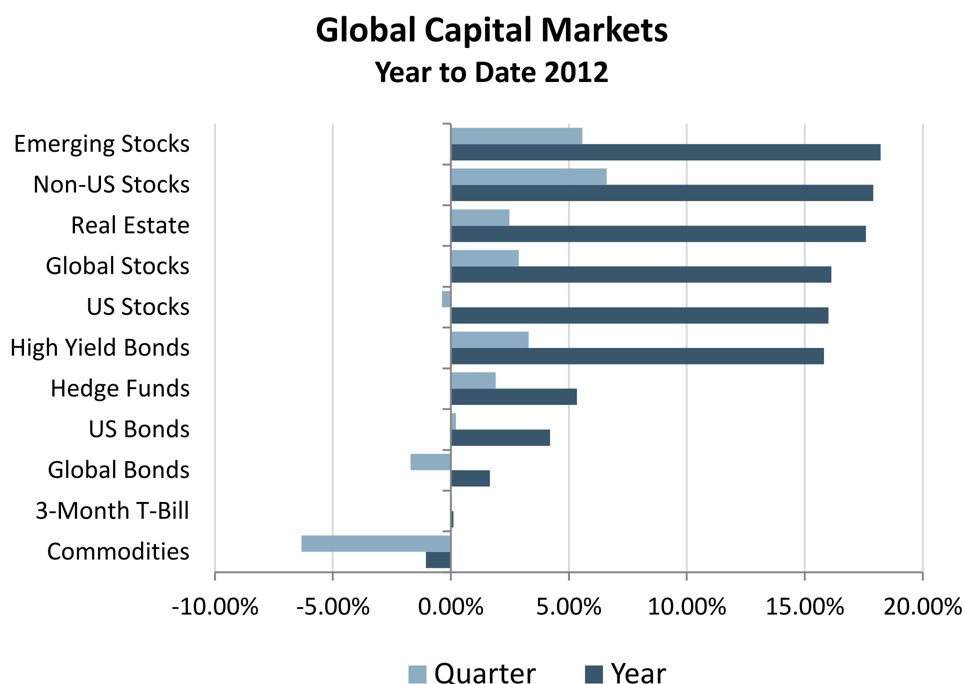
The McCabe Perspective

4th Quarter 2012

Global equities posted a positive 2.9% return in the fourth quarter and 16.1% for the year according to the MSCI All Country World Index. The quarter's strong performance was led by non-US developed markets which gained 6.6% in the quarter as measured by the MSCI EAFE Index, with both Europe and Japan contributing positively. For the year emerging markets posted the strongest gain with an 18.2% return as measured by the MSCI Emerging Market Index. This was true even though global economic growth slowed significantly during the year and came in well below expectations set at the beginning of 2012. The equity rally was liquidity driven, since the overall policy stance of major central banks, already expansionary, was to aggressively ease during the second half of the year. This reduced the probability of outright recession and the discounts investors applied to future profits which were based on the real rate of interest. Again, fixed income posted relatively modest gains for the quarter and the year. The Barclays Capital U.S. Aggregate Index returned 0.2% in the quarter and 4.2% for the year. High-yield bonds posted "equity-like" returns for the year and outpaced U.S. equity and bond markets in the fourth quarter.

Exhibit 1: Global Capital Markets Overview



Source: S&P 500 Index, MSCI EAFE Index, Barclays Capital U.S. Aggregate Index, Barclays Capital U.S. High Yield Index, Citigroup World Government Bond Index, Wilshire REIT, Dow Jones UBS Commodity Index, HFRI Fund of Funds Diversified Index, ML 3-Month T-Bill.

The US Economy

A division in the US economy continues to evolve between the stagnant manufacturing sector, plagued by weakness in export orders and domestic capital spending, and the services sector, which has begun to recover substantially in recent months. While the manufacturing PMI Index has remained at slightly below 50 (contraction) to slightly above 50 (expansion), the non-manufacturing ISM Index has remained above 50 and has recently risen to over 56. This is important since the service sector, which represents most of the non-manufacturing index, is responsible for 86% of jobs in the US.

