

GLOBAL EQUITY COMMENTARY

FOURTH QUARTER 2011

Global Markets

Global equities reflected significant volatility and unpredictability during the fourth quarter as markets moved up and down and generally finished positive for the final quarter of 2011. As the year drew to a close, most investors had concluded that the continuing woes of the Eurozone were unlikely to be fixed quickly. Policy and macroeconomic moves weighed heavily on equity markets and continued to be the key driver for performance with underlying stock fundamentals taking a back seat. Economic indicators in the U.S. seemed to reflect continued growth albeit at low levels. Overall, global economic markets have been reliant on consistent efforts from central banks to add liquidity into the financial system to prop up asset prices in an environment where deleveraging is required to deal with a long period of accumulated debt from both consumers and businesses. During the quarter, equity markets in the U.S. performed well but specific areas of Europe, Asia and the emerging markets struggled to deliver positive returns.

The MSCI World Index rose 7.79% in local terms and 7.59% in USD terms. Index markets generally were mixed in Europe with major indices reporting in local terms: Austria -1.93%; Spain 1.05%; Italy 4.11%; and the United Kingdom 9.36%. In Asia, major country indices provided mixed performance as reflected by Japan -4.04%, Singapore -1.51%, and Hong Kong 6.04%, respectively. On a relative basis, the U.S. market outperformed global markets as the S&P 500 index returned 11.82% versus 7.59% for the MSCI World Index in USD terms. Additionally, performance in emerging markets was positive as reflected by the MSCI Emerging Markets Index reporting 4.84% in local terms.

Outlook and Positioning

During the fourth quarter the world's stock markets jumped twice in response to a new flood of freshly printed money, first by the US Federal reserve in early October and then by the European Central Bank (ECB) in late November. Banks in Europe appeared to be facing a serious shortage of short term liquidity as the tragic and sometimes comical dithering of European leaders shut down access to private investment flows. The unworkable network of poorly capitalized, opaque, complicated and highly levered "special" investment vehicles that were positioned as the solution for Europe gave way to the old favorites of swaps, repos and lowered collateral standards. The ECB's three year LTRO (long-term refinancing operation) proved to be hugely popular with the parched banks as they took down \$650 billion in funding that the central bank "hopes" to be recycled into Eurozone sovereign debt. This continued the pattern of the markets in 2011 — where the disappointment of cheap talk was followed by the excitement of cheap money — resulting in manic price movements that commentators termed "risk on/risk off." The outcome was historic levels of asset price correlations combined with the lowest level of serial correlations ever observed; stocks tended to go up and down together but never in the same direction for very long. This was a difficult environment for bottom up, fundamental value investors such as us that depend on asset price dispersion and sustained mean reversion. Portfolio positioning relative to the market's "volatility" was the key to relative performance and the markets tended to reward being short volatility last year. During the quarter, factors such as low beta, high yield and high quality provided the best results while value, high earnings volatility, high beta, low yield and small size showed poorly.

Through all of this noise, there were some underlying fundamental trends related to margins, profit growth and the steady rebalancing of the global economy. Three pillars of the "super-cycle" theme in evidence since the late 1990's underperformed last year: financials, commodity cyclicals and emerging market stocks. To our investment team, this reflects a transition away from those earnings driven largely by increasing leverage, monetizing higher prices and trading of inflated assets. In contrast, our view is that the ability of companies to grow in the future will rely on the efficiency and effectiveness by which both companies and countries employ scarce capital and savings. Additionally, consumption will be funded by rising incomes and actual wealth. Some investment observers would call this the "Old Normal."

Throughout 2011, this phenomenon manifested itself fundamentally in the steady decline in earnings growth expectations. Notably at the beginning of 2011, bottom up forecasts called for the best margins in human history and profit increases of 15% globally. However, by the fourth quarter, the level of analyst

estimate reductions and lowered company guidance had reached levels last seen in late 2008 and early 2009. Moreover, the number of companies in the S&P 500 guiding earnings downward reached the highest level since the 2001 recession. In Europe, the revisions were rapid and significant with expected growth halving in just the month of October. To contrarian value investors, this represented a significantly positive step in the de-risking of the markets and in particular the traditional deeper value sectors of financials and cyclicals. The combination of low valuations and expectations are most common in the regions of greatest uncertainty including Europe, China and the United Kingdom. Profits in the U.S. were maintained relatively well last year given the write back of losses in the banking sector and a strong showing by leading American consumer brands and exporters. Defensive U.S. names also did well, with telecommunications services, utility, foods/beverages and healthcare staging a powerful fourth quarter rally. While the solid performance of the U.S. is likely to continue in the near term, many of these stocks are no longer attractive from a fundamental standpoint.

