

## Half Time Report: Understanding the Oscillating Waves of Fear and Greed

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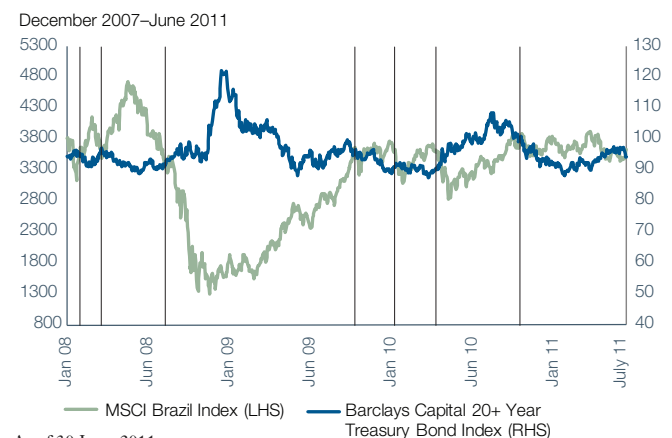
Global capital markets continue to be volatile, as reactions to economic events are causing radical shifts between risk-on and risk-off assets. With the high level of uncertainty around sovereign debt crises, global growth expectations, emerging market inflation, and other important issues, we believe that much of the opportunity for investors can be discovered in the wide dispersion that is occurring around major market asset classes. Tactical investing in this rapidly changing market environment can be advantageous if investors can identify the true beneficiaries of the next wave in the market.

Over the past four years we have been subject to a wide range of macroeconomic shocks and inputs that have caused an oscillating pattern of risk-on and risk-off investing environments. In spite of the volatility over this period, as investors we have generally understood what types of assets would outperform during risk-on periods as well as during risk-off periods. During risk-on periods, cyclical sectors often connected to emerging market growth have been the market leaders. Whether it be direct emerging markets investments or investments in the materials, commodity, or industrial sectors that perform in line with strong emerging markets growth patterns, the leadership has been clear. During risk-off periods, generally more stable asset pools, such as government securities, provided leadership and clear defensive characteristics.

Exhibit 1 illustrates the volatile return patterns between Brazil and long-dated U.S. Treasury securities. These two asset classes are representative of risk-on and risk-off assets, and the chart clearly shows the oscillating return patterns and volatility which we have experienced since 2008. As frustrating as this volatility has been, to a certain extent it has been predictable in terms of asset class returns. One just had to have the correct view on the marketplace

and then implement his or her investments accordingly. However, 2011 has been more difficult for investors, as the bad news seems to be pervasive, yet markets have generally risen throughout this time. Additionally, the investment leadership has clearly changed and in many cases has surprised investors.

Exhibit 1  
Risk-on versus Risk-off



As macro investors, we believe that the overall environment does matter and that one needs to have a big-picture viewpoint. Exhibit 2 summarizes our viewpoints across eight key economic and investment drivers, which we assess when determining our macro outlook. We look at these variables both on a global and regional basis, and today we have conflicting data. Economic growth remains high in the emerging markets, but that rate of growth is slowing. Meanwhile, Europe seems to be in a flat to

## Exhibit 2 2011 Q3 Key Economic and Investment Drivers

Each Driver has three possible states: Rising, Stable, and Contracting

Driver	State	Rationale
Real Economic Growth	Rising	In spite of headwinds, the U.S. economy continues to grow. The emerging markets (EM) growth rate has slowed, but remains fundamentally high. Japan has experienced an uptick in economic activity post-earthquake. Europe continues to struggle with structural growth problems and increasing government austerity.
Inflation	Stable	Inflationary concerns have diminished, as the spike in energy, food, and commodity prices have been met with increased supply and diminished demand.
Real Interest Rates	Stable	Monetary policy remains bifurcated, with the U.S. and Japanese central banks engaging in accommodative policy, while European and EM central banks are generally tightening.
U.S. Dollar F/X Value	Rising	The dollar has been weak since the initiation of QE2, but we believe it should begin to reflect the relative strength of the U.S. economy.
Taxes and Regulation	Contracting	Debt reduction remains a priority for fiscal policymakers.
P/E Ratios	Stable	In spite of continued increases in corporate earnings, P/E multiples are not high, as investors remain skeptical of equities.
Fixed Income Risk Premiums	Stable	Corporate spreads are tight and are likely to remain so as investors look for incremental yield in a low interest rate environment.
Volatility	Rising	Volatility remains structurally low, but is subject to shocks on the back of bad economic or geopolitical news.

