creating a mathematically unavoidable slowdown in the GDP's first derivative.*** Structurally, this domestically-focused slowdown has retarded growth and employment in the non-tradable goods sectors that dominated job growth in the US since 1990. In contrast, the component of the US tradable sector most reactive to foreign growth as currently comprised does not materially increase employment.

What is needed to reignite US growth? Sustainable solutions will need to come not only from the private sector but from government policies and initiatives focused on productivity, innovation, and proper alignment of incentives. Policies would include comprehensive tax legislation, a viable, cohesive and good faith deficit-reduction program, education reform including re-skilling of American workers, infrastructure, technologies and energy policy. ***To summarize, while the road to renewed US prosperity is long and winding, over the long term, we think the US remains the force to be reckoned with. If we are to assume that the global imbalances that started this crisis in the first place are to be rebalanced in the coming years, we think the current account deficit countries will benefit more. This crisis, in our opinion, is the single best thing that has happened to the US in over four decades so long as we don't let the crisis go to waste. Is Washington listening?***

European Economic Outlook

Introduction

Eurozone governments continue on their path towards contention, debate and brinkmanship as each sports different views as to how to escape the cascading effects of the sovereign debt crisis. The almighty German core insists that periphery countries adopt draconian fiscal austerity programs to solve their problems. They often cite successful precedent as persuasive authority to press their case, including Canada's recovery in the 1990s, Scandinavia (Sweden) in the early 1990s, and the UK in the 1980s.

Prior examples, however, are largely inapplicable in the new paradigm we are facing, requiring different solutions. For instance, prior instances where countries were able to "grow" out of their debt problems while implementing fiscal austerity ("contractionary expansion") occurred within the context of a growing and vibrant global economy. Moreover, these isolated countries undergoing fiscal contraction were materially insignificant relative to the global economy. By contrast, the global economy remains in the doldrums and those economies that need to undergo

fiscal austerity now make up a good portion of the global economy. If everyone is in the process of retrenchment, the corresponding drop in GDP will only cause fiscal deficits to rise further. Additionally, these countries were able to gain competitiveness through currency depreciation. Here, the periphery find themselves in a fixed currency regime at a time when the whole world is in a race to the bottom as no one wants a strong currency in order to gain competitiveness. Lastly, these isolated countries were able to offset the void left by fiscal contraction through monetary expansion and lower interest rates. With most of the world close to ZIRP, monetary policy is no longer a viable option.

To conclude, we do not believe in the German solution, namely that the road to prosperity for the Eurozone periphery is solely through austerity. Why? Interest rates are already at record lows, the global economy remains in a state of economic stagnation, the whole world cannot devalue at the same time, and the banking/credit system is in a state of total disarray. The best combination is a mix of fiscal austerity and growth. But where will the growth come from? The logical answer is from the current account surplus countries (i.e., China), provided that these economies decide to start spending and exporting their domestic demand. This seems very unlikely at the present time for reasons we discussed above. Most importantly, Germany's recommended solution epitomizes the very reason why this crisis continues to worsen; namely the misdiagnosis of the true problem. We will go into that in depth later.

In the meantime, Europe is in the grasp of a feedback loop between growth, debt concerns and integrity of their banking system. As economic growth dissipates, government fiscal positioning worsens along with the credit ratings of government sovereign debt. Further, the increasing risk of recession further erodes the strength of the banking sector, which already faces large losses from risks of magnifying losses from sovereign debt – hence the iniquitous loop. As the Eurozone economy, inclusive of Germany, continues to erode, prospects for an orderly and successful resolution are quickly dissipating, mostly because policymakers cannot diagnose the problems correctly. ***It appears the major European creditor (i.e., Germany) has mixed up causality of the process as we would argue that the debt is not the cause of the true problem, but a nasty consequence. Until they get it right, they will muddle through at best.***

The True Eurozone Problem Leading to the Sovereign Debt Crisis & Solutions

It remains our contention that sovereign debts are not the underlying problem in the Eurozone but are a mere manifestation of the problem. Rather, the true problem is not a fiscal crisis but one grounded within the context of a structural Balance of Payments crisis taken out of an Economics 101 textbook.

The original founders of the European Monetary Union (EMU) were under the false belief that a balance of payments crises was not possible under a fixed exchange rate regime. This was a false assumption. If there is no mechanism in place to guarantee automatic cross-border financing, usually found within fiscal unions, external deficits will emerge in the form of sovereign debt crises.

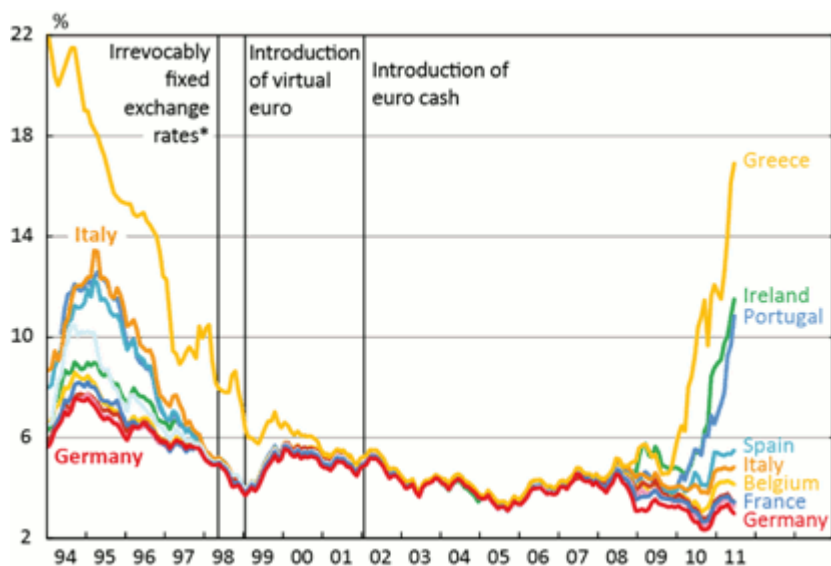
So what really happened? We think the answer is simple: Germany implemented policies to boost its savings rate, forcing periphery countries to spend beyond their means. Balance of Payments accounting is not simply a function of domestic activity, but more a function of domestic policies **plus** foreign policies, which in the Eurozone context affects the relationship between domestic periphery consumption and German core savings. Let's look at what transpired in the Eurozone since its inception.

The strength of the German economy and the Eurozone in general since the Eurozone's inception has predominantly been a function of its export success. However, for Germany to run a large current account surplus,

the periphery necessarily need to run large offsetting current account deficits.⁶ Otherwise, the Eurozone in the aggregate would run external current account surpluses to the rest of the world, causing the euro to surge and undermine Germany’s export competitiveness. The major mechanism for this current account transmission was the low interest rates which ensured the capital-starved periphery would over-consume.

In fact, the first major development that occurred at the onset of the EMU was the convergence of interest rates to the German bund yield, as shown in the chart below. The depreciation risk premia of the various Eurozone currencies all but disappeared with the advent of the euro, allowing bond yields to converge.

10-Year Eurozone Government Bond Yields (1994 thru Present)



Source: Reuters, Eurostat, VoxEU

These low interest rates unleashed a credit-financed boom in the periphery countries, which initially catapulted their economies. The private sector took advantage of cheap credit to boost construction and wages, whereas the public sector used cheap credit to raise the salaries and benefits of public-sector employees. Everyone benefited. Economies in the region grew at much greater speeds. This growth was further implemented with a strong inflationary underpinning, originating from rising wages and prices, causing the competitiveness of these periphery countries to erode as a result. Moreover, this weakened exports while the nominal increase in wages fuelled imports and current account deficits in turn. The large capital inflows into the periphery were used predominantly to fuel domestic consumption and not productivity enhancing fixed investment.⁷ The capital came primarily from Germany, which had a growing current-account surplus since 2002 and became, after China, the world’s second-largest capital exporter.⁸ More importantly, the institutional infrastructure was already in place to facilitate the channeling of capital from the Eurozone current account surplus core countries into the periphery.

