Capital Markets Quarterly

KEY INDICATORS:

ECONOMY:

Stat	Qtr	TTM*
GDP	4.1%	-0.2%
Real GDP	3.2%	-1.0%
CPI	0.8%	2.3%
Core CPI	0.5%	1.1%

FIXED INCOME:

Index	Qtr	1-Year
BC Agg	1.8%	7.7%
BC Treasury	1.1%	-1.2%
BC Credit	2.3%	20.8%
BC MBS	1.5%	5.2%

EQUITIES:

Index	Qtr	1-Year
S&P 500	5.4%	49.8%
EAFE	0.9%	54.4%
Em. Markets	2.4%	81.6%
AC World	3.2%	56.3%

ALTERNATIVES:

Index	Qtr	1-Year
HFRI FOF	1.5%	12.8%
NAREIT	10.0%	106.7%
NCREIF	0.8%	-9.6%

**Trailing twelve months*

Source: BEA; BLS; Barclays Capital; S&P; MSCI; FTSE; NAREIT; NCREIF; HFRI

Economy

Gross Domestic Product

The U.S. economy expanded for the third straight quarter, as real GDP grew 3.2% on an annualized basis. This puts the cumulative decline in real GDP since the start of the recession at -1.4%. Only the Great Depression and the recession of 1945 stayed negative longer. For the quarter, inventories accounted for approximately half of the growth, increasing 1.6%. This is a decrease from last quarter's 3.8% contribution and is evidence the inventory cycle is beginning to phase out. The consumer was the largest component, contributing 2.6%. Despite the recent increase, the outlook continues to be for low growth in spending until labor markets rebound. Business investment was another area of positive note, growing at more than 4.0% on an annualized basis. The majority of the investment was in equipment and technology (specifically software) and shows that businesses are becoming more optimistic about future prospects. Government spending detracted from GDP by 0.4%, as state and local spending declined at a faster rate than federal spending grew. Net exports (-0.6%) were also a detractor, as stronger import demand outweighed stronger exports. Personal disposable income increased by 1.5% and personal outlays increased by 5.0% for the first quarter. As a result, the personal savings rate fell from 3.9% in the fourth quarter to 3.1%.

Employment

With the economy in recovery, the missing piece to the puzzle remains job growth. There are two keys that lead to sustainable employment expansion: (1) strong corporate profits and (2) positive business sentiment. While profits have experienced two straight quarters of robust growth, business sentiment remains pessimistic (NFIB Small Business Optimism Index's last reading in March). Most of the pessimism surrounded the lack of credit and policy uncertainty. Since the last survey, lending standards have finally begun to loosen (% of banks tightening lending standards turned negative in the first quarter) and some of the policy uncertainty has been removed with the passage of the healthcare bill, which could turn business sentiment more positive in the coming months.

For the month of March, Nonfarm payrolls increased by 162,000, which was below consensus estimates of 190,000. Taking a closer look at the numbers reveals that payrolls grew by a much smaller rate, as weather related hiring and temporary census hiring contributed approximately 100,000 jobs. This puts the job growth well below the amount needed to decrease unemployment. Currently the unemployment rate has held steady at 9.7%, but in all likelihood this rate will cross back over the 10.0% mark before year end. This will most likely occur because, as the labor market improves, previously discouraged workers that removed themselves from the

labor force will begin to seek work, adding to the labor force and pushing up unemployment even in the face of positive job growth.

Leverage

According to the Fed, the level of debt in the U.S. peaked at $52.9 trillion in the first quarter of 2009. Since then, the economy as a whole has shed $466 billion in debt. Financial institutions and households have been the major drivers in the de-leveraging process, decreasing leverage by $1.4 trillion and $310 billion, respectively. While decreasing the debt load on the private sector is healthy, federal and state governments have added $1.6 trillion during 2009.

Fiscal Policy

Supporting the economy through the credit crisis and ensuing recession has been costly to the U.S. government, and the administration has forecasted that deficit spending will continue for the foreseeable future. The cumulative deficit over the next five years is budgeted to be $4.5 trillion, which will put government debt-to-GDP at 77.4% by 2015. The status quo is simply too costly for the economy, and there will need to be major reforms relating to the deficit, or the government will have to contend with increasing interest rates. Increasing rates have already occurred in European states that have been fiscally irresponsible, and the market reaction could be a pre-cursor to the situation in the U.S.

Monetary Policy

The Federal Open Market Committee (FOMC) continues to hold Federal Funds at a zero bound rate (0 to 25 basis points) and continues to reiterate that rates will remain low for an "extended period." In the eyes of the Federal Reserve, the liquidity injected into the economy through various tools (i.e. Fed Funds Rate, Discount Rate, reserve requirements, quantitative easing, etc.) will be maintained as long as there is no significant risk to rapidly increasing inflation. The verbiage of the FOMC statements points to unemployment as the indicator to maintain stimulus.

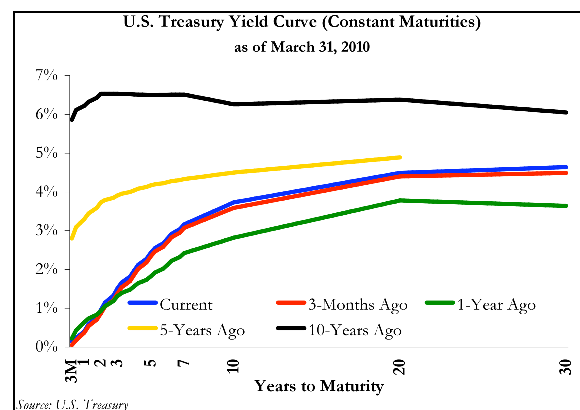
Even though the National Bureau of Economic Research (NBER) has not "officially" stated that the recession has ended, it appears that the economy has turned the corner into a recovery mode. In order to propel into a sustainable growth period, there are several issues that need to be addressed (i.e. unemployment, fiscal responsibility, etc.); however, the Federal Reserve will most likely continue to be accommodative.

