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ECONOMIC AND MARKET COMMENTARY

Fourth Quarter 2011

The past year was another difficult and complex one for financial markets in the U.S. and globally. The market gyrations which dominated the year were largely the result of three factors, the European debt and banking situation, the political and social instability in a number of oil producing and neighboring countries, and the massive Tsunami in Japan and resulting nuclear power leakage. These ominous events overshadowed a slow but steady recovery in economic activity in the U.S., despite the effects of fiscal tightening by state and local governments and the threat of federal budget tightening by Congress.

Against this backdrop, investors globally looked for the safety of U.S. assets, particularly U.S. Treasury securities, despite their lowered rating to AA, Swiss Francs, and Japanese bonds. This occurred despite the fact that the U.S. has a debt/GDP ratio of just over 100 % and Japan's debt/GDP is over 200 %. Still, both of these nations have strong economies and the ability to control their own currencies, and a substantial portion of their debt owned domestically and by government related agencies.

The Festering Eurozone Crisis

There is a significant question as to whether Europe can avoid a deep recession, unanticipated default by one of the eurozone countries, or a split up of the eurozone. All these possibilities could lead to a serious financial event and could have a devastating effect on the world financial system.

The most optimistic scenario is that the eurozone, after experiencing a shallow recession, eventually grows its way out of a crisis. The ECB is now extending unlimited loans to banks in the eurozone through its long term refinancing operation (LTRO). These loans mature in three years, by which time it is hoped that steady growth will have returned. In an effort to ensure their borrowing is covered, the European commercial banks have taken up €489 billion of three-year loans. This provides about €235 billion net additional funding for the 523 participating banks, since some of the money is being used to repay short-term loans. The additional €235 billion takes central bank funding to the banking system to €979 billion. The three-year maturity of the new funding takes the average maturity on ECB loans to about 21 months, up from a mere ten weeks before the program was announced. These loans should reduce the liquidity problems of Europe's banks[1].

[1] The Economist, December 31, 2011

If the eurozone economy starts growing again before the loans are due, the central bank's effort to fix the continent's sovereign liquidity and bank crunch problem will have succeeded. The plan will have relieved pressure in the money markets and on financial institutions since they would be backed by the wealthier, more credible eurozone governments behind the ECB. It has substantially reduced the probability of a Lehman-like event.

There are however some other possible scenarios under which the economies of some major European nations will continue to stagnate. For example GDP per capita and industrial production in Italy are lower than they were 12 years ago[2], which suggests that it may well be trapped in a stagnant growth mode (see exhibit 1). Unless major structural reforms can take place which would improve the competitiveness of the Italian economy, more borrowing from the European Central Bank is simply continuing an unsustainable situation.

The Role of the European Central Bank (ECB)

The ECB has stopped short of a guarantee for sovereigns. Indeed, its reluctance to fund governments by purchasing bonds on a large scale, even in the secondary market, continues to be significant as evidenced by the high Italian 10-year bond yield (see exhibit 2). At the same time, the ECB has shown a strong willingness to fund banks that already lend to governments. There is a question about whether this convoluted procedure will provide significant additional financing to governments with liquidity problems, although demand for newly issued French, Spanish and Italian sovereigns seems to have increased recently. Facing higher capital requirements, many banks are not in a position to add sovereign debt to their balance sheets.

We believe that the ECB will not let the situation deteriorate to the point of eurozone break up and use downgrades of the sovereign debt collateral of banks as an excuse to do so. This, together with additional rate cuts by the ECB and a weaker euro, makes a deep recession in the eurozone (a decline in GDP of greater than 5%) less likely. However, short term exchange rate adjustment and policy measures do not address the long term structural issues such as divergence in competitiveness between countries and the overall debt overhang. A broad based strategy is required. This would involve higher consumption in the northern countries, higher inflation (to reduce real debt and unit labor costs) as well as reduction of sovereign debt.

