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ECONOMIC AND MARKET COMMENTARY

Second Quarter 2012

During the second quarter, especially in May, investors sold off risky assets because of fears regarding the stability of the euro zone and slowing growth in China and the US and recession in Europe. It became clear that the potential solution to the crisis in the euro zone had not yet crystallized, but would take a long time to effect. The mid quarter selloff was mitigated by initial enthusiasm about a new regulation scheme for euro zone banking announced on June 29th.

There is evidence that the weaker markets in the euro zone (the peripheral countries plus Italy and Spain) are having a negative impact on the core (Austria, France, Germany, Belgium, the Netherlands), with German and French economies starting to slow. Changing political leadership within Greece and France, which reflects the tension between the need for growth versus austerity, has introduced even more uncertainty to the already fragile situation. Consumer confidence indices eroded across Europe and continued to reduce imports from China, which had an adverse effect on Chinese growth.

In our view, global growth concerns are justified. They are corroborated by recent readings in key business surveys, not only in the euro zone but also in China, the US and on a global average basis (see Exhibit 1). While there are areas of strength, the general trend again this year (as it was last summer) is one of slow growth and uncertainty regarding the near term environment. With US presidential elections approaching and the need to address the fiscal tightening that may occur as a result of the expiration of key tax cuts and looming expenditure reductions, we expect the recent volatility to persist.

Global equity markets, as measured by the MSCI All Country World Index, are still in positive territory with a 5.65% return year to date through June despite fading global growth. However, in the second quarter equity markets fell across the world. The US market's return of -2.75%, as measured by the S&P 500 Index, outperformed non-US developed markets which returned -7.13% for the quarter (MSCI EAFE Index) and emerging markets which returned -8.89% (MSCI Emerging Markets) for the quarter.

Often considered an indication of global demand, commodities lagged during the quarter, with the Dow UBS Commodity Index declining by 4.55%. US bond markets, as measured by the Barclays Capital US Aggregate Index, returned 2.0% in the quarter. Safe haven US Treasuries, as measured by the Barclays Capital U.S. Treasury Index, led the bond market with a 2.84%

return in the quarter as investors anticipated a slowing of global growth. The demand for US debt remains high despite the relatively low 1.6% yield on the ten-year bond. Short-term Swiss government bonds are selling at a negative yield. As a result of investor risk aversion and liquidity demands, both investment grade and non-investment grade corporate bonds failed to outperform Treasuries in the quarter[1]. Global bonds, as measured by the Citigroup World Government Bond Index, returned 0.92% in the quarter.

Euro Zone Situation

Spain led the concern this quarter with banks teetering under the effects of shaky sovereign bond holdings and ballooning yields (see Exhibit 2), declining property values, record unemployment, at about 25%, and the concomitant economic contraction. Elections in Greece brought in candidates committed to austerity and reform, while in France the winner, François Hollande, promised to increase budget spending while increasing taxes. Hollande's budget proposal, only a month later, shows that he has himself retreated from his campaign promises in favor of a higher growth model and is proposing that half of the necessary fiscal adjustment be made in spending.

Markit, a leading global financial information services company, estimates that euro zone real GDP declined by 0.6% in the second quarter and that "even Germany has fallen into renewed decline." [2] The euro zone unemployment level in June reached a record 11.1%,[3] which certainly indicates economic contraction for the remainder of this year. The final days of June brought a new proposal from EU leaders for a new EU-wide bank supervision system to replace the individual national systems, and promises of bank capital contributions and lending directly from the ESM (European Stabilization Mechanism), an EU entity, accompanied by oversight from the solvent northern countries, rather than from the individual countries. Though limited to the Spanish bank recapitalization, the fact that the ESM was not given absolute sovereignty over other creditors is an important provision of the summit agreement. Prior bailouts have perversely discouraged private sector creditors from continuing to buy bonds because their holdings had become junior to those of the official lenders in the event of default. Direct bank recapitalization by the ESM based on the summit agreement was considered a major European breakthrough, because the recap would not be added to the debt of the bank's home country. This should break the negative sovereign-bank feedback loop since the cure for the troubled bank would not increase the yield of the bank's home country sovereign debt, its main asset, thus reducing the value of the bank's capital and the marginability of its main holding.

Another provision of the June 29th agreement is that individual countries can enter into a contract with the euro zone rescue funds which requires these funds to purchase a country's government

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[1] Barclays Capital Live

[2] www.markit.com, July 4, 2012

[3] www.guardian.co.uk, July 2, 2012

bonds in the open market. Such open market operations would support bond prices and reduce borrowing costs which could have threatened the ability of Spain and Italy to finance themselves and to stifle the spending necessary for recovery. The plan becomes effective only after a banking supervisor, based at the European Central Bank, is set up to regulate banks in the 17-nation euro zone – itself a major step. Leaders said they would sign off on the banks' supervision arrangement by the end of the year. Of course, the concern is what will happen until that occurs. The lack of a consistent, credible and transparent system of bank regulation and supervision is one of the euro zone's largest vulnerabilities. However, it is difficult to establish such a system rapidly.