Fixed Income

US Treasury Market

In order to stabilize financial markets and the U.S. economy, the Federal Reserve continues to maintain a zero interest policy. This combined with higher inflation expectations in longer dated maturities has resulted in a steep yield curve, see **Figure 1.1**. The current slope of the yield curve (as measured from the two to ten year) is 277 basis points, which is approximately 197 basis points steeper than its historical slope of 80. During the quarter, current yields (**blue line** in **Figure 1.1**) remained close to the year end levels (**red line**), with slight increases in longer maturities. Yields have risen significantly from one year ago (**green line**), but remain well below rates five (**gold line**) and ten years ago (**black line**). As a result, the Barclay's Capital Treasury Index decreased 1.2% over the past year. Over longer periods, the index has benefited from a declining yield trend, returning 5.2% and 5.9% over the five and ten year periods respectively.

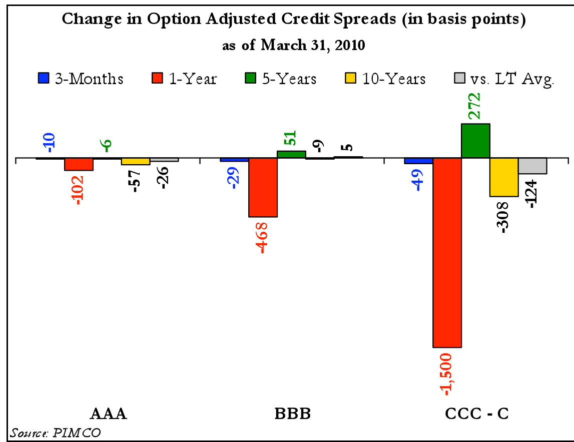
Figure 1.1



Credit Markets

Low yields on U.S. Treasuries and a stabilizing economy have encouraged investors to reach for yield in riskier bonds. This can be seen in the contraction of credit spreads versus U.S. Treasuries (see **Figure 1.2**). High yield bonds have been the main beneficiary as these bonds were the best performing sector over the past year (+56.2%) and five year (+7.8%) time periods. Investment grade credit bonds also performed well, as the Barclay's Capital Credit Index returned +20.8% for the past year. Over longer time periods, credit marginally outperformed U.S. Treasuries, returning +5.4% and +6.7% over the five and ten year time frames.

Figure 1.2



Securitized Markets

Securitized markets (i.e. ABS, MBS, CMBS, etc.) have benefited from government programs that have injected liquidity into struggling markets. Programs such as TALF, PPIP, etc. were specifically targeted to re-start these markets, as they were completely shut down during the financial crisis. The effects in these programs can be seen in the returns over the past year. The Barclay's Capital ABS index has gained 18.5% in the past year. Positive performance in the mortgage-backed sector has been due to the Fed directly purchasing these securities; however, this program has ended and questions still remain when (or if) the Fed will begin to sell back into the market, which could have downward pricing pressure on these securities.

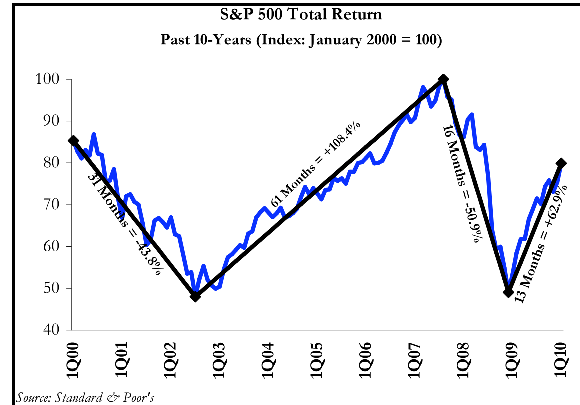
In the broad market, the Barclay's Capital Aggregate Bond Index was up 1.8% for the quarter and 7.7% for the past year. Looking to the future for bonds, it appears that the Federal Reserve is no hurry to withdraw liquidity in the market as the recovery has yet to become a self-sustaining expansion. This would point to little action in the form of interest rate movements on the short-end of the curve this year, thus leaving investors either to accept zero to low returns or stretch for higher yields in riskier markets.

Equities

U.S. Equities

The stock market continued its rapid recovery with a +5.4% return for the first quarter and +49.8% for the past year. While the recovery has been strong (+62.9% for the past 13-months, see **Figure 2.1**), the S&P 500 is still below its peak. On a total return basis, the S&P 500 would need another +25.2% to wipe out the losses incurred from October 2007 through February 2009. This represents an annualized total return of +7.8% for the next three years or +4.6% for the next five years.

Figure 2.1



There have been numerous reasons behind the run in stocks over the past 13-months; however, the two themes that are the most likely catalysts to the +72.9% price return (since 3/9/09) are low interest rates and improving fundamentals. Low interest rates can be a positive for equity returns because they can (1) increase the opportunity cost for investors seeking safety and (2) increase the present value of equities when using a discounting model.

In general, investors cannot afford to earn near zero rates of return for very long and still meet their objectives. Therefore, the longer rates remain low, the more likely investors will begin to reach for yield in riskier assets, thus pushing up prices.

