

INTERNATIONAL EQUITY COMMENTARY

FOURTH QUARTER 2010

International Markets

International equities reflected significant outperformance in the fourth quarter of 2010 elevated by great expectations for economic recovery. Optimism notwithstanding, investors continued to mull over Europe's sovereign debt woes, unemployment concerns in the U.S. and inflation in China and other emerging markets. Despite these concerns, global stock markets dodged myriad worries to rack up solid returns across varied asset classes and geographies. Markets benefited from central bank intervention and stimulative strategies across the globe with support expected to continue in the major developed countries of Europe, Japan and the U.S. Stock returns were bolstered by the impact of consistent stimulus and response from policy makers that drove prices higher across a wide range of asset classes. In the U.S. and Europe, central banks supported government bond markets, ultimately bolstering stocks and corporate bonds. In the U.S., the latest move came in the form of extended tax breaks and new tax measures that provided fiscal stimulus to the markets. In Europe, despite flare ups of sovereign debt issues, many developed countries did well although the PIIGS countries – Portugal, Italy, Ireland, Greece and Spain – did poorly for the year. Notably, these downtrodden countries in Europe face long term austerity measures and recovery will take considerable time. In many emerging markets, commodities continued to soar and accompanied strong business growth that elevated inflation pressures in many key countries. An issue that is feeding returns in the emerging markets is the global equity arbitrage – in short, that the majority of the global growth in the future will come from developing countries, not developed countries – a gap that is widening over time. No doubt as investors contemplate the New Year, the prospects for economic growth in both developed and developing economies will be key factors in determining performance for stocks in 2011.

The MSCI EAFE index was up 5.62% in local terms and 6.61% in USD terms. Index markets were generally mixed in Europe with major indices reporting in local terms: Austria 13.69%; Spain -7.12%; Italy -0.67%; and the United Kingdom 6.73%. In Asia, major country indices reported generally positive performance as reflected by Japan 8.85%, Singapore 3.99%, and Hong Kong 4.94%, respectively. On a relative basis, the U.S. market outperformed international markets as the S&P 500 index returned 10.76% versus 6.61% for the MSCI EAFE Index in USD terms. Additionally, performance in emerging markets was solid with the MSCI Emerging Markets Index reporting 5.74% in local terms. From an international perspective, all sectors reflected significant positive performance over the month as measured by the MSCI indexes.

Outlook and Positioning

Stock returns advanced significantly over the quarter with our investment strategies benefiting by the move upward in prices. Despite positive performance, given relatively high valuations and expectations for earnings, we would anticipate modest returns in the equity markets in early 2011. The markets appear to be linked to continued macro stimulus that serves to meet expectations and our view is that unaddressed imbalances remain and additional deleveraging is required. The environment of more debt, more unfunded consumption, and cheap money continues to under price risk and encourage investors to speculate versus invest in productive ventures. Our view is that the under pricing of risk distorts the market and prevents the full development of a solid foundation for the global economy. In short, progress has been made in acknowledging the sovereign debt problem as well as many of the remaining issues left from the financial crisis, but by shifting debt from the private sector to the public sector, the underlying problem remains: too much leverage and not enough capital. The recent bailout associated with Ireland comes to mind as an example of this phenomenon. Earnings continue to be strong for many companies with a key factor being the control of costs, which is not sustainable from our perspective, as signs that the corporate sector has exhausted the exploitation of operating leverage vs. labor cost become evident. We remain concerned about 2011 and 2012 earnings estimates, which appear to us to be very aggressive based on our bottom up assessments and the dubious sustainability of higher earnings assumptions.

The specter of inflation in developing countries is evident as central banks monetize debt and ramp up liquidity, which departs country borders for speculative endeavors in the emerging markets. Of late, the risk trade has been on which has benefited pricing for basic commodities, junk bonds, and high risk strategies. We remain concerned about excess capacity in many industries as well as operating rates that are relatively low. Our view is that despite current media hype—the underlying global economy is still fragile and lacks the dynamism that would signal sustained growth in 2011. We see increasingly high food prices globally as a risk, especially in the emerging market countries, with low income consumers facing the headwinds of increased costs for necessities and higher interest rates. The income disparities across the world remain stark and this is reflected in China, Brazil, and India. Moreover, investors seem to be relying on growth that will come from the Chinese consumer, however the Chinese stock market dropped precipitously in 2010 – not a positive signal. On the positive side, industrial sectors in the U.S., Germany and Japan were booming during the year and many Asian countries were taking steps to modernize and automate production and processes. Japanese equities reflected a significant bounce in both the month of December and the fourth quarter, which represented a favorable response in light of solid consumer spending and rising inflation expectations around the world in a country that has been priced for deflation. In the Euro zone, sovereign issues continue to play out, with a temporary fix in Ireland; however, much foreboding remains as to outcomes in Greece, Portugal, Spain, France, and Italy. Overall, in Europe, the political and social implications of a restructuring of the welfare state are underappreciated and difficult to anticipate. More disruption and unrest could result from the current state of affairs. Our perspective on emerging market opportunities, which we believe is a very powerful long term story, is to be creative, careful, and patient in the short to medium term with a focus on valuation and the quality of the individual franchise.

Our philosophy is centered on the belief that the best returns come during periods when stocks are undervalued and expectations are low. Current adjusted price-to-earnings ratios imply modest long-term returns going forward and in combination with record high earnings expectations, represent some downside risk. Accordingly, in times of volatility, both on the upside and the downside, prudent active management can be very beneficial in navigating global equity markets. Our analysts are focused on the fundamentals – margins, valuations, and earnings – leveraging our contrarian investment discipline with a bias toward high quality, defensive companies at this point in the market cycle.

From a macroeconomic perspective, we anticipate modest, slow economic growth with substantial variation around current expectations across various markets. We believe that the ‘risk on / risk off’ marketplace is characteristic and consistent with a range bound market and that we can anticipate a continuation of these market conditions for the foreseeable future. Resilience continues to be a main theme characterizing our current portfolio. We believe we have extracted significant returns from cyclical stocks and stocks with mispriced growth characteristics during the past quarter. Currently, we are inclined to expand our investment in large capitalization, high quality, non-cyclical companies that meet our investment criteria. We believe that as the market environment ignores fundamentals myriad opportunities are created for investors willing to invest in firms with the best valuations and earnings prospects – and we seek to capture these opportunities for the benefit of our clients.

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