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"It is difficult to get a man to understand something when his job depends on not understanding it"

- Upton Sinclair -

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Executive Summary

We highlight the new export-led growth philosophy adopted by nations around the world because it raises the most fundamental question imaginable. How can every country simultaneously export its way out of recession? **W*here will all the buyers come from***? Are we to expect the world economy to be one hand clapping?

We remain ***True* Normalists** in a world where markets will revert to a different mean, not likely to resemble past patterns and trends. The traditional monetary/fiscal policy tools to ward off economic recessions under the Old Normal will be much less effective under the ***True Normal***.

The bottom line for the US is a growth trajectory resembling the ***True Normal.*** Associated with this slow growth is a huge output gap that will result in deflationary forces lingering for some time. While QEII may help to spur rallies in risk assets around the world, it is likely have limited effectiveness in stimulating aggregate demand.

We still witness bifurcation and divergence in growth paths among the developed and the emerging markets, but the tether that connects the two through global trade/export linkages may prove too powerful a constraint to achieve maximum growth velocity for the Emerging Markets (i.e. economic decoupling) — a development that we continue to monitor.

Looking at the implications for investment, we see a world where the printing presses continue to run without global cooperation to resolve imbalances. That makes gold and precious metals the clear winners, since they're seen as surrogates of fiat currencies with inelastic supplies and liabilities to no one.

We believe that quantitative easing will do little to stimulate demand in the wider economy because the cost of borrowing is *not* the problem in this economy, given that Treasuries, corporate bond yields and mortgage rates already at record lows. In the current predicament, where banks and households are focused on repairing their over-indebted balance sheets through deleveraging, monetary policy becomes increasingly ineffective in boosting economic activity.

Although QE has failed to boost lending and domestic demand, it appears to have ignited a rally in risk assets, as can be seen in the price action of global equities in September. Investors have gained greater confidence that QEII policies will be able to lift world economies out of their doldrums.

Alongside a deleveraging private sector, we see a bloated public sector as the government attempts to pick up the output slack. The US budget deficit is a fire-breathing biblical Leviathan, likely in 2010 to exceed $1.3 trillion, or 10% of GDP, with longer-term trends promising yet more brimstone.

Butting the headwind of a slowing US economy, but sailing the tailwinds of profit diversification into faster growing regions, corporations have managed a robust growth of earnings from the lows hit in the last quarter of 2008.

We need either very robust GDP growth or soaring profits and soaring productivity gains to realize the forward earnings growth that has been priced into current equity markets. With the economy in our present state, forcing the Fed into further quantitative easing, we don't see either being likely.

With the entire Eurozone, including Germany and France, in the midst of a *Grand Bargain* fiscal austerity squeeze, and with the recent strength of the euro an inevitable drag on the Eurozone export sector, we view a sustained recovery as unlikely.

While we are perhaps more optimistic than consensus on Japan's growth prospects, we remain neutral from an investment perspective, as we believe that better opportunities can be found in other equity markets. We must remind ourselves that although Japan is a wealthy country, it has a shrinking working demographic and is plagued by a lingering deflationary liquidity trap and a weak and continuously revolving political leadership.

This domestic and foreign injection of capital and liquidity into emerging markets from overseas QE programs could prove highly bullish for emerging-market equity investments over the short to intermediate term.

Longer term, China has reached a turning point in its demographics of labor, having been gradually transitioning away from its perceived role as the ultimate global outsource of cheap labor: one of China's chief competitive advantages. A demographic withering is also occurring, as there will be fewer and fewer younger workers, the long-term fruit of China's multi-decade one-child policy. Other competitive advantages China has relied on are disappearing as well, among them cheap land and natural resources. These predicaments will create China's version of the ***True Normal.***

The China-demand explanation for the recent spike underestimates, we believe, the role that global financial markets have played on commodities. More specifically, the anticipation of further QE by the world's major central banks, led by the Fed and the Bank of England, has boosted the prices of most global risk assets, making many commodities particularly bullish.

With all major countries — developed and emerging — eager to enhance export modalities, no country wants a strong currency, and with the Fed on the QE bandwagon, asset bubbles are the most likely scenario as each country tries different ways to ratchet down its currency. The major beneficiary remains gold.

Given a current sub 1.0% trimmed CPI reading, a stubbornly high output gap that is not improving, and a housing market that remains in turmoil, we foresee a very high probability of deflationary pressures in 2011 as measured by core CPI. Such an outlook will provide the proper environment for further gains in bonds — an asset class that is clearly "under-owned" by an aging demographic that needs fixed income and safety.

Since the beginning of September, we have seen the USD slide to new lows, gold hit yearly highs, the TIPs break-even increase and the yield curve steepen (the gapping up of the 10s/30s yield spread), while risk assets rallied.

These all suggest that investors have been buying some inflation protection. While investors have been piling into the reflation trade, government data continue to paint a powerful counter-inflationary picture, even when factoring in increased food and energy costs.

The liquidity and QE push by the Fed could create extreme global asset price bubbles in real estate, commodities, and equities as most emerging countries rush to devalue their currencies versus the USD, thereby protecting their export markets.

In a world where deficit countries need to reduce domestic demand, while surplus countries are unwilling to reduce their reliance on export-led growth, currency tensions will inevitably reach the boiling point. No country in our current global environment wants a strong currency, because everybody is in search of buyers. ***Alternatively, those who want to consume cannot and those who can consume don't want to***.

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- Upton Sinclair -

Where Will the Buyers Come From?

Introduction

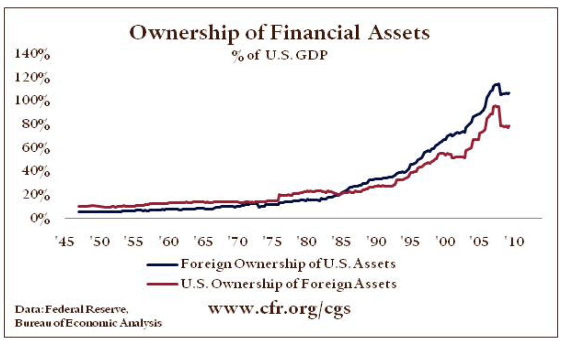
As we enter the last quarter of 2010, we continue to experience mercurial price movements in global equity, credit, commodity and currency markets. One plausible explanation for this uncertainty is the vast disparity of growth forecasts across regions/countries and the varied interpretations of macroeconomic data. There exists an apparent bifurcation between the faster growing Emerging Markets (EM) and the more stagnant developed markets. In fact, while US corporate cash balances, cash flows, productivity levels, and profit margins are at historically high levels, developed market public and private debt have reached levels that seem unsustainable. Traditionally, this cash hoarding would translate into an eventual surge in investment and capital expenditures for business and forecast heightened potential for economic growth. However, with the recent credit crisis and continued output gap, as well as a protracted process of deleveraging across private and public sectors, conventional wisdom is simply inapplicable. Given these unprecedented circumstances, empirical trends may no longer be valid, thereby making prognostications of economic eventualities using past experience all the more difficult.

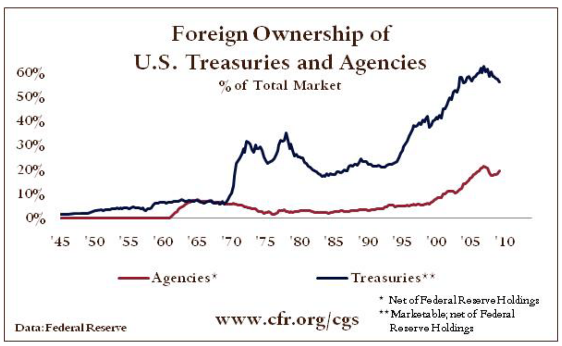
While many global uncertainties remain, a few were recently purged from the markets. US Financial Regulation was signed into law, the European Stress Tests were completed, the IMF and EU came to the rescue of Greece and implemented a short- term bail out for other potential Eurozone sovereign debt problems, the BP oil spill appears to have been permanently plugged, and Goldman Sachs settled with the SEC. All of these events helped to take some pressure off the markets, as evidenced by the contraction of the 3-month US LIBOR rate by over 24bps from June of 2010 (from 54bps to just under 30bps).

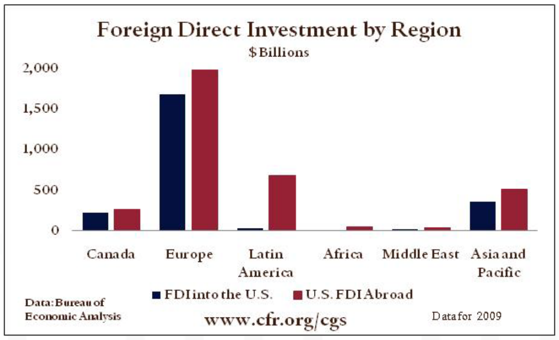
However, as some of these conundrums have appeared to wane, we see others making their way to the forefront. Geopolitically, we see a number of potentially market-moving trends growing, including the continued stalemate between the once very strong strategic relationship between Turkey and Israel (over the flotilla incident), Iran (especially Ahmadinejad's speech at the UN General Assembly), North Korea, and China and Japan (Japan's arrest of a captain of Chinese fishing boat in disputed waters). Geo-economically, we are now faced with the potential for global currency wars and trade protectionism as a means to attempt boosting demand and economic growth. This can only be exacerbated with the increased likelihood that developed nations will take further quantitative easing measures to boost their own economies. In our view, the most pressing of these underlying uncertainties is due to the lack of an effective international institutional framework for resolving such complex issues. The consequences of that fact will inevitably surface as globalization increases the interconnectedness of nations, and the complexities of these relationships. Until a dispute-resolution mechanism is implemented, these uncertainties will likely evolve into significant headwinds against global growth.

Meanwhile, the current economic recovery begins to resemble the last economic recovery in many respects, the one which started in late 2001 and almost relapsed in 2002. However, by the third quarter of 2003, GDP growth was growing at an annualized clip of 7%, eliminating the potential for a "double dip". Is the current lull in economic activity, temporary though it may be, the same animal we saw back in 2002? We don't think so, because our beastmaster's whip today isn't as snappy as it was in 2002. Back then, the Fed had more muscle to perk the economy by instituting a 75bps rate cut in 2003 (using conventional monetary policy). Additionally, fiscal policy came to the rescue when Congress passed a second series of Bush tax cuts. Now, however, conventional monetary policy is powerless given interest rates at near-zero levels for more than 18 months now. Further unconventional, quantitative easing would seem the only solution.