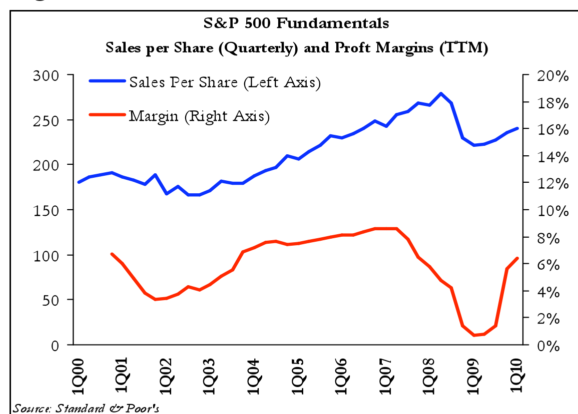
In his quarterly commentary, Bill Priest of Epoch wrote about the power of low interest rates and their effect on discounting the cash flows of a company (which then reflects the intrinsic valuation of a stock). Basically, falling interest rates push up the intrinsic value and the price investors are willing to pay for a stock.

To illustrate, consider a company that pays an annual dividend of $3.00 per share that is expected to grow at two percent per year. Using a simple dividend discount model would have produced substantially different results at the beginning of the recovery compared to March 31, 2010. On October 31, 2009, the discount rate used would have been 7.5%, which is derived from the 10-year U.S. Treasury yield (4.5%) plus an equity risk premium (3.0%). These inputs would have calculated the intrinsic value of this company's stock to be $54.55. On March 31, 2010, the stock's intrinsic value would have increased to $75.00 (or 37.5%) simply

because the yield on the U.S. Treasury fell to 3.0%. While the lowering of interest rates have note been the sole explanation of increasing stock prices, decreasing rates have been a significant tailwind to price advancement.

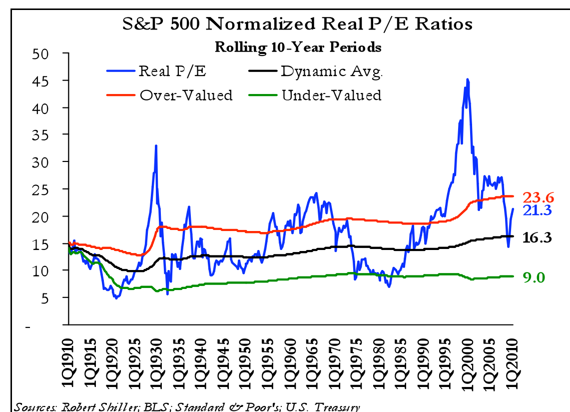
As for improving fundamentals, companies responded to the recession by aggressively cutting costs in order to remain profitable throughout the crisis. While not all companies were able to remain profitable (i.e. financials) the S&P 500 Index as a whole was able to maintain positive margins (see **red line** in **Figure 2.2**). Trailing twelve months earnings per share (as reported) have increased drastically from $6.86 for the first quarter 2009 to an estimated $59.34 for the first quarter 2010. While cost cutting has been the major driver for earnings improvements, some top line growth is beginning to appear (see **blue line** in **Figure 2.2**).

Figure 2.2



Even though the rebound has been a dramatic one, the increasing fundamentals have kept the market from becoming extremely overvalued. **Figure 2.3** shows the market's normalized real price-to-earnings ratio over rolling ten-year periods is approximately 21.3, which is above the long-term average of 16.3. This metric was made popular by Robert Shiller in his book Irrational Exuberance and looks at the valuation (excluding inflation) over ten year periods in order to dampen the cyclicality of earnings.

Figure 2.3



International Equities

Developed international markets (as measured by the MSCI EAFE) lagged U.S. markets in local currency terms, returning +4.3% and +44.7% for the quarter and one year periods, respectively. When taking into account currency movements, these markets outperformed the U.S. due to a declining dollar, returning +54.4% over the past year. Australia was the best performing international developed market over the past year, returning +87.1%; however, all of the excess return (compared to the U.S.) was due to the appreciation of the Australian dollar. In local currency terms, Australia actually trailed U.S. markets, gaining 38.7%. Over the past year, emerging markets have been the best equity market performer, returning +81.1% (+58.4% in local currency). Investors continue to allocate capital to the sector in order to access markets that have higher growth potential than the developed world.

The future for equities remains uncertain, as the economy continues in its transition mode. Sustainable growth is not a forgone conclusion, as economic stimulus will need to be delicately maintained and monitored. If the stimulus is removed too quickly, it could send the economy back into recession. On the other hand, if the stimulus is left in the economy too long it will become a drag on output due to the crowding out effect. This delicate balancing act will most likely lead to increased volatility and many positive and negative surprises, increasing the probability of oscillating equity markets

Alternative Assets

Hedge Funds

Despite a robust equity market over the past year, hedge fund managers have remained pessimistic over the sustainability of the rebound. According to the Bank of America Merrill Lynch Hedge Fund Monitor, long/short equity managers have been steadily decreasing their exposure to the equity markets. Their net equity exposure is currently at 25% to 30% compared to their historical average of 35% to 40%. Even though these managers are at the low end of their exposure, they returned +28.6% over the past year. This is roughly 57% of the return with less than a third of the exposure. Long/short managers are also beginning to shift their portfolios to smaller cap stocks and value oriented companies. This is a marked reversal of their positioning from 2009.

Equity market neutral managers have not performed as well as others, returning +3.1% over the past year. This is due to their net short positioning throughout the past year. This exposure has also reversed to positive net long exposure.

Macro hedge funds continue to struggle relative to equity markets, returning +5.5% on a one-year basis. These funds continue their long commodity (specifically crude oil), short U.S. dollar, and short long-dated U.S. Treasuries exposures.