We recall that even when the ESM and related entities were created, it was viewed by economists that the funding on a net basis (now estimated to be below €400 billion) was substantially short of the necessary amount. This ranges from about €700 billion (Gavyn Davies)[4] to about €2.8 trillion (Martin Wolf).[5] There is substantial empirical evidence from foreign currency crises that speculators can make riskless profits by trading against a fund recognized as too small to stabilize a market. In addition to not providing for increased ESM funding, there is yet to be agreement on an insurance arrangement for euro zone bank deposits, further intervention by the ECB to support sovereign bond markets, or on a euro bond arrangement that would reduce the sovereign debt exposure of certain peripheral countries. All these measures, plus more symmetric adjustment by both core and peripheral countries to rebalance competitiveness within the euro zone, are necessary to contain the crisis.

China

According to the HSBC/Markit Survey,[6] Chinese manufacturing remained in contraction for the eighth straight month in June. Q2 growth in China has come in at 7.2% per annum on a quarter over quarter basis and 7.6% year over year versus 7.2% and 8.1% in Q1. The People's Bank of China (PBOC) reduced the deposit and bank rates for the second time in a month, according to a July 5, 2012 announcement. We expect that this and other policy easing measures will affect the economy gradually and lead to a bottoming of growth by the end of the year.

Additional policy steps in China strike a balance between the need to facilitate slower, more stable growth and the need to prevent serious damage to confidence and stability resulting from a stop and go pattern of growth. According to Barclay's Capital,[7] these steps include: 1) the government lowering the tax burden and introducing subsidies to support consumption; and 2) various local governments relaxing restrictions on non-investment purchases of properties and construction of small and medium-size apartments.

[4] http//blogs.ft.com/gavyndavies, June 22, 2012
[5] http://www.ft.com/intl/comment/columnists/martin-wolf
[6] http://www.hsbc.com/1/2/emerging-markets/em-index/flash-purchasing-managers-index
[7] http://www.barcap.com/client-offering/global-markets.html

The government has the will and the means to take further policy steps depending on economic conditions. The PBOC is already pursuing an aggressive easing program, involving a sequential lowering of reserve requirements as well as a series of interest rate cuts. The Chinese Yuan (CNY) has weakened by 1.2% against the US dollar this year. While periodic appreciation seems increasingly unlikely, we think the PBOC will probably try to avoid persistent depreciation of the currency, given the US presidential candidates' opposition to it and the policy intention of internationalizing the currency. However, the authorities may stimulate tradeable goods actively through extra export tax rebates and providing credit to support the export sector.

We are still calling for 7.0% – 8.0% year over year growth in China in 2012, which is still below the consensus forecast, though closer than it was last quarter. The biggest risks to this outlook are twofold: firstly, a deeper than expected recession in Europe, which accounts for approximately 20% of Chinese exports and about 6.0% of Chinese real GDP; and secondly a sharp decline in Chinese residential housing construction and prices. Residential construction, accounting for 9.2% of Chinese GDP (three percentage points higher than that of the U.S. at the peak of the housing boom), may be at a level too high to be sustainable and property prices are still ballooning. An economic turnaround is more likely to occur over a 12-month horizon than over a six month horizon.

The US Economy

The US economy has shown evidence of slowing in the second quarter. Indeed, the Institute for Supply Management PMI Index (US PMI Index) for manufacturing was at contraction levels for the month of June, the first such reading in three years (see Exhibit 3). At the same time, the four-week moving average of unemployment claims has been rising and monthly non-farm payroll gains[8] have averaged only 75,000 for the second quarter down from a monthly average of 225,000 in the first quarter. Consumer durable orders were up in May but merely offset an April decline. Auto sales slowed from a rapid pace and capital expenditure has been sluggish. We anticipate that GDP growth in the second quarter will be between 1.0% and 1.5% annualized and probably below the 1.9% registered in the first quarter (based on the first revision).

The Thomson Reuters University of Michigan US Consumer Sentiment Index declined sharply in June to 73.2, the lowest level since December, from 79.3 in May. Measures of consumer expectations and current conditions declined similarly. Analysts and Bloomberg attributed this decline to continuing high unemployment, slower growth in new jobs, little growth in real personal income, lagging stock market and housing prices, and a general uncertainty about the economy. The Conference Board/Nielsen Consumer Confidence Survey declined similarly in June, continuing its May trend. The decline in consumer sentiment also might be related to a general dissatisfaction with the upcoming elections and the inability of Congress or the administration to get the economy growing again.