Equity Markets

Following a strong rebound in the fourth quarter on better than expected economic fundamentals; U.S. stocks managed a small positive return for 2011(see exhibit 3). Non-U.S. stocks, both developed and emerging rebounded in the quarter but declined for the year due to concerns over

[2] Trading Economics; Bloomberg

the deterioration of the European sovereign debt crisis and fears of a slowdown in China, both of which remain risks in 2012. In general, companies that were higher quality in nature and those that maintained or increased their dividends attracted capital in 2011 which led to their relative outperformance against those that were more cyclical in nature. While globally, virtually all industry sectors and countries (except the U.S.) showed declines, these results were dominated by declines in the MSCI indices of 45 % for EMU banks, 37 % for European banks, and 21 % for U.S. banks. As a result, managers who outperformed the indices significantly in 2011 could do so simply by underweighting the financial sector.

While Europe is the dominant risk in the markets today, it is not the only one. We raise China not because it is the largest risk, but because it is likely to play out in the near future. Many hedge funds are betting on a hard landing in China and markets are likely to put Chinese economic numbers under a microscope and seriously scrutinize them regularly. China's economic expansion in 2011 is quite similar to that of 2008, overheating at the start of the year, moderating as a result policy tightening around midyear and experiencing greater deceleration in the fourth quarter due to a sharp decline in exports to Europe. However, 2012 is unlikely to be a repeat of 2009 and neither a hard landing nor sharp rebound is in our base case outlook. The fact that inflation is falling in China means that the government has more room for further monetary stimulus, a process that started in earnest in the fourth quarter.

U.S. equity valuations are low relative to their history, at least by the standard of the period from 1982 to 2007, "the period of great moderation." At its end of 2011 value (1258), the S&P 500 is trading at about 12.5 times conservatively estimated 12 month forward earnings[3]. This compares with an historic (120 years) average forward earnings multiple of about 13.5. The ratio of the S&P 500 price to cyclically adjusted earnings (CAPE) is above the 120 year historic average of 17. However, the trailing 10-year average of earnings per share at the end of 2011 is biased downward because it includes two periods of unprecedented earnings decline. Even the current measure of CAPE at 20.75 would indicate that stocks are fair to undervalued, at least by post-1982 standards[4]. The equity risk premium, the spread between the forward earnings yield and the real rate of return on ten-year TIPS, is about 8% as of December 30, 2011 which is very high by historical standards. This suggests that stocks are undervalued in relation to default free bonds.

Last year was a period of multiple compression with earnings increasing by 15% and large cap stock prices remaining flat. While we do not anticipate further declines in the price to earnings ratio, we believe that per share earnings growth for the S&P 500 could slow to 6% which would

[3] Bloomberg
[4] Robert Schiller, Yale University

imply about an 8% return for the index in 2012. This is consistent with a $104 earnings estimate on the S&P 500 versus the consensus estimate of $106[5].

As for non-U.S. equities, at 10.44 times trailing 12-month earnings, the MSCI European Union index is not cheap[6]. Morgan Stanley estimates that the fair value for the 12-month forward earnings multiple is 10. This multiple implies that earnings must grow by 4.4% in 2012 to justify the current market value of EU equities. Yet given that the EU has entered a recession, earnings are likely to decline by at least 30% and the trailing 12-month earnings multiple would have to be 7 or less for the market to be fairly valued[7]. Therefore on a relative valuation case the U.S. still looks more attractive than Europe.

Emerging markets price to book and price to forward earnings multiples are about 1 standard deviation below their 20 year average. Emerging GDP growth in 2012 is expected to be about 5.7%[8]. Given that the forward earnings multiple for emerging market equities is likely to increase significantly from its December 30 value of 10, emerging market equities should return in excess of 20% in these circumstances. Even in a global recession where global GDP growth falls to 1.9% and emerging market GDP growth to 4.3%, we would expect about a 2.0% positive return in 2012 on emerging market stocks. However, such a scenario seems highly unlikely given the fact that global leading economic indicators are showing positive growth (see exhibit 4).