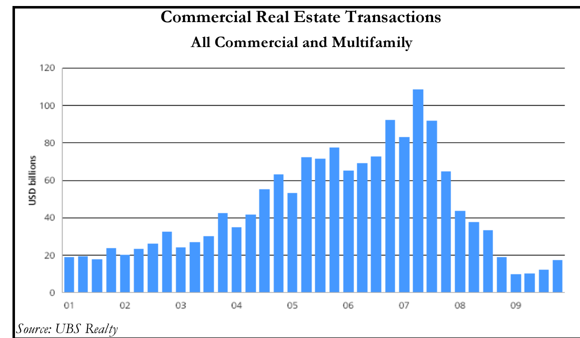
Real Estate

Public real estate (as measured by the FTSE NAREIT Index) markets have responded significantly over the past year, increasing 106.7%. This market was one of the worst hit, with a peak-to-trough drawdown of 68.3%. REIT investors would need another 46.7% total return to wipe out losses incurred during the period from February 2007 through February 2009. Looking to longer time frames, REITs have performed favorably to traditional equities, returning +3.8% and +11.4% over the five and ten year time frames. Investors seeking yield purchased REITs, as the dividend yields on these securities reached 10.8% in February of 2009. Current yields have declined to approximately 3.9% compared to their long-term average of 7.3%.

Private real estate (as measured by the NCREIF Index) experienced its first positive total return (+0.8%) since the second quarter of 2008. This period has been the worst commercial real estate correction since the foundation of the NCREIF Index in 1978. The correction represented a 23.9% loss on a total return basis and a price depreciation of 30.4%. The current positive performance still contained price depreciation (-0.9%), but it was off-set by current income (+1.7%).

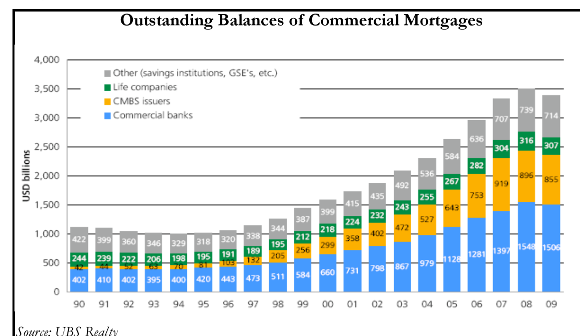
Both public and private real estate markets are influenced by the performance of the underlying properties. The decreasing prices experienced in the real estate market were during a period with very little transactions (see **Figure 3.1**). Slowly, transaction volume is starting to pick-up.

Figure 3.1



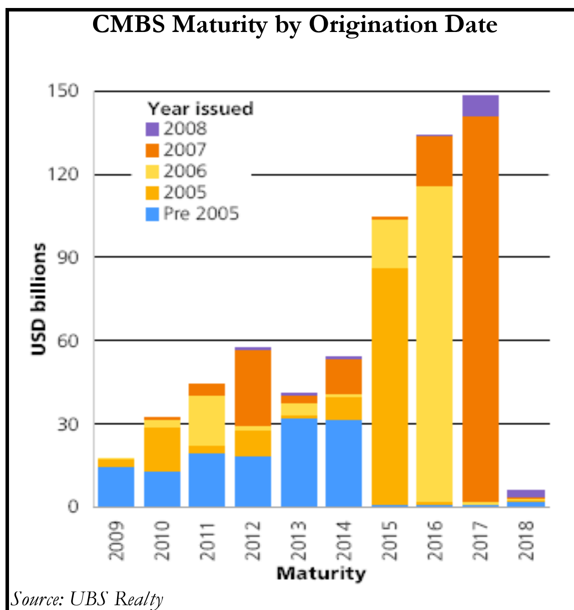
Another area of concern is the financing available to complete transactions and to refinance existing properties. Market participants have been increasingly anxious over upcoming maturities, specifically CMBS markets. Most of the concern is that the properties will not be refinanced due to a drop in prices that have pushed loan-to-value ratios too high, causing foreclosures and downward spiraling prices. While this could pose a problem, CMBS only represent about a quarter of the debt outstanding on commercial real estate (see **Figure 3.2**). The vast majority of balances outstanding are held by commercial banks, which have proactively restructured outstanding mortgages in order to prevent any refinancing issues.

Figure 3.2



When focusing on the CMBS balances, only a fraction of the outstanding issues are scheduled to mature during 2010 (see **Figure 3.3**). Looking further at the maturing CMBS in 2010, roughly half of the maturities are ones that were originated during periods of high prices (issued 2005 through 2007). While these issues need to be addressed, they do not appear to be the Armageddon scenario painted by some in the mainstream media.

Figure 3.3



Source: UBS Realty

Going forward, commercial real estate markets will have to overcome the current low levels of occupancy caused by the recession before growth can be sustained; therefore, it could take this market some time before losses (since the market peak) are completely recouped.

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Em. Markets	-8.4%	23.2%
AC World	-12.0%	12.3%

ALTERNATIVES:

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HFRI FOF	-2.4%	4.9%
NAREIT	-4.1%	53.9%
NCREIF	3.3%	-1.5%

** Trailing Twelve Months*

Introduction

The second quarter began with optimism, as the economy was expanding and risk assets were continuing their upward trajectory. All came to an end when data released during the quarter pointed to the economic recovery losing steam and the details surrounding Greece's fiscal spending came to light. What ensued was a European debt crisis that forced a joint effort by the United Nations and the ECB to contain it and reduce the probability of contagion. While outright default was avoided, there was no shortage of drama as governments in Europe openly discussed their unwillingness to "bail out" their southern neighbors. This led to investors seeking shelter and falling equity prices around the globe. Since then, G20 administrations have been discussing austerity measures and central bankers have been anxiously poised to utilize all monetary tools necessary to avoid another economic contraction. It remains to be seen whether the slow down being witnessed is in fact a routine slowing of growth in the middle of the recovery cycle or if a more disastrous road lies ahead.