[8] http://www.briefing.com/investor/calendars/economic/releases/employ.htm

May US personal income rose 0.2%, matching April, while personal consumption was level, with the personal savings rate increasing from 3.7% in April to 3.9% in May. By June, retail sales had declined for three consecutive months. It appears that the consumption spike that occurred in January and February in retail purchases was temporary and possibly resulting from income tax refunds for the previous year and unusually warm weather.

On a more positive note, US housing starts, new home purchases and the Case-Schiller Housing Price Index have started to rise. There is preliminary evidence that lower mortgage rates promoted by the Federal Reserve have begun to have a positive effect on housing demand, which still remains low by historic standards. While residential housing prices are not extremely low (only 8.0% below their 2001 inflation-adjusted level), they are still below intrinsic value.

Investment Implications

Given the uncertain economic outlook in the US, Europe and China, as well as the US fiscal cliff, we expect global equity market volatility to stay elevated for the remainder of the year. Both developed and emerging market equities are trading below their historic multiples, both on value and growth measures. While equity prices have declined since March, profitability for the most part has remained firm. However, we anticipate that even in the US, equities are beginning to face earnings headwinds and there could be absolute declines in earnings-per-share in the US, as well as Europe. We are neutral to underweight in global equities over a three- to six-month horizon, which reflects our uncertainty about the timing of a recovery in world GDP growth and the political uncertainties in the US and Europe. Beyond this, we are more constructive on global equity market performance but expect the US market to underperform over a 12-18 month horizon.

The eight major emerging markets' (China, Brazil, India, Indonesia, Mexico, Russia , South Korea and Turkey) share of global equity market capitalization is substantially lower than their share of global GDP, which is nearly all of the 42.7% emerging market share (see: James O'Neill of Goldman Sachs: "The Growth Map," Penguin: 2011, and "Viewpoints," July 6, 2012). The difference between the two is greater than it has been at any time in recent years. This would indicate that emerging markets are undervalued in relation to developed markets. The relative earnings multiple of emerging markets is also low relative to that of developed markets based on historic time periods. However, we would not move toward overweighting in emerging market equities, which tend to have high betas with respect to the global market, until a clear path has been developed through the euro zone crisis and the potential fiscal drag on the US economy in 2013 has been contained. Asia ex-Japan looks particularly attractive if these conditions are met. It has compelling valuation based on consensus earnings over the next 12 months (NTM) with a projected P/E of 10.5[9] and strong earnings growth.

[9] Goldman Sachs, Global Insights, July 16, 2012, Exhibit 7.

Within the developed market space, the European market has substantially underperformed the US and global markets (see Exhibit 4). The NTM earnings multiple on the Euro STOXX 50 Index (9.9 on consensus earnings)[10] is substantially below that on the S&P 500 (12.5),[11] both on an absolute basis and in relation to its historic average.[12] The expected five-year return on US equities, according to Barclays Capital,[13] is about 5% and that on European equities about 9%, assuming a reversion to historic relative multiples. Moreover, the sensitivity of European markets to the global market is only about 50% higher than that of US equities. Based on these numbers, a combination of European equities and cash has a higher level of expected return and less sensitivity to global markets than an all US equity portfolio. However, it is tactically premature to move to an overweight position in Europe as the risk of the European crisis intensifying in coming months seems too high and statistical analysis based on historical factors cannot take into account tail risk, especially for European markets. There is no precedent indicating how bad things can become if there is a major sovereign default or other implosion in the euro zone. This is not to say that at some time in the future Europe will not become compelling.

Even though European equities are at their lowest valuations relative to comparable US stocks in 40 years, the opportunity to enter may be when markets dive further and European authorities are forced to act. If this were to happen, the ESM could become a bank and issue its own bonds which the ECB could buy without limit through monetization. If followed by other measures cited above, this would help contain the crisis and provide investors with an opportunity to buy highly undervalued European equities. Unless there is either major forced action by the ESM/ECB or significant improvement in the sovereign situation though a banking union, we intend to maintain Europe underweight despite its attractive valuation.

With regard to US equities, expected returns are still positive but lower than they have been since 2009. Volatility will remain high and reduced, even negative, earnings growth in some sectors will produce selloffs. The odds of a double-dip recession in the US economy are still below 50% and there is a large risk premium built into the US equity market, which provides downside protection against negative events. Based on a normal multiple of long-term trend earnings, the S&P 500 is below fair value but less so than non-US equities or when stocks are valued based on a trailing ten-year earnings average. Absent an unexpected resolution of the euro zone problem, a reasonable budgetary compromise, or higher than expected growth, we would expect the S&P 500 to fluctuate around a flat or slightly declining trend during the remainder of the year. This would imply a single digit return from December 31, 2011 to December 31, 2012.

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[10] Goldman Sachs, Op. Cit.
[11] Goldman Sachs, Op. Cit.
[12] Goldman Sachs, Op. Cit.
[13] Goldman Sachs, Op. Cit.