Fourth quarter retail purchases were held back by one-off factors. On the positive side, US growth continues to be supported by recovery in the cyclical sectors of autos and housing. Pent-up demand, easier financing conditions and the extent to which buying is cheaper have prompted consumers to start looking for mortgage credit and to buy homes again. The homebuilder survey is zooming, as are housing permits and starts. Up to now, the housing recovery has not relied on credit, as shown by the lack of a pickup in mortgage applications in 2012. Moreover the residential overhang is diminishing. As a result housing should contribute roughly 0.75% to growth in 2013, according to JP Morgan estimates[1]. The US consumer also has the potential to come back with improved balance sheets and a rise in the cyclical component of the job market although the end of the payroll tax holiday is a headwind for consumers with low wages. At the same time, the outlook for specialty retail is favorable.

The above discussion suggests that the moderate US growth is likely to continue, but that it is subject to the assumption that the decline in business and consumer confidence associated with the unresolved fiscal cliff will gradually reverse as greater fiscal policy clarity is produced. We are assuming that about $240 to $280 billion in additional fiscal tightening occurs, owing to a combination of the expiration of the payroll tax cut, tax increases from the Affordable Care Act, increasing taxes on upper income households and some expenditure cuts, which will fall substantially short of the full sequestration amount.

Although tax austerity scheduled for 2013 was reduced by two thirds and the automatic expenditure cuts (sequestration) were postponed, the US fiscal problem was only partly fixed on January 1. We expect a debt limit, expenditure cut showdown in February, but we are assuming that further reduction in the fiscal deficit through expenditure cuts

[1] JP Morgan, Eye on the Market, January 2013

and lower tax deductions will be less than 0.50% of GDP which, when combined with the January 1 agreement would result in a total increased fiscal drag of 1.75% of estimated GDP (which translates into 1.5% of fiscal drag over the year). If the agreement involves substantially more fiscal drag or the negotiations go beyond the end of February and uncertainty about the debt ceiling intensifies, we would expect private sector capital spending to remain constrained and growth in the first half of 2013 to fall below 1.0% annualized, which is well below consensus and close to stall speed. Many analysts seem to believe that the battle in February will be much tougher than that at the end of 2012 because the debt ceiling (crucial to world economic stability) is being held hostage and because Republicans are adamant about not raising it unless they get their desired level of spending cuts.

We expect a one percentage point decline in consumption growth from the tax increases already passed. In the first quarter, these tax increases will produce an actual decline in household income on a year over year basis (usually a sign of recession), but based on Goldman Sachs estimates, this will not be enough to produce an outright contraction in consumer spending. As 2013 progresses, improvements in the housing market and private sector investment should offset most of the depressing effect of the increased fiscal drag on GDP growth. GDP growth is expected to rise from 1.5% in the first quarter to close to long term trend in the fourth quarter[2].

European Economy

The euro zone is still in recession and agreement on a common bank regulator and fiscal pact is lacking. Yet European equity markets have performed well and the euro is close to its 52 week high with respect to the dollar; in particular the German DAX was up 29.06% in 2012. There seems to be increased investor confidence that the euro zone will hold together as a result of the ECB's commitment to preserve the euro and unlimited bond buying power available under the ECB’s outright monetary transactions (OMT) program. Moreover, improved competitiveness in the European peripheral countries is getting increased investor attention. This is especially true in Ireland and Portugal but also in Spain.

It is still too early to declare an all clear but the probability of an imminent euro zone break up has diminished considerably. Central bank balance sheet expansion has brought down the cost of credit and bank and sovereign insolvency risk significantly, at least for the time being. The immediate problem facing the euro zone is continued

[2] Jan Hatzius, Goldman Sachs: US Economic Analyst, January 2013

recession. A major cause of concern is weakening activity at the core. For example, not only is France facing a significant downturn in both household and business spending, but Germany as well appears to be close to stall speed. The expansion of economic weakness in the core countries suggests that even with upside surprises a sharp, as opposed to a very gradual, growth recovery in the euro area is unlikely to occur soon.