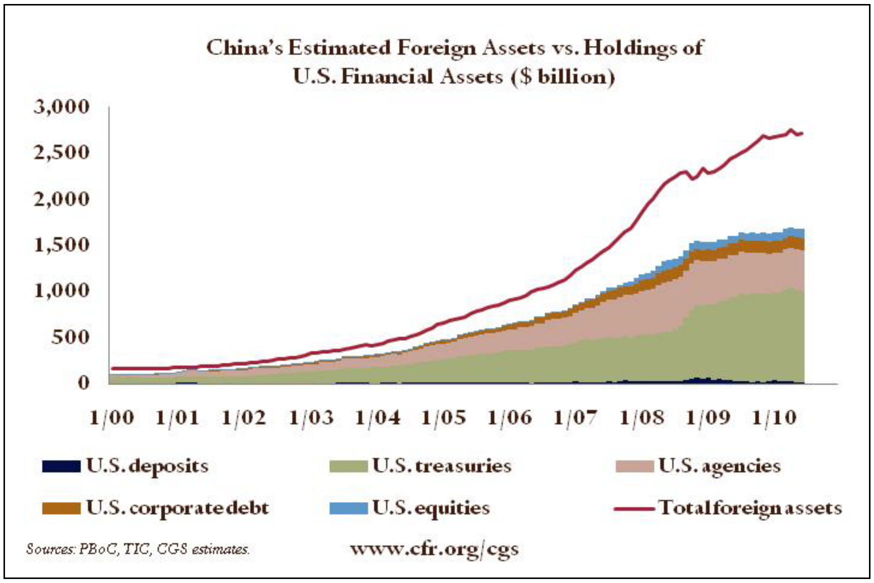
Other market-moving trends we see gathering momentum are the continued climb in size and power of sovereign wealth funds (SWFs), which are estimated to reach over $12 trillion in asset size by 2015.[1] The rapid expansion of SWFs was fueled by high and rising prices of natural resources/commodities and by policies that led to massive accumulations of foreign exchange and financial resources. SWFs are the paradigms of two major trends in the global political economy: (1) a redistribution of wealth and economic & financial power from the United States, Europe, and other developed markets to countries perceived to be less firmly grounded in similar economic, financial, and political principles (i.e. China and the petroleum-producing Gulf states); and (2) an increasing role of governments in managing wealth and economic power in the current global economy. As a corollary to SWFs, foreign exchange reserves of EM, especially the BRIC countries, have begun to grow again, almost entirely driven by China. Most of these reserves are held in Treasuries, with China dwarfing the rest of the EM countries at ~$2.7 trillion. That said, while foreigners own more US assets than US residents own foreign assets (as the US runs persistent current account deficits and capital inflows), the US net international investment position has remained roughly flat (positive for 2009) because US-owned foreign assets have appreciated faster than foreign assets in the US. In fact, based on the graph below, the US invests more directly into operating companies abroad than foreigners invest into those in the US.







[1] "Sovereign Wealth Funds: Threat or Salvation?", Edwin M. Truman, September, 2015.



The New Normalists vs. the Old Normalists

As we have discussed in prior musings, the world remains divided into two strategist camps. There are the ***Old Normalists*** who think that the world is in the midst of a sustainable global economic recovery with GDP levels reaching pre-crisis levels and little risk-appetite deterioration. Accordingly, any pullbacks should be seen as buying opportunities. Then there are the ***New Normalists*** who believe that the most of the developed world will undergo a period of sub-par growth due to overbearing deleveraging forces caused by major output gaps (capacity underutilization), government re-regulation, de-globalization bringing very real 1930s-like trade protectionism and currency wars, and fiscal austerity.

We remain <u>True</u> Normalists in a world where markets will revert to a different mean, not likely to resemble past patterns and trends. The traditional monetary/fiscal policy tools to ward off economic recessions under the Old Normal will be much less effective under the ***True Normal***. While deleveraging, re-regulation, de-globalization, and increased taxes will be the prevailing characteristics, we will also undergo domestic weakness in the emerging markets as well. As powerful as many of the larger and more developed emerging markets are, they are still interconnected to the developed markets by strong global trade linkages that cannot be ignored. Their domestic consumption markets are still too underdeveloped to take any leadership role. China, by its numerous admissions, continues to label itself a “poor nation”. Thus, a larger-than-expected fall in developed countries’ current account deficits, notably in the US, would be a daunting challenge for the EM sector. Even with elevated EM growth rates, it remains to be seen whether these countries can pick up the global output baton and lead with it. Let’s dig a bit deeper to address some of these issues.

TwinFocus Macroeconomic Overview

Keynesianism versus Supply-side Rigidities: Growth through Export-Driven Modalities

According to the IMF, in the midst of the crisis the developed market countries committed over 50% of their respective GDPs to capital injections, liability guarantees, and outright central bank purchases of bad assets (quantitative easing) from the major banks. Despite these unprecedented and globally coordinated actions by finance ministers and central bankers, it was not possible to prevent the financial-market crisis from spilling over into the real economies. Credit tightened, investment fell, global trade collapsed, and unemployment rose globally.

Global policymakers also participated with a prodigious response. Nearly every developed economy launched comprehensive and aggressive Keynesian stimulus programs to prevent prolonged and protracted recessions and outright deflation. This revived Keynesian solution came with a large price tag, however. Government finances deteriorated, with government deficits soaring across the Eurozone, the US, UK and Japan. Based on a highly timely and seminal study conducted by Professors Rogoff and Reinhart of Harvard University, history quite clearly proves that banking and credit crises of this magnitude are followed by sovereign debt crises and/or periods of prolonged financial stress and below-trend growth. The mechanism by which public sector finances suffer consists of the automatic stabilizers of government programs, such as unemployment benefits, increased discretionary spending (fiscal stimulus plans such as infrastructure projects, etc.) and bailouts of key industries. Paradoxically, as the private sector enters a prolonged period of debt deleveraging and increased savings, we see GDP decreases, government revenue shortfalls, increasing deficits and fiscal stress. This creates a debt spiral with all its ill effects.

Coincidently, since the apparent "recovery" began over twelve months ago, global growth has been less than spectacular, especially among the developed countries, much to the chagrin of policymakers. The economies of the US, Europe and Japan appear to be slowing more quickly than anticipated. While different countries and regions may be at different points in their cycle, global growth is undoubtedly faltering and the outlook for major advanced economies is on the dismal side. The growth areas remain in Emerging Markets, although even there the ill effects of the export mechanism on developed markets will no doubt cause a slowdown as well, the magnitude of which remains to be seen.

In the face of such grim circumstances, slow-growing developed nations have concluded that traditional Keynesian policies are not potent enough to fuel economic recoveries.[2] Their answer has been to solve their supply-side rigidities and grow through exporting to the rest of the world. For example, in the US, President Obama reiterated in his most recent State of the Union address his desire to double exports in five years, which is ***twice*** the US historic rate. The US economy is on government life-support; the budget deficit this year will amount to 12.5% of GDP, and 40% of the federal budget is credit financed. In 2011, the debt-to-GDP ratio will exceed 100% and move closer to the levels reached in Greece. The US economy needs new sources of growth to earn its way out of the most recent credit crisis — so what better way than an increase in exports, as all other components of GDP have been tapped out. The UK government has made the same motions towards exports. As well as meeting with foreign ministers and cultivating contacts with potential investors and sovereign wealth funds, ambassadors and diplomats are now expected to lead road shows in Britain, meeting entrepreneurs first hand to help them export.[3]

[2] Additionally, not all government spending has the equivalent long term economic impact. For example, whenever government and not the private sector is the mechanism through which capital is allocated, we are concerned whether such spending will produce the things that society truly needs to boost the general wealth and improve the welfare of the country — vs. spending for the purpose of temporary elixirs, which too often results in misallocated resources and the ultimate destruction of wealth, a dilemma, in our opinion, that China continues to face.

[3] "Diplomats to become UK plc's salesman", *Financial Times*, Alex Barker, August 4, 2010.

In Europe, Germany has made clear that it will not help solve Eurozone imbalances by reversing its prior efforts to increase competitiveness, which has boosted its terms of trade and helped increase exports. It has requested that all Eurozone countries do the same and adopt strict policies (wage controls, fiscal austerity, etc.) to increase their competiveness and increase exports to the rest of the world.[4] Lastly, emerging markets such as China still emphasize exports and will continue to do so for a very long time. Despite actions to re-value the RMB, no major change has taken place. China continues to be the export machine to the world, shipping out over 30% of its GDP (versus US exports of only 9%, but with German exports of over 40%).

The coordinated policy efforts of global policymakers to the Great Recession and their continued rhetoric not to resort to protectionist measures are highly commendable. The most recent G-20 summits in Washington, London, and Pittsburgh all delivered explicit language in their declarations strongly rejecting protectionism. We are reminded that the G-20 was created to be a more representative global group than its predecessor institutions had been, failing as they did to represent key EM countries. However, we are also reminded that the G-20 is comprised of the Group of Twenty Finance Ministers and Central Bank Governors, leaving Trade Ministers themselves unrepresented. Is this intentional? It remains to be seen whether future meetings will really result in specific recommendations and rules to address this question.

We highlight the new export-led growth philosophy adopted by nations around the world because it raises the most fundamental question imaginable. How can every country simultaneously export its way out of recession? ***Where will all the buyers come from***? Are we to expect the world economy to be one hand clapping? Further, explicit policies favoring export sectors create economic inefficiencies by subsidizing export industries and distorting the national economy.[5] Exporting is fine so long as it's balanced and coordinated, and is left to the workings of free markets within a well-developed international monetary system. But when countries focus *solely* on export growth/promotion, the result can be dangerous. The need to increase patterns of global growth should not become a synonym for neo-mercantilism. Similarly, we must remember that economists are not politicians, but rather social scientists focused on analyzing data. Politicians (need we say!) proceed by seizing on solutions to solve the immediate needs of their constituents, and all too often shy away from sound economic policies because they are not politically palatable. With mid-term elections changing the political landscape, and with the world becoming increasingly export-driven, economists will have their work cut out for them to avoid outside political interference as they engage in a worldwide treasure hunt for buyers.

The War of the Worlds: Currency Wars & Trade Protectionism

As we mentioned above, two years after the onset of the financial crisis, economic growth in developed economies remains direfully anemic and deflation a serious medium-term threat. Fiscal and conventional monetary programs are effectively exhausted, and unconventional monetary policy has shown little efficacy. The deleveraging forces of the private sector have proven too overwhelming even in the face of a public-sector explosion of debt. One option for policymakers that has not been taken yet is to weaken their currencies.

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[4] With the Eurozone currently running a **balanced external account** (to the rest of the world), and with the Chinese RMB and many other Asian currencies still pegged to the USD, any significant improvement in the Eurozone's export performance will result in Eurozone current-account surpluses when one factors in the Eurozone's weaker domestic demand due to new fiscal austerity measures. These will potentially hurt Eurozone imports and exacerbate the global imbalance dilemmas. For example, anti-Keynesian austerity measures in France, Germany, and the PIIGS countries will likely cut deficits dramatically, exacerbating Eurozone unemployment and shrinking domestic consumption, thereby bringing about a decrease in the purchase of global exports.

[5] ""Made in America" is not the way out", *Financial Times*, Jagdish Bhagwati, August 9, 2010. "By promoting manufacturing of all kinds (as can be expected as the sector's lobbies get down to work) at the expense of more innovative and dynamic service sectors, precisely when America is faltering in its recovery from the crisis, this unhelpful fascination promises to inflict gratuitous damage on an economy that can ill afford new wounds." We believe that the US needs to pursue a more balanced approach of creating both high value-accretive manufacturing and service jobs to promote growth levels experienced before the crisis.