■ Bullish     
 ■ Neutral     
 ■ Bearish

As of 30 June 2011 and is subject to change.

potentially declining GDP scenario, while GDP in the United States is growing at approximately 2%. Inflation is not an issue in most developed countries, yet it is problematic in emerging markets, though less so than just a few months ago. Monetary policy is also mixed as the U.S. Federal Reserve and the Bank of Japan remain accommodative, yet the European Central Bank and many emerging market central banks have been tightening. One common theme, however, is that virtually everywhere around the world policymakers are being forced to re-evaluate government debt levels and rationalize the size, scope, and cost of government. This is one of the main sources of investor anxiety. Readers of the book *This Time It's Different* by Carmen Reinhart and Kenneth Rogoff should not be entirely surprised by these developments related to government debt. The book, which was published in early 2009, outlines the history of private sector banking crises and the subsequent government debt problems that inevitably develop, as well as the deleveraging process that then needs to occur in the public space. This deleveraging of the public sector is likely to continue to cause volatility and concern among investors, as the history of public sector deleveraging has had both positive and negative outcomes. We are not entirely bearish because we believe that the global economy continues to be on a positive growth trajectory, though it is at a slower pace than we would prefer. Ultimately, the deleveraging in the public sector could be positive for the economy and markets over the longer run. All of this is contingent on sound choices made among policy makers to avert a systematic event and ensure economic growth going forward.

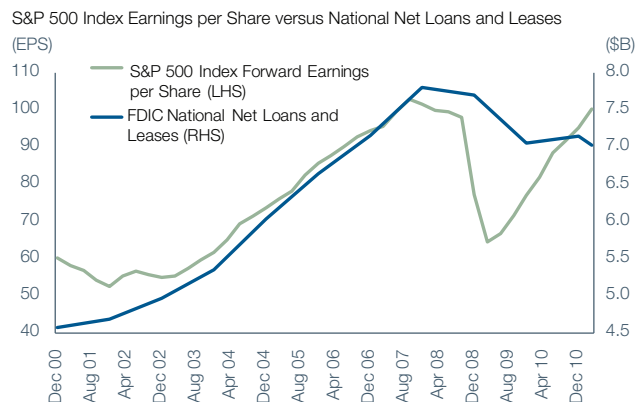
## Exhibit 3 Equity Market Performance



As of 13 July 2011. Source: Bloomberg  
Past performance is not a reliable indicator of future results.

Exhibit 3 shows global equity market returns for this year. While they have not been the above-average numbers we saw in 2009 and 2010, they are far from catastrophic given all the potential systematic crises the market has faced thus far in 2011. In fact, equity prices have declined approximately 5% from the April highs, which does not even qualify as a correction. As you can see in the exhibit, year-to-date returns remain positive and, as we know, the one- and two-year returns are sharply positive. So it is important to maintain a relative perspective here as it applies to the most recent bout of volatility; we would say we are in a mild correction phase of a two-year bull market.

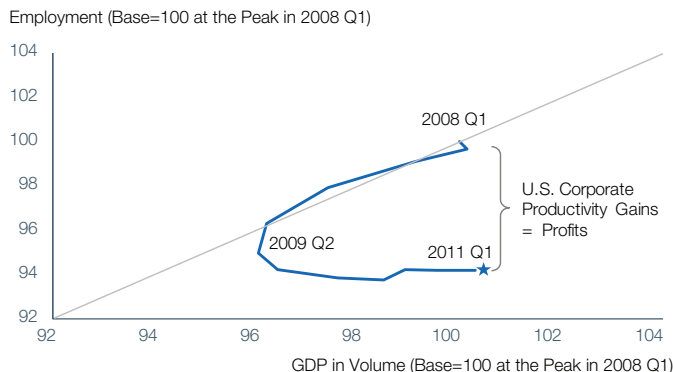
### Exhibit 4 Private Sector Deleveraging versus Earnings Growth



As of 31 March 2011. Source: U.S. FDIC, TrendMacro  
Past performance is not a reliable indicator of future results.

Why have investment returns been so resilient in light of the deluge of bad news hitting the market? In our opinion, it has been the fact that the profit cycle remains so strong in spite of the important deleveraging headwinds which exist; both real deleveraging in the private sector as well as potential deleveraging in the public sector. Exhibit 4 demonstrates the trends of deleveraging and profits. The profit cycle has been much stronger than expected, and it remains the greatest source of good news in the economic landscape. For example, both IBM and Novartis recently reported better-than-expected earnings, illustrating strong microeconomic data points against a tide of seemingly weak macroeconomic news.