Further euro area integration will be slow to take place and have many fits and starts which will produce considerable headline risk. For example, the coming elections in Italy have revived political uncertainty there for the first time in over a year, as well as producing concern that the badly needed structural reforms enacted by Mario Monti in the past year will be reversed. The ongoing severe recession in Spain and the resulting missing of fiscal targets have brought the country's debt sustainability into question and may require Spain to request outside assistance. The resulting uncertainty in financial markets could lead to another upward spike in the interest rates of Spanish and possibly Italian sovereign debt.

Still the ECB stands ready to buy Spanish sovereign debt if Spain needs it. The 12% rally in European stocks since early July to the end of the year also suggests confidence on the part of market participants that the ECB will backstop the euro zone economy in other ways. We believe that it will also undertake additional monetary easing in the form of further reduction in the bank rate and LTROs if the euro zone economy continues to contract. European policy makers have managed to get ahead of the curve in dealing with its sovereign debt and banking crises for the first time. Following Mario Draghi's July speech, Spain has diminished its assets financed by the ECB, the market for the debt of peripheral banks has been restored, credit spreads have diminished substantially, bank deposits and private ownership of Spanish and Italian bonds have stabilized and Greece has conducted a successful buyback of its debt. The ECB has certainly managed to cast a wide net.

Chinese Economy

Investors entered 2012 concerned about a hard Chinese landing, but they came into 2013 with greater assurance that this will not occur. For example, the latest PMI number published by the Hong Kong Shanghai Bank climbed to 51.5 for December from 50.5 a month earlier. The new orders in the PMI rose to a 23 month high of 52.9 from 50.8 in November[3]. Retail sales in real and monetary terms have picked up, demand for energy, a proxy for economic growth, has risen and profits of the Chinese

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[3] Financial Times, "China's Economy Ends on a High Note", January 1, 2013

industrial companies are increasing. The growth recession in China probably bottomed in September with improvements in export orders and strengthening infrastructure expenditure.

We expect some but not dramatic growth acceleration in 2013 given the depressing effect of continued European weakness on external demand. In 2013, fiscal policy should remain modestly expansionary and the monetary stance should return to neutral from the accelerated easing that occurred in 2012. Still, China's economic momentum should be a benefit to the world economy, not a detriment as it was in 2012.

Global Equities

Given our expectations of improving economic growth we favor global equities over global bonds in 2013, although we do not believe all regions are equally attractive. Since the start of the recovery in 2009 U.S. corporate profits for the S&P 500 constituent companies excluding financials, utilities and transports have reached all time highs. Figures from Bloomberg indicate that the U.S. equity market is trading at a forward PE of approximately 13.0 as of January 14, 2013[4]. While the market is not as cheap on this measure as it was in March 2009, when it was selling at a 9.5 times forward earnings, it is far from being overvalued at this point.

Admittedly valuation multipliers (Price to Forward PE, Price to Book and Price to 10 Year Cash Flow and Price to Trend Earnings) were on average slightly above their historic median at the beginning of 2013 as opposed to being below it at the start of the previous year. However the S&P 500 would have to rise by more than 100 points to above 1600 to attain its top valuation quartile where bull markets have peaked in the past. In fact, forward price earnings multiples are below historic levels at current GDP Growth and core and headline inflation rates.[5]

When one compares the forward earnings yield of the U.S. market of 7.1% (the inverse of the forward PE) to the 1.85% yield of the U.S. 10-Year Treasury bond as of January 14, 2012[6], the risk premium assigned to the equity market remains in excess of 500 basis points. This compares favorably to a more normal 200 to 300 basis point equity risk premium pre-crisis. While valuations on an absolute basis are not overly cheap, they look quite interesting when compared to those in the U.S. government bond market.