In fact, in late September, Brazil's Finance Minister, Guido Mantega, declared that an "international currency war" has broken out around the world as governments compete to lower their exchange rates, seeking to boost competitiveness and their export sectors.[6] Mr. Mantega's comments followed a series of central bank interventions in Japan[7], South Korea, Switzerland and Taiwan, to name a few, in efforts to devalue their currencies. China has continued to suppress artificially the value of the RMB, in spite of pressure from the US and the international community to allow it to appreciate. Officials from other countries such as Singapore and Colombia have issued similar clarion calls over the strength of their currencies. The situation we are witnessing, therefore, is one in which global demand is notably deficient, and issuers of reserve currencies (i.e. US) adopt expansionary monetary policies, while non-issuers (China) respond with currency intervention to prevent their currency from appreciating and hurt their export-led growth strategy.[8]

Furthermore, non-issuer countries, not intervening in currency markets (say, Brazil) find their currencies soaring while their future competitiveness plummets. In fact, the Brazilian real has appreciated over 30% against the USD since hitting a high in December of 2008. Another dilemma is that emerging markets are trying to prevent their currencies from appreciating under the impact of large-scale capital inflows and actions taken against asset bubbles. Brazil is the paradigm case in point.[9]

Despite such fears, we think that a currency war among the advanced countries is highly unlikely at this point.[10] The US has continually voiced its objections to currency manipulators, preferring instead to have exchange rates determined by free-market forces in a well-organized international monetary system over deliberate FX actions. It seems implausible that the US would mimic the Chinese, having criticized them for years over their exchange-rate practices. Even if policymakers in the developed markets did begin to engage in large-scale currency intervention, they could not achieve all of their objectives. Aside from the fact that intervention is usually successful only when well coordinated to correct fundamental misalignments, not everyone can have a depreciated currency and export their problems away without willing buyers.

The developed world is suffering from gaps in structural demand and output. For none of the six largest economies was GDP in the second quarter of this year back to where it was in the first quarter of 2008. These economies are now operating significantly below their previous trends (à la ***True Normal***). As mentioned above, all the world's trying to pursue export-led growth simultaneously, thinking to solve their growth problems. This is as true for those with trade surpluses (i.e. Germany and Japan) as for those with trade deficits (US). In the aggregate, this can work only if the world becomes more balanced, i.e. if the emerging markets begin consuming more of their savings and surpluses. Otherwise, we must ask — yet again — where on the living earth are the buyers comin' from?

Looking at the implications for investment, we see a world where the printing presses continue to run without global cooperation to resolve imbalances. That makes gold and precious metals the clear winners, since they're seen as surrogates of fiat currencies with inelastic supplies and liabilities to no one. We believe that as unconventional monetary policy proves ineffective during this round, our investment thesis will become even more apparent.

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[6] "Brazil in "currency war" alert", *Financial Times*, Jonathan Wheatley & Peter Garnham, September 27, 2010.

[7] The Bank of Japan intervened in the currency markets to weaken the yen on hopes that large-scale intervention by the major central banks would be an important methodology for quantitative easing (unconventional monetary policy), utilized to boost demand and asset prices to avoid deflation.

[8] "Currencies clash in a new age of beggar-thy-neighbour", *Financial Times*, Martin Wolf, September 28, 2010.

[9] Foreign exchange reserve growth is a byproduct of currency intervention. With respect to China, reserve growth helps maintain China's undervalued RMB and current account surplus.

[10] This is not to say that developed countries will never engage in exchange-rate intervention. In 1985, the US, UK, W. Germany, France, and Japan entered into an agreement to depreciate the USD in a coordinated effort to battle a fundamental misalignment. The agreement was formally called the Plaza Accord.

Developed countries may not be anxious to pursue direct currency intervention, but there are indirect ways they could weaken their currencies, say by taking on yet further unconventional monetary policies. More quantitative easing seems like a significant possibility in the US and even in the UK and Eurozone. However, we believe that further quantitative easing through more asset purchases will not necessarily lead to weaker currencies. The slack in the economy is such that even an expansion of the monetary base is not likely to ignite inflation in the near to intermediate-term. Even with the Fed leading the way with unconventional monetary stimulus, the trade-weighted dollar index is higher today than at the levels which prevailed before the financial crisis began in 2008.

Are currency wars analogous to trade wars? It appears to us that we are now at a fulcrum point in global trade, where pressure starts to be felt to take protectionist measures that could foment trade wars. If domestic economies remain weak and unemployment high, policymakers will be backed into pursuing the most politically palatable alternative — cast their eyes abroad for a solution, just as they did in the 1930s. Some countries, most notably the US, might impose punitive tariffs on Chinese imports if China is not prepared to allow greater strength in the RMB. A resulting trade war would be in essence a currency war by another name, causing detrimental effects to the global economy that would parallel the catastrophes of the 1930s.

What we need, to repeat the point, are domestic and international reforms that will foster cooperation, and the strength of will to make the necessary adjustments that will correct the global demand-supply imbalance and the economic pathologies it breeds. Capital account surplus nations like China are in a strong position to initiate much-needed international cooperation. Such actions would earn China enhanced legitimacy in the eyes of the international community. Lack of action now could result in a breakdown of the international monetary system and the global economy with it. Further monetary and fiscal stimulus is not likely to be effective, which seems to leave us afloat on a prolonged period of lackluster economic growth, high unemployment and deflationary pressures. What needs to be avoided at all costs is a resort to currency manipulation and the regulatory trade policy that so often goes with it, trying to boost the economy by mandate. What we need to see is a world in which the players all pursue coordinated efforts and wave off the old sweetmeats of a *beggar-thy-neighbor* policy. We need a world where it is easy to identify both the sellers and buyers.

Quantitative Easing & Deleveraging

It is looking increasingly likely that the Fed and other global central banks will announce a new round of Quantitative Easing ("QEII") programs in the near future, their latest efforts to stimulate their respective economies. We believe that the Fed will opt for a smaller QEII that will be more agreeable to some of the hawks sitting on the Fed Board. Accordingly, while QEII might present some very limited opportunities, we do not think it will be enough to lift the US economy out of its current malaise.

Why not? The problem is that QE is still a largely **experimental** policy tool.[11] Our experience with QE is limited to the 2009 financial crisis. There is no assurance that banks, interest rates or economic activity will respond in the same manner now as they did in 2009. In fact, *we do not think they will*. We believe that it will do little to stimulate demand in the wider economy because the cost of borrowing is *not* the problem in this economy, given that Treasuries, corporate bond yields and mortgage rates already at record lows. Half of all mortgage borrowers do not qualify to refinance at lower rates because they lack sufficient home equity. Lower rates will not lead to significantly more benefits. Besides, businesses are already hoarding stockpiles of cash on their balance sheets

[11] Briefly stated, quantitative easing is an unconventional monetary policy used when interest rates are at near-zero levels. QE refers to an increase in the quantity of reserves held by banks at the central bank. Such an increase can occur either directly (i.e., a central bank buys assets from banks and credits their accounts with reserves by way of payment) or indirectly (i.e., if a central bank buys assets from non-banks and those non-banks then deposit the proceeds at commercial banks). In either case, the resulting increase in reserves provides commercial banks with a larger monetary base to increase lending and stimulate the economy.

which they could otherwise deploy to take on new employees or invest in capital expenditures. For these reasons, it does not appear to us that additional reserves through QEII will alleviate these problems.

Moreover, commercial banks are not lending out the massive excess reserves they have on their balance sheets to make new loans. What they prefer instead is to play the yield-curve arbitrage by buying longer-dated Treasuries to earn the spread differential by taking virtually zero risk.[12] Providing them with even more reserves will most likely have little impact. This is also evidenced below by the lack of growth of M2 money supply (despite the explosion of the monetary base and impregnated Fed balance sheet) and the precipitous fall in the velocity of money. This will introduce yet another market uncertainty concerning the impact of QE2 on the US economy.

M2 Money Supply (10.31.2004 – 8.31.2010)

Velocity of Money (12.31.1995 – 6.30.2010)

Source: Bloomberg

In the current predicament, where banks and households are focused on repairing their over-indebted balance sheets through deleveraging, monetary policy becomes increasingly ineffective in boosting economic activity. Rates are already very low, but households and businesses remain stubbornly reluctant to take advantage and borrow more. Many households are still constrained by the size of debts already accumulated and the loss of wealth from past asset-price declines. Businesses are made skittish by the high level of economic uncertainty about how strong future economic growth will be, and whether demand will really perk. If they *did* decide to increase capital expenditures, they would have plenty of cash on hand to fund new expansion — so lower bond yields would be unlikely to make much of a difference. Small businesses dependent on banks for their funding requirements and actually in need new credit availability continue to face highly pinched credit conditions. In summary, banks are sitting on over $1.3 **T**rillion in reserves, while little lending is taking place in the private sector. All of these are characteristics of a liquidity trap that will not be solved by QEII.

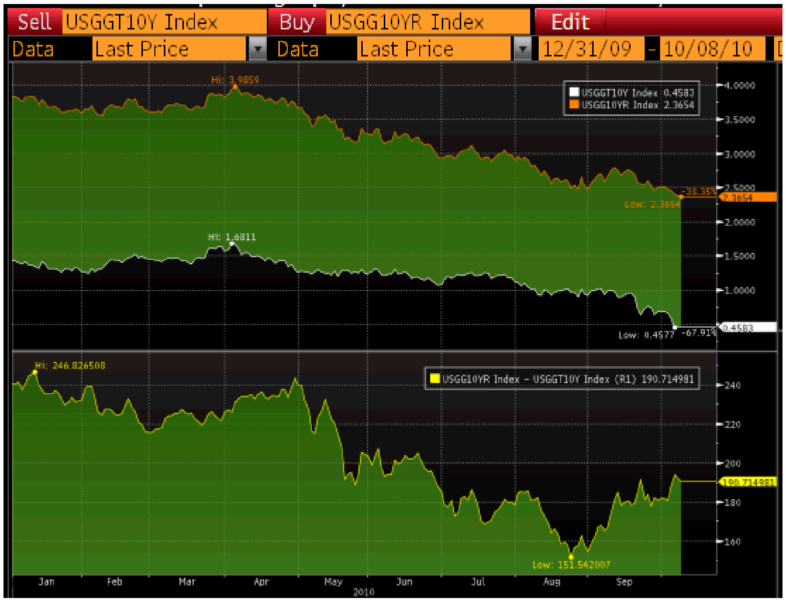
What are and will be the effects of future Global QEII Implications?

Financial markets are in the process of discounting another round of US QEII with maximum liquidity injection of $1.0 trillion over approximately 12 months. This seems entirely consistent with the recent falling USD and surging precious metals prices.[13] Further, since rumor has emerged that the Fed might be increasingly likely to undergo another round of QE, we have seen credit markets factoring into their prices the potential for increased future

[12] "Breakfast with Dave", Gluskin Scheff, David Rosenberg, August 23, 2010.
[13] "The global implications of QE2", *Financial Times*, Gavyn Davies, 10.04.2010.

inflation. For example, as the following graph illustrates, after falling to a multi-period low in late August of 151 bps, inflation expectations have reached a recent high of over 190 bps, even while the real return on the 10-year Treasury has steadily fallen to the current 45 bps. In other words, increased inflation is not accompanied by increasing nominal yields but actually by decreasing nominal yields, at the expense of the real interest rates.