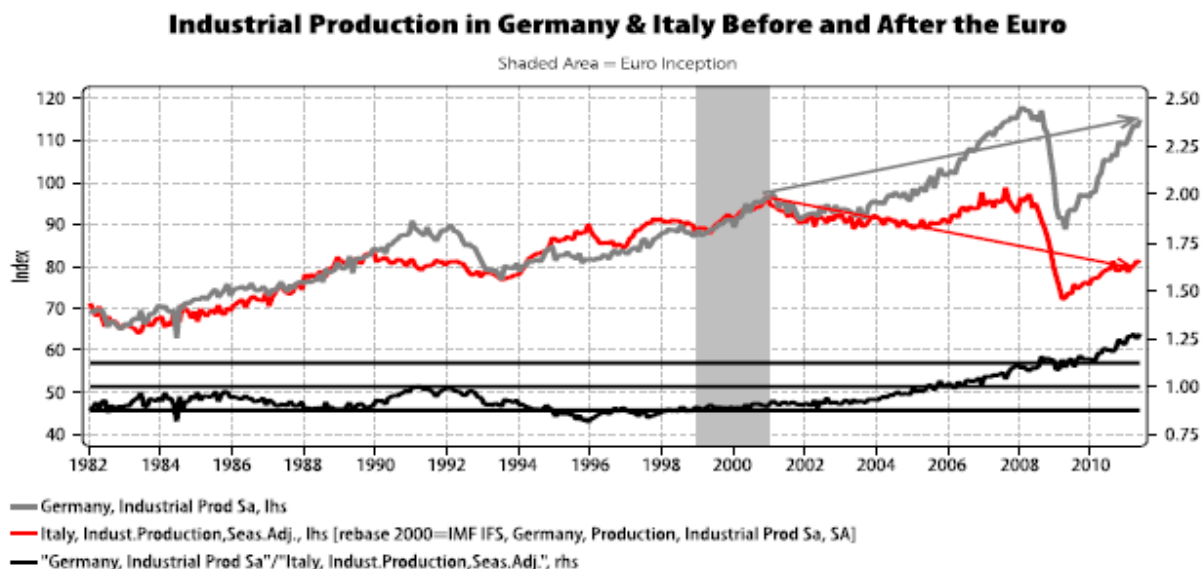
⁶ We would further argue to this point that Germany’s current account surplus is a further function of German domestic policies of suppressing consumption and subsidizing production.

⁷ As long as Germany runs current account surpluses and the periphery runs deficits, there must by definition be capital flows that run from Germany to the periphery as Germany purchases government bonds of the periphery to balance the current account imbalances.

⁸ “Germany’s Capital Exports Under the Euro”, Hans-Werner Sinn, *VoxEU*, August 2nd, 2011. The aggregate savings in the German economy amount to €1.6 trillion since the inception of the EMU. Approximately one third, or €550 billion of this savings was invested within Germany. The remaining €1.1 trillion was flowed abroad, with less than €227 billion going into direct investments. The Germans put their savings in bank deposits and these financial institutions invested them in securities of other governments such as periphery government bonds.

To put our thesis another way, German consumption growth is largely determined by the growth in household income, which will be less than the growth in German GDP. The reason is that government policies are in place to suppress wages to make the national economy more competitive. Also, we must remember that national savings is mathematically equal to aggregate production less aggregate consumption. As production rises faster than consumption, by mathematical definition the savings rate must rise. ***In other words, if German GDP growth is greater than consumption growth, the German savings rate will rise automatically, regardless of whether the Germans are more fiscally prudent than the profligate periphery – it's purely a function of policy and mathematics.*** Lastly, because the trade surplus equates to the spread between domestic savings over domestic investment, Germany will run a corresponding large trade surplus.

But how does Germany's savings conduct affect the periphery nations? The most effective way is through the nominal currency rate. If Germany has an undervalued currency, by definition the periphery must have an overvalued currency relative to Germany. This is regardless of the fact that these economies share a common currency because it is the nominal currency relative to prices and productivity that matter. The undervalued currency for Germany acts as a *de facto* tax on German imports and subsidy on manufacturing exports. The flip side is a tax on periphery exporters used to pay the subsidies on periphery imports from Germany. We offer graphical proof of this in the chart below, which displays a big divergence in industrial production between Italy and Germany before and after the inception of the EMU.



Source: GaveKal

What actually happened to the German economy during this time period? Germany underwent a massive transformation. The re-unification of Germany offered low-wage labor to German companies and also contributed to capital exports. This all occurred at the expense of German economic growth as Germany chose to export its capital rather than invest internally. During the 1990s, Germany experienced the lowest net investment rate among all developed countries, translating into the slowest growth of all OECD countries. Mass unemployment also forced Germany to undergo painful reforms under the Schroeder government, which dismantled the wage regulation posed by unemployment benefits and reduced minimum wages. Since wages barely rose during this time interval,

Germany managed to regain competitiveness. At the same time, Germany implemented policies to reduce consumption and subsidize production. This slowly created the German exporting powerhouse we see today. We only have to look at the chart to demonstrate what the true Eurozone problem is.

To summarize, we think Europe is suffering from several separate but related problems:

Structural Problems Creating Misallocations of Capital

The first problem is **solving** the institutional and structural deficiencies and shortcomings of the EMU. It is no longer viable to have a monetary union without a concomitant fiscal union. Any fiscal union must involve a mechanism to prevent such debt build-up and the individual country policies that nurture such intra-Eurozone debt imbalances. ***Additionally, this institutional solution must also address and involve a Eurozone-wide arrangement that facilitates the gradual deleveraging of the member countries with excess debts.*** It could be implemented with parameters similar to the Maastricht debt limits but with a much more effective policing watchdog and mechanism.

It must be executed with financial instruments similar to Eurobonds which are flexible enough to allow growth in indebted countries, with fiscal and structural reforms that ensure the long-run fiscal viability and competitiveness. ***This monitoring, however, cannot be made on an individual country-by-country basis as we believe that the actions of any Eurozone country necessarily affect what other countries do.*** This is the requisite burden-sharing that is needed by both creditors and debtors. Creditor countries will provide the funding and debtor countries will endure the short term costs of fiscal retrenchment and discipline.

Growth & Competitiveness Problems

Most of the periphery countries suffer from low growth rates mainly as a result of faltering productivity. Many of the periphery economies have become increasingly uncompetitive, largely from the policies of the previous decade, translating into stagnant growth. With stagnant growth comes falling government tax receipts, deteriorating fiscal/budget deficits and increasing debt overhang. Also, without the option of devaluing currencies to increase competitiveness (not that it is clear to us such action will work in today's environment), increasing debt burdens and debt servicing costs, many of these countries are slipping into Japan-style debt traps. Individual countries can implement domestic initiatives to increase competitiveness by lowering taxes and real wages (internal devaluations), incentivizing tradable goods sectors, education reform, eliminating local corruption, and additional fiscal stimulus aimed at productivity-enhancing infrastructure investments but with longer-term fiscal discipline.

In some circumstances, certain periphery countries will no doubt need to undergo a systematic and orderly default where debt will need to be written off and the ECB will need to step in as the lender of last resort and backstop liquidity provider with the aid of the EFSF. A combination of solutions enumerated above will need to be implemented that are different for each periphery country because each has its own unique issues and circumstance.

We think the tangible and intangible benefits created by the EMU are worth keeping it alive. Every effort should be made to keep the entire Eurozone intact. That will no doubt include partial defaults from the likes of Greece and major economic structural reforms in ***all*** Eurozone countries – even Germany. The alternative could be quite dire.

Greece: Should We Throw Out the Baby with the Olive Oil?

