MCCABE CAPITAL MANAGERS, LTD.

Three Radnor Corporate Center, Suite 305, Radnor, PA 19087
Tel.: (610) 971-1901 Fax: (610) 971-1909

ECONOMIC AND MARKET COMMENTARY

First Quarter 2012

> *"Information received since the Federal Open Market Committee met in January suggests that the economy has been expanding moderately. Labor market conditions have improved further; the unemployment rate has declined notably in recent months but remains elevated. Household spending and business fixed investment have continued to advance. The housing sector remains depressed. Inflation has been subdued in recent months, although prices of crude oil and gasoline have increased lately. Longer-term inflation expectations have remained stable…"*
>
> - March 13, 2012 FOMC Statement

As indicated in the March 13, 2012 Federal Open Market Committee (FOMC) statement above, conditions in the U.S. economy have been improving. Economic growth has been positive, inflation has been negligible and the unemployment rate has declined. Global capital markets initially responded favorably to these trends and global equities increased in value while the U.S. bond market retreated. However, by the end of the quarter, concerns about rising gasoline prices in the U.S., continued uncertainty in Europe and slowing growth in China caused this optimism to wane. Perhaps most telling was what the FOMC statement did not say. Market participants were hoping for further stimulus in the form of a third round of additional bond purchases by the Federal Reserve (Quantitative Easing 3). The fact that this most recent statement did not suggest additional liquidity was imminent was enough to disappoint investors and led to a weak finish to an otherwise strong quarter.

Global Capital Markets

Markets seemed to focus on the positive during the quarter ended March 31, 2012 despite potential headwinds. Global equity markets were up significantly. The S&P 500 Index returned 12.59% in the quarter, the benchmark's strongest start since 1998. In fact, the pattern of equity price advance across sectors is quite similar to that which occurred in the late 1990s, when hard asset prices fell. The drivers of US equity prices in the first quarter were attributable to three sectors: technology, financial, and consumer discretionary. This is very similar to the concentrated pattern that occurred in 1998 and 1999, when old economy stocks, including materials and chemicals, substantially underperformed in the US and commodity prices were under significant downside pressure, especially in 1998. International equities gained 10.86% over the first quarter of 2012 as measured by the MSCI EAFE Index, and emerging markets, which started the year quite strongly, finished the quarter up 14.08% according to the MSCI Emerging Markets Index.

In contrast, U.S. bond markets, as measured by the Barclays Capital U.S. Aggregate Index, managed only a 0.30% return for the quarter. Safe haven U.S. Treasuries lost 1.29% in the quarter as investors looked for higher yielding securities. As a result, both investment grade and non-investment grade corporate bonds generated better returns than Treasuries in the quarter[1]. Global bonds, as measured by Citigroup World Government Bond Index, returned -0.51% in the quarter, reflecting the fact that risk appetite shifted higher globally.

The American Consumer

Since the credit crisis in 2008, consumers have increased saving and reduced spending in the face of lower house prices and higher unemployment. This is the primary reason that the recovery has been so lackluster. However, in the first quarter evidence of better consumer spending started to emerge.

Based on data for the first two months of the year, retail sales and consumer spending in the U.S. have increased significantly, due in part to an improving jobs market. However, there are many one-time factors that must be considered when evaluating the sustainability of this trend. In our view, the increase seems to have been mainly attributable to a decline in the savings rate as opposed to an increase in disposable income. In fact, real disposable income declined by 0.1% in February[2]. In addition, unusually warm weather helped to lift retail sales in the quarter and this makes the year over year comparison quite favorable. Finally, it is likely that the significant increase in consumer spending in the first quarter of this year was also a result of income tax refunds or anticipated tax refunds.

The real test will be whether the spending rate is sustainable in the face of higher gasoline prices, which tend to have a negative impact on disposable income. In our opinion, the 7.83% increase[3] in gasoline prices during the first quarter will certainly reduce consumer discretionary spending in the U.S. and also in the EU during the next two quarters. Given the decline in real disposable income, we anticipate that consumer spending growth will slow substantially in the current quarter.