Market Inflationary Expectations
(Spread between 10-Year Treasury and 10-Year TIPs, Year-to-Date)



Source: Bloomberg

Although QE has failed to boost lending and domestic demand, it appears to have ignited a rally in risk assets, as can be seen in the price action of global equities in September. Investors have gained greater confidence that QEII policies will be able to lift world economies out of their doldrums. For example, the day that the Bank of Japan announced its new asset purchase program and a lowering of its key rates, the markets in the US and elsewhere rallied vigorously on the news. However, if QEII proves to be ineffective, and investor confidence is reversed, risk assets and equities in particular will likely experience a significant pullback.

Additionally, QE programs affect other parts of the world through indirect mechanisms. For instance, as mentioned above, QE is largely seen as an *indirect* form of currency manipulation. As developed market currencies depreciate, countries that do not wish to see their currencies appreciate may be required to respond by intervening in foreign-exchange markets. In fact, a majority of Asian and Latin American economies are likely to increase their foreign-exchange intervention by selling their domestic currencies in exchange for USD. Even though some or all of this may be sterilized through asset sales by their respective central banks, it will still increase the liquidity of the domestic financial sector, and eventually spill over into higher equity prices. Countries like China, India, and Brazil will likely pursue such currency intervention, which would be favorable for the short to intermediate term.[14]

[14] "The global implications of QE2", *Financial Times*, Gavyn Davies, 10.04.2010. The IMF research quoted earlier shows that equity prices in Asia and Latin America generally rise when excess liquidity is transferred from the G4 to the emerging economies. But the extent of this is determined in part by the foreign exchange policy of the various emerging economies.

Finally, such monetary expansion in those emerging markets with strong economic fundamentals could boost demand and continue to drive local equity markets higher. Investors in developed markets who become disenchanted with the ill results of QEII are likely to search for yields overseas, a move borne out by history. That will make it harder for emerging markets to manage the inundating inflows of foreign capital and the direct investments in their capital markets. With equity markets already booming in many emerging countries, the challenge for policymakers there will be to prevent asset bubbles from developing. As we have seen in China, policymakers have been responding in very calculated ways. However, things could get much tougher as QEII results fail, capital inflow pressures increase and equity markets in many emerging markets face significant inflows.

Deleveraging

Deleveraging by the private sector is but one of the reasons why further quantitative easing is not likely to work as expected. We see this in the government data on consumer debt levels before and after the crisis. In the first quarter of 2008, cumulative consumer household debt-to-income ratio was 136%. Currently it stands at 123%, 80% above the pre-crisis normal level. To bring the current level down to the historic norm, we would need a further deleveraging of $6.0 trillion in debt — *ten times* the mere $600 billion of bad debts that have been written off thus far.[15] In essence, we have only begun the long journey to leaner consumer balance sheets.

One of the structural predicaments that explains our downbeat ***True Normalist*** outlook is the fact that the private sector, the consumer in particular, needs to deleverage further. Until that has occurred, annual GDP growth is unlikely to top 2%, leaving the unemployment rate at elevated levels for a protracted period of time.[16] Although the deleveraging process is underway, it may be several more years before households can once again be the engine of growth.

Furthermore, the latest Flow of Funds release shows that the US is still very much a debtor nation. At the end of the second quarter of 2010, the debt of the US in aggregate (that is, households, businesses, financial institutions and government) stood at $50 billion — $154 billion higher than in the first quarter.[17] While the US became even more indebted, however, the faster increase in nominal GDP in the second quarter meant that the debt-to-GDP ratio actually fell. All of the increase in domestic debt was due to a rise in public sector debt, and by almost $500 billion (private sector debt *fell* by $339 billion).

Household debt has now fallen in every quarter since the start of 2008, leaving it $473 billion below its peak.[18] Nevertheless, this decline in household debt may not be as good as it looks seems, because over half of the reduction is due to household debt default rather than debt paid down through organic savings. Indeed, at 123% in the second quarter, the household debt-to-income ratio remains high by historical standards. While it is hard to gauge exactly how far this ratio needs to fall before we can say that the deleveraging process has completed itself, the historic trend levels noted above put us still in the early innings of the game.[19]

[15] "Breakfast with Dave", Gluskin Scheff, David Rosenberg, August 17, 2010.

[16] In fact, the most recent September payroll report reveals that the US economy is loosing the little momentum it had, a fact that will only solidify the outlook for more QE programs.

[17] "Flow of Funds Accounts of the United States", Federal Reserve Statistics Release, Flows and Outstandings, Second Quarter 2010.

[18] US Economics Weekly, Capital Economics, September 27th, 2010.

[19] Moreover, households are currently not using all of their new savings to pay down debt. Instead, they are funneling a large part of their savings into Treasury securities, essentially funding a good deal of the rise in public sector debt. For example, in the second quarter, households bought $177 billion of the $344 billion of new Treasury debt issued — more than the $123 billion acquired by foreign purchasers. US households now own over 12% of all outstanding Treasury debt. That's still much less than the 46% owned by foreigners, but impressive compared to 18 months ago when households owned just 3.8%.

So we'd have to sum up the present situation with a grit rather than a smile. While the government pokes about for ways to stimulate the economy, the deleveraging process continues on. These facts may doom any stimulus programs by the Fed or Congress to limited success. The bottom line for the US is a growth trajectory resembling the ***True Normal.*** Associated with this slow growth is a huge output gap that will result in deflationary forces lingering for some time. While QEII may help to spur rallies in risk assets around the world, it is likely have limited effectiveness in stimulating aggregate demand, given the current liquidity trap and the paradox of thrift.

Global Capital Markets Overview

The global recovery has not gone according to expectations, a fact which has central bankers, policymakers, finance ministers — and now trade ministers — re-sharpening their pencils. Data from around the world show that economic activity is slowing on the heels of the "green shoots" which had bolstered a seeming "V-shaped" recovery. The output gaps (industrial capacity underutilization) in developed countries remain wide by historic levels and GDP growth remains significantly below pre-crisis charts.

Global cooperation on such issues as economic imbalances and currency values remain in disarray following a recent meeting of finance ministers with central bankers, hosted by the IMF and occurring one month prior to a crucial meeting of the G-20 finance ministers. The world looks to be on the brink of a major confrontation over exchange rates, trade policies, capital flows, and popular sentiment over globalization and trade. Thailand and Brazil have now imposed taxes on foreigner bond income, while the Chinese central bank is printing money like a drunken sailor to prevent RMB appreciation despite global attempts to strengthen their currency. China is doing everything in its power to avoid appreciation, not unlike the actions taken by the Japanese in 1985 under the Plaza Accord, which strengthened the yen and ushered in two lost decades. Moreover, to diversify out of the USD and continue to maintain the peg to the USD, the Chinese have embarked on a program of buying Korean and Japanese bonds. To prevent loss of competitiveness, the South Koreans and a host of other Asian countries have undertaken their own currency interventions as well, and the Bank of Japan has attempted *twice* to weaken the yen — to no avail.

In Europe, the Swiss have also seized upon currency intervention, hoping that a weakened currency will protect their export sector. The Eurozone is the only region that has yet to buckle to depreciation pressures. The ECB refuses to adopt further quantitative easing measures, given the flex of economic muscle by the likes of Germany and even Italy. This, we believe, could prove only temporary, since the euro's strength will inevitably hurt exports, especially in light of the continued fiscal problems along the periphery.

Although individual countries are at different points in their business cycles right now, global growth as a whole appears to be faltering, and the outlook for developed countries remains weak, despite glimmers of temporary hope from the Eurozone. ***We still witness bifurcation and divergence in growth paths among the developed and the emerging markets, but the tether that connects the two through export linkages may prove too powerful a constraint to achieve maximum growth velocity for the Emerging Markets (i.e. economic decoupling) — a development that we continue to monitor***. While the US economy began the year on a strong note, that initial strength appears to be fizzling. Similarly, Japan continues to struggle, mired in its deflationary quagmire and unsustainable public debt. Data from the Eurozone are much more encouraging, but this is due almost entirely to the strong performance of German exports, and this does not seem sustainable given a slowing global economy, a strengthened euro, and our lurking fiscal woes.

On the Emerging Markets (EM) front, what we continue to monitor first and foremost is China, given its size and importance in that sector. China's economy shows signs of slowing, partially as a result of the government's coordinated efforts to cool inflationary pressures and avert potential asset bubbles in real estate. The outlook for the remaining EM complex is generally positive against the backdrop of very loose monetary policies, provided of course that developed markets do not fall into another double-dip.

Our general outlook on global economic growth and profits growth remains cautious, in light of geo-economic rumblings about Fed actions. The lingering restraint of the credit crisis and the deleveraging process translates into a global economy less likely to reduce the spare capacity and output gap created during the previous decade. **These should continue to exert broad deflationary forces on the global economy for some time to come.**

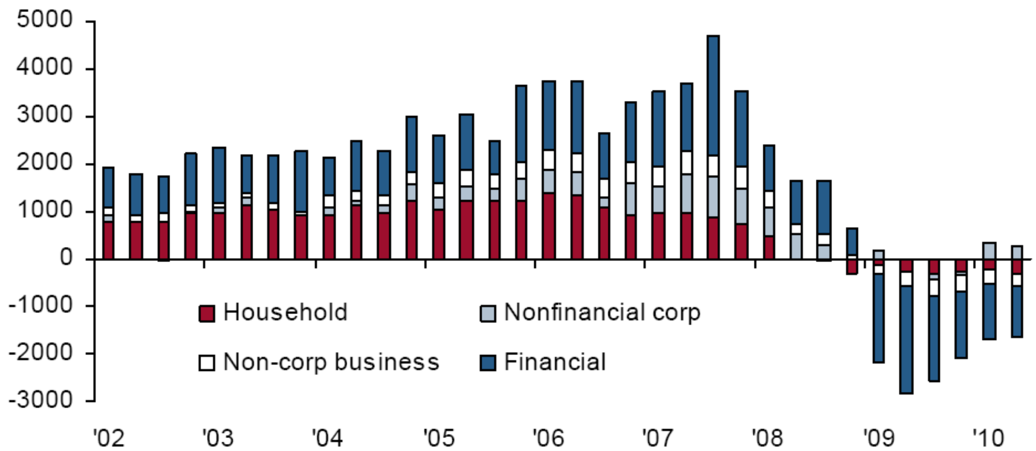
Domestic Markets

United States

What we are seeing in the US are a number of structural trends that seem to have changed the behavioral patterns of the entire US private sector. Households which can no longer use their homes and other assets as ATMs are boosting their savings. Likewise, corporations are building cash stockpiles on their balance sheets against possible rougher weather ahead. Many larger corporations with access to capital markets can borrow today and lock in opportunistic rates that are lower than earnings yields. Corporations can take advantage of the current credit landscape by refinancing existing short-term liabilities at high rates with low, longer-term financing, thus protecting their balance sheets from any higher-rate environment lurking down the road. Although debt-to-equity ratios have increased, debt servicing costs have fallen as a result of record low rates, and increased working-capital ratios have made corporations very healthy.[20] The largest challenge now is for US corporations to deploy some of these precautionary funds for new productive capital expenditures, thus seeding new life into the US economy and spawning employment opportunities.