### Exhibit 5 The Jobless Recovery: U.S. GDP and Employment Growth



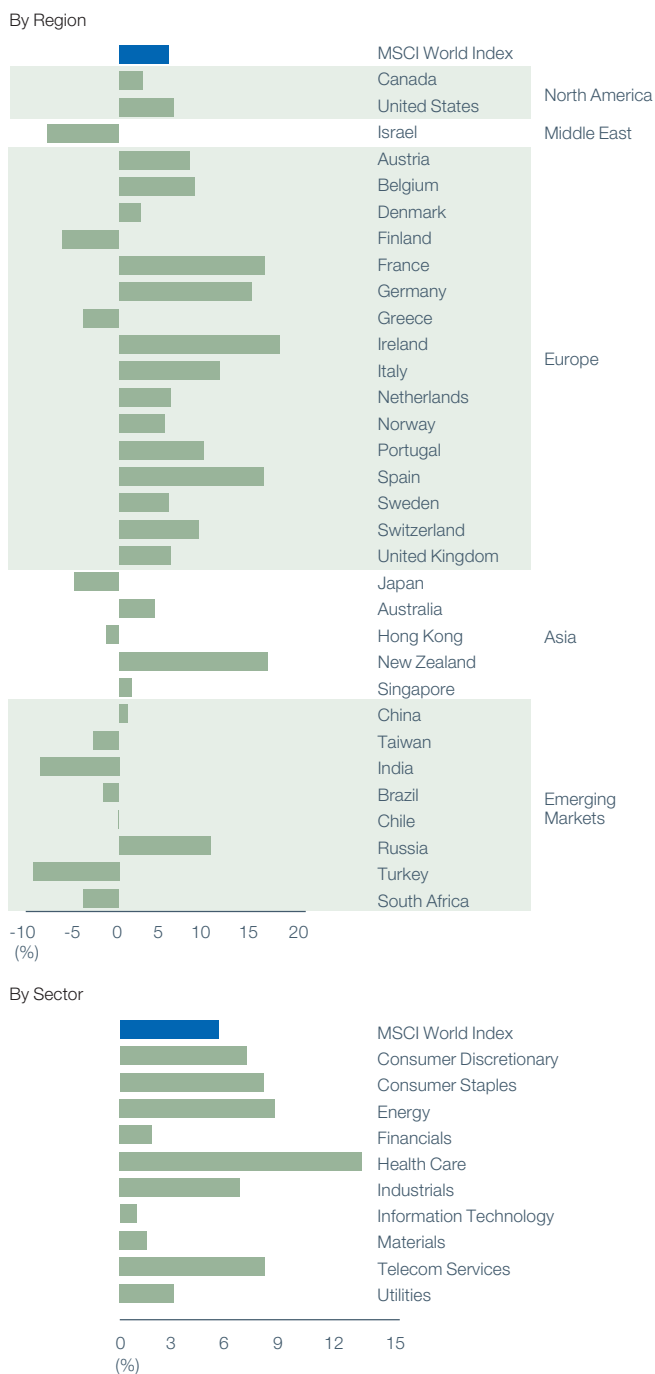
As of 31 March 2011  
Source: Exane BNP Paribas

We examine the reason why profits have grown in Exhibit 5, which shows U.S. employment relative to GDP, both measured from their peaks in the first quarter of 2008. We have returned to peak GDP levels, but employment is still 6% below its peak. That gap represents productivity gains and, thus, higher profits.

While some have argued that without an improvement in employment, economic growth is unsustainable, we do not fully adhere to that viewpoint. Rather, we believe that from profits, taxes and dividends are paid, stock is repurchased, and reinvestment occurs

### Exhibit 6 MSCI Country and Sector Returns

Year-to-date Returns in U.S. Dollars



As of 30 June 2011. Source: MSCI  
Past performance is not a reliable indicator of future results.

in business, which would include hiring. Therefore, we believe we should see improvement on the employment front over time. GDP growth is likely to remain subpar, as the effect of deleveraging is real and will have an impact. But it is from profits that we believe that both economic growth and, ultimately, employment improvement will be derived.

Exhibit 6 provides a review of country and sector returns, which have been positive year to date based on the MSCI World Index. What is important to note is that we have seen a change in leadership from emerging markets to developed markets, and within developed markets, we have had a greater dispersion among countries. As one would expect within Europe, Germany has been a leader and Greece a laggard, but the outperformance of Ireland has been a surprise. It is this rotation between regions that is critical and indicative of an environment of rapid change and constantly evolving sentiment. In addition, equity investments in China continue to disappoint, but Japan appears to be showing signs of economic growth following the catastrophic earthquake and tsunami in March. In spite of posting negative returns for 2011, Japan is up over 20% from its post-earthquake lows.