Capital markets as proxied by CDS spreads are currently pricing in an almost 100% probability that Greece **will** default on its debt. The economic news is going from bad to worse and there appears no catalyst in sight to alter this trend. The two possible scenarios to solve the Greek Dilemma include:

1. Maintaining Greece within the EMU while allowing for an orderly default; or
2. Letting Greece break away from the EMU and allow it to default and devalue.

We think the former is the most enviable solution for several reasons:

First, there is no **legal framework** in place that allows for an orderly exit from the euro. Greece would have to negotiate with all the Eurozone and 27-member European Union countries separately.⁹ The EU Treaty does provide for a voluntary exit from the EU but not from the EMU. **Thus, there is a viable means of leaving the EU and forfeiting the considerable regional aid associated with being a member state, but there is no provision for leaving the EMU while staying in the EU for this benefit.** This is not exactly the scenario Greece is looking for.

Second, there are **technical** and **logistic** reasons – Greece would have to print new drachma, and develop new IT systems to convert and transition to a “new” currency. Leaving the euro would no doubt cause serious disruption and be costly. As a corollary, any exit from the EMU and default by Greece could wreak havoc to the Greek banking system, causing potential contagion to other Eurozone countries, not to mention turning the spotlight onto other periphery countries should Greece leave the EMU.

Third, while **devaluation** could theoretically make Greece more competitive, the value of any New Greek currency will ultimately be determined by the markets and the **credibility** Greek policymakers will have over the discipline of their printing press. With Greece suffering from a severe credibility gap, we could see a severe depreciation along the same lines as experienced by Argentina in 2002 where the pesos lost over 75% of its value in a matter of six months. While a severe depreciation would make any economy competitive, it would also assure domestic inflation, choking an already over-levered consumer sector and preventing companies from acquiring equipment to enhance productivity to allow Greece to grow out of its problems. Any minimal benefits from increased exports would be greatly outweighed by the potentially devastating effects from domestic inflation on the consumer and corporate sector, with the risk of contagion greatly magnified.

Fourth, if Greece were to leave the Eurozone and reinstate and devalue the drachma, it would not accomplish much because her economy is the **least exposed to international trade** relative to all the other Eurozone countries. Any such benefit to net exports will be minimal. Additionally, currency depreciation is not as effective when many of a country’s trading partners are experiencing a sluggish economic recovery in the aftermath of a financial crisis. Therefore, a boost to Greek GDP through exports is highly unlikely.

Fifth, Greece has a large quantity of debt denominated in euros. A switch to the drachma would not alter the currency denomination of the loans. The drachma’s devaluation would only act to effectively increase the amount of debt in drachma terms.

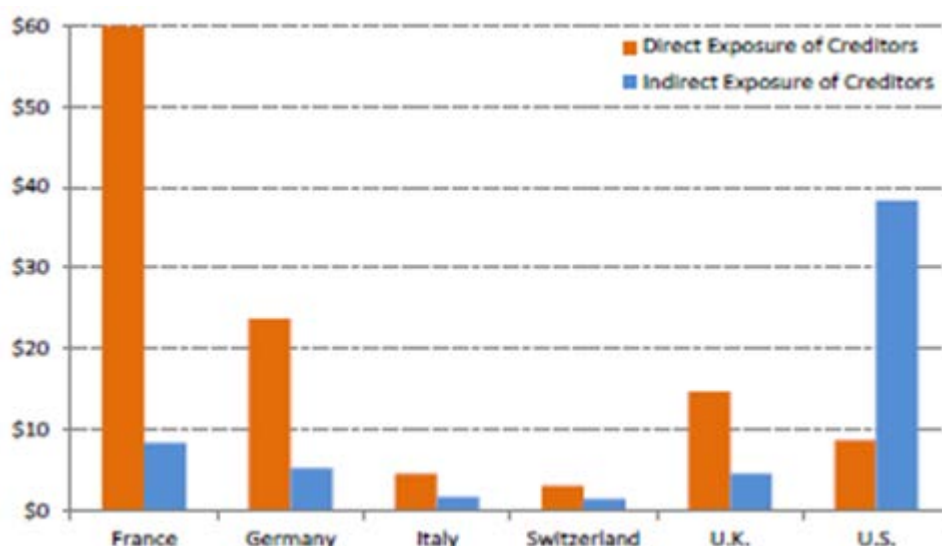
In summary, any small advantage gained by **exiting the euro** will be lost immediately. Most importantly, would Germany want such a move? As we mentioned above, German exports, the most vital component to the German economy and German growth, would decline with any exit of any periphery country as a result of the appreciation of the euro. As Greece and potentially other periphery countries exit the Eurozone, Germany would no longer have any control over policies within these countries. Such a lack of control may pose a serious disincentive to allow

⁹ “Greece is not leaving the Eurozone, not now, not never”, *Financial Times*, Ian Bremmer, September 28th, 2011.

Greece or any other periphery from exiting, not to mention, German exports into the periphery represent over 25% of the Germany economy. It would only take a marginal reduction of German exports into the periphery to put Germany into recession. A German recession should be avoided at all costs as the Eurozone faces severe banking problems.

Furthermore, even though we all know that Greece is bankrupt and default is absolutely inevitable, why do Germany and France continue to provide Greece with bailout funds? We think there are two plausible reasons. First, we know banks in Germany and particularly France have large exposure to Greek government bonds. (See chart below.) Delaying a potential default will allow the German and French banks to recapitalize and strengthen their balance sheets to withstand further losses from Greek and potentially other sovereign debt, as well as reducing exposure to such debt. Second and more importantly, the reason for French and German attempts to postpone a Greek default is to avoid any contagion of defaults from other periphery countries. We only have to look at the salvo of recent sovereign downgrades which could portend to more ominous developments.

Total Exposure to Greek Default (\$, billions)



Source: Bloomberg

Not All PIIGS Are the Same

While the popular press has painted all the periphery countries with a broad brush, we believe there are distinct differences with all of them that need to be understood before solutions can be crafted and final impacts determined. For example, while the Portuguese and Greek debts were largely public sector focused, the Irish and Spanish debt originated primarily from the private sector to fund real estate construction spending. Ireland and Spain in fact had fiscal surpluses and negligible net public debt.

Ireland in particular is in stark contrast to the other PIIGS economies. Greece used credit at low rates to borrow and increase the wages and benefits of government workers, as well as kick-backs and other unproductive purposes. Greece is over-indebted and bankrupt not because it built too many bridges and homes, but because her

government borrowed too much to hire too many government employees which served no productivity-enhancing purpose other than to garner votes for incumbents. If we look at a country such as Ireland, we see that the debt was used for an unprecedented real estate bubble. Ireland was never about lack of competitiveness. Once the banks are slowly recapitalized, Ireland has the capabilities for a strong comeback. The Irish undertook major structural reforms by cutting wages, and other government budgets were slashed. As a result, Ireland now has a surplus trade account which will help offset deleveraging by the private sector and banking sector reform.

China & EMs to the Rescue: Do We Want to Kill the Goose That Laid the Golden Egg?

The latest news from the Italian government was that China might buy a large amount of Italian government bonds. Additionally, Brazilian finance minister said BRIC nations would meet to figure out a rescue plan for Europe. We think that minimal assistance will originate from these countries because, if Germany, which possess superior information on the Eurozone debt to China is unwilling to purchase periphery country bonds, then why should the Chinese? But there is a more economically fundamental reason as well.

The Chinese coming in and buying periphery debt in a wholesale manner will inadvertently affect the trade environment of the Eurozone countries in a very disadvantageous way. If China comes in and starts running capital account surpluses with the Eurozone region in the aggregate, the Eurozone, primarily through Germany, will need to run current account deficits to counterbalance the capital account surpluses.¹⁰ This could kill the German export machine, or Europe's golden goose.