Bond Markets

Currently, both long-term U.S. Treasury yields and high quality corporate yields are artificially depressed. Central bank action, in addition to uncertainty in the European peripheral countries and in Italy and Spain, has caused capital to be reallocated to safer sovereign markets, including the U.S., Germany, the U.K. and Japan. This has resulted in strong performance of these markets, with the Barclays Capital U.S. Treasury Index posting a 9.8% return for the year ended December 30, 2011 (see exhibit 5). A somewhat similar situation existed in the early 1940s when long-term U.S, Treasury yields hit a record low as a result of bond pegging actions by the U.S. Federal Reserve and capital flight out of Europe with the fall of France[9]. We believe that the European situation will stabilize during 2012 and that U.S. Treasury yields should increase as a result of reduced haven demand.

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[5] The Bank Credit Analyst (BCA), "U.S. Equity Strategy Weekly Bulletin", January 9, 2012. and Seeking Alpha: At the end 2011 the S&P 500 was trading at a 5.8% discount to its normal trend earnings multiple. The trend earnings growth rate was estimated at 6.1% per annum from 1995 to 2010. At the end of 2011 the S&P 500 was trading at 15 times its normal multiple. See Chuck Carnivale, "Professor Schiller and CAPE May be Correct Generally but the Market is Currently Cheap", Seeking Alpha, October 12, 2011.
[6] Bloomberg
[7] Graham Secker, European Equity Strategy – Morgan Stanley, January 2012
[8] Jonathan Garner, Asia/Global Emerging Market Equity Strategy, Morgan Stanley, January 1992 to December 14, 2011
[9] Ibbotson Yearbook

At the same time, there are other factors that will tend to keep Treasury yields below their current equilibrium level (about 3.5% for the ten-year bonds). This has not been a typical recovery and a number of forces have combined to keep yields at unusually low levels. In particular, deleveraging has weakened private sector credit growth, investors have viewed long term Treasuries as a hedge against heightened deflation risk, commercial banks have increased bond holdings to comply with higher capital requirements and volatility has prompted investment flows into bonds, regardless of yield levels.

The expected return on U.S. municipal bonds and high quality, high yield corporate bonds is still competitive with that on U.S. equities after adjusting for risk. In 2011 the return per unit of risk was substantially higher for municipal bonds and high yield bonds (in the 1 to 3 range) than it was for large cap U.S. equities at 0.08[10]. We believe that this difference is much less likely to be repeated in 2012 since the decline in long term interest rates was nearly unprecedented.

Even though the probability of a European meltdown is likely to diminish, the other forces that have kept yields down are not likely to change anytime soon. The deleveraging cycle has a long way to run, there is little prospect of an early tightening and monetary policy, banks still have much work to do in repairing balance sheets and investors anxiety about equities is not likely to heal quickly. Thus, although the Bank Credit Analyst (BCA) model shows that U.S. government bonds are overvalued, we do not anticipate an early back up in yields.

<u>**Alternatives**</u>

Alternative Investments, including both hedge funds and commodities, suffered losses in 2011. Hedge Fund returns suffered in 2011 due to high volatility and reversals within equity, bond, currency and commodity markets which negatively impacted all sub-strategies. Long/Short Equity and Global Macro strategies suffered in August and September given the sharp reversal in equity markets and declines in specific commodities such as oil, gold and corn which fell dramatically over the summer after holding up well at the beginning of the year. While the fourth quarter was a better quarter for most asset classes, the hedge fund index as measured by the Dow Jones Credit Suisse Core Hedge Fund Index, returned only 0.47%. Managed Futures and Emerging Markets were among the few strategies to hold up better than the hedge fund index in 2011.