Eurozone Situation

Europe is in recession and the impact of further austerity will continue to be a drag on growth. This is becoming more evident in the key economic indicators for the region. Markit's Eurozone PMI dropped to 47.7 in March from 49.0 in February and has been below the 50 mark, which divides growth from contraction, since August. The Eurozone New Factory Orders Index fell to 45.4 from February's 47.3; this Index has remained below 50 for the past ten months, and

[1] Barclays Capital Live
[2] U.S. Department of Commerce, Bureau of Economic Analysis, Friday March 30, 2012
[3] AAA Daily Fuel Gauge Report, March 30, 2012

manufacturing output in the Eurozone also declined in March. Eurozone unemployment in February rose slightly to 10.8%[4].

Spanish and Italian bond yields fell significantly in the first quarter, partly as a result of some progress with regard to austerity measures and structural reform, although this was mainly attributable to the Long Term Refinancing Operation (LTRO) program providing substantially more bank liquidity. European finance ministers increased the current Eurozone lending fund by €200 billion and created a new fund, the European Stability Mechanism (ESM), for future events, at €500 billion, part of which will replace the expiring European Financial Stability Facility (EFSF). This should total €700 billion. In addition, there is the possibility that the G20 will agree to let the IMF contribute an additional €250 billion[5]. Is this enough? It will probably keep Spain afloat for a while, but will be strained if Italy also requires more help. It appears to represent about half of what is required if Europe continues in recession. The lack of full commitment is consistent with the selloff in European banking stocks towards the end of the quarter and the recent back-up in Spanish and Italian government bond yields.

Strikes have affected Spain recently because of the austerity budget, already modified under public pressure, and in France there are elections this month, where Sarkozy is trailing the Socialist candidate, François Hollande. All of this will keep Europe in its austerity and debt-driven recession for some time.

China

The Chinese economy appears to have a slower growth rate than in previous years. Our estimates are in the 7% to 8% per annum range, which is significantly below the 9.2% growth rate estimated for last year. In the first quarter, China's GDP grew 8.1% year over year against 8.9% year over year in the fourth quarter[6]. The most recent evidence of slowing growth is the HSBC Manufacturing PMI data. Although these data, showing further weakness, are inconsistent with the official data, which show improvement, the HSBC data are more reliable in that they have much better seasonal adjustment. The new orders to inventory ratio in the HSBC PMI lead output growth by a few months. This ratio is low, implying further growth deterioration in China.

There are a number of factors contributing to slowing growth: First, Chinese monetary authorities have failed to ease significantly. Second, property sales had been declining for six months before a recent rebound, which is likely to be short-lived. Property prices remain very expensive and housing inventories are too high. Third, Chinese exports to Europe have slowed substantially. In general, the Chinese government seems to be more concerned about inflation and excessive growth than stimulus. By tightening controls, they hope to avoid the degree of domestic discord that is presently occurring in Europe.

---

[4] Reuters, www.Markit.com
[5] Financial Times, "The G20 should say no to the Eurozone," Wolfgang Munchau, April 1, 2012
[6] Dow Jones newswire, April 13, 2012

U.S. Equity Markets

Global equities started the year quite strongly, as evidenced by the MSCI All Country World Index return of 11.88% for the quarter. The U.S. equity market was among the strongest performers, benefiting from stabilization in Europe, an improving employment situation and strong corporate profits. It is the last point that deserves some attention.

As a proportion of GDP, U.S. corporate profits are at a record high. There is significant controversy over whether this margin will revert to its historic mean. If there is mean reversion, then corporate earnings growth over the next decade will be highly depressed. Post war data show that abnormally high profit shares are correlated with abnormally low earnings gains over the subsequent five years.[7] We do not believe that significant margin compression will occur in the next two years because globalization has made labor markets more competitive than they were in the past, the U.S. economy still has a large output gap and there is still a high unemployment rate, both of which will hold wage increases down. Understanding the future trends in profits has implications on how one views the current valuation of the U.S. equity market.