Said another way, without offsetting capital outflows, the consequence of capital inflows into the Eurozone would be a shrinking Eurozone trade surplus (from Germany), mainly through a stronger euro. In fact, if Europe began to import capital rather than export it, its current account surplus would disappear into a current account deficit, eliminating the only true source of intra-Eurozone growth it now has. Europe cannot afford such ill-conceived and shortsighted policy.

Reaching out to foreigners for capital will only intensify the Eurozone's problems. ***If China and other EM economies want to help, they should export more of their demand and not capital.*** This will help the Eurozone grow out of its problems while alleviating global imbalances. If the Eurozone policymakers do not want to fund credit-impaired Eurozone periphery countries, we would urge them not to accept foreign capital to do so because it will only exacerbate Europe's insolvency problem.

Sovereign Debt & Emerging Markets: Are EM Economies Immune from Contagion?

Generally speaking, Emerging Markets are not immune from the sovereign debt crisis plaguing Developed Markets, but most are well-positioned to deal with the volatility. While facing significant structural issues of its own, China, along with the rest of emerging Asia, has policy mandates and options to respond to potential contagion. We expect Latin American economies to slow by more than most anticipate in the coming quarters, but such a slowdown should be transient. The exception remains Central and Eastern Europe, where a number of countries are facing recession and are considerably more connected to the financial stresses associated to the Eurozone.

The contagion effects of sovereign debt could impact Emerging Markets through three potential transmission mechanisms. The first and most obvious is weaker export demand. Here Eastern Europe is most vulnerable to the Eurozone while Latin America is more closely associated with the US economy. The second mechanism is through capital flows. Countries such as Turkey and Latin American economies such as Brazil that run current account deficits are most at risk. The last channel is through banking and financial interconnectedness. Here too Emerging

¹⁰ Foreign central banks would sell USD and foreign FX to buy euros. This would cause the euro to strengthen and in turn causing Germany to become less competitive. German exports would decrease, potentially throwing the Eurozone into recession.

European countries are most vulnerable because they are most heavily reliant on bank financing for economic survival.

To summarize, few Emerging Market economies suffer from the same debt and deficit concerns plaguing Developed Markets. Among the more systemic Emerging Market economies, contingent government liabilities in Brazil and China are increasingly becoming a concern. But with nominal GDP growth likely to remain robust over the short to intermediate term, debt projections in both countries look manageable, even with some policy tweaking. And while the future for Emerging Market economies is definitely not perfect, the outlook relative to Developed Markets remains much brighter. The only question in our mind remains how long this divergence can last and how much of the good news is already discounted into capital market prices.

Concluding Remarks

Since the inception of the EMU, periphery countries in the Eurozone engaged in heavy borrowing from foreign private investors (i.e., Germany), allowing domestic spending to far outpace incomes. Large intra-EMU savings and borrowing imbalances ensued. In many circumstances, most of this spending was for domestic consumption and unsustainable social programs and not for fixed income investment designed to enhance economic productivity such as roll-out of important infrastructure.

This financing arrangement came to an abrupt halt in 2010 when yields on Greek government bonds spiked amid growing concerns about the sustainability of the country's balance sheet. Interest rates soon became exorbitantly high for other fiscally-troubled periphery countries such as Ireland and Portugal. These countries were forced to seek financial support from the International Monetary Fund (IMF) and the European Union to make up for the credit vacuum from private investors. Foreign capital is no longer available to sustain consumption-based economic growth. The question and problems that remain include:

- How these sovereign debts will be repaid back over time; and
- How best to lower domestic spending and implement fiscal austerity while avoiding economic stagnation, all within the constructs of the EMU.

These problems will have to be resolved against the backdrop of a severely weakened banking system that makes up a disproportionately large part of the Eurozone economy.

The ultimate success of any resolution for the Eurozone will depend on how quickly the periphery countries can structurally enhance their productivity in tradable goods/services to boost exports and on developments within Germany and other world economies to boost their domestic demand to import more from the periphery. To date, the progress has been suboptimal, with overall growth still not where it needs to be, but with some early gains in labor productivity, especially in Ireland. ***Without meaningful demand from current account surplus countries such as Germany and China, productivity gains will have to come through lower wages, slower domestic consumption and investment spending which will only drag economic growth at a time where it is becoming politically untenable.***

As far as Greece is concerned, we can only hope Greece will remain an isolated basket case. In our opinion, the final solutions to getting Greece on the proper path are multi-faceted, some within its power and others dependent on outside forces. For example, Greece will need to undergo a complete internal restructuring to make its economy competitive and complete, free from government corruption and nepotism that have prevented Greece from becoming a true Western economy. This will require a revamping of the tax laws, corporate regulations and governance rules, labor and pension reform as well as a restructuring of its public sector and immigration laws.

While these developments are implemented and begin to take effect, ***Greece will no doubt require debt relief in the range of 50% to 70% to even begin to have a chance. And while this default occurs, the ECB will need to backstop any significant banking losses to prevent contagion and panic.***

Further, a total solution for Greece and for the overall periphery as well requires structural and institutional reform at the EMU level. Denying and postponing implementation of a framework for a true federal or fiscal union is no longer an option. It remains our contention that when a group of economies are tethered together by a common currency and interconnected by a complex web of financial, regulatory and political channels, what one country does *will* affect other countries. If Germany, for example, decides to run policies that incentivize saving and manufacturing to strengthen exports, this will create offsetting forces in other Eurozone countries. This in turn will create saving/borrowing imbalances that, if left unchecked will foster crisis. Fiscal unions are the proper mechanism to prevent such imbalances from occurring and if/when they do occur will provide the necessary intra-Eurozone infrastructure to implement capital transfer mechanisms to prevent crisis, much the way the federal government works in the US.

In our opinion, one thing is certain: Letting Greece break away from the EMU should be avoided, as the costs overwhelmingly outweigh the benefits for all the Eurozone countries. If Greece were allowed to break away, we would initially enjoy a rally in European capital markets including the euro. However, such a relief rally would be short-lived.

The major problem in the Eurozone and the global economy remains the uniform misdiagnosis of the true problems by our policymakers. Sovereign and private sector debt is not the cause of the problem but the consequence of the problem. Until we focus on fixing the cause, the solutions offered are mere Band-Aids that only exacerbate the underlying problems. This will no doubt allow us to capitalize on opportunities in certain capital markets and avoid traps in others.

Latin America & Brazil Economic Outlook

Introduction & Overview

The downtrend in financial markets endemic throughout Latin America has made valuations look very attractive, at least from a historical perspective. However, while this could lead to a nice relief rally once markets stabilize, recent market turmoil may be indicative that the risks to regional growth are most likely skewed to the downside over the short to intermediate term.

Understanding this, we have to keep in mind that we are in a systematic downtrend in the world's Developed Countries (US & EU). This has several implications. First, the majority of Latin American countries are in relatively better economic conditions than the US & EU. Second, the divergence in growth trends and prospects should translate into healthy capital inflows into the region. Valuations look empirically very cheap. For example, Brazilian equities are trading at below sevenfold forward earnings, compared to their 5-year average of twelvefold. Third and most important, while the longer term outlook remains bright, growth is likely to slow over the short term as these Emerging Markets remain no doubt tethered to Developed Markets' slowdown through export channels. In some sectors, it appears the slowdown can become quite severe. As an example, Latin America has benefited from strong commodity prices, improved terms-of-trade, and capital inflows to fund fixed investments where domestic savings has not been enough cover investment needs. All of these components have led to strong domestic demand-led growth which may be slowing. We can therefore conclude that the slowdown in the Developed Markets may have mixed results for the likes of Brazil.