From a sector standpoint, there has also been a change in leadership, where the sector beneficiaries of emerging markets growth are no longer the clear winners. Instead, the health care sector, which many discounted due to the potential for greater government intervention, has provided market leadership in 2011. However, financials remain depressed based on the impact of deleveraging, which continues to plague the sector.

The volatile environment may continue, but the typical patterns of returns between risk-on and risk-off assets appear to be changing. Dispersion within asset classes can create opportunities that are likely to be very different from the last cycle. In Exhibit 7, we highlight

### Exhibit 7 Finding Opportunities (Greed)

Opportunities	Rationale	Returns
Japan	Mitigation of supply chain disruptions plus reconstruction demand could lead to above-trend growth for several quarters	<b>MSCI Japan Return since Earthquake Struck: 23.1%</b>
Gold Miners	The recent outperformance of the gold commodity versus the equities of gold mining companies creates potential opportunity	<b>Market Vectors Gold Miners ETF YTD Return: -9.2%</b>
U.S. High Yield	The absolute current yield and total return prospects remain attractive in a low interest rate environment	<b>BofA Merrill Lynch High Yield Master II Index YTD Return: 4.9%</b>

As of 30 June 2011. Source: Bloomberg

The information should not be considered a recommendation or solicitation to purchase or sell any securities. Past performance is not a reliable indicator of future results.

### Exhibit 8 Seeking Useful Diversification (Fear)

	Diversification Alternatives	Rationale	Year-to-date Return
Yield	Consumer Staples stocks	Consumer staple dividends provide a strong income stream	<b>MSCI Consumer Staples sector: 7.7%</b>
Capital Preservation	Gold	Gold is a true diversifier to fiat currencies	<b>Gold Commodity: 5.6%</b>
Equity Correlation	Corporate Bonds	Corporate bonds offer a private sector alternative in the fixed income space	<b>Barclays Capital Corporate Index: 3.2%</b>

As of 30 June 2011. Source: Bloomberg

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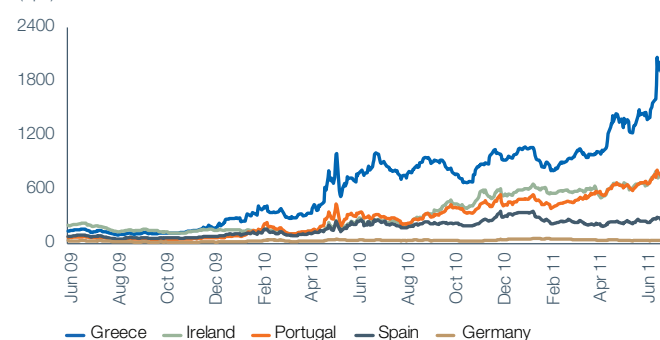
some alternatives to the traditional risk-on investment of emerging markets equities, which have returned just 0.8% year to date.

In risk-off environments, many investors turn to government securities for yield, capital preservation, and correlation benefits. Exhibit 8 provides three alternatives that could help to achieve these objectives away from government securities, which have returned just 2.2% year to date.

A specific example of the risk-on/risk-off dynamic we have analyzed is the credit default swaps on several European nations' government bonds. This is a part of the marketplace where we have had a tremendous amount of volatility and dispersion, as illustrated by the spreads shown in Exhibit 9. We have had an opinion for some time that this problem would be one which is not easily resolved, and one that is likely to be a source of systemic risk due to the banks' holdings of the distressed sovereign credits. The

### Exhibit 9 European Country Comparison

5-Year Sovereign Bond Spreads, 1 June 2009 to 30 June 2011 (bps)



As of 30 June 2011. Source: Bloomberg

Past performance is not a reliable indicator of future results.

lack of fiscal or political union, or more importantly, mechanisms for which to resolve disputes within the monetary union, have concerned us for a long time as it applied to European investments.

Correspondingly, from a fundamental basis we feel that investors cannot incrementally manage risk in this area by marginally underweighting Europe, but need to take a very active viewpoint as it applies to the countries and sectors where the risks may lie. As such, we have advocated avoiding the peripheral European nations and European financials and engaging in the areas of Europe that are currently stronger, such as Germany. Again from a fundamental basis we believe that this positioning makes sense and also results in an effective hedge against a source of systematic market risk.

In summary, while we are concerned about the news flow, particularly as it applies to government debt problems, we are not entirely bearish on the economy, as corporate profits continue to validate our viewpoint that equity-oriented risk takers will be fairly compensated for risks. We are convinced, however, that the environment will continue to be volatile and return patterns will be dispersed within an investor's opportunity set. Therefore, we believe investors need to take an active stance on both the risks taken in portfolios as well as risks to be avoided.

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