Private Sector Deleveraging

Net, New Private Sector Credit Market Liabilities (2002 through 2010, USD$ bln)



Source: Credit Suisse Research, Federal Reserve

[20] US Economic Digest, Credit Suisse, Neal Ross & Dana Saporta, 9.29.2010. By the first quarter of 2010, the debt-to-net worth ratios of corporations stood at six-decade highs (over 57%). While this is the case, the interest expense-to-internal funds ratio as a proxy for debt-servicing costs has gradually moved lower, to a multi-decade average of 22%.

Alongside a deleveraging private sector, we see a bloated public sector as the government attempts to pick up the output slack. The US budget deficit is a fire-breathing biblical Leviathan, likely in 2010 to exceed $1.3 trillion, or 10% of GDP, with longer-term trends promising yet more brimstone.[21]

Most recent US economic analysis, however, seems to center instead on US monetary policy. Given the continued weakness of the US economy, complete with a deflationary liquidity trap ready to rear its ugly head, the Fed has peeped its intent to pursue further quantitative easing. The minutes from the last FOMC meeting intimated that the Fed is about to introduce a second round of quantitative easing in November (aka “QE2”). But given the increasingly divisive public debate between the Fed officials on the FOMC, there is barely a majority favoring more QE in general, quite apart from the particulars of its size and type. The Fed may buy Treasury securities — but in what amount, for how long, and until what economic goal is met? We hear no answers as yet.

Given recent movements in the price of gold and in real interest rates, together with market inflation expectations (as evidenced in the TIPs break-even spreads), and a gap-up between the long bond and the 10-Yr Treasury (indicating a steepening yield curve) and thus a rally in risk assets, it appears to us that the markets are pricing in a large, possibly a $1.0 trillion program. Even so, we would not be surprised to see a smaller injection thanks to the evident disrelish by many members for further helpings of stimulus. Moreover, while the Fed has managed to ignite inflation expectations and produce negative real rates, if temporary, this will benefit the economy only if businesses respond to the negative real interest rates by increasing capital expenditures, and if consumers begin spending more now to avoid future price hikes. If we consider the trillions that need to be delevered from consumer balance sheets and the huge stock pile of cash on corporate balance sheets, we still have to question how much of the Fed’s reserve creation through QE programs will increase credit creation — even if the Fed *is* successful in firing up risk appetites and breeding asset price inflation (through negative real interest rate creation) while the global economy remains anemic.

For this reason, in determining the course of the US economy, we would much prefer to focus on the factors that give the Fed chairman the very basis to consider such a move. These include an unemployment rate bristling with too high a political price tag, below-trend GDP growth which is unlikely to pick up any time soon or create necessary employment growth, below-trend inflation (current core CPI came in at 0.0% for the second month in a row), and a stubbornly high output gap unlikely to contract in the near future.

- The Durable goods report adds to our belief that the manufacturing recovery has lost nearly all of its momentum and is fading significantly. Manufacturing output contracted in September, indicating that the previous recovery in the manufacturing/factory sector has faded, showing a potential for another leg down. Overall industrial production has slacked off in September as well, illustrating that economic growth is slowing rather than accelerating;

- Core CPI has come in at 0.0% for two months in a row, further proof of the lack of pricing power in the US economy and giving the Fed more reason to fear economic deflation. However, a jump in agricultural and energy commodity prices has found its way into the core pipeline inflation metrics such as Producer Prices, portending a potential contraction in the current record-high corporate profit margins;

[21] According to the Congressional Budget Office, nondiscretionary government spending, such as social security, together with medicare, medicaid, and other healthcare entitlement programs, will grow to consume almost all government tax revenues by 2035, based on current demographic projections. The US can finance these deficits in the short term given its exorbitant privilege as the world’s reserve country. In fact, even in the face of these fiscal headwinds, US Treasury rates continue to plummet. However, if there is no policy initiative to reverse these trends, serious trouble lies ahead, for both the US and the world economy.

- September's payroll report also adds to the evidence that the recovery is losing what little forward momentum it had. The broadest measure of unemployment, the U6 unemployment rate, which includes marginally attached job seekers and those forced to work part-time, jumped to 17.1% from 16.7%. Additionally, the two-week improvement in jobless claims has reverted once again, indicating that willing employees are losing their jobs and being forced to file unemployment claims;

- The housing market has ground to a halt since the homebuyer tax credit expired in April. In July, for example, total home sales fell by 26% m/m, despite record lows in mortgage rates. August's new home sales came in at 288K, well below the average monthly reading of 900. Meanwhile, new home prices continue to fall, now ***down*** four of the last five months. A continued drop in homeownership rates and an unusually high supply of existing homes will most likely translate into a weak housing sector for years to come;

- Consumer confidence is likely to remain low because of high unemployment and a renewed decline in housing prices, backdropped by continued uncertainties about the US economy.

- Consumer credit fell by $3.3 billion even as corporations sit on more than $1.6 trillion of cash in their balance sheets and banks have over $1.0 trillion of reserves;

- The growth of real disposable income has slowed in recent months, with incomes falling outright in July. Moreover, nearly a quarter of all homeowners had negative equity in their home. The private sector continues to pare back on debt, but the deleveraging game remains in the early innings;

- The growth rate in business investment appears to be slowing but remains one of the few bright spots in this economy. The latest monthly indicators point to an annualized gain in the third quarter. Additionally, business inventory growth was stronger than expected in July;

- Much to the dismayed expectations of economists, the most recent monthly (August) US trade deficit widened, and the bilateral trade deficit with China reached a record high (China's foreign currency reserves soared by a record $194 billion as well), further fueling speculative fears of a currency war and concomitant trade war;

- Oil prices inched above the $80 per barrel range, translating into higher gasoline prices. Add in higher food prices, a record number of unemployed, and a deleveraging consumer, and you arrive at a less than sunny consumer outlook.

We conclude that a double-dip may not be inevitable, but there are clear signs that economic growth, as measured by GDP, will slow significantly from its pace in the first half of the year, reflecting a more ***True Normal*** scenario.

US Equity Markets: The Bright Spot… and the Not-So-Bright Spot

The major bright spot that remains in the US economy is that domestic corporate profits have managed to grow by double digits this year, staging a very impressive comeback since the onset of the Great Recession***. Butting the headwind of a slowing US economy, but sailing the tailwinds of profit diversification into faster growing regions, corporations have managed a robust growth of earnings from the lows hit in the last quarter of 2008***. During this interval, we enjoyed real GDP growth of 5% in the fourth quarter of 2009, 3.7% and 1.6% growth in the first and second quarter of 2010, respectively.[22]

[22] We believe a 1.5% to 2.0% GDP print for this quarter (although the consensus is significantly higher). We arrive at lower estimates based on our prognosis that a) a housing recovery is simply nowhere to be found, b) the consumer deleveraging process is alive and kicking, c) state and

Now for the not-so-bright news. While profits and GDP have staged a recovery, the recovery has since stuttered, as the growth trajectory in profits has been losing momentum faster than the ***Red Sox***. As we pore over the S&P 500 earnings figures and the US government prints, we see that the prior 12-month EPS was $73 and that the most current sell-side consensus (bottom-up operating 12-month forward EPS) is an estimated $87[23] which would indicate EPS growth of over 19%. In order to arrive at this type of earnings growth, we would ***need to see over 5% nominal GDP growth***. Not even our strategic Polyannas see 5% GDP growth in the US in the near future.[24]

What could get us a GDP growth of ~5% and EPS of $87? For one, we would need profit margins to be at the trough cycle, leaving them plenty of room to expand and grow the bottom line without much top-line growth. This is hardly the current case, as we already see *unprecedented* high profit margins, with no place to go but down (especially with pressure coming from Producer Price prints and lack of pricing power to pass along to end users). In fact, we believe that EPS rebounded since the summer of 2009 due primarily to widening margins from major cost-cutting efforts with little aid from top-line growth. Margins are likely to get squeezed during the remainder of 2010 and 2011. To quantify: Over time, margins tend to be mean-reverting as they follow business cycles and productivity trends. Currently, profits are 50% above their historic mean. If we assume GDP growth at a 3.0% clip to historic margins, we would get an EPS of around $70.[25] At current S&P levels, this would give us a P/E of over 16.7x, not quite something to be excited about. Our expectation is for earnings to be weaker than many expect.

Let's touch briefly on a few other issues that relate to earnings. First, while we considered operating earnings above, we also analyzed earnings "as reported" so that we could gauge valuations in order to arrive at the real health and integrity of earnings as intended by GAAP standards. Operating earnings, on the other hand, conveniently eliminate the one time write-offs, or "bad stuff," and so can yield a less than reliable doctor's report. But even using this metric, we get over 15% EPS growth rate, which does not look plausible. Second, looking at the second quarter national accounts profits data, we see that profits have been decelerating drastically to 2.3%, quarter-over-quarter, from previous prints of over 13%. We also see significant erosion of national accounting profits growth on a sequential quarter basis as well. Third, we would need major productivity improvements for the same reasons as profit margins. Here again we are already at historically high productivity levels, given where we are in the business cycle, with the most recent government data consistent with this viewpoint. Productivity dropped at an annual rate of over 1.8% in the second quarter, the worst data point in over four years. Lastly, corporate profits from the rest of the world — the final component of overall US corporate profits — grew by a mere 5.6% in the second quarter, down sequentially from the previous quarter, where it tracked growth of approximately 32%.

With respect to multiples (i.e., the price set by the market for corporate earnings), a few points are worth mentioning. If we use a more realistic $75 forward operating EPS metric to the current market level, we get a P/E of over 15.6x. We would argue that the historic trend for forward operating EPS multiples is closer to 15.5x, making markets today fairly valued at best. However, let us use several other conventions to P/E analysis to see if we get the same results.

First, if we use the Shiller Method based on the trailing 10-yr average reported earnings to calculate EPS, we get a PE of over 23x, making the markets overvalued by more than 30%. Second, if we use the most recent core inflation print released by the government, and then perform a regression analysis, we see than when core inflation is below

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local governments are cutting back in record pace, offsetting any federal stimulus injections, d) net exports are not contributing in any manner, and e) 80% of the economic growth in real GDP from the 2009 lows was attributable to federal stimulus and inventory adjustment — two dying tailwinds. That is how we arrive at the not-so-bright spots.

[23] We would also emphasize that this number was previously $94 (in April) and consensus views have continued to be revised down by over 7.5%.

[24] On a calendar year basis, consensus estimates for the 2010 and 2011 operating EPS are $82 and $94, respectively, translating into 14% YoY growth.