The traditional approaches to equity market valuation compare current prices to trailing earnings or future earnings based on estimates. The earnings used in these calculations are currently at post war highs. Another method is to compare the current ratio of total market capitalization of listed securities to GDP with its post 1969 average and post 1969 range. This ratio is independent of profit margins. As of April 11, 2012, the ratio of total market capitalization of listed securities to GDP was approximately 0.95, which is slightly above the post 1969 mean and very close to the midpoint of the range (35% to 148%).[8]

Using the standard approach, we calculate the trailing price to earnings ratio (P/E) of the S&P 500 Index as of March 30, 2012 to be 14.5, which indicates equities are fairly valued relative to their history. The forward price to earnings ratio of 11.8 (using 12/30/2013 as an estimate point) suggests the same[9]. To address today's historically high level of corporate earnings, we believe that Shiller's Cyclically Adjusted Price Earnings Ratio or CAPE, which was 22.3 as of March 30, 2012,[10] compared with a post 1981 average of 22.4, is a more accurate reflection of the market's current value. This reading is higher than the other measures, mainly due to the fact that the last ten years on which the data is based included two significant recessions, one in 2002 and the other in 2008.

While the U.S. market may look fairly valued relative to its history, it looks quite attractive when compared to the U.S. bond market. The current equity risk premium, which is the difference

---

[7] Cullen Roche, "Beware Profit Margin Mean Reversion," Seeking Alpha, March 26, 2012.
[8] GuruFocus.com
[9] Bloomberg
[10] Online Data, Robert Shiller, Yale University March 30, 2012

between the estimated forward earnings yield on stocks and the real rate of interest on ten-year TIPS, is a common method to assess the relative value of stocks versus bonds. As of March 30, 2012, the forward earnings yield for the S&P 500 Index was 8.50% while the ten-year TIPS yield on this date was -0.13%. Therefore, the current equity risk premium is 8.63%, which is very high compared to history. However, we would adjust this number downward by estimating lower earnings for the S&P 500 Index and increasing the real bond yield to a more normal equilibrium level. Even with these adjustments, the relative attractiveness of stocks versus bonds remains high.

In our previous letter we suggested that 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% this year, which would imply a return of about 8% for the index in 2012. This is consistent with a $104 earnings estimate on the S&P 500 versus the consensus estimate of $106.[11] The earnings advance in the first quarter is not likely to be broad based. Thompson Reuters estimates that the increase in S&P earnings per share will be 3.8%, with Apple Inc. included, and 1.2% with Apple Inc. excluded.[12] We maintain this outlook and, as evidenced by the last few weeks of the first quarter, the consensus estimates may have been too optimistic.

As for non-U.S. equities, at 15.26 times trailing 12-month earnings, the MSCI EAFE index is not cheap.[13] Given our expectation that European growth will continue to decline and given that the core of Europe is suffering from lack of demand within the Eurozone and the slowdown in China, we feel that earnings growth will weaken from here. Japanese equities had a strong first quarter and the Yen began to weaken against the U.S. dollar which bodes well for exporters. However, on a relative valuation case, the U.S. still looks more attractive than Europe and Japan in our view.

Emerging markets, despite their strong start to the year, still face significant headwinds. China is slowing and inflation is picking up again. According to the Bank Credit Analyst Emerging Market Strategy dated March 13, 2012, Chinese growth and asset price performance will be driven by domestic fundamentals and less by global factors. The two reserve requirement cuts so far have not been enough to boost money or credit growth. Weak industrial output in the December to February period (slowest in ten years) and slowing imports suggest that domestic demand is decelerating.[14] Finally, from a valuation standpoint, emerging markets seem to be trading at a 20% discount to U.S. equities based on trailing P/E ratios.[15] However, when making the comparison to other markets, one must consider that approximately 30% of the emerging market benchmark is commodities and these companies tend to trade at low multiples.