U.S. Economy

Gross Domestic Product

The U.S. economy expanded for the fourth straight quarter, as real GDP grew 2.4% on an annualized basis. This puts the cumulative decline in real GDP since the start of the recession at 0.7%. Looking at the components of GDP, fixed investment accounted for over half of the growth, increasing 2.1%. While inventories (+1.1%) have been the main contributor for the past three quarters, business investment (+1.5%) led the way this quarter, as the inventory cycle is beginning to phase out and companies are beginning to invest in capital projects (e.g. capital equipment, technology, etc.). The consumer, the largest component (70% of GDP), contributed 1.2%. Although consumption has been positive since the second quarter 2009, the pace of growth has been lackluster. Low economic activity combined with high unemployment has led to stagnant personal income growth. Couple that with historically high levels of debt, and the U.S. consumer is in no position to rapidly accelerate spending. Government spending added 0.9% to GDP, as all levels of government (i.e. local, state, and federal) were positive for the quarter. Net exports (-2.8%) were the largest detractor, as a stronger U.S. dollar made foreign goods more attractive than domestic goods.

Employment

The unemployment situation is and will be the most persistently observed statistic in the economy until sustainable growth is well underway. A rebound in the

employment numbers could very well be the cog that turns the economy from a moderating recovery to a sustainable expansion. However, a tough road lies ahead for job growth, as the economy shed 8.4 million jobs from peak to trough (see **Figure 1.1**), leading to the highest unemployment rate since 1982 (see **Figure 1.2**). Although roughly 880 thousand jobs have been added, a lot more improvement is needed in order to reach the previous peak employment. The one area of the economy that points to higher future employment is the profitability of corporations. As corporations become more profitable, they generally use the increased margin as a catalyst to expand production and hire more workers. This relationship can be observed by comparing the earnings per share of the S&P 500 to the non-farm payroll numbers (see **Figure 1.3**). While profitability is certainly a tailwind for job growth, there still remains obstacles (i.e. increased taxation, increased regulation, economic uncertainty, legislative uncertainty, etc.) that could prevent it from materializing in the near term.

Figure 1.1

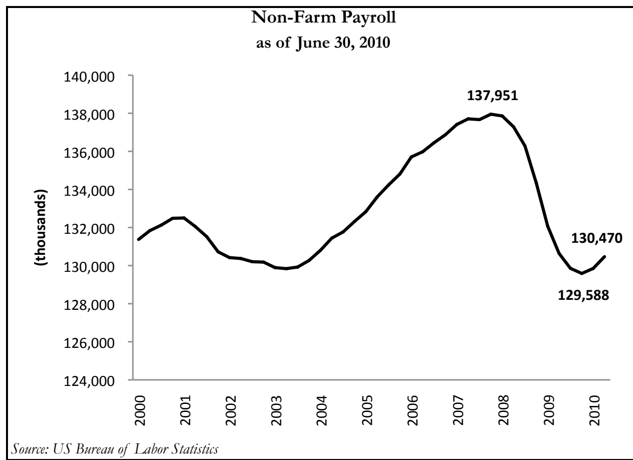
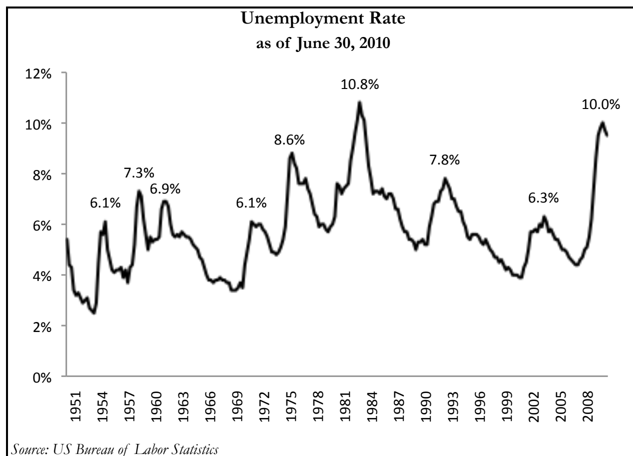


Figure 1.2



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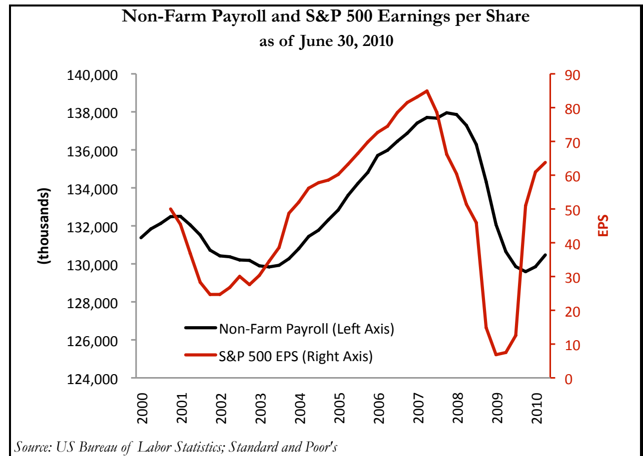


Leverage

De-leveraging in the U.S. continued during the second quarter. The total debt shed by the U.S. (according to the Federal Reserve) has been approximately $775 billion from the peak. While this number seems muted compared to the $52.1 trillion outstanding, the private sector in aggregate has paid off $2.3 trillion or 5.3%. Financial companies (cutting 12.5%) and households (shedding 2.9%) have done the most to improve their balance sheets. However, the absolute levels of debt remain extremely elevated and will need to be brought back down to reasonable levels.