Under these conditions, we are emphasizing defensive equity strategies and dividend payers. In our large-capitalization equity blend strategy, we have tactically overweighted the Powershares S&P 500 Low Volatility ETF. This Fund tends to outperform during periods of below trend GDP growth and weak earnings advances, as well as during periods of rapidly vacillating equity markets as we have experienced during the second quarter and expect to experience to some degree for the remainder of the year. We are also investing in equities with high but sustainable dividend yields.

We are now including Master Limited Partnerships (MLPs) and beginning to take positions in business development companies in client portfolios. MLPs, which derive most of their cash flows from natural resources such as energy pipelines, have been depressed due to an abnormally warm winter and disappointing first-quarter earnings reports. We believe that this problem is only temporary and that the long-term outlook for MLPs is very positive since they will benefit from the natural gas boom. The Alerian MLP Index has a yield of 6.1%, as compared with 2.1% for the S&P 500 as of 06/29/2012 according to Bloomberg. High quality business development companies, i.e., those with limited mezzanine debt exposure and substantial exposure to senior secured debt, will continue to perform well. The middle market companies they lend to have heavy exposure to the US economy and virtually no exposure to Europe. We believe that credit conditions could deteriorate somewhat but we also believe that the downside risk is nowhere near as great as it was in 2008. High quality business development companies provide dividend yields in excess of 7% and are likely to continue to grow their dividends.

<u>Fixed Income</u>: Globally, since 2007, there has been an excess of private savings which has been offset partially by an increase in government dissavings. This has created a deficiency of aggregate demand and falling interest rates in safe haven countries. Because many countries are reducing fiscal stimulus, which should make savings more abundant, because the crisis in Europe has sustained safe haven flows into the fixed income market and because we seem to be entering a period of low inflation or even deflation, the UK, German and US Treasury yields reached a record low in the second quarter. For example, ten-year bond yields approached 1% and were over 450 basis points below those of comparable Italian and Spanish bonds (see Exhibit 5). Our current stance on Treasury bonds is on the negative side; any reflation expectations and a return to risk appetite could drive yields back upward. According to Goldman Sachs, high quality sovereign yields are about a percentage point below their estimated equilibrium level based on current macro fundamentals.[14] Because of the skewed risk/reward, we are maintaining less than benchmark weighting in this space.

We believe that US investors should overweight munis, which represent an attractive fixed income opportunity from a tax efficiency standpoint. Historically, municipal and corporate bonds have rarely deviated from their tax-adjusted spreads, but since 2010 muni spreads have

[14] Goldman Sachs, Op. Cit.

exceeded their normal level. This is probably due to rising fears of default, but in reality most AAA rated municipal bonds have sound finances with minimal default risk.

While credit spreads in investment grade corporate remain exceptionally narrow, credit spreads for US high yield bonds have risen somewhat in the second quarter. We advise clients to take some credit risk by investing in higher quality high yield bonds, but to keep durations relatively short. This is because the greatest risk is a back-up in ten-year Treasury yields. Since most US companies issuing high yield bonds have virtually no international exposure, a deepening European recession should not adversely affect them.

Even if market conditions in the second half of 2012 are more adverse, there is little risk of a near term crisis in high yield. Two years of proactive refinancing activity have left a well backed maturity profile on high yield bonds. Moreover, the small amount of high yield debt maturing in the near term skews overwhelmingly toward higher quality.

<u>Alternatives</u>: We differentiate between liquid alternatives and illiquid alternatives when assessing this market segment. Alternative assets that have an active market and trade on a daily basis such as REITS, commodities and managed futures fall into the liquid alternatives category, while certain hedge funds, private real estate and private equity in which there are fewer valuation points and longer holding periods fall into the illiquid category.

With respect to the commodity sector, in every second quarter since the financial crisis of 2008/2009 we have witnessed sharp declines in commodity prices. The latest second quarter decline in prices marks the third year in a row that has seen commodities test medium-term support across a wide range of markets due to macroeconomic fears. The steepness of the latest collapse in commodity prices coincides with the European crisis entering a new and much more dangerous phase and the intensification of fears of a Chinese hard landing. Looking forward, we believe that policy responses and strong fundamentals, such as net deficits in the oil and copper markets present a strong case for higher commodity prices. The strong dollar and other factors have caused gold to decline by 4.3%, however, over the longer term, it may benefit if the dollar softens and if China achieves its projected 7% growth rate.[15] Gold prices respond positively to quantitative easing by the Fed and we believe that QE3 is likely to be initiated. Continuing high inflation in India, another major consumer market for gold, should help increase demand for the metal as a safe holding.