---

[11] The Bank Credit Analyst (BCA), "U.S. Equity Strategy Weekly Bulletin," 1/9/ 2012, Seeking Alpha 10/12/2011.
[12] Thompson Reuters
[13] Bloomberg
[14] Bank Credit Analyst, Emerging Markets Strategy, Weekly Bulletin, March 13, 2012
[15] Bank Credit Analyst, Emerging Markets Strategy, Weekly Bulletin, March 13, 2012

Bond Markets

Both long-term U.S. Treasury yields and high quality corporate yields remain depressed due mainly to Central Bank action. However, the recent sell off in bonds has increased yields to 2.21% as of March 30, 2012.[16] This resulted in weak performance of these markets during the quarter, with the Barclays Capital U.S. Treasury Index posting a -1.29% return for the quarter. The fact that the European situation has stabilized somewhat over the last several months has meant that U.S. Treasury yields increased as a result of reduced haven demand.

However, there are factors that will tend to keep Treasury yields below their current equilibrium level (about 3.5% for the ten-year bonds).[17] Firstly, Federal Reserve Chairman Ben Bernanke has indicated that he intends to keep interest rates at zero through 2014. Therefore, only if the U.S. economy booms or inflation rises significantly would the market re-price to the equilibrium level. While we do see improvement in the U.S. economy, we do not expect either scenario to occur in the near future. Secondly, market factors have played an important role in keeping the rate lower. Investors continue to view long-term Treasuries as a hedge against heightened deflation risk and the volatility in equity markets, while lower in the first quarter, has not curtailed investment flows into bonds, despite better return opportunities in other asset classes.

Non-Government bonds, particularly U.S. investment-grade corporate and high yield bonds, produced strong returns in the quarter, generating 2.08% and 5.34% returns, respectively, according to the Barclays Capital indices.[18] The fact that corporate balance sheets are healthy and that economic growth is moderately positive meant that investors looking for higher yield were willing to move assets into these categories during the quarter. Despite the additional interest, the option-adjusted spread (OAS) of the Barclays Capital U.S. High Yield Index finished the quarter at 576 basis points, which still compares favorably relative to U.S. Treasuries of an equal duration as well as to its own ten-year history.

European government bonds, particularly Spanish and Italian sovereigns, rallied strongly during the quarter on the back of significant support by the European Central Bank, although momentum slowed by the end of the quarter. The upcoming elections in Greece and France, along with austerity-induced recession in the Eurozone, introduce uncertainty which means that despite the low yields on U.S. government bonds, their role as safe haven assets in portfolios remains.

---

[16] Bloomberg
[17] Bank Credit Analyst, Global Investment Strategy, Weekly Bulletin, March 30, 2012
[18] Barclays Capital Live

Alternatives

Hedge Funds, as measured by the Dow Jones Credit Suisse Core Hedge Fund Index, declined by 0.82% in March but generated a 2.75% return year to date.[19] The quarter's performance was driven higher by positive returns across most sectors and specifically within the Convertible Arbitrage and Event Driven categories. These strategies are beneficial when the opportunity exists to profit from security specific events, including spin-offs, as well as mergers and acquisitions. This typically occurs when markets are driven by company fundamentals rather than by sentiment or severe macroeconomic shocks. Trend following strategies, such as Managed Futures, produced negative returns in the quarter due mainly to the sudden reversal in U.S. Treasuries, commodities and emerging market equities. Equity Long/Short and Global Macro strategies produced positive returns and outperformed the hedge fund index[20] in the quarter, although both gave up some of their gains in March. The performance of the underlying hedge fund categories in the quarter was consistent with the returns to the five key factors that tend to influence hedge fund returns. The global stock market and credit factors increased, which supported the Equity Long/Short, Event Driven and Credit Arbitrage strategies consistent with their historic pattern. In contrast, the trend following and non-oil commodity factors negatively influenced the relative return on Managed Futures and commodity funds.