Monetary Policy

The Federal Reserve maintained an accommodative stance during the second quarter. They continue to hold the federal funds rate at a zero bound (0 – 25 basis points) level and have repeatedly vowed to maintain rates at low levels for an "extended period." In the Fed's view, maintaining an accommodative stance is warranted due to a slowing of the economic recovery and weakened underpinnings of the economy. Ben Bernanke has also communicated during his testimonies to Congress that the Federal Reserve will utilize all monetary tools available to prevent deflation and/or another contraction in the economy.

Outlook

The economic recovery has lost some of its momentum as the level of growth has decelerated. Increased business investment is an encouraging sign; however, an increasing labor force could lead to higher unemployment rates and overshadow any gains made in the payroll numbers.

Combine this with the heightened level of political uncertainty and the near term outlook is for low growth. While monetary officials are utilizing all tools available to prevent the possibility of another contraction in the near term, the risks for one are rising.

Fixed Income

U.S. Treasury Market

Fears that the European debt crisis would send the global economy into a "double dip" recession invoked a "flight-to-quality" during the second quarter, causing yields across the maturity spectrum to fall (see **Figure 2.1**). At the same time, the US Federal Reserve Board reiterated their intent to remain accommodative as long as the U.S. economy continues to struggle with softening demand. The result continues to be an extremely steep yield curve (see F**igure 2.2**). The current slope is approximately 155 basis points over its long-term average (80 basis points since 1976). Against this backdrop, U.S. Treasury securities performed well during the second quarter, gaining 4.7%. Over longer time frames, U.S. Treasuries have benefited from a declining yield environment, gaining 5.4% and 6.2% over the five-year and ten-year time frames, respectively.

Figure 2.1

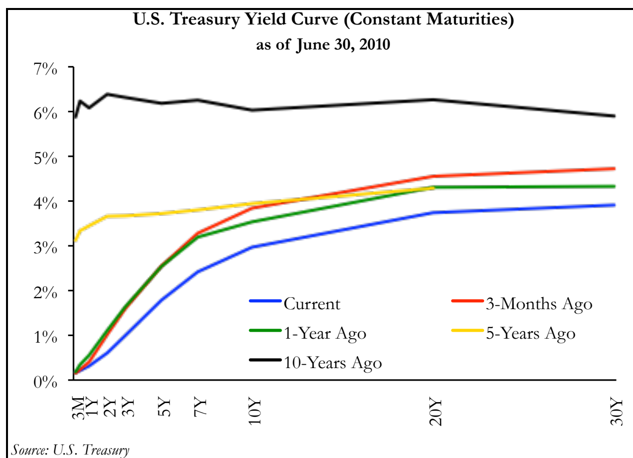
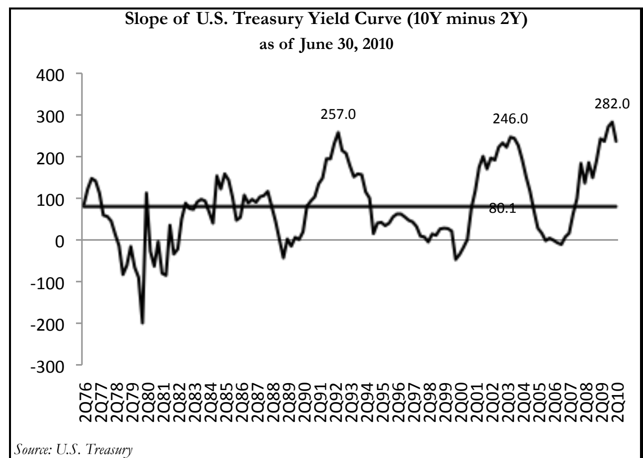


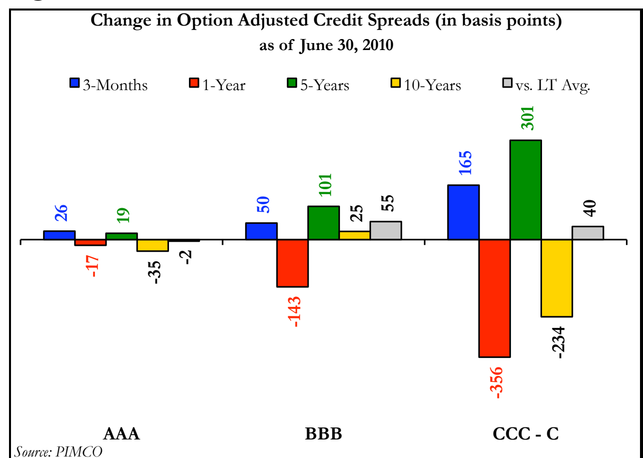
Figure 2.2



Credit Markets

Even though investors were avoiding risk during the quarter and spreads expanded (see **Figure 2.3**) for the first time since 2008 (fourth quarter), credit instruments (+3.3% for the quarter) posted positive returns due decreasing yields. Not all credits held up as returns in the credit quality spectrum varied. Investment grade credit (bonds rated BBB or better) performed well (+3.4% for the quarter) whereas high yield bonds suffered (-0.1% for the quarter). Net issuance was significantly lower than the first quarter ($58.1 billion vs. $130.5 billion according to Barclay's) as uncertainty around the globe has corporations reluctant to issue.