For the year as a whole, the Dow Jones Credit Suisse Core Hedge Fund Index fell 7.40%. There are three primary reasons for this. First, the high correlation within and across asset classes made it difficult to make money through tactical allocation and security selection on both the long and short side. Second, there was extremely high return volatility and a tendency for markets to go to extreme points. Since the dollar return tends to be an increasing concave function of certain risk factors such as the dollar return of the stock market, large return differences for the risk factor

[10] "Monetary Reflation vs. Austerity: Outlook for 2012", Bank Credit Analyst, December 30, 2012

will tend to reduce the dollar return on the hedge funds related to it even though the average return on the risk factor hasn't changed[11]. Third, hedge fund returns are related to five risk factors; global stock market return and risk, the credit spread, the return on commodities, the steepness of the yield curve and return to trend following strategies. None of these factors moved in a direction that would increase hedge fund returns in 2012.

In the last two months of 2011, due to concerns about Europe and China, liquidity plays like gold did even worse than growth plays like copper and oil, correcting the earlier run-up in the liquidity versus growth dynamic. China has a great influence on commodity prices because of its heavy resource requirements. China should again start to increase its demand for commodities as it begins aggressive monetary reflation. In addition, we anticipate that industrial sector growth will start to pick up as a result of a second half recovery in Europe, China's largest trading partner, and substantial fiscal stimulus. The reversal of agflation has reduced the raw material cost of processed food producers in the U.S. China has also been a big beneficiary of falling agricultural prices, which has caused its headline inflation to ease. This should enable the central bank to reduce interest rates for the first time since 2008.

Conclusion

Despite the credit led European recession in the first half of the year and weaker world GDP growth, U.S. growth may not decline significantly and at least should remain out of recession in 2012. We do not believe that there will be a hard landing in China, despite the hedge fund view, and believe that there could be a muted European recovery in the second half of 2012. In addition, we anticipate there will be a significant monetary easing in Asia and Latin America. This could set the stage for improvement in U.S. and emerging market equity and commodity prices in 2012, although we are less positive on the outlook for European stocks. We are aware that tail risk (the potential for unlikely market outcomes) is much higher than normal but we have attempted to reduce our exposure to tail outcomes by employing managers that control risk well and by including asset classes, when the mandate allows us, such as managed futures and certain commodities that are negatively correlated with equities.

Sincerely,

James L. McCabe, Ph.D.	Mark E. McCarron, CFA
President	Chief Investment Strategist

January 18, 2012

[11] V. Agerwal, "Risks and Portfolio Decision Involving Hedge Funds", Review of Financial Studies, 2004