Further, there are increasing signs, though still unclear to us, on the sustainability of these regional growth rates. For example, according to a group of strategists, it appears by some measures that consumer credit might become stretched. Moreover, the fact that current account deficits have now been growing while terms of trade have remained positive, indicates to us that domestic demand may be very vulnerable to a drop in commodity prices. With China and the OECD countries set to slow, it appears very likely that commodity prices will slow down severely. We therefore think that growth in these regions is definitely skewed to the downside. We further see justification in Dilma Rousseff's widely unexpected decision to cut policy rates for fear of a slowdown. If we integrate fears of this outlook into historic volatility exhibited by these markets, we are well-justified in pursuing Brazilian-focused satellite exposure through a long/short approach. Such an approach serves not only to hedge out this beta volatility, but to capitalize on it by shorting sectors/companies most vulnerable to the downside risk of growth, most notably in commodity-based industries more highly levered to the global business cycle. Let's focus more on Brazil and why we think it presents a unique and misunderstood opportunity.

Neo-Mercantilism & the “Dutch Disease”: China’s Economic Impact on Brazil & LatAm

Because growth through the production of tradable goods is the focal point of China's current political regime, China has been on a global hunt to secure raw materials and natural resources to keep its production machine running and keep people employed. In fact, China's demand for coal, oil, gas, iron ores, minerals and food commodities has caused a secular metamorphosis in the supply chain of global commodities markets. Besides procuring long-term contracts for access to these raw materials, China has even purchased control of their means of production and transportation infrastructure – i.e., ports and rail.¹¹ This strategy has a profound impact in Latin America, with structural changes for economic growth, long-term industrial development, and geopolitical impacts with the US. ***Primarily out of necessity, in recent years China has entered the region with a vengeance, with imports into and exports from the region increasing by over 900% each. At these rates, China will displace the European Union as the region's second-largest trading partner over the next five years, trailing only the US, whose trading relationship with LatAm is in slow decline.***

Because the countries in the region currently benefit from the sale of raw materials into China (as witnessed by their explosive growth in GDP over the past decade), there is little political will or incentive to step back and implement much-needed reforms to enforce longer term economic benefits to the region in the form of a value-enhancing manufacturing base. These exports act as a temporary elixir to their much-needed promotion of broader-based development and longer-term economic positioning. In fact, Chinese exports of Brazilian raw material have benefited Brazil by:

- Boosting demand for Brazilian exports, especially industrial commodities;
- Boosting prices of Brazilian commodities; and
- Allowing Brazil to build up foreign currency reserves and cut the country's current account deficit to fund expanding social programs that unleashed this consumer demand boom.

However, this China-led boom has created its own unique set of problems. China is primarily buying raw materials – i.e., commodities make up over 80% of Chinese purchases. Conversely, China in turn exports into the region very competitively-priced manufacturing goods, directly threatening Latin America's manufacturing base in countries such as Mexico, Central America and, most notably, Brazil. This Chinese demand has pushed up the value of the real over 100% since 2003, posing a large problem for non-commodity Brazilian exports, as they are no longer competitive in global markets. Additionally, Brazil has been caught up by Washington's recent QE2 wave of liquidity

¹¹ This strategy is mercantilist at its core, designed to keep the ruling party in power, having nothing to do with building multi-lateral relationships, for example.

as US capital flooded the Brazilian markets in search for higher returns. This capital has not been channeled into much-needed infrastructure investment, where bottlenecks create supply-constrained inflation, but into financial assets potentially creating dangerous asset bubbles. Finally, there is the Chinese RMB manipulation that makes Chinese exports more competitive in Brazilian markets.

In short, what we are evidencing is China buying raw materials from the region, enhancing these natural resources through value-add production at home and reselling the finished manufactured products back into the same region where it undermines their own value-add industries and efforts at artificially depressed prices. Brazilian competitiveness has suffered dramatically as a result. Ten years ago, Brazilian manufacturing made up almost 60% of exports whereas now they are almost half that level. Meanwhile commodities have surged from 22% in 2000 to over 45% in 2010. To make matters worse, a recent study has shown that Brazil is losing market share on 45% of its exports to Latin America and 94% of its high-tech exports, while China has gained market share in these same categories.¹²

To compare the US to China in its dealings with Latin America is grossly incorrect. What is the difference between US and Chinese commerce in the region? US companies have traditionally used economic relationships in the region to encourage much needed reforms in Latin America. They abide by US anti-corruption statutes, provide access to global markets, source through local means and abide by local tax rules. On the flip side, Chinese companies do not abide by the same rules and even use Chinese workers in their regional operations, lacking the goodwill of hiring local workers. Brazilian policymakers now feel they are not getting the full benefits of this booming trade with China as Deindustrialization through the Dutch Disease has become a hot topic now among Brazilian businessmen and politicians and the current administration has taken bold actions.

To cite an example, Rousseff is addressing this pressing matter of China's policies by being very corporate interventionist and forcing many different Brazilian companies in which the government has control to invest in many different vertical markets so as to compete directly with the Chinese. For example, Rousseff has recently replaced the CEO of Vale, one of the biggest mining concerns in the world, and forced it to become more vertical outside its core mining operations. One externality of this new government interventionist policy has been an overall market concern that she will expand government control into other companies (Petrobras) and sectors, causing market multiples to contract and the stock market to correct more than it would otherwise.

Additionally, Rousseff is much more willing to use anti-dumping and tariff measures to protect Brazilian companies. The real risk is that she will take domestic steps that try to boost its competitiveness in the face of this China threat that will do more harm than good – and she has already started. For example, she recently implemented a 30% tax on certain imports into Brazil (except from Mexico and Argentina). This, we believe, may backfire because it will subsidize local inefficient producers.

We therefore have to question whether Chinese mercantilist practices are beneficial to the long-term economic health of the region beyond the short-term economic gains of raw material exports. Such Chinese engagement lacks the beneficial characteristics of a US relationship that emphasizes more balanced international norms and values. This Dutch Disease of the region's de-manufacturing process is clearly not in the long-term interest of any Latin American country. The outcome and nature of the relationship with China (and other EM exporting countries) will help mold the region's geopolitical direction and their ability to compete in the long term – a development we have identified and continue to monitor.

If we examine other key economic issues facing Brazil, we see there are many different initiatives Brazil can take to alleviate some of its economic problems. For instance, a country that saves much less than it needs for domestic fixed investment requires heavy capital inflows to fund such current account deficits. This, coupled with high real interest rates that continue to climb as a result of inflation, pushes the real even higher, making exports even more

¹² "All in a samba", *China Economic Quarterly*, Geoff Dyer, September 2011.

noncompetitive. The only moving variable within the government's discretion, barring a global slowdown that would push commodity inflation lower, is control of Brazil's fiscal budget and deficit that grew out of control during the Lula administration.

On top of fiscal reform, Brazil is ripe for a major tax overhaul and reforms to its bureaucratic red tape. Brazil is also in need of qualified workers because its wages are increasing as a result. Private investment in infrastructure could alleviate some of the deficits and supply bottlenecks. Well-crafted industrial and policy initiatives can foster and nurture efficiency in industry that would be able to compete with Asian firms while not creating inefficiencies at home. However, the combination of fiscal indifference and too much government interference with corporate governance and activism will make it all the more difficult to handle the Asian threat.

Brazil's Credit Growth Conditions & Growth Initiatives

Many strategists now believe that despite Brazil's relatively strong banking system, its recent credit growth trends need closer scrutiny by policy makers. The fear is such rapid growth of credit (over ~ 20% per annum) could jeopardize the quality of loans on bank balance sheets. Part of Brazil's recent strong growth was a result of strong credit growth by the middle class at relatively high interest rates (both on a nominal and real basis).

While the conditions have not reached those similar to the US subprime prior to the crisis, and with the debt-to-GDP levels at 45%, the consumer debt service burden as a result of high interest rates is approaching 25% of disposable income.¹³ While Brazil's banks have taken serious macro-prudential measures to fortify their positions, such as imposing higher reserve requirements, there still are elements of potential abuses with credit quality – an aspect of Brazilian growth that needs monitoring.