[25] "Breakfast with Dave", Gluskin Scheff, David Rosenberg,.

1.0%, multiples contract by north of 30% — not expand as many would claim. They expand if inflation rates stay within the 1.0% to 3.0% range, the sweet spot of the Great Moderation that we have enjoyed for the past three decades. To qualify our thesis further, multiples expand during episodes of disinflation caused by lack of supply-side rigidities, which see lower taxes, productivity gains through technology, globalization, lower tax rates, deregulation, etc. But today, disinflation is due to demand-side anomalies caused by credit contraction.

To sum up: ***We need either very robust GDP growth or soaring profits and soaring productivity gains to realize the forward earnings growth that has been priced into current equity markets. With the economy in our present state, forcing the Fed into further quantitative easing, we don't see either being likely***. At a realistic $75 EPS and 14X multiple (to be generous), more realistic fair valuations would be in the 1050 area for the S&P over the next 12 months. We therefore conclude that the US equity markets are overvalued by many metrics, and at best, fairly valued by others at these levels. That said, we remain enthusiastic about the global diversification that US multi-nationals have been able to achieve, growing their operations and profits even during the worst of times. We prefer to remain exposed to these large multi-nationals, levered to global growth, with large cash balances, healthy dividend yields (versus current Treasury yields), and a history of rising dividends. In the event that the US and/or the global economy takes a turn for the worse, we could consider an S&P in the 950 range as an opportunistic level to increase risk exposure.

International Developed Markets

Europe

The European economy has performed unexpectedly well despite continued fears over sovereign debt in the periphery countries. The recent strength of German industrial production and French trade data suggest that the Eurozone's major economies are holding up well. For now, the Eurozone's largest economies seem to be pulling the Eurozone train. In fact, even Italy's industrial production prints show unexpected strength. Nonetheless, there are several reasons to be cautious as we try to judge whether the Eurozone economic recovery can be sustained.

The Eurozone's economic prospects seem to be dipping amidst continued worries over the periphery, and from signs that the recovery in the core economies might be starting to lose momentum.[26] As the global economy slows and the export/trade boom withers, the Eurozone especially will suffer from the recent strength of the euro. With the ECB reluctant to react to a global currency war or another round of quantitative easing similar to that of the Fed, the Eurozone risks sliding back into significant economic slowdown. Given industrial/business surveys that point to a sharp slowdown to come, it would take strong growth in consumer spending to support a sustained recovery in these economies and in the Eurozone as a whole. With the entire Eurozone, including Germany and France, in the midst of a *Grand Bargain* fiscal austerity squeeze, and with the recent strength of the euro an inevitable drag on the Eurozone export sector, we view a sustained recovery as unlikely.

Additionally, with spare capacity and the output gap intact, Eurozone inflation will remain at bay, allowing the ECB to leave rates low for the foreseeable future. One key risk that remains is the refusal of the ECB to participate in

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[26] "Germany's rebound is no cause for cheer", *Financial times*, Wolfgang Munchau, August 29, 2010. "So while I expect the German economy to perform better than the Eurozone average, it is important to keep some perspective and not draw false inferences from the 9 per cent annualised growth rate during the second quarter. If you look at the period since the beginning of the financial crisis, Germany's economic performance has been dismal." According to preliminary figures, Germany posted the fastest quarterly growth rate since reunification, at around 9%. This appears to have been based primarily on exports and inventories, since domestic private consumption contracted in each of the last three quarters.

another round of quantitative easing, in line with Fed actions.[27] Failure to intervene in the present currency wars could leave the euro at elevated levels, thus hobbling exports, which are the primary drivers of Eurozone economic growth today. In fact, the euro's recent strength has prompted EU Commissioner for Monetary and Economic Affairs, Olli Rehn, to suggest that "if the euro continues to bear a disproportionate burden in the adjustment of global exchange rates, the recovery of the euro-area economy might be weakened."[28]

To conclude, we believe that the Eurozone is set to underperform compared to other major developed markets. This fact, combined with fresh concerns over sovereign debt risks, should eventually lead to a renewal of downward pressure on the euro. However, any euro adjustment could be delayed by global policymakers and by currency traders seeking to diversify out of the USD, where further QE is reasonably assured in the next largest and most liquid currency market. The fundamental problems in our eyes remain: large budget deficits and public debt levels that will be hard to delever/adjust sufficiently; large current-account deficits and private-sector debt; loss of competitiveness (driven by a decade-long loss of market share in labor-intensive exports to emerging markets, by rising unit labor costs, by artificially lower credit costs which misallocate resources, and by the strength of the euro until 2008); low ***True Normal*** growth trends; and huge risks to banks and financial institutions.

We therefore remain very cautious about European equities. Nonetheless, a good deal of bad news has been discounted into these equity markets, making the Eurozone one of the least expensive of them. We see value in many areas of the Eurozone economy, primarily in larger companies with healthy profit margins, leveraged for emerging market growth by developing their export segment, and with competitive cost structures.

Japan

The recent announcement of a new asset purchase scheme by the Bank of Japan (BoJ), and its symbolic lowering of the key policy rate, demonstrates that the BoJ is willing to broaden the range of policy tools it uses to combat the deflation contagion that has plagued Japan for the past two decades. The BoJ said that it would acquire government and private sector assets, from JGBs to commercial paper, corporate bonds, exchange-traded funds (ETFs), and real estate investment trusts (REITs), in order to bring down interest rates and risk premiums. However, given that the BoJ has enacted similar asset purchase schemes over the past two years, it does not appear that this recent announcement will entail a substantial policy departure.

Despite BoJ intervention, Japan's markets have not panicked at the relentless appreciation of the USD versus the yen. On a trade-weighted basis, the yen is actually weaker since the intervention announcement, translating into discernable economic benefits. While the recent Japanese data have been mixed, there are some clear signs suggesting that the economy is continuing to recover. For example, a surge in machinery orders in August should augur well for both orders and capital expenditures in the third quarter, despite the stronger yen. ***We therefore believe that increased business investment could assist in Japan's return to positive growth in the third quarter of 2010.***

While we are perhaps more optimistic than consensus on Japan's growth prospects, we remain neutral from an investment perspective, as we believe that better opportunities can be found in other equity markets. We must remind ourselves that although Japan is a wealthy country, it has a shrinking working demographic and is plagued

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[27] ECB President Trichet did indicate the ECB's willingness to continue supporting commercial banks and purchasing additional peripheral government bonds. There was no indication that the ECB was considering unsterilized QE programs or any currency intervention.

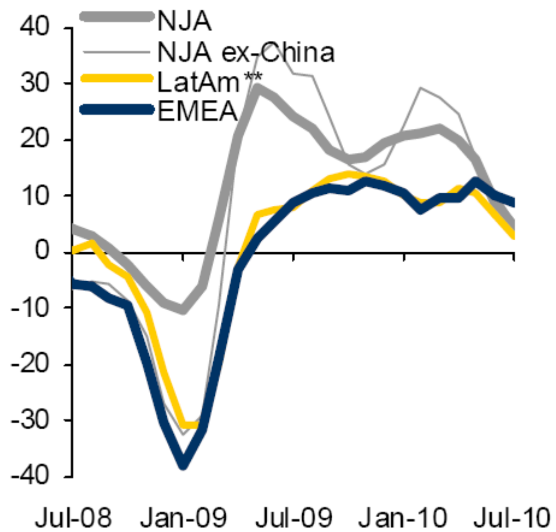
[28] "How much will the strong euro hurt?", European Economics Weekly | Capital Economics, Roger Bootle & Jonathan Loynes, October 11th, 2010. Rehn also started a war of words with China by singling out its exchange rate policy for criticism. With respect to export slowdown, Eurozone companies could adjust to a stronger euro through lower profit margins (although PIIGS countries with a fundamental lack of competitiveness have little room for margin contraction) and governments can tone down their austerity programs. This, in turn, would ultimately hurt domestic segments of the Eurozone economy.

by a lingering deflationary liquidity trap and a weak and continuously revolving political leadership.[29] Unless we see some level of yen weakening, it will be inherently difficult for Japanese markets to undergo any sustained rally from this point. ***Most importantly, because it is such a large economy, it bears close monitoring, since any major disruption in the Japanese economy could create another geo-economic crisis.***

Emerging Markets

We started to see significant slowdown in global GDP growth in sequential QoQ terms beginning after the first quarter of 2010, most notably in the industrial and financial sector. The slowdown quickly spread to the EM space. In fact, industrial production growth largely ground to a halt for all of the BRIC countries in the second quarter of 2010 on a sequential monthly basis.[30] Still, although industrial production in EMs has weakened from its pre-crisis peak, the correction has not been as severe as the one that hit developed markets. While we see a slowdown in EM growth compared to the growth exhibited in the previous decade, this growth-pattern divergence from developed markets should remain for some time to come.

Emerging Market Industrial Production
(Annualized % Change, Previous Quarter-Over-Quarter)



Source: CreditSuisse Research

Although we believe that EM growth has slowed and will continue to slow in the coming years, we cannot paint all markets with the same brush. In some EM countries where the output gap has contracted since the crisis, inflation remains a concern. Policy rates have only risen in those countries which have little to no output gaps, including Brazil and India. As with economic performance, EM have divergent market performance attributes as well. For

[29] "Japan's Leadership Muddle", *Project Syndicate*, Masahiro Matsumura, September 16, 2010. Having seen a new prime minister every year for five consecutive years, Japan just narrowly avoided having its third in 2010.
[30] Emerging Markets Quarterly, Credit Suisse, Q4 2010.

instance, we saw a general outperformance in emerging Asia, with the large EM countries of Brazil and Russia underperforming, while India remained the outlier.

Given the complexities of each individual country within the EM universe, we think the best way to invest is through a diversified portfolio of managers and strategies, remaining exposed to a diversified sub-set of countries, regions, sectors, industries and currencies. One can then benefit from the multiple economic cross-currents that encompass this asset class at any one point in time. Moreover, while we entered the year weighted heavily in the US domestic market on the belief that US companies should benefit from their alignment and leverage to EM, we now feel that EM itself could benefit from tactical developments in the global macroeconomic environment (i.e., from increased fund flows as a result of QEII).

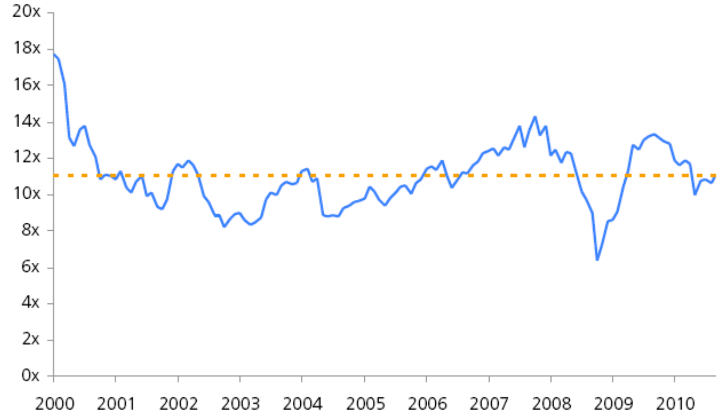
Impact of Developed Markets' QE on Emerging Markets

As previously mentioned, the prospect of additional QE by a number of central banks, mostly in the developed world, has created a powerful rally in risk assets. We believe that while the equity rallies in the countries where QE will be introduced will be short lived — i.e. US and UK — additional QE will provide a strong tailwind for further gains in many EM equity markets. ***While QE gives banks and other financial institutions the ability to lend more and create credit, it does not mean that they will effectively do so — and for a variety of reasons, including lack of creditworthy borrowers and lack of willingness to borrow despite near-zero rates.*** This is particularly the case in a post-credit collapse, a deleveraging environment which Japan has experienced for the past two decades and which we currently seem fated for, if only for the time being.