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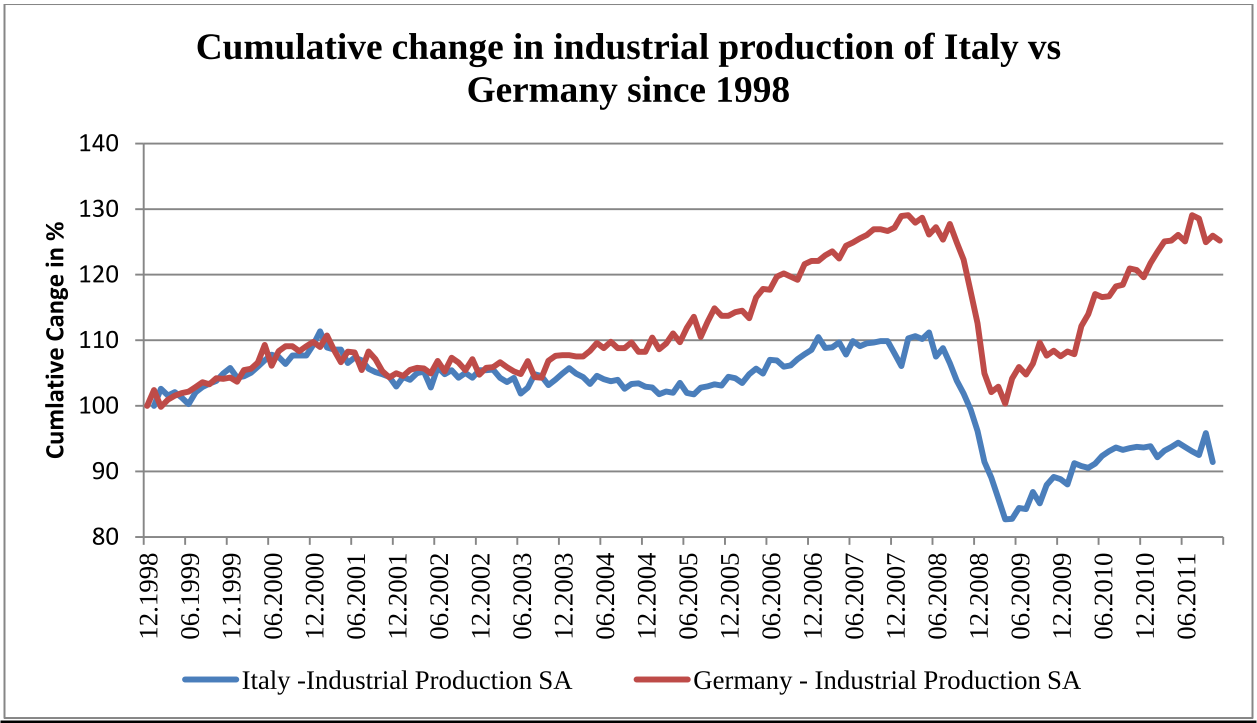
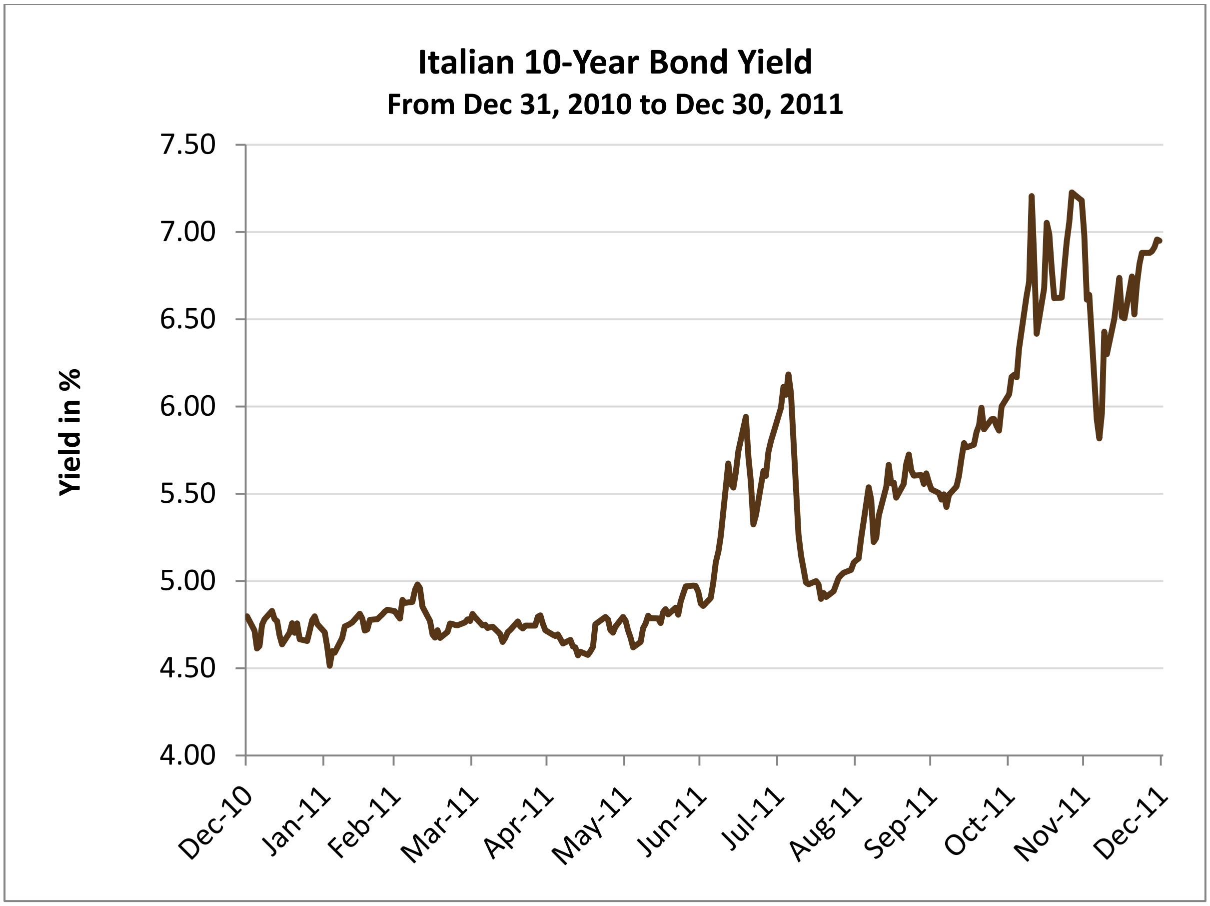
Exhibit 1