We must however be cognizant that while credit has exploded, the base still remains very low and Brazilian consumers still maintain low levels of credit exposure. Only 4% of the households in Brazil are subject to mortgages. Additionally, very short term maturities and high interest rates translate into very high service costs to disposable income ratios, which are not directly compatible to over-levered US consumers. Thus, this ratio should be recalibrated to provide a more meaningful comparison. Regardless, we think that Rousseff will need to implement structural reforms to shift Brazil to an even faster growth projection to open up the economy, improve the business environment and raise investment through domestic savings rather than foreign borrowing. ***Stated differently, Rousseff will need to transition to a new growth model from one that is based on consumption to one that is based on increased fixed investment and savings (to fund investment). We remain very bullish that the structural foundation is present to make this transition.***

Overblown Inflation Fears

Inflation remains a much bigger concern to the markets than to the government. We tend to agree with the government that inflation fears are indeed overblown. Currently, two-thirds of the CPI in the services and government tariffs components are where all the inflation can be found.¹⁴ The remaining one-third in durable goods exhibits no inflation but there is fear that with these new import tariffs, this could change. The main concern to the government is if the inflation found in services transitions to durable goods. For now, given this current inflation makeup, the government prefers the tradeoff between more growth through lower policy rates, so long as inflation within durable goods remains tame.

¹³ "Fraga warns on Brazilian credit growth", *Financial Times*, Joe Leahy, 02.23.2011.

¹⁴ The majority of the inflation can be found in services which is mainly derived from labor shortages.

To summarize our bullish thesis on Brazil:

- We think inflation concerns which have been discounted in are largely a non-issue at this point in Brazil's business cycle;
- Rousseff's use of the central bank to solve micro and macro-prudential policies, along with other economic uncertainties and misperceptions, have put a downward pressure on Brazilian market multiples which we think have only created value opportunities. Some of these issues include:
 - Inflation concerns;
 - Consumer credit concerns that are somewhat overblown because it is severely inappropriate to compare US consumer metrics with those of Brazil; and
 - Rousseff's very interventionist policies in handling the Asian competitiveness threat, although we think the worst may largely be over, as lots of bad news is already reflected into the markets.
- While the real has every reason to be strong from a structural perspective, we think some of these key reasons may have changed, as evidenced by this recent weakness in the USD/real cross rate. As interest rates remain steady, commodity prices fall, and inflation remains in check, we think the real should not pose a problem here;
- The administration has a wide plethora of policy tools that it can use to turn growth around in a very sustainable fashion, not available to Developed Markets and even most Emerging Markets; and
- Because there are still many industries and sectors within Brazil that are still highly fragmented, there are plenty of growth opportunities not yet discounted into stock prices for mergers, acquisitions and consolidations to realize tremendous synergies

How do we prefer to access Brazil under these conditions? We prefer to access these markets through long/short strategies with a true eye towards the macro risks. Volatility inherent in these markets provides ample opportunity for alpha generation on the long and short side. Additionally, we would focus on the domestic demand story of Brazil and shy away from commodity-based exposures more levered to global growth.

II. Capital Markets Overview & Outlook

Capital Markets Summary

On the heels of a strong *fear on trade* (i.e., risk off) and a flight to safe haven status, the USD got a big boost in September from the Eurozone's intensifying debt crisis and gloomy news on the global economy. The trade-weighted USD index rose by ~ 6%, following a slight gain of ~ 1% in August. The USD was also supported by a further shift in relative prospects for monetary policy in the US and the Eurozone, reflected in an additional contraction in the interest rate differential between the Eurozone and the US, as well as in the Fed's decision to implement Operation Twist in a sterilized manner rather than undertake more quantitative easing and expansion of its balance sheet.

Major Western developed stock markets had a very rough third quarter as the prospects for growth continued to deteriorate and the euro-zone debt crisis took its toll on the share prices of banks in particular. The US S&P 500 dropped by ~ 14%, while developed international and emerging markets shed -19% and -22.5%, respectively. This recent pull-back in US equity prices has left valuations undervalued by some metrics and much less stretched based on other empirical metrics founded on two widely-watched metrics –Tobin's equity Q for the US non-financial corporate sector and the 10-year cyclically-adjusted Price/Earnings ratio of the S&P 500. At the end of the third quarter, both measures have continued to converge towards their long-term geometric averages, although they still remain in overvalued territories. If we examine forward-looking analyst estimates and apply a P/E ratio reflecting empirical long-term trends in this type of growth/inflation setting, it appears that this market is not significantly overvalued, but this assumes that we have full confidence in achieving analysts' forward earnings bogeys.

For Emerging Markets, capital market performance was mixed. Credit spreads between the JP Morgan EMBI Global Index over Treasuries rose by ~ 100bp in September, as investors continued to apply their brakes on the risk trade and preferred the relative safety of Treasuries in the face of escalating Eurozone woes and China's potential hard landing. Emerging Market economies such as Russia and Venezuela were both particular contributors to the increase in the overall EMBI spread, reflective of retreating oil prices. Equities in Eastern Europe fared worst among Emerging Market regions because of their much greater exposure and leverage to the Eurozone economy. From a regional perspective, markets in Latin America and Asia fared relatively better, especially in local currency terms, with a notable exception of India which continued to suffer from foreign capital outflows. Amid the turbulence in the financial markets, the USD gained significant ground on average against the Americas' other major trading partners within Emerging Markets. Both the Brazilian real and the Russian ruble dropped precipitously for reasons very idiosyncratic to each individual country, while China remained on their long-term objective of preventing the RMB from appreciating against the USD for reasons we discussed above.

The Third Quarter also saw major dispersion in price action across global credits markets. Operation Twist prompted a sharp decline in long-term Treasury yields as planned. The fall was primarily driven by a drop in inflation expectations, reflecting the Fed's decision not to undertake an expansionary QE3. Treasuries also remained supported by the outlook for interest rates following the Fed's zero-interest-rate-policy for at least another two years. Eurozone periphery bonds, including those of Greece, Italy, Portugal and Spain remained under pressure as fears of contagion spreading to core countries. Moreover, the further transfer of risk from the Eurozone's periphery to its core necessary to prevent a break-up of EMU continued to boost the cost of CDS on German government debt.

Intermediate term (7-10 year) corporate bond spreads widened further in the US and Europe. For triple-B US corporate bonds, spreads increased considerably during the Third Quarter, well above the ~ 200bps average since 2000. Further down the credit spectrum, spreads continued to rise even more substantially. If the financial crisis

worsens, these spreads could widen further. This would be most likely be the case if the US were to experience a double-dip recession, as spreads experience wide fluctuations during business cycles. However, we think the US is more likely to experience a protracted period of anemic economic growth accompanied by continued accommodative monetary policy. If we are correct in our outlook, we would not be surprised to see corporate bond yields trend lower again. As an example, the average yield on triple-B corporate credits in the 7-10 year part of the curve has only risen by ~ 30bp or so since the end of July. A material portion of the spread widening was more a result of Treasury yields dropping sharply. Even if the US economy folds, companies are in a stronger position now, being embedded with much less leverage, to service their debts. Liquid assets held by nonfinancial companies at the end of Q2 were at their highest level as a share of short-term liabilities since the mid-1950s.

Global Equities

Our capital markets outlook remains largely unchanged since the start of the year, even after most of our conviction themes and biases have thus far paid off handsomely. ***Our prediction that the US markets would outperform international markets remains intact. On an YTD basis, the S&P 500 has outperformed the MSCI Emerging Markets and MSCI EAFE Indices by ~ 1550 bps and ~ 670 bps, respectively.***

Further, we continue to believe the US stock market has a better risk-reward profile than most other OECD equity markets. A weak USD, plenty of liquidity, avoidance of a double-dip, and low interest rates will continue to subsidize corporate profits for those large, well-placed multi-nationals that continue to cut costs and boost productivity. So long as earnings and profit margins do not significantly disappoint, the US stock market remains one of the few places to hide in a dangerous neighborhood. In this environment, we continue to emphasize larger capitalization stocks as safe havens for our equity allocations, buffered from volatility by their high dividend payouts and stable business models.