As a result of investors' search for yield and improving balance sheets in the sector, Real Estate Investment Trusts actually increased in value during the second quarter, posting a 3.71% return during the quarter as measured by the Wilshire REIT Index.[16] According to Bank of America Merrill Lynch, REITs trade at 101% of net asset value versus a long-term average of 102%

[15] Bloomberg
[16] http://web.wilshire.com/Indexes/RealEstate/REIT

(REIT Weekly, July 6, 2012). We view a 95% ratio to net asset value as being an attractive entry point.

Finally, trend following strategies within the managed futures category were generally positive for the quarter up until June when a sharp reversal in commodity and currency markets on the last day of the month caused many strategies to falter. For example, most trend followers were short oil given the declining trend in the price only to be caught out on the last day of June when oil jumped over 9% on the European summit announcement. However, they did provide a good hedge against a sharply declining equity markets in May. Hedge funds in general, as measured by the Dow Jones Credit Suisse Core Hedge Fund Index, returned -2.26% for the quarter and have generated a relatively modest 0.42% return year to date through June. Although the returns for the less liquid funds were significantly higher, they were still for the most part less than those of US equities. This is because return correlations for individual stocks, markets and styles have been unusually high and the daily return on risky assets followed a saw tooth pattern, especially in June.

Conclusion

We expect financial and commodity market volatility to increase in the second half of the year. The agreement in principle reached at the euro zone summit on June 29th, 2012 represented progress but is likely not a game changer for the European economy and growth in China now depends on whether policymakers can adequately stimulate domestic demand. The resilience of the US economy is now in dispute given the uncertainty of business leaders regarding the European debt crisis, the looming fiscal cliff, the high federal debt level and household concerns about flagging employment.