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[4] Bloomberg

[5] Goldman Sachs Outlook: Over the Horizon, January 2013 pages 51-52

[6] Bloomberg

Exhibit 2: Forward Return Expectations based on Current Valuation Levels

REAL ANNUALIZED RETURNS OVER THE FOLLOWING FIVE YEARS*			
BONDS		**STOCKS**	
REAL YIELDS AT TIME OF PURCHASE**	**10-YEAR TREASURYS**	**SHILLER P/E AT TIME OF PURCHASE**	**S&P 500**
BELOW 1	**-1.0%**	BELOW 14	10.8%
BETWEEN 1 AND 2	0.1%	14 TO 19	9.7%
BETWEEN 2 AND 3	1.3%	**19 TO 22**	**7.5%**
BETWEEN 3 AND 4	3.9%	22 TO 25	1.3%
ABOVE 4	7.0%	ABOVE 25	-2.0%

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* CALCULATIONS ARE BASED ON QUARTERLY DATA SINCE 1953.
** NOMINAL YIELDS MINUS BCA MEASURE OF INFLATION EXPECTATIONS.

As shown in Exhibit 2 above, at the present negative real rate of interest on Treasurys and the present cyclically adjusted price earnings multiple (in the 19-22 range), past data indicate that the real rate of return on equities in the subsequent 5 year period would be over 7.0% whereas that for bonds would be negative[7].

As discussed in our third quarter letter, we felt that European equities were more attractively priced than U.S. equities and this was recognized by the market in the fourth quarter 2012. As we start 2013, major non-U.S. economies have lower equity market valuations than the U.S. and unlike the U.S., have accelerating as opposed to decelerating earnings growth and are experiencing fiscal easing or stimulus, rather than fiscal tightening. These three factors are conducive to foreign stocks outperforming U.S. equities in 2013.

[7] Bank Credit Analyst, Outlook 2013, January 2013 Table 6, page 29

Exhibit 3: Forward Price Earnings Multiple Estimates

Market Indicator	Bloomberg**	Bank Credit Analyst***
S&P 500 Index	13.1	13.0
MSCI EAFE	12.7	N/A
MSCI Japan*	14.3	12.8
MSCI Euro	10.9	11.0
MSCI Emerging	11.0	10.6
MSCI Latin America	12.7	N/A
MSCI EM Asia	11.3	N/A
MSCI EM Europe	7.0	N/A
MSCI China	10.3	9.9

* Price/EPS Positive
** As of January 14, 2012
*** As of January 11, 2012

For example, corporate earnings growth of U.S. companies measured by the constituents of the S&P 500 Index averaged over 25% from 2009 to 2011, according to BCA Research[8], but they are beginning to peak. In fact, earnings growth expectations are being revised lower for U.S. companies. European and Asian markets have sold off substantially relative to the U.S. equity market over the past several years. The MSCI EAFE Index, a free float-adjusted market capitalization index that measures the equity performance of 22 developed market countries excluding the U.S. and Canada, is trading at a forward PE of 12.7. Within this universe, Euro area stocks are even cheaper and are trading at a 10.9 times forward PE ratio even after a strong fourth quarter. European equities have to rise 31% to achieve the historical average cash flow multiple discount to U.S. equities. While we expect Europe will remain in recession for the next 12 months, there are potential catalysts that could drive stock prices higher from here. They include improving corporate profits (especially for multi-national companies) albeit from a low base, a more stable banking sector helped recently by postponed Basel III rules as well as a reduced need for austerity as a result of improving fiscal balances.

In Japan there has been quite a shift in market sentiment of late, driven largely by the election of Shinzo Abe and the strong mandate given to the Liberal Democratic Party (LDP) as a result. We expect that the government will follow through on their intention

[8] Bank Credit Analyst Global Investment Strategy, January 11, 2013

to stimulate the economy through large infrastructure projects and the Bank of Japan (BOJ) has announced that it will expand its balance sheet by ¥50 trillion in 2013. Japan's equity market is currently trading at a forward PE 12.8 according to BCA (see table) and it has started to perform quite well. In addition, the price to book ratio of Japan is close to 2009 levels and more than half of the constituents of the TOPIX index are trading below book value. At the same time the Yen has started to weaken against most major currencies, particularly the dollar, as Japan authorities have intended. A weakening Yen usually leads to an acceleration of corporate profit growth[9].