That said this major sell-off in Emerging Markets has made their relative and absolute valuations more (and in some cases historically) compelling from a purely tactical perspective, provided of course that the global economy does not tailspin into a recession. This view would be isolated to capitalize on any transient beta rally in Emerging Markets.

Despite the recent selloff in European and other International Developed Markets equities and their very attractive historical valuations, we prefer to maintain underweight positions to long-biased Developed Market allocations until we obtain more concrete evidence of regional stabilization and that policymakers are taking the necessary actions to solve their structural problems – a daunting task in our view.

Some additional general observations on stock market valuations. The S&P 500 has now fallen ~ -10% since its Second Quarter highs. If this economic slowdown turns into a full-blown recession, we think the index could slide to the ~ 900 level.¹⁵ But we think the economy is more likely to remain in slow growth phase for the remainder of 2011. Accordingly, barring any left tail event from Europe or a hard landing in China, we do not expect to see any further sell-off of significance in equity prices. In fact, a strong bounce in equity prices is probable given the scale of the recent drawdown, current valuations and the amount of liquidity in the system that was not present during the 2008 crisis. Therefore, it is hard to see the catalyst for a sustained rebound even if the Fed does undertake more accommodative easing. Although valuations in Emerging Markets equities today are arguably undervalued, we believe the prospects for super-robust economic growth in Emerging Markets are deteriorating rather than

¹⁵ There have been 14 official recessions in the US since the Great Depression. On average, equity prices have fallen ~ 40% from peak to trough around these economic downturns, with sell-offs ranging from below 7% to more than 86%. The recent drop in the S&P 500 is on the lower end of this range. A peak to trough to decline of 40% from the recent peak of around 1371 on May 2nd would leave the index at a ~ 850.

improving and any rally should be used to marginally rebalance and pare down long-only Emerging Markets exposure. Further, this should provide major headwinds for any sustained rally in global equities.

To summarize, our capital markets outlook on our global equity allocations remains unchanged. We maintain overweights in domestic equities at the margin and underweights to long-only Emerging Markets, although we could see a strong snap-back rally. We believe that the cyclical undertones in stocks that began in March of 2009 may extend further into the election cycle. Our US economic outlook remains unchanged as well. We have not changed our baseline scenario in the US for anemic growth extending into the foreseeable future, as the public/private deleveraging process weighs down GDP growth. Moreover, this most recent *soft patch* in US and global growth data may serve as warning signals that investors will be faced with further disappointment in terms of the economic releases. This outlook is predicated on our view that corporate profits should not experience any major downtrends usually observed during recessions.

Global Fixed Income

Here too our global credit market outlook remains largely unchanged despite major moves in interest rates, as we predicted. Fixed Income & Credit remains a core allocation to us for a variety of reasons. While many at the start of 2011 predicted that US Treasury rates would trend significantly higher, we disagreed and have been proven correct, with most fixed income sectors outperforming equities. We think this trend will continue into 2012.

US Treasuries

We maintain our outlook for the nominal 10-year Treasury yield to remain below 2.0% for longer than many people think. Our thesis is partly predicated on the prospect for global monetary policies likely to be even more supportive for the economy. In the US, policymakers have also decided to lengthen the maturity of the Fed's portfolio of securities rather than undertaking a third round of quantitative easing. We think this explicit attempt to drive long-term yields lower via Operation Twist will be more bond-friendly. Additional reasons for this outlook include structural weakness in the US economy through higher unemployment and capacity underutilization leading to lower inflation expectations.

If we further dissect the nominal yield on the Treasuries into the implied real yield and inflation expectations components and analyze the trends of each component, we see that the fall in real interest rates has been the primary driver for the nominal yield falling. This in turn can be explained by expectations that the Fed will keep its ZIRP policy in place for a prolonged period in response to sluggish economic activity, persistent problems in the financial sector, and the problems looming in the Eurozone. We even think that real yields will turn negative during periods of financial stress, most likely triggered by events across the Atlantic and maybe the Pacific as well. Additionally, there is also plenty of room for inflation expectations to fall, especially if our outlook is correct that global commodity prices (particularly industrial) have further to fall. We only have to look to 2008 when the 10-year breakeven inflation rates fell close to zero in the early stages of the global financial crisis as fears of deflation took hold. ***If we thus focus on the true fundamentals, they all point to Treasury rates going lower, including the outlook for the economy, inflation and interest rates, left tail risks and associated safe haven demand. Lower rates will be the case whether the Fed is among the purchasers or not.***

Credit Spread Bonds

Recent material outperformance of US Treasuries relative to US corporates, international, and other credits spread products coupled with this most recent risk on rally from the October lows, will most likely translate into a

temporary rotation out of Treasuries and into these other credit-sensitive sectors that are trading at inexpensive valuations. As part of this outlook, we will be using any rally in credit spread products to rotate into more stable fixed income strategies that trade in government-guaranteed securities exhibiting more linear-like returns that trade in similar fashion to Treasuries because of their implicit federal backing.

To summarize, our views remain very favorable to Fixed Income and Credit across all sub-asset classes including domestic, including government, corporate and municipal (where appropriate), as well as global/international where the broader opportunity set provides active management with a plethora of fertile alpha generation opportunities, at lower cross-correlations to other fixed income exposures. With respect to corporate credits, we prefer to invest higher in the corporate capital structure, protected by bond indentures, and with attractive return expectations, given the current credit valuations.

Commodities

There are several reasons that make us step back and reassess the short to intermediate term outlook for commodities. The first is the potential for a hard landing in China, evidenced from rising inventories, disappointing manufacturing prints, and slowing bank credit, all making the case for a weaker growth from China. Because China is believed to be the dominant marginal buyer of commodities, any China demand weakness will translate into lower commodity prices. The second is a more prolonged uptick in the value of the USD. As the desire to de-risk portfolios around the world takes hold, we think the natural safe asset investors will flock to will be the USD along with gold.

The third relates to the fall of foreign reserves held by central banks.¹⁶ When central banks reserves start to fall, as they have since the First Quarter, then either world trade shrinks or an economy running large current account deficits cannot find financing and defaults. Historically, such liquidity crises have ended either with the US stepping in as consumer of last resort by running ever larger current account deficits, or with plummeting global commodity prices.¹⁷ Perhaps the recent weakness that we saw in September is the beginning of what would be the key adjustment to the global economic and liquidity squeeze. As such, going forward, we expect most commodity prices to fall further during the remainder of this year and 2012. This will be a major source of disinflation in both advanced and emerging economies which will in turn be bullish for fixed income exposures.

- Crude oil prices are also likely to fall and/or remain weak for two main reasons. First, global oil demand should remain weak, particularly in the US, which still consumes more than twice as much oil as China. Secondly, supply should not be as tight as the markets expect, especially in the shorter term.
- Agricultural commodity prices are also likely to fall further by year-end. They tend to move in tandem with oil prices, partly because energy is an important component/cost in food production, associated with fertilizer. Also, weather-related supply shocks have dissipated for some key agricultural commodities, including wheat.
- Industrial metal prices that correlate to manufacturing activity are also likely to fall further, in line with the recent decline in global manufacturing data prints. With 40% of world copper and aluminum being bought by China, the recent slowdown in China will also affect industrial metal prices. In fact, China recently revealed a much larger copper stockpile than was expected.

¹⁶ "Checking the Box", *GaveKal*, September 29, 2011.

¹⁷ "Checking the Box", *GaveKal*, September 29, 2011.

For these reasons, we remain cautious in our commodities outlook going forward until we have greater clarity on the direction of the global economy and/or the value of the USD . Of course, the only exception is gold, which we would argue is no longer a true commodity.