The investment environment, dominated by macroeconomic and policy risks, has been steadily evolving over the past few years and has materially altered the behavior of market participants. In the U.S., virtually all of the money placed with long only mutual funds since 1996 has been poured into equity ETF's. The most popular question in a recent survey of institutional investors was "How do macroeconomic factors impact your investment process?" Every day our investment team is barraged by another investment strategy provider with a macro driven stock selection model that, in perfect hindsight, navigated the credit collapse of 2008 and subsequent rally. Ironically, the contention that "stock picking is dead" can be proven with the same statistical certainty that led to the conclusion "home prices have never fallen on a nationwide basis in the US." So the consensus has evolved from trading houses to trading "volatility" using complicated ETF factor baskets based upon macro-driven signals. Some of the most esteemed global investors have weighed in with predictions of a "bi-modal" world of tail risks bracketed by deflationary depression and a money printing, hyperinflationary boom. In a world where investors are positioned to swing between extreme outcomes — might not the most likely effect be to cancel each other out? Using an acoustic analogy, where the "noise" of exactly the opposite frequency leaves just pure "signal" — could be an apt description of the coming year. This is not to say that stock prices won't be volatile, but that the movement will be driven more by company-specific and possibly country-specific factors. Already, our investment team is seeing a greater dispersion in the cost of capital and growth in domestic demand around the world, particularly in Europe and emerging markets. Notably, a lower nominal global GDP growth environment also produces a smaller number of companies capable of growing faster than the overall market as firms compete to gain market share.

Ultimately, the correction of the mispricing of money, risk and assets that built up over the past 20 years may be painful in the short term, but is also a powerful long term positive. Our investment professionals are heartened by the recent failed attempts to suspend corrective market forces, given that this is the only way to discourage imprudent behavior. Economies, markets and societies have become increasingly disconnected with the consequences being felt socially and politically around the world. Unworkable and unsustainable systems are collapsing or facing significant reform. The key improvement from an investment standpoint is essentially better allocation of capital away from the "fantasy" financial economy and inefficient public sector to deleveraging, savings, investment and other private uses. As this process unfolds, markets begin to function again as distributors of capital and as a mechanism for transparent risk and price discovery. Clearly, we are a long way from restoring the foundation of trust in the global economy, but it is likely that the turmoil of the past few years has been a positive influence in steering away from the path of ruin.

Currently, our view is that the market has discounted the consensus macro expectations of a mild recession in Europe, sluggish but decent growth in the U.S., and a soft landing in China's slowdown. Therefore, from a contrarian standpoint the risks are to the upside in Europe, the downside in the US and about mixed in China. Our process informs us about the potential changes in market leadership and long term drivers of growth. In short, we see a shift in the opportunities surrounding abundance and efficiency versus scarcity. While investors are currently focused on the downside of global rebalancing between consumers and producers, historically this has led to material improvements in total productivity and wealth. China's local



consumer goods companies are early in their development stage and the world's producers of everything from health care, movies, aircraft, apparel, electronics, media, and advertising still stand to benefit from rising incomes in the emerging world. Also, given the record capital spending in the commodity sectors, up nine-fold since 2003, global consumers may also benefit from a fall in the cost of goods, further adding fuel to plays on abundance. In short, the past decade or so has disproportionately rewarded the owners of the things that make life necessary — while the next cycle might shift to the things that make life wonderful!

Given where we are in the global economic cycle, we believe that early cycle investments will do better going forward, such as specific financials, global cyclicals and consumer stocks. Recent economic news has been coming in better than expected, but the monthly data remains highly volatile and statistically suspect due to large seasonal adjustments. The positive surprises have led to a measure of economic sentiment at levels that are consistent with some moderation or reversal. One sector where the tone of business has improved from very low levels is housing and construction in the U.S. Counterproductive meddling by politicians and central bankers is always possible, but the recent signs of recovery are driven by a gradual moderation of distressed inventory and a rise in apartment demand. We are also evaluating individual companies with resilient cash flows – such as health care, consumer staples, software, commercial services and household product companies. Currently, we believe it is too soon to invest in the late cycle companies that led the market for much of 2011. Looking ahead, our investment team's focus is on building a diversified portfolio of high quality, global industry leaders trading at attractive valuations based upon conservative levels of profits. Our view is that demonstrated 'safety' stocks are no longer cheap while the valuations of more distressed stocks in Europe, UK and China have become more attractive. In emerging markets, generally our view is that valuations have more room to decline relative to the developed world. Despite the wall of worry in equity markets, we continue to seek companies that exhibit low valuations, depressed profitability, and low expectations and believe that there are promising opportunities for individual stocks to deliver solid performance going forward.

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