Figure 2.3



Securitized Markets

Much like other bond sectors, securitized markets (ABS and MBS) lost steam during the quarter. ABS markets suffered not only from investor sentiment, but also structural head winds. In March, FAS 166/167 went into effect that

forced corporations to re-incorporate revolving trusts back onto their balance sheets (they have been treated as off-balance sheet entities prior to March). Also in March, the Term Asset Lending Facility (TALF) expired. Both of these factors have led to a reduction in the amount of supply for the year; however, the private sector has begun to show signs of life (without government support) for the first time since 2007 as several private deals were completed (without government support) during the quarter

Mortgage rates remain low nation-wide, while constraints on origination (credit standards and competitiveness) have led to lower volumes of mortgage loans. However, the lower supply levels have been matched by lack-luster demand due to continued housing weakness and uncertainty surrounding the Federal Reserve's involvement in the market. These dynamics led to mortgage-backed securities (MBS) underperforming the broad market during the quarter (+2.8%). One bright spot however came from GNMA mortgages, which performed well during the quarter (+3.3%) as investors began to view these securities again as substitutes for U.S. Treasuries.

Inflation-Linked Bonds

The "-flation" debate continues, with many well respected figures on opposite sides of the table. While low rates of inflation have been prevalent, there are plenty of warning signs (i.e. increasing government spending, accommodative Fed policy, mounting debt levels, etc.) that point to higher rates of inflation in the future. At the same time, there continues to be no clear indicators as to the possible timing. U.S. Treasury Inflation Protected Securities (TIPS) offer investors inflation protection; therefore will be beneficial when inflation takes hold and nominal bonds struggle. This has created increasing demand in a small portion of the U.S. Treasury market (TIPS represent $550 billion of the $8.3 trillion U.S. Treasury securities outstanding), which has added a significant tailwind to the sector. For the quarter, TIPS (as measured by the Barclay's Capital U.S. TIPS Index) gained 3.8%. Over longer periods (+7.6% for the three-year, +5.4% for the seven-year, and +7.5% for the ten-year), these securities have been able to outperform the broad market. The implied inflation (difference in yield between nominal Treasuries and TIPS) expectations of these securities have decreased over the last two-years, with expectations ranging from 1.8% for the next five-years to 2.1% for the next ten-years.

Broad Market and Outlook

With global uncertainty increasing during the quarter, bonds in general benefited. The Barclay's Capital Aggregate Index increased 3.5% for the quarter and has performed well over the five-year (+5.5%) and ten-year (+6.5%) time frames. Declining yields have been the normal environment since Volker tamed inflation in the 1980s; however, the risk return trade-off seems asymmetrical at this point in time (rising rates are more detrimental and probable than the rewards for declining yields) as the yield on the Barclay's Capital Aggregate Index remains near historical lows. At the end of the day, bonds ultimately earn their yield thus low yield environments beget low future returns.

Equities

U.S. Equities

The S&P 500 declined 11.4% in the second quarter. This was its first quarterly loss since the first quarter of 2009 and was the second worst quarterly loss since the peak of the market in October 2007 (see **Figure 3.1**). The stock market had experienced a rapid recovery through April, up 65.5% since the market low in March 2009, before giving back 12.8% over the last two months of the quarter. The S&P 500 has now swung into negative territory for the year (-6.7%) after gaining +5.4% in the first quarter (see **Figure 3.2**).

Figure 3.1

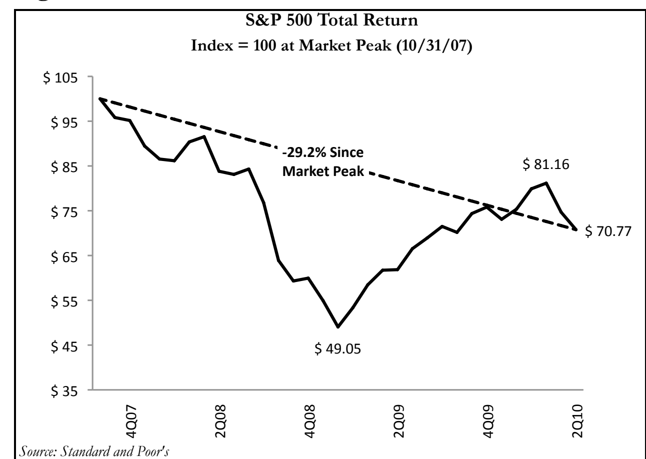
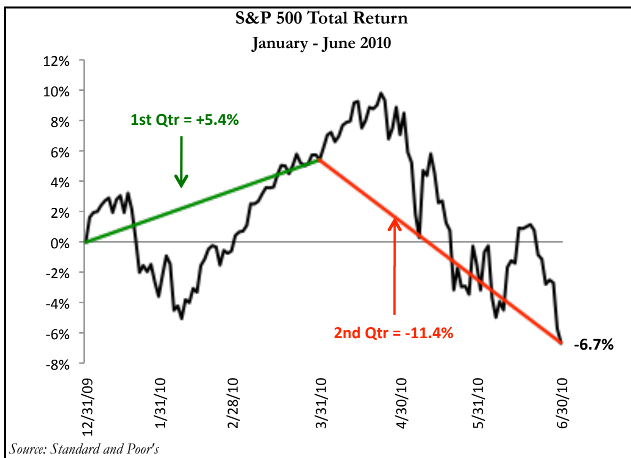