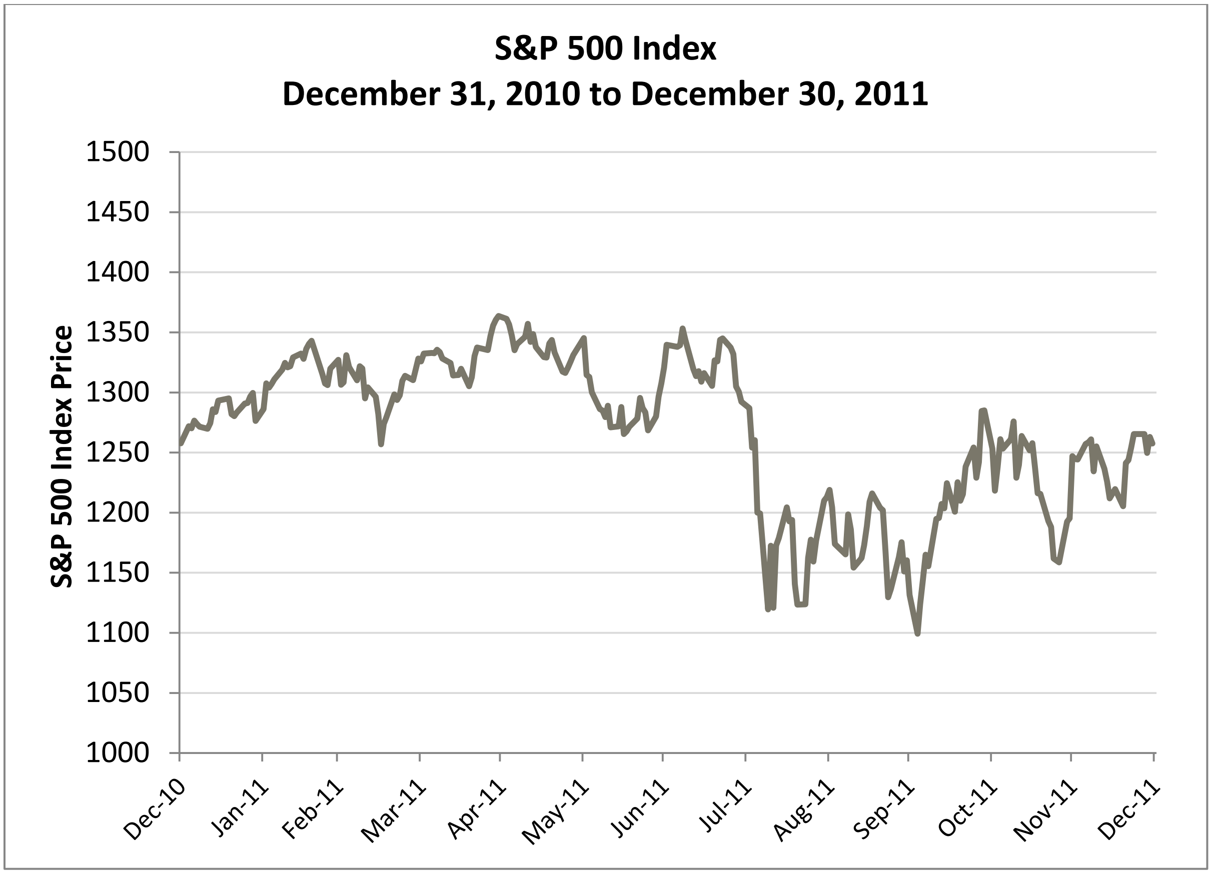
Source: Bloomberg

Exhibit 2



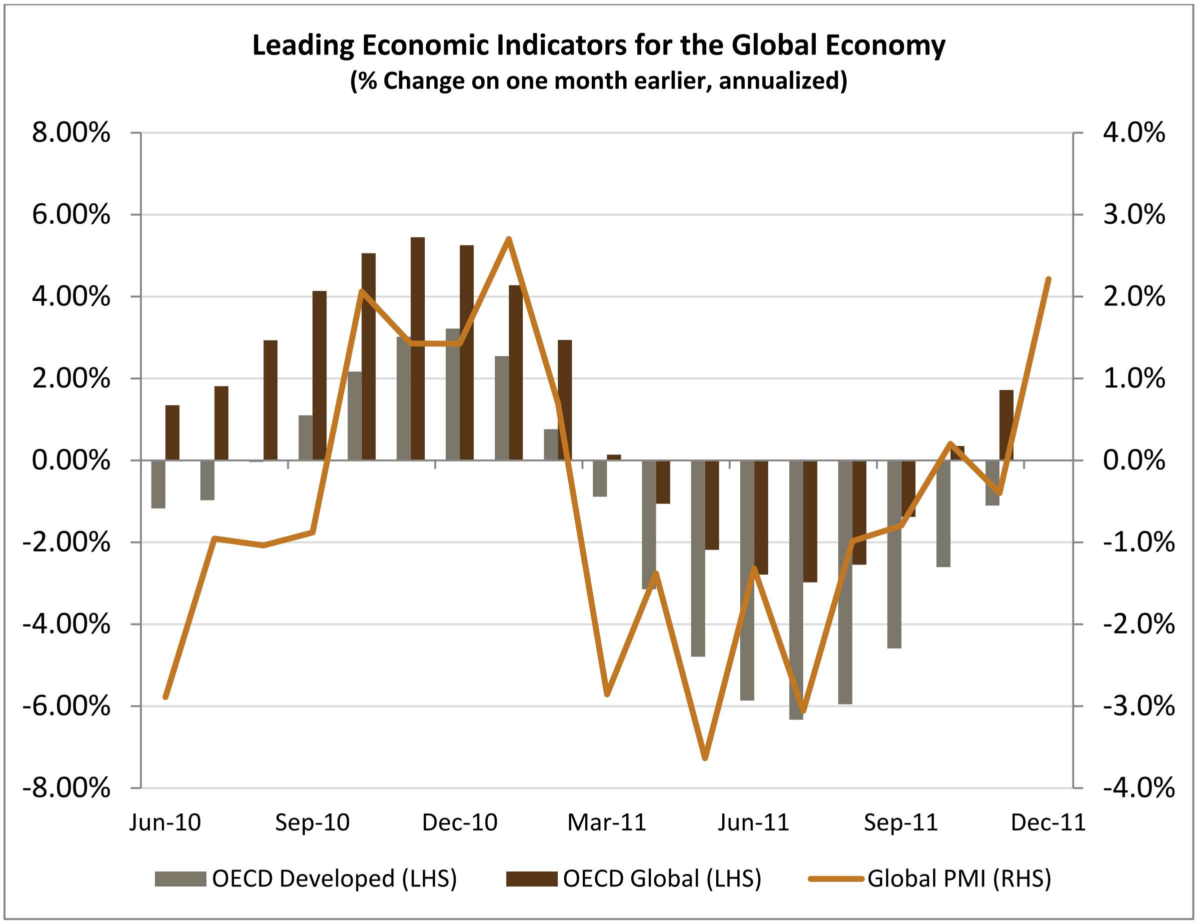
Source: Bloomberg

Exhibit 3



