

GLOBAL EQUITY COMMENTARY

SECOND QUARTER 2011

Global Markets

Global equities struggled during the quarter bogged down by lackluster economic signs — yet finished with a rousing rally as stocks gained in the final weeks of June. Concern about economic growth in the U.S. and other key areas of the world, default worries in Greece, and inflation in the developing world loomed. The sharp outperformance at the quarter's close reflected positive though unimpressive signs that the global economy was growing. A wall of worry concerning Greece and its fiscal affairs and how the European Union and International Monetary Fund have dealt with the crisis in Europe plagued investors. Despite a decision for a temporary fix, uncertainty reined in Europe and many citizens took to the streets to express their dissatisfaction for the decisions of their governmental representatives. The issue of debt — by individuals, institutions, or nations — weighed on capital markets. While economic growth continued its topsy-turvy status, corporate profits expectations for the second quarter were anticipated to be robust and stronger than the economy in general. Many corporations benefited by cost cutting during the recession, resulting in improved productivity and profitability coupled with strong demand from emerging markets. Notably, profit growth is expected to slow in the second half of 2011. In the U.S., the overhang of a U.S. government debt downgrade, the end of the second round of quantitative easing and the uncertainty of whether the federal borrowing limit would be raised remained key issues.

The MSCI World index fell -0.63% in local terms and rose 0.47% in USD terms. Index markets generally were mixed in Europe with major indices reporting in local terms: Austria -0.72%; Spain -0.50%; Italy -4.66%; and the United Kingdom 1.57%. In Asia, major country indices generally declined in performance as reflected by Japan -2.39%, Singapore -0.57%, and Hong Kong -0.92%, respectively. On a relative basis, the U.S. market underperformed global markets as the S&P 500 index returned 0.10% versus 0.47% for the MSCI World Index in USD terms. Additionally, performance in emerging markets declined as reflected by the MSCI Emerging Markets Index reporting -2.68% in local terms.

Outlook and Positioning

The second quarter was a volatile period that delivered stock price declines with the exception of a powerful rally in the second half of June. The rally was driven mostly by the sound of the revolver hammer hitting an empty chamber in Europe's game of Russian Roulette. Earlier in the quarter, markets had plunged on the growing realization that Greece was running out of money again, followed closely by Portugal and Ireland. The 'pretend and extend' game continued with the pretense being debt restructuring — versus default — and the extension being long enough for U.S. firms' CDS instruments to expire and Europe's banks garnering additional time to raise capital. This time the traditional providers of extend 'pixie dust,' — the rating agencies — are proving less willing to enable financial fantasy and are perceiving the plans for debt restructuring for what they are — default. In Europe, the IMF and the ECB hope to pull off a voluntary 're-orientation' of bank debt — but to do so, require a complex web of private, multinational interests. These plans will prove tough to broker. In the end, the bailout of the 'PIGS' countries is really a bailout of the banks in Europe at the expense of the citizens in Europe. Too much debt and not enough capital will not allow decision makers to just let them default and go away. We anticipate continued vulnerability in the Eurozone for the foreseeable future.

Market weakness during the quarter was also driven by concerns about the pace of growth in the global economy. Many businesses in the U.S., U.K., and China experienced unusually sharp slowdowns. Even the previously booming manufacturing sector lost momentum — partially due to the Japanese earthquake. Our view is that the rise in basic costs and commodities hit consumers hard and also began to show up in strained corporate margins and volumes, finite project budgets, and signs of demand destruction. China, along with 27 other nations took steps to tighten liquidity to battle rising commodity, labor and asset prices. These actions have led to a debate about what type of landing the emerging economies will experience.

Currently, many of the world's businesses are expected to have some of the best margins in history predicated on raising prices, cutting costs and gaining market share in emerging markets. The second

quarter hinted at some loss in confidence of earnings growth with the impact of quantitative easing employed by central banks coming to an end. Our view is that we are at an important turning point in independent central banking given that the largest buyer of sovereign debt is the central banks, which is unsustainable and destabilizing. Going forward, higher interest rates and positive real interest rates will be required for effective capital allocation. In short, we believe that the global financial system remains vulnerable since very little deleveraging has been accomplished. We believe that the market is also particularly vulnerable to a sudden rise in the U.S. dollar. While not in the 'double dip' recession camp, we do not see the foundation for strong, sustainable growth. The theme of debt fueled consumption and trading inflated assets hasn't worked to date.

Our current view is that the moderation of commodity prices promises some relief for the consumer, but likely not until 2012. The focus on fiscal sustainability in many regions is a good thing, but will create transitional pressure on countries and politicians, with implications not easily estimated. Notably, not every country will be able to run the current account/trade surpluses needed to offset fiscal austerity and private sector deleveraging. The U.K., with its ability to maintain a weaker currency, might be one country capable of accomplishing this feat. In short, the battle continues between those seeking to fix the system and those seeking to game the system – and ultimately, risk will be priced appropriately — including the price of money. Accordingly, this will improve long term capital allocation versus rewarding bad decisions and bad behavior.

The second quarter resulted in good performance for healthcare, growth stocks and stable consumer stocks with commodity, cyclical and emerging markets stocks generally underperforming. These trends could persist during the second half of 2011 as earnings growth slows. Notably, low price-to-earnings on peak profits tends to be a classic value trap. Our view is that the market is not cheap on price-to-sales or price-to-book valuation metrics. Banks and financial companies generally have fell to new relative lows as their main asset, real estate loans, continued to suffer. We are evaluating this sector closely with a focus on potential profitability and value. We are focused on identifying financial firms with strong structural growth and temporarily depressed profitability, which excludes many of the last cycles' leaders. Technology firms are in transition, from PC and mobile phones to tablets and smart phones – leaving some past leaders behind. Notably, video and content portability is driving strong demand for bandwidth. We are attracted to companies characterized by high quality, larger capitalization, low earnings volatility and embedded growth prospects – all factors that will position firms for outperformance from our perspective. We are using the correction in more cyclical areas to upgrade quality or fundamentals, but are not increasing our weightings just yet. Although we feel it is early to make big commitments, we are beginning to identify companies within the PIGS countries and emerging markets that are well positioned. We like what we see in Japan and the United Kingdom regarding the potential for macroeconomic surprises and opportunities given the economic pain both countries are facing this year. Significantly, the global markets continue to offer opportunities for our investment team to invest in stocks with low expectations, low valuations, and solid earnings prospects – that provide the potential for outperformance over time.

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