To take this analysis one step further, many investors see QE as a *de facto* form of currency devaluation. Those countries that do not want to see their currencies appreciate (to protect exports) will intervene in the foreign exchange markets. They will in essence print their own money to buy USD, effectively importing QE. EMs with strong local economies could boost demand through expansionary monetary policies, possibly incurring a home-grown inflationary threat. Moreover, investors in developed countries who realize that QE programs do not bear fruit are likely to search for yield, instead diverting large foreign investment flows into emerging markets, which would make it all the more difficult to manage the inflow of foreign capital and prevent asset bubbles from developing. ***This domestic and foreign injection of capital and liquidity into emerging markets from overseas QE programs could prove highly bullish for emerging-market equity investments over the short to intermediate term***.

From a valuation perspective, EM remains attractive despite a recent run-up. The chart shows that EM (MSCI Emerging Markets Index as a proxy) is trading at its trailing 10-Year average (~11x) whereas the MSCI World Index is trading over 12x, with decidedly less growth. Any significant foreign capital into EM could keep it well within historic P/E ranges (potentially up to 14x on the higher end). What can throw our thesis for a loop? China, of course…

MSCI EM Valuations (2000 – 2010)
P/E Ratio (Blue Line – Forward, Consensus Earnings Estimates) & Average P/E Ratio (Dotted)



Source: DataStream, UBS Research

China

China's growth has been decelerating from the rebound experienced at the beginning of the year. The slowdown has been largely driven by a sharp decline in investments, which were the primary drivers behind the massive infrastructure stimulus that shored up the Chinese economy during the crisis.

China continues to run record account surpluses and accumulate record foreign exchange reserves. Although export growth has been robust, it has fallen MoM for September, with new export orders slowing and not boding any imminent revival. However, imports have continued to rise, painting a picture of strong domestic demand while the recovery in exports seems to be running out of steam. We see this as fully congruent with a general slowdown in the global economy. Such an imminent downtick in exports will force Chinese policymakers to turn to domestic issues faster than they might have planned.

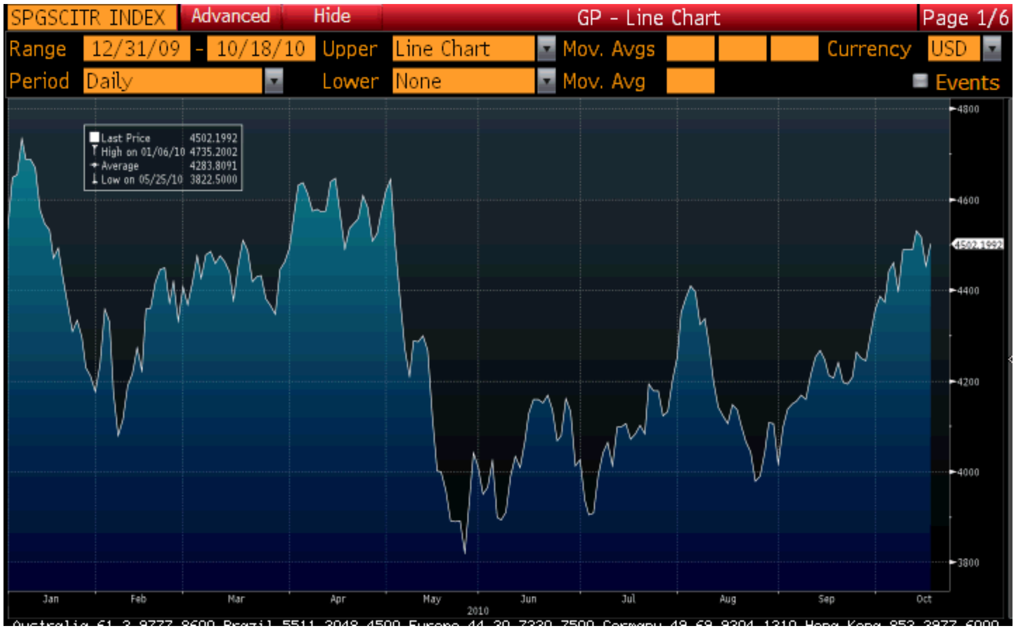
On a more recent note, the People's Bank of China unexpectedly raised its benchmark rate. We don't see this as a result of inflation fears, since the major components of recent inflation, namely food, have stabilized since the summer. More likely, it reflected policymakers' attempts to put a curb on lending for real estate purchases in order to prevent asset price bubbles, and was entirely consistent with the aim of raising reserve requirements on a number of banks. Additionally, recent negative real interest rates have led investors to liquidate time deposits and invest in real estate, creating a potential bubble. A rise in interest rates could prove an incentive to keep savings in time deposits.

China's massive stimulus program is showing signs of running out of steam, prompting the government to take a variety of clampdown measures this year against potential real estate bubbles. Longer term, China has reached a turning point in its demographics of labor, having been gradually transitioning away from its perceived role as the ultimate global outsource of cheap labor: one of China's chief competitive advantages. A demographic withering is also occurring, as there will be fewer and fewer younger workers, the long-term fruit of China's multi-decade one-child policy. Other competitive advantages China has relied on are disappearing as well, among them cheap land and natural resources. These predicaments will create China's version of the ***True Normal***. It will no longer be able to grow in the mid-double digits, but more in the neighborhood of 7% to 8%, as it expends capital to upgrades its social infrastructure, social safety net, and decent wage environment, paving the way for a transition from a production and export economy to one of widespread consumption and imports.

Commodities

Commodities have taken a bouncing rollercoaster ride since the start of the year. As the chart below shows, the S&P GSCI Commodities Index was down over -15% in late May, only to post a huge rally on the back of other risk assets in September. As of the time of writing, the Index remains flat for the year, but with significant performance variations of certain sub-sectors within the overall complex. Gold, silver and other precious metals were the shining stars, as were agricultural commodities such as corn, sugar, soybeans, and cotton. Oil and nickel also performed well.

S&P GSCI Commodities Total Return Index (Year-To-Date)



Source: Bloomberg

The recent strength in the prices of industrial metals and the oil complex have sparked renewed talk of a commodity super-cycle, driven by strong demand from the emerging markets. While we remain constructive on the commodities complex over a longer time frame, and in the precious metals group in particular (they have become more of a ***currency*** play than true commodities), ***we are skeptical of this recent move and believe that some of these commodities may be forming bubbles, given how inventories of certain commodities are stockpiled at bloated levels.***

The China-demand explanation for the recent spike underestimates, we believe, the role that global financial markets have played on commodities. More specifically, the anticipation of further QE by the world's major central banks, led by the Fed and the Bank of England, has boosted the prices of most global risk assets, making many commodities particularly bullish. The weak USD has provided an additional boost to commodity prices that are pegged to greenbacks. Commodities have also benefited from increased demand for hard assets, being the traditional hedge against the possibility that QE may lead to a surge in inflation down the road, a simmering fear reflected in US credit markets (i.e., TIPs spreads).

This mechanism of price appreciation reveals a number of downside risks to commodities going forward. For one, the QE program that the Fed introduces could be smaller than the market anticipates, or could eventually reverse if the economy strengthens (we think the former much more likely, given the divisiveness of the FOMC). We could also see a reversal/rebound in the USD given the state (or lack thereof) in the global currency markets. No country in this global economy wants a strong currency, not even many of the emerging Asian markets. Moreover, any boost to the US economy from additional QE could prove bullish for the currency. Other central banks, including the ECB, might possibly implement large-scale QE as well. Alternatively, the markets' focus could shift from QE to other factors which would support the USD, such as another crisis which makes the USD a safe haven. Such a crisis could originate from renewed fears of Eurozone sovereign debt defaults, or Japanese fiscal positioning, or a severe economic slowdown in China.

We continue to believe that demand for commodities is more likely to disappoint. To the extent that this demand remains strong from EM, we think that much of this bullishness has already been priced in. For instance, many of the industrial commodities such as copper have risen above their 2008 peaks when the global economy was at full thrum. Although China is now the single most important growth driver of industrial metals, the next three regional drivers include the US, Japan and Germany, ***all*** of which face a long period of sluggish growth. Nor is China immune from convolutions in the developed world. Lastly, there are plenty of downside risks to growth in China, not least its shared fate with the developed markets through export linkages. Lastly, based on empirical observation, the supply of certain commodities might remain tight in the short run, but technological advances can synthesize effective substitutes, putting downward pressure on demand and therefore on prices over the longer term, thus contributing to traditional cycles in commodities.

In summary: While strong momentum and additional QE may lift the prices of commodities in the coming months, we remain cautious going into 2011. Our only conviction pick within the commodities complex remains gold and precious metals. Why so? Gold seems to be one of the few assets that could benefit from shifting and even contradictory market scenarios over the coming months, quarters, and years. ***With all major countries — developed*** **and** ***emerging — eager to enhance export modalities, no country wants a strong currency, and with the Fed on the QE bandwagon, asset bubbles are the most likely scenario as each country tries different ways to ratchet down its currency. The major beneficiary remains gold.***

Fixed Income & Credit

Bond markets continue to rally despite the prognostication of many strategists. Corporate bond spreads have contracted as of September, especially near the belly of the yield curve. For investment grade credits, spreads have contracted even more, and have yet further squeezing to go in our opinion. For example, for triple-B credits in the middle of the yield curve (7 to 10 years), assuming a low 40% recovery rate, the probability of implied default priced into these credits is around 15%, a whisper to us of room for improvement. In general, however, the current low level of bond yields is entirely consistent with the prospects of a very long period of low interest rates, low to negative inflation (deflation), and lackluster returns on risk assets that increase demand for government safety and lower returns. These factors have kept Japanese government bond yields low — *much lower than current US and Eurozone yields*.[31]

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[31] Although the Japanese situation is beyond the scope of the current commentary, structural factors idiosyncratic to Japan have played a key role in keeping rates down, such as a large pool of domestic savings and buyers. However, similar factors can come into play in the US as well. ***For instance, changing regulatory requirements, additional QE, and persistent lack of demand for new loans in the US can cause financial institutions and households (who have been net new buyers of US Treasuries) to hold more government bonds on their balance sheets. If consumers begin to expect more deflation to set in and stay, a Japanese-style interest rate environment can be upon us for some time***. Global Markets Update, Capital Economics, Julian Jessup, August 20th, 2010.