Gold & Precious Metals

Gold is considered a zero-duration asset because it lacks an earnings/income stream. This makes gold all the more difficult to value on a stand-alone basis. If we use a relative valuation methodology, we get mixed results. While the most popular relative valuation technique requires comparing the total stock of gold to the total stock of money in circulation, we have expanded this analysis to include comparisons of other assets such as equities and crude oil in order to arrive at a more robust conclusion. However, such an exercise does not produce either a bullish or bearish dispositive indication.

As such, we prefer a more Top-Down approach to determine the directionality of gold prices, assisting us with our ultimate decision whether to remain overweight gold or begin taking profits more aggressively. Here, the results are clear and concise - giving us a unilateral bullish signal. The key global macro factors that we believe drive gold supply/demand dynamics and prices higher are fully in place, with no indication that things will change any time soon. Alternatively, those factors that will cause a bearish gold trend are very remote based on our views of current global macro conditions and they too are unlikely to change in the near term.

We therefore remain steadfast in our long-term conviction in gold so long as the current conditions which appear structural and deep-rooted remain in place. While gold could pull back on technical selling or selling pressure from margin calls and liquidity needs as other capital markets sell off, we think such consolidations should be viewed as healthy and as buying opportunities.

We reiterate our bullish outlook for gold and gold equities and believe their bull market has legs to run despite this recent technical sell-off.

Currencies

Overview

The contrasting effects of the financial crisis on different economies have resulted in sharp exchange rate volatility as Developed Markets focus on reviving their domestic economies and Emerging Markets focus on controlling inflation. The USD finally reversed its slide in September, aided by the Eurozone's intensifying debt crisis and the impact that the crisis, alongside gloomier news on the global economy, had on risky asset prices. The USD was also bolstered versus the euro because of the Fed's decision not to implement further QE which would help narrow the spread between interest rates in the Eurozone and the US. The only major currency that kept pace with the USD during the risk off trade in September was the yen. The yen has been underpinned by the small interest rate differential in the US and Japan, the reluctance of the Japanese central banks to pursue more accommodative monetary easing, and by its perception as a safe haven.

Emerging Market Currencies

The precipitous fall in Emerging Markets currencies against the USD does not reflect fundamental shifts in exchange rate policy in these countries nor underlying economic fundamentals, *per se*. Instead, the main driver appears to be renewed demand for the USD as a safe haven from a global slowdown and a risk off trade

culminating from the crisis in the Eurozone. Downward pressure on EM currencies may continue. However, we would expect those of Emerging Asia should reverse, as they trade more in accordance to their underlying fundamentals.

The falls in the currencies of Emerging Southeast Asia have been interpreted as a sign these countries have decided to allow their exchange rates to fall in order to protect exports as the global economy weakens. However, some central banks have reportedly been intervening in the currency markets to slow the decline. Similarly, there have been even larger falls outside Asia as notably the Brazilian real, Hungarian forint, Polish zloty and South African rand all dropped by over 10% in September alone.

We think this is more of a case where the USD has strengthened because of the Fed's decision to put the printing press on hold and the USD status as a safe haven, and not reflective of weakness in EM currencies because of any underlying fundamentals. This is not to say that policymaking in Developed Markets haven't played a role. For instance, the Brazilian central bank's decision to cut rates clearly contributed to the real's slide.

We do expect the currencies of Emerging Asia to be among the first to recover. Aside from their strong relative fundamentals, strong balance sheets, surpluses, foreign reserves, and superior growth rates, we think the recent decision by the Swiss government to peg the Swiss franc to the euro will shift capital flows from the franc into South Asian currencies, possibly the Singapore dollar, as an alternative diversifying currency to the USD.

Lastly, while some of the International/Global Fixed Income funds have been particularly hit hard by their allocations to Emerging Market debt and currency exposures, we think these levels represent buying opportunities for longer-term investors.

III. Concluding Remarks

With very broad strokes, we have touched upon the major issues and problems that dominate discussion of the global macroeconomic environment. Hopefully it should be quite clear that this economic downturn is unique in magnitude and duration. ***Growth during the past two decades was artificially founded on credit creation, especially among the Developed Market economies, facilitated by an antiquated International Monetary System.*** After the bubble burst and credit flows came to a halt, assets prices that acted as collateral for the underlying debt collapsed while the face value of the debt did not. This has created solvency issues throughout the private and public sector debt overhangs of unprecedented proportions.

Saddled with this debt, the painful process of deleveraging has begun in most OECD countries. Deleveraging has had several negative consequences. The first is that it has put pressure on aggregate demand. As long as there is unsustainable debt and deleveraging, there will be a decrease in spending, which will crimp economic growth and employment. The longer this persists, the worse it will get and the closer economies will approach Japanese-style debt traps. Second, this distortive deleveraging has effectively made monetary policy completely impotent. And with fiscal policy no longer a viable alternative as most government checkbooks are deeply and dangerously in the red, the policy tools to stave off another downturn in the future are ominously missing.

More specifically, the United States should avoid another recession over the next several quarters, but any recovery will most certainly will remain below expectations. Even while deleveraging has been going on for some time now, households have made little progress in paying down aggregate debt, unemployment lingers and outside of limited technology spending, private investment growth will remain subpar. The Federal Reserve will persist with its zero interest rate policies (ZIRP) and Operation Twist and may take some other small steps to stimulate activity.

Further, the Eurozone is heading back into recession as Germany's export machine is dwindling quickly and the sovereign debt crisis is spreading to the core. Three periphery economies are participating in the IMF/EFSF programs while the larger Italy and Spain are dependent on bond purchases by the ECB to keep refinancing rates from exploding. Over the next several weeks and months, Eurozone governments are expected to announce widespread recapitalization of their banking sector, larger write-downs of Greek sovereign debt than initially planned and significant enhancement of the EFSF.

In terms of global impact, it is not only the US and the Eurozone that will feel the brunt of this structural economic malaise. China and other Emerging Market economies are beginning to experience slowdowns as well, partially from measures to fight domestic inflation (mainly food inflation) and credit-creation, and partially from weak growth in the Eurozone and the US dampening export demand.

While the solution is very straightforward, its implementation and execution is not. The solution entails policies that will reverse the global imbalances allowed to build up over decades. To allow this to happen requires major institutional changes to the current International Monetary System and more cohesive policy coordination, regardless of how politically unpopular it may be. While the resulting debt is not the problem but a symptom, the debt has reached a level where it has become a major problem. ***Said differently, the debt accumulation is not the cause of the current economic malaise but a consequence of it.*** This means that debt must be now addressed, reduced in part by restructuring and in part by forgiveness.

This will allow growth to be driven, not from credit creation and overconsumption in Developed Markets suffering current account deficits, but from consumer demand from the likes of China, Germany and the oil exporters. While the US' *exorbitant privilege* has allowed it to over-consume and invest overseas financed by cheap debt obtained through the USD's role as the global reserve currency, this can no longer be a reliable source of global growth. ***To summarize, with public/private balance sheet malaise in the US and the Eurozone, and global imbalances***

plaguing the world, are these approaches and policy responses appropriate or are we destined for prolonged anemic growth and increased volatility in global capital market?

In light of this global macroeconomic environment, our portfolio positioning remains unchanged going into the end of the year. Our conviction themes and biases lead us to the following:

- 1) Maintain a cautious outlook on Global Equities while maintaining a marginal overweight to US Equities;
- 2) Overweight Global Fixed Income & Credit despite its solid YTD outperformance. We would emphasize investment grade US corporate credits because they remain undervalued, until we obtain greater clarity on the US economy and maintain our International Credit Exposure with marginal overweight to EM credits and currencies because we believe the selloff has created tremendous values at these levels; and
- 3) Maintain our cautious view on Commodities with the exception of Gold & Precious Metals allocations which remain conviction themes in this environment.

In terms of positioning, our investment philosophy remains one of positioning for ***multiple scenarios*** with core strategic positions around our key themes and tactical maneuvering at the margin as we look to benefit from capital market volatility.

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