The Asian and Eastern European emerging markets have lower forward price to earnings multiples than does the S&P 500 although Latin American equities are less attractively valued than U.S. equities on a sector adjusted basis. While this is not the case in other regions, Asian emerging market fundamentals are better than those in the U.S. Per share earnings growth is for the most part accelerating and there is room to expand fiscally and in some cases governments have already done so.

For example, in China the recent change in political leadership and their intention to focus on economic restructuring and fiscal stimulus bodes well for both economic growth and the stock market in our view. While risks remain in China with respect to their housing market and a large shadow banking system, at this point the emphasis on growth is clear and equity values remain quite attractive on a relative basis. China is trading at a forward PE of 9.9 (using BCA data) which is lower than most of the other major equity markets.[10]

Global Fixed Income

We expect U.S. government bond markets to remain under pressure in 2013 just as they have for the last three months. The price return of the U.S. Barclays Aggregate Index, a proxy for the U.S. investment grade fixed rate bond market, was negative. Since 2000 real bond yields have declined significantly. In fact real yields on U.S. 10-year Treasury bonds have been negative for almost two years. This is largely been driven by accommodative monetary policy by the U.S. Federal Reserve in the face of slow economic growth, high unemployment, low inflation and the constant risk of another financial crisis in Europe or China. Minutes of the last FOMC suggest that there is some disagreement on the extent and timing of continued monetary stimulus and in the absence of a strong buyer such as this, we would expect bond yields to drift higher over

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[9] Financial Times, "Japan's Last Stimulus", Lex Column, January 11, 2013, Goldman Sachs Outlook, Over the Horizon, January 2013 p. 59

[10] Bank Credit Analyst, Weekly Report, January 11, 2013 pps 9-10

the year (and therefore bond prices to drop lower). Clearly as the debate over the debt ceiling and expenditure cuts occur, bonds still have the potential to provide some balance to risky assets as investors seek the relative safety of this asset class. However, as we have discussed in the past there remains an asymmetric risk in the U.S. bond market. The fact that nominal yields are near 30 year lows and the 10-year real yield is negative means that there is little buffer to protect investors if interest rates were to rise. For example the capital loss for a mere 19 basis point increase in the 10-year yield from 1.85% is enough to wipe out one year's interest earnings.

This relatively low yield environment is not exclusive to the U.S. government bond market. Municipal bonds, investment grade corporate bonds, agency mortgage-backed securities and high yield bonds are all trading at or near record low yields (high prices). In fact the high yield bond market, as measured by the Barclays High Yield Index, fell below a 6% yield level for the first time which suggests that investors are willing to move down the quality scale in a search for yield. High Yield spreads are below historical levels at current GDP growth rates. We believe that the risks inherent in such bonds are still valid in the current economic environment especially with substantially weaker U.S. consumption growth expected in the first half of 2013 and accompanying corporate cash flow strains. Because current yields and credit spreads provide less compensation for the assumption of these risks, we reduced our position in high yield bonds near the end of 2012 though we remain invested in the higher quality segment of this asset class[11].

Global bonds, particularly those in the peripheral European markets and emerging markets have performed strongly over the course of the past year. This has largely been due to the European Central Bank providing a backstop behind European financials which led to an increase in the risk on trade. Not only have European bank stocks started to outperform, but yields in Ireland, Italy, Spain and Greece and those of local currency emerging market debt have declined significantly over the course of the last three months. We expect this trend to continue and therefore believe that there remain attractive opportunities in bond markets outside of the U.S.