July 20, 2012

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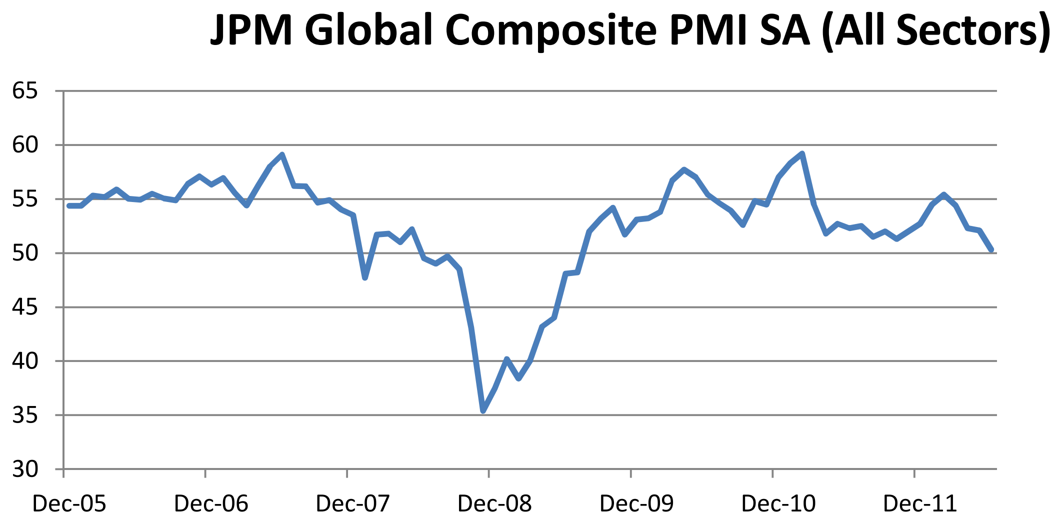
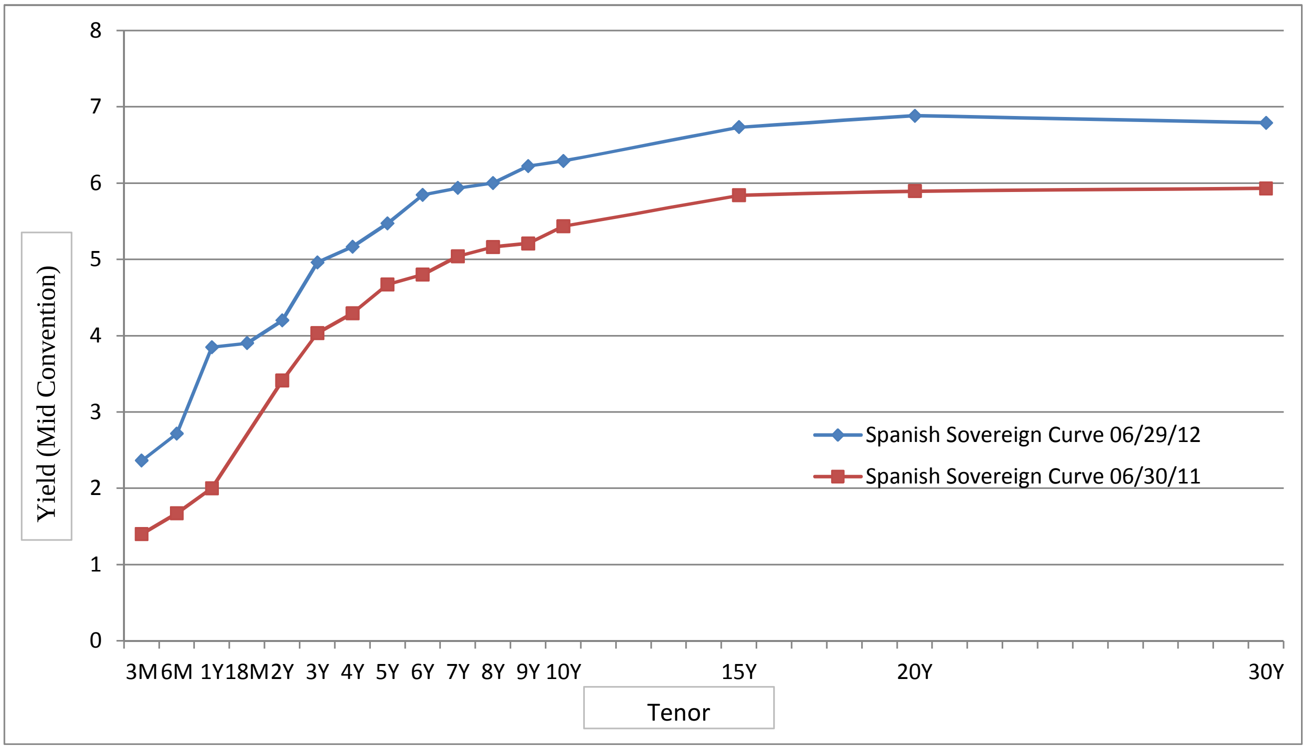
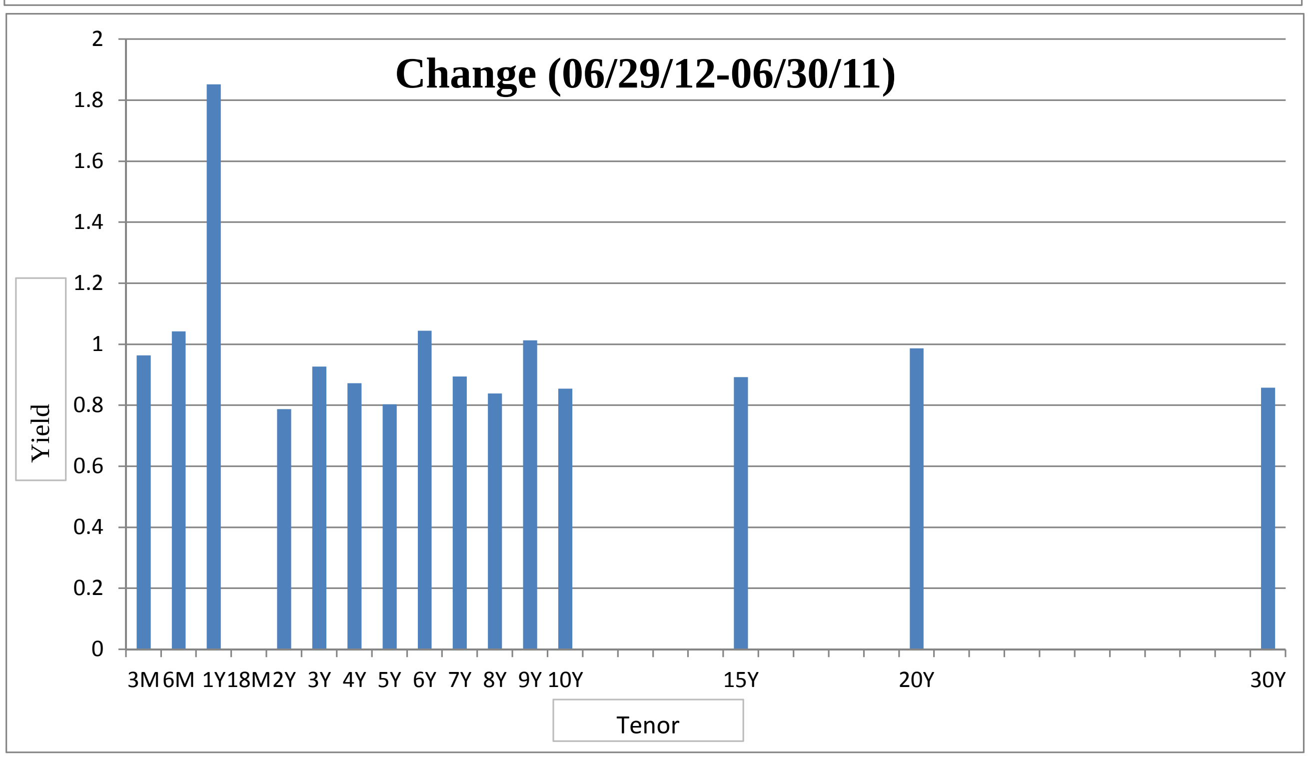
<u>Exhibit 1</u>: JPM Global PMI