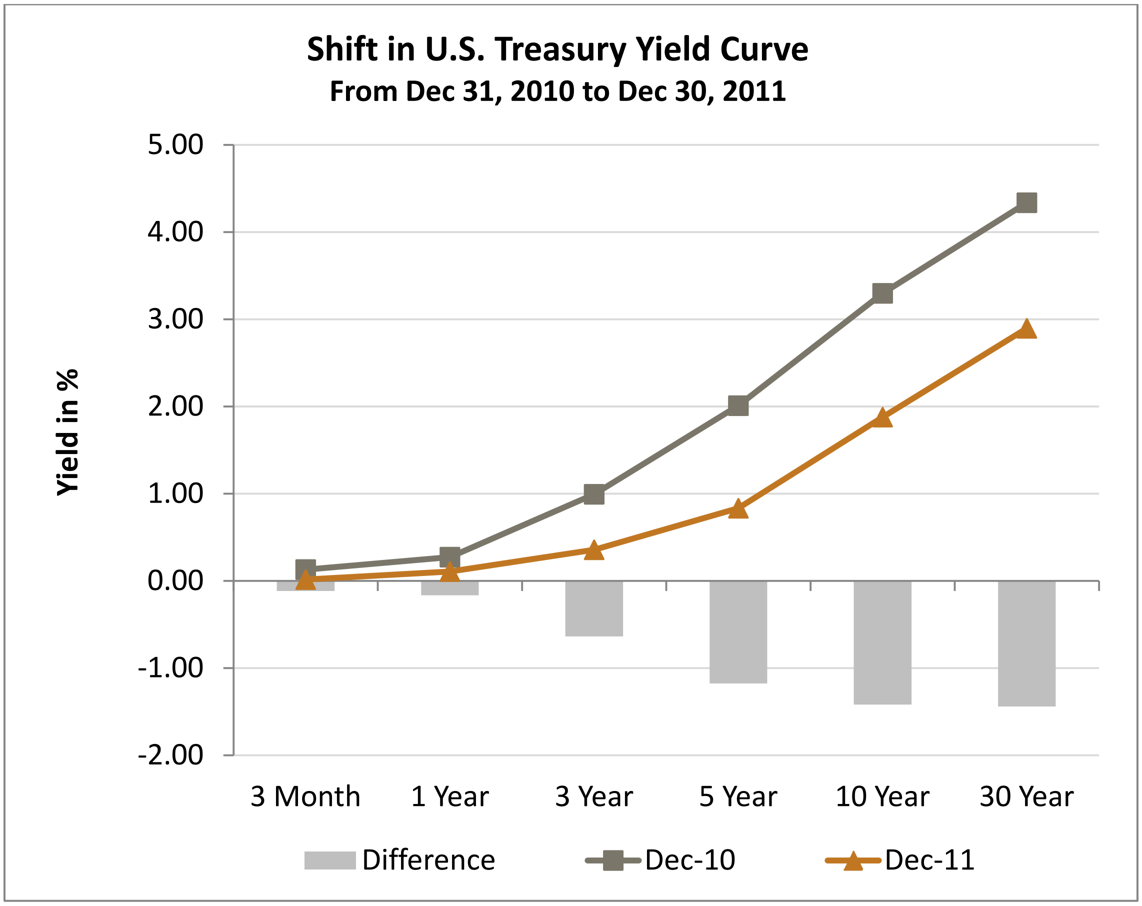
Source: Bloomberg

Exhibit 4



Source: Bloomberg, JP Morgan, OECD

Exhibit 5



Shift in U.S. Treasury Yield Curve
From Dec 31, 2010 to Dec 30, 2011
Yield in %
5.00
4.00
3.00
2.00
1.00
0.00
-1.00
-2.00
3 Month
1 Year
3 Year
5 Year
10 Year
30 Year
Difference
Dec-10
Dec-11