Commodity markets were mixed in the quarter, with stronger oil prices offset by weaker industrial metals, such as copper. The greatest concerns in commodity markets are the political effects of government actions and tighter budgets in Europe, as well as concerns about possible military action in Syria, Iran and Korea, which have increased the risk premium in oil prices. European political unrest is causing the Chinese government to reverse the movement toward free markets, which is having a depressing effect on world commodity demand. Political unrest and government instability tend to reduce demand for risky assets, both directly and indirectly. The indirect effect is largely through appreciation in the U.S. dollar, in which all commodities are priced. We anticipate that Nymex and Brent crude prices will remain firm for the remainder of the year. Inventories are well below the five-year average level and OPEC spare capacity is limited. The spare capacity that exists has not been previously tested. The tight supply chain makes the market highly vulnerable to supply disruption. We believe that a major spike in crude prices is likely to happen if any geopolitical event that could interrupt supply should occur.

Conclusion

We expect U.S. economic growth, despite the global headwinds, to increase at a moderate pace. The employment situation is in fact improving, although from month to month we expect volatility in the figures. Despite the fact that we have some concern for the outlook for corporate earnings, data in the U.S. suggest that the equity market is fairly valued when compared to its history but still attractive when compared to yields available in the bond market. As a result, we

---

[19] Dow Jones Credit Suisse
[20] Dow Jones Credit Suisse Hedge Fund Index

remain cautiously optimistic on the prospects for U.S. equities and we prefer non-government bonds to government bonds within the U.S. fixed income market. While Chinese growth is slowing, we do not believe that there will be a hard landing in China. However, following such a strong quarter for emerging markets, we expect some pull back relative to other markets.

As always, we thank you for allowing us to manage your funds and for your continued confidence and support.

Sincerely,

James L. McCabe, Ph.D.
President

Mark E. McCarron, CFA
Chief Investment Strategist

April 13, 2012

All information contained herein is based on past performance and is not intended to be indicative of future results. The indices used are unmanaged and return figures reflect the reinvestment of dividends and earnings. There is no guarantee that historical risk and rate of return will persist in the future.

Any third-party information contained herein has been obtained from sources believed to be reliable; however, no assurance can be given that all external information is correct. All market prices, data and other information are not warranted as to completeness or accuracy, may not be audited information and are subject to change without notice.

Statements in this commentary that are not historical facts are forward-looking statements based on the investment team's current expectations and assumptions of economic and other future conditions and forecasts of future events, circumstances and results. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied by such statements.

The forecasts and opinions in this piece are provided for informational purposes only and may not actually come to pass. The views and opinions expressed above are those of the portfolio management team at the time of writing and are subject to market, economic and other conditions that may change at any time, and, therefore, actual results may differ materially from those expected. They should not be construed as recommendations to buy or sell securities in the asset classes or countries discussed. The analysis provided should not be relied upon as the sole factor in an investment decision but as illustrations of broader economic themes.

We assume no obligation to update any forward-looking statement made by us or on our behalf as a result of new information, future events or other factors.

The financial instruments described may not be suitable for all investors. All investments contain associated inherent risks including possible loss of principal. Please be aware that portfolios may be subject to certain additional risks. For details on additional risks, please review McCabe Capital Managers, Ltd. Form ADV Part 2A.

Investment in alternative investment products requires that the investor meet certain suitability standards, and therefore, investment in these alternative investment products may not be suitable for all investors.

Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with foreign investments.

This material does not constitute a recommendation to the suitability of any product or security and does not constitute an offer to buy or sell any financial instrument or to participate in any trading strategy.