Source: Bloomberg, JP Morgan

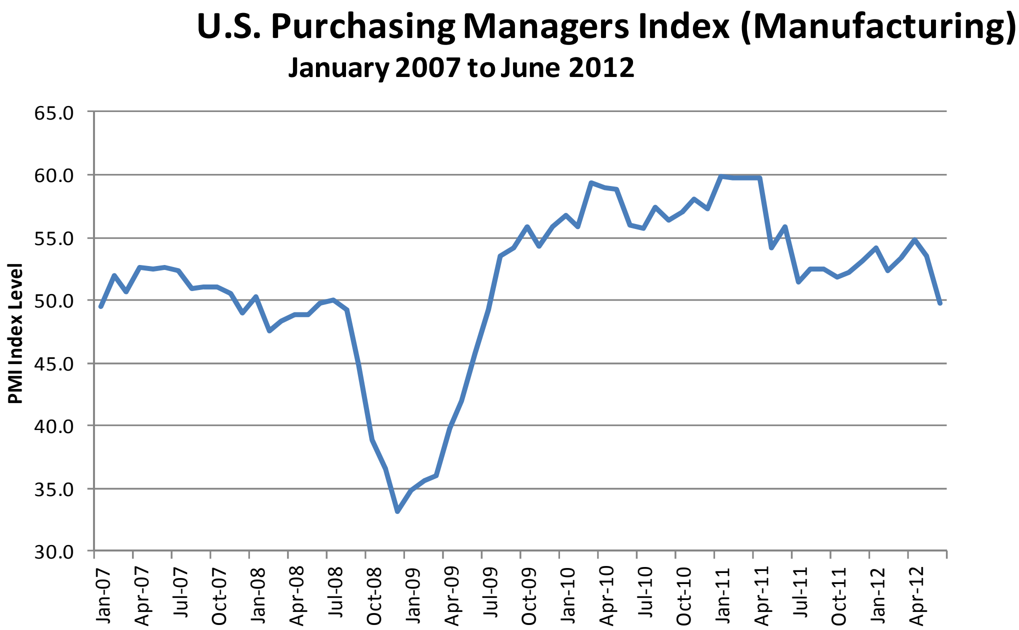
<u>Exhibit 2</u>: Spanish government bond yield curves as of 06/29/12 and 06/30/11, and change in rates between those two dates