Emerging market local currency debt remains attractive despite a 17.3% appreciation in 2012 according to the BofA Merrill Lynch Global Diversified Fixed Income Index. The average debt to GDP ratio in countries issuing this debt is 40%, about half that in the OECD countries[12]. Emerging market central banks have also become more adept at controlling inflation which has made fixed income securities in these countries much

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[11] Bank of America Merrill Lynch, "2013 Credit Outlook: The Inflection Point", January 4, 2013
[12] Goldman Sachs Outlook: Over the Horizon, January 2013 p.71

more appealing. Exposure to local currency debt should be more rewarding than exposure to dollar denominated debt because the countries issuing local currency debt are stronger credits and because their currencies are likely to appreciate modestly against the dollar.

Alternatives

The alternative asset classes such as hedge funds, commodities and real estate had a mixed fourth quarter. Those asset classes associated with strong and improving fundamentals, such as the Global REIT market performed quite well in the fourth quarter and for the year as a whole. Hedge funds, as a group, provided modest performance in 2012 although there was a clear distinction between the sub strategies that performed well and those that did not. Long biased equity long/short strategies as well as event driven and credit strategies tended to produce the strongest results given the opportunities available in these markets. The fact that equity and credit oriented strategies performed well in 2012 is not surprising given the performance of high yield and global stocks since they tend to have relatively high correlation to these asset classes despite their hedged exposure to them.

Global macro funds and managed futures funds that tend to either capture return by predicting global economic trends or following them were the worst performing strategies. As was the case in 2011, these strategies have been negatively impacted by the significant intervention by the world's governments and central banks in global capital markets. While fundamentals may suggest a country, currency or market is deteriorating an announcement of additional fiscal or monetary stimulus can quickly reverse the trend and cause many investors with fundamentally based strategies to be caught out. Despite this, their role in a well diversified portfolio of hedge fund strategies is still valid in our view. They provide uncorrelated and often negatively correlated return patterns than can add value in falling markets. As trends develop in currency, commodity and interest rates we would expect the global macro and managed futures strategies to capture these trends and capitalize upon them[13].

In addition, the market atmosphere for equity long/short and macro hedge funds may improve in 2013. Individual security and asset class selection may be more important in driving performance than it has been since 2009. A measure of the implied average correlation of the 50 largest S&P 500 stocks has declined by over 20% in the last year[14]

[13] HFRI Indices, January 2013

[14] Goldman Sachs, COMEX

suggesting that the opportunities to profit from fundamental research at the company level is increasing.

Summary

Our cautiously optimistic outlook is based mainly on the assumption that there will be a small increase in global growth (as evidenced by the recent rise in the global PMI to above 50) driven by a European GDP stabilization, higher real GDP growth in China and 2% GDP growth in the US, although supply shortages will also play a role.

There are some important downside risks to this view. These include a US fiscal cliff that cannot be made to disappear, social unrest resulting from the European employment crisis, a surprising decline in U.S. consumption early in the year, the overhang of Spanish debt, the decreasing return to credit expansion in China, the potential imposition of even greater austerity throughout the OECD, and a possible Iranian crisis.

The worst part of the fiscal cliff (over $600 billion in fiscal tightening) has been avoided through the American Taxpayer Relief Act (ATRA). However, an optimal comprehensive fiscal restructuring has not been addressed. This “grand bargain” designed to achieve a stable debt to GDP ratio without overly compromising growth would have combined short term fiscal support with long run deficit reduction. Instead the U.S. Congress has adopted a series of micro deals which probably do not constitute even a second best solution and exacerbate uncertainty by postponing important fiscal decisions. The U.K. and parts of the Eurozone where the private sector is less solid than that of the U.S., have adopted a similar piecemeal approach. Fortunately this approach and the uncertainties it creates are known unknowns for market participants. It is likely to be over discounted during risk off periods when improving prospects for risk assets are also ignored. We try to take advantage of these mispricings through moderate risk assets such as the equities of European multi-nationals, low volatility equities, near investment quality high yield bonds and non-U.S. bonds when they are temporarily undervalued.

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