The US core CPI index has generated virtually flat readings for the past two months. Additionally, if we analyze this metric closely, we uncover weakness not only in the core goods CPI but also in the core services CPI, and not just in the key rents component. The current recession and the deleveraging on its tail has impacted countercyclical sectors such as education and healthcare. And take a look at the Cleveland Federal Reserve, which publishes a "trimmed-mean CPI," adjusting for distortions caused by large components of traditional CPI measures, such as equivalent rent. This metric is now running at a historic low of 0.8%, down from 0.9% in September.[32] ***Given a current sub 1.0% trimmed CPI reading, a stubbornly high output gap that is not improving, and a housing market that remains in turmoil, we foresee a very high probability of deflationary pressures in 2011 as measured by core CPI.*** Such an outlook will provide the proper environment for ***further gains in bonds*** — an asset class that is clearly "under-owned" by an aging demographic that needs fixed income and safety. Similarly, the recent increase in inflation expectations as discounted into the TIPs spreads will provide for good opportunity to position for lower inflation expectations going forward.

We therefore foresee yields in the US to remain at current levels for the foreseeable future, with the risk skewed to the downside. We see reactions in the Treasury bond markets that are entirely consistent with the scenario described above. There are no current compelling reasons for nominal bond yields to increase in this global macroeconomic landscape. In fact, we look to the following to justify our conclusion that the current bond market is **<u>not</u>** in bubble territory:

- Households are rebalancing their asset allocation because a very low percentage is in fixed-income securities. This is why we see a portion of household savings going into new purchases of US Treasuries, and portfolios being rebalanced from equities into fixed income;

- Fed policy and YoY change in CPI readings are highly correlated to the direction of bond yields. It is difficult to sustain a bear market in bonds when the US government is providing plenty of fodder for a bull market — i.e. you don't want to bet against the most powerful House in the world;

- Looking at previous bond metrics, the long bond remains approximately 350bps above the overnight rate at a time when the historic spread is only 200bps.[33] This leaves plenty of room for further price appreciation on the long bond;

- Aggregate corporate creditworthiness has become positive while high yield companies have cut their leverage ratios, have improved their interest coverage ratios (due to lower interest rates), and have drastically lowered their default rates, which had hit a 2009 peak of 13%.

More on Inflation

As we mentioned above, since the beginning of September, we have seen the USD slide to new lows, gold hit yearly highs, the TIPs break-even increase and the yield curve steepen (the gapping up of the 10s/30s yield spread), while risk assets rallied during September. These all suggest that investors have been buying some inflation protection. While investors have been piling into the reflation trade, government data continue to paint a powerful counter-inflationary picture, even when factoring in increased food and energy costs.

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[32] Federal Reserve Bank of Cleveland, US Inflation :: Current Median CPI, October 15, 2010.
[33] TwinFocus Capital Partners Research.

Under a renewed reflation trade brought about by a sustainable economic recovery, one would normally expect to see nominal Treasury rates increase as higher inflation expectations gradually priced themselves into credit markets. However, we continue to see rallies in Treasury bonds. What this reflects is a significant decrease in real interest rates — yet further evidence that the credit markets are not entirely convinced of a recovering US economy, instead seeing the government trying to reflate asset prices.[34] Currently, the real rates on the 5-Yr is at -0.59% (market inflation expectations at +1.73%) and for the 10-Yr, it stands at a +0.35% (+2.07% inflation expectations).

How can we profit from this scenario? While the TIPs yield (5-Yr) has tumbled to a record low, it could fall farther if nominal yields dip even more or if inflation expectations continue to increase. We think that both are unlikely. First, while nominal yields currently stand at +1.14% (5-Yr), they are limited to where they can fall. The nominal yield on 5-Yr conventional Treasuries has also fallen considerably since the September FOMC meeting, which suggests that further asset purchases are widely discounted (especially given our interpretation of wide dissent among FOMC members). But no matter how many Treasuries the Fed buys, the Fed cannot push the nominal yields below zero. This creates a lower bound on the 5-Yr TIPs at approximately -1.73%. This lower bound will be reached if nominal yields actually head to zero on the 5-Yr and the government cannot further increase the inflation expectations priced into TIPs (i.e., inflation expectations remain unchanged). If the government can increase inflation expectations (highly unlikely) while keeping nominal yields at zero, our -1.73% bound could be breached — again, we think this highly unlikely. The more likely scenario is for the government to lose its battle with inflation expectations as the US economy stays trapped in the doldrums and nominal yields remain capped. ***Under a scenario of decreasing inflationary expectations with capped nominal yields (or even unchanged from current levels), TIPs will appreciate, creating an opportunistic trade.***

To conclude, we continue to see value in credit markets despite their outperformance thus far. Corporate credits have further spread compression and Treasury markets face stable rate environments with risk clearly to the downside. We believe that the recent move in real interest rates as a result of increasing implied inflation expectations is unsustainable, and therefore provides an opportunity in TIPs. Lastly, the international and global bond complex provides a wealth of inefficiencies in credits, currencies, and duration, to name a few, ready to be exploited. ***We foresee our overweight in the global fixed income and credit sectors to remain intact, given the continued global macroeconomic environment that we are observing.***

Currencies

Not to beat a dead horse, we believe that the international currency markets are in a state of disarray. And what has us most concerned is not the current conditions but the total lack of institutional infrastructure to bring about viable solutions. The recent IMF meeting did not produce fruitful results, and we are afraid that the upcoming G-20 meeting in Korea will be much the same.

That said, what are the major developments we foresee?

- A large QE program by the US will likely pour more fuel onto the global currency fire. The USD lost ground against the euro and sterling, despite relative credit risks from lingering fiscal concerns;

- Those countries not participating in the devaluation of their currencies — i.e. intervening in the foreign exchange markets — in order to stay competitive as a result of US QE programs, such as Canada and

[34] "Getting to Grips with TIPS", Global Markets Update, John Higgins, October 13th, 2010.

Australia, are likely to remain firm. Our favorite remains **Australia,** given the central bank's continued efforts to bridle inflation as a result of a contracting Australian output gap;

- As long as the ECB does not do any easing and the economy remains somewhat stable with no blow-ups, we foresee the euro remaining firm at these levels. ***However, the more likely scenario for the Eurozone is to weaken thanks to the strong euro and for the ECB to begin easing, thus laying the groundwork for a weakening euro***;

To summarize: The liquidity and QE push by the Fed could create extreme global asset price bubbles in real estate, commodities, and equities as most emerging countries rush to devalue their currencies versus the USD, thereby protecting their export markets. So, as the Fed prints, likewise does the Peoples Bank of China (to the tune of 20% annual money growth) to keep the RMB down. ***Not only does China buy USD, but it grabs at other currencies within Asian markets, such as the Korean won, the yen and even the euro — to diversify out of USD***.[35] This puts upward pressure on these other emerging markets' currencies, bruising their global competitiveness, and they in turn crank up the printing presses to devalue, creating a global economy awash in liquidity at a time when most regions of the world are in deleveraging mode. ***This creates the perfect scenario for deflation in goods-and-services sectors while creating inflation in financial asset prices — a scenario not likely to end well, especially without a prudent institutional framework to work through these issues***.

Concluding Remarks

As we continue to emphasize and reiterate, the most important issue on the global economic agenda remains the rebalancing and restoring of global demand and the coordination dilemma associated with such rebalancing. The sudden halt in excess consumption in the US as a result of recession and crisis makes the meeting of these challenges more urgent than ever. Without an effective global rebalancing program, growth will be sub-par, since all the countries of the world will try to become sellers at a time when there are no buyers. The natural source of buying is the domestic markets of surplus countries, but they are not large enough nor developed enough to step in. A healthy and stable global economy will need the surplus countries to sustain growth while reducing excess savings. Simultaneously, we will also need deficit countries to implement viable growth strategies predicated on structural change as well as fiscal prudence.

Rebalancing is the first step to restoring global order. The next step is to fix the international monetary and exchange-rate system. The current system in which advanced countries operate with floating exchange rates while developing countries pursued pegged exchange rates via reserve accumulation as part their growth strategies (i.e., Bretton Woods II), worked as long as emerging markets' economies were relatively small. But as emerging markets have swelled, and the ensuing imbalances inherent in such a monetary system have reached an unstable pinnacle, such an exchange-rate arrangement is no longer feasible.

What this currency landscape has given us is the perfect storm for today's currency wars. In a world where deficit countries need to reduce domestic demand, while surplus countries are unwilling to reduce their reliance on export-led growth, currency tensions will inevitably reach the boiling point.[36] No country in our current global

[35] This Fed action has infuriated the Eurozone, as it has put upward pressure on the euro at a time when the ECB has placed interest rates on hold, given positive data points from Germany and Italy, while the BoJ and the Fed are easing further. This euro strength will soon cause severe hardship to the periphery countries already suffering from global un-competitiveness to the PIIGS, whose recessions will deepen, causing their sovereign risk to rise.

[36] "Only the Weak Survive", *Project Syndicate*, Nouriel Roubini, October 14, 2010.

environment wants a strong currency, because everybody is in search of buyers. Aside from the Eurozone (which will eventually be coming to the QE party as well), the US, Japan, China, and the United Kingdom all need a weaker currency, just to name a few. The unintended consequences of currency wars are trade wars, especially if trade balances are not restored. Since the crisis, we have seen nil attempts to improve global imbalances, a fact which will strew some healthy tacks for our tires down the road.

Keeping our outlook cautious in this mixed environment, we see definite opportunities in these areas:

- ***Global Equities:*** ***Large US capitalization equities (strategic due to secular trends) and Emerging Markets (tactical overweight) remain our high conviction themes, based on visible growth opportunities and the manner in which the quantitative easing program is likely to play out in the months to come;***

- ***Global Fixed Income & Credit:*** ***Our constructive outlook remains intact despite strong performance in 2010. We continue to see opportunities in our favorite sectors, including Treasuries and Municipals (both investment grade and high yield), Corporate credits (both investment grade and high yield), and Global/International Fixed Income;***

- ***Commodities:*** ***We remain cautious about the overall commodities universe, excepting only the precious metals complex (Gold and Gold Miners), which remains our high conviction theme;***

- ***Currencies:*** ***We believe that the November FOMC meeting will have a major impact on trends in currency markets. Any aggressive QE programs announced at that meeting will result in potential weakness in the USD. Our favorites are currencies that remain on the intervention sidelines, most notably the Australian dollar. While the ECB has for now decided not to participate in further QE stimulus, this seems to be a temporary stance. In any case, renewed economic weakness in the Eurozone will cause the euro to lose some of its recent strength. We would therefore remain on the euro sidelines until more color is given by the ECB, in which event we would aggressively put ourselves on the short side of the euro.***

In closing, we thank you for your continued confidence in our team's abilities to navigate these interesting times. As always, should you have any questions, please do not hesitate to contact us.

Respectfully,

Paul Karger, CFA	**Wesley Karger, CFA**	**John Pantekidis, CFA, JD**
Managing Partner	Managing Partner	Director of Research

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