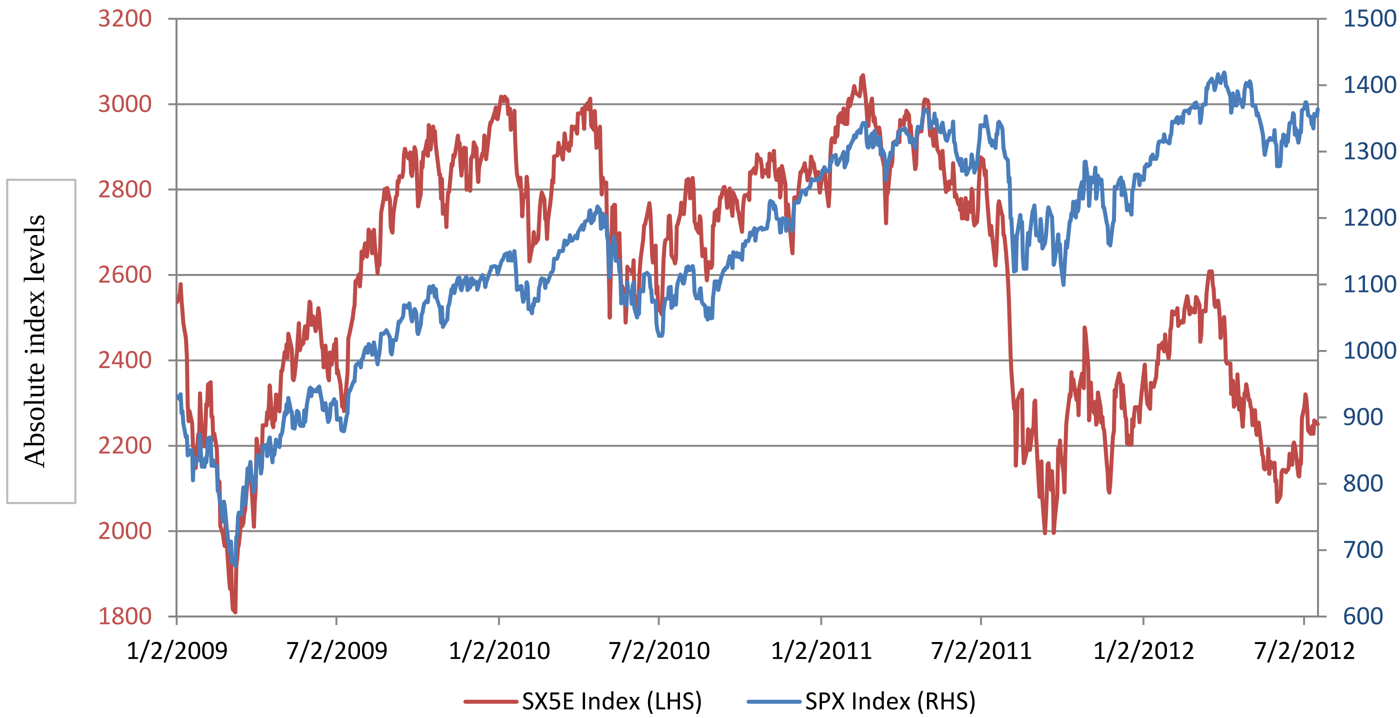
Source: Bloomberg

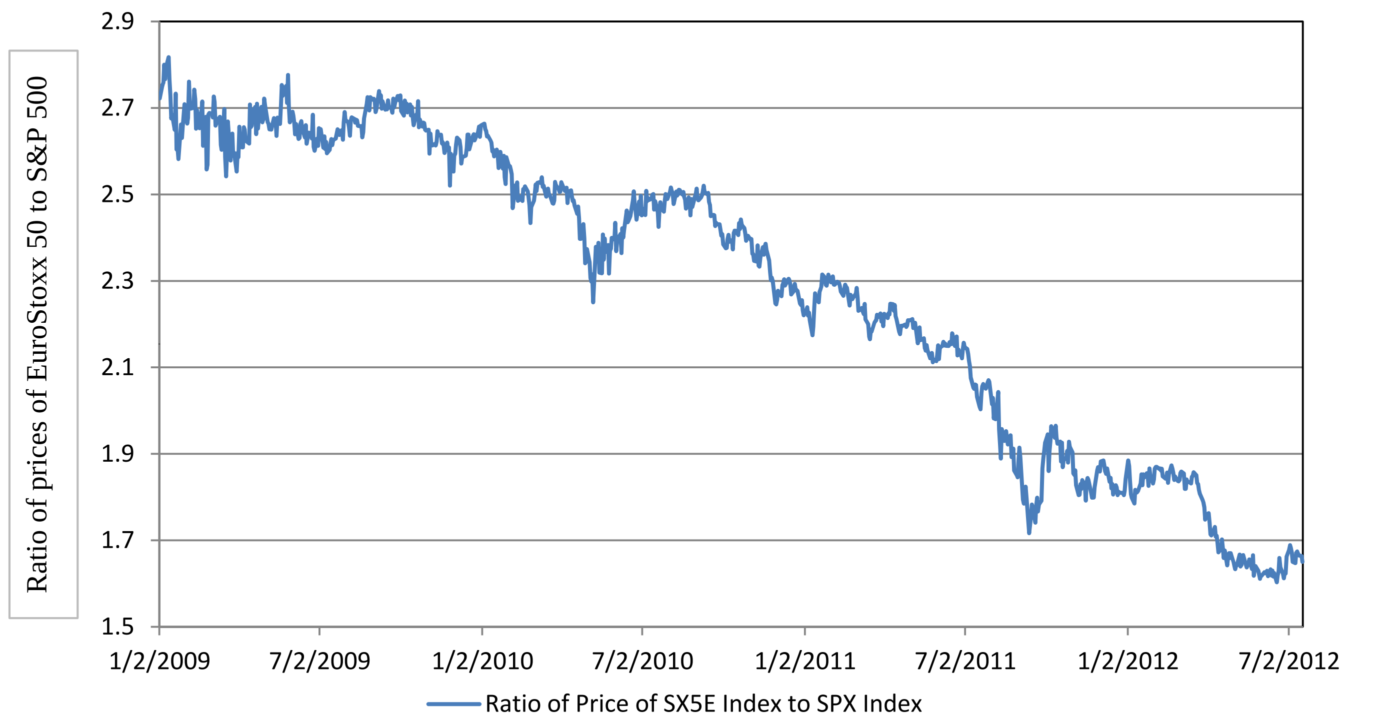
<u>Exhibit 3</u>: US PMI Index



Source: 12Markit U.S. Manufacturing PMI

Exhibit 4: Ratio of the EuroStoxx 50 Price Index to the S&P 500 Price Index





Source: Bloomberg

Note: SX5E is the EuroStoxx 50 Index. SPX is the S&P 500 Index.