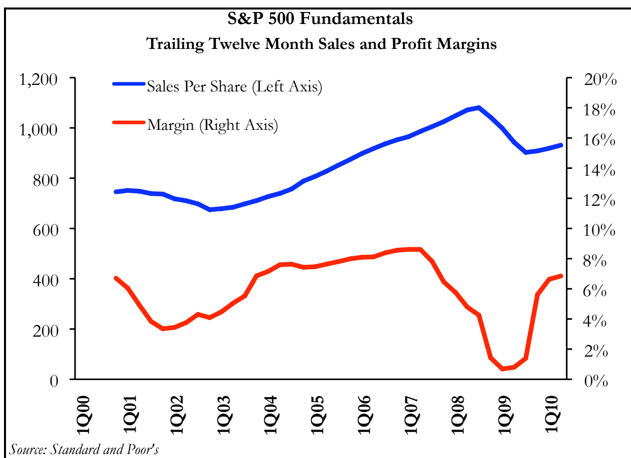
Figure 3.2



Most of the selling pressure was a result of weak economic indicators released during the second quarter combined with expectations that a weakened European continent would dampen profits for U.S. companies. While the health of Europe does have an impact on the future prospects for U.S. companies, current fundamentals paint a very different picture.

Both sales and earnings-per-share, on a trailing twelve-month basis for the S&P 500, have increased from their lows experienced last year (see **Figure 3.3**). While these two fundamental factors are important, they are not the only ones that point to the soundness of corporate balance sheets' (non-financial). According to JPMorgan, corporate cash as a percentage of current assets is over 25% and is the highest in over 20-years.

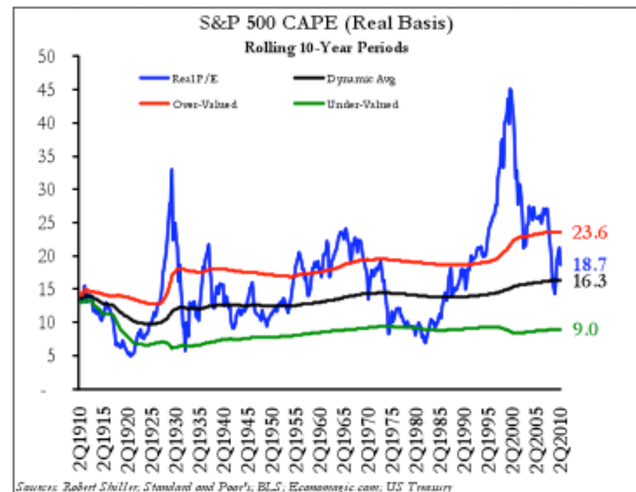
Figure 3.3



Examining the Federal Reserve's Flow of Funds data also reveals more insight to corporate America's financial soundness. The corporate financing gap (total internal funds minus capital expenditures) illustrates that businesses are able to fund expansion without the need for outside capital. This is partly due to corporations slowing down their investment in capital expenditures, but also due to increasing internal funds (retained earnings) even during the recession. Also, debt-to-equity ratios for business are the lowest they have been since 2000 (and 1970s before that). Interest coverage for non-financial businesses has also increased since its low during the recession, which was the highest bottom in this ratio since the 1970 recession.

All of these fundamental factors have steadily improved during a quarter in which prices were falling. Therefore, the cyclically adjusted price-to-earnings ratio (CAPE) shows that market pricing has improved but continues to be over its long-term average (see **Figure 3.4**).

Figure 3.4



International Equities

International developed markets (as measured by the MSCI EAFE) were the hardest hit during the quarter (-13.7%) as these markets were ground zero for the escalating sovereign debt crisis. For the year, the MSCI EAFE is down 12.9% (-7.0% in local currency terms). The outlook for international developed markets (especially Europe) is extremely uncertain due to the solvency of their governments. Many believe that fiscal problems will eventually translate into severe headwinds (i.e. higher taxes, protectionism policies, increased regulation, civil unrest, etc.)

for companies operating in these countries. The problems are exacerbated even further for the weaker countries in the euro zone (Greece, Spain, Portugal, Ireland, etc.), as they are not able to manipulate their currency to make themselves more competitive versus other countries. This leads to a situation were the stronger countries in the euro zone continue to become stronger (by exporting cheaper goods to their weaker partners), but will have to routinely bail out their governments to prevent default.

Emerging markets declined 8.3% (-5.5% in local currency terms) during the quarter. For the year, these markets have declined 6.0% (-4.2% in local currency terms), but continue to offer investors access to the faster growing economies.

Outlook

Equity markets throughout the world continue to struggle with the prospects of decreasing consumer demand that accompanies a major deleveraging cycle. While the recovery in the U.S. is looking for solid footing, investors should be prepared for increased volatility and lower than historical returns until the current headwinds (i.e. fiscal solvency, de-leveraging effect, economic uncertainty, etc.) subside. As for the international markets, the developed countries look eerily similar to the U.S. and should have similar results. The emerging markets will have better prospects economically; however, it still remains to be seen whether they can decouple from the developed world and seek demand from inside their own borders. Until that day comes, these markets will experience a close correlation to the rest of the world.

Alternatives

Hedge Funds

Entering the quarter, hedge fund managers were at the lower end of their historical equity market exposure. As a result hedge fund losses were modest, dropping only 2.5% as measured by the HFRI Fund Weighted Composite Index. For the year, these funds have declined only 0.2%.

Increased volatility in traditional long-only markets has led to positive capital inflows for hedge funds, with approximately $9.5 billion (according to HFRI) going into this sector during the quarter. Most of the inflows have favored larger, more established funds, with $8.8 billion of the inflows were to funds with assets greater than $5 billion. Also, fund of funds continued to experience outflows during the second quarter, losing $2 billion.

As for positioning (according to the Bank of America Merrill Lynch Hedge Fund Monitor), long/short directional managers increased their net equity exposure at the close of the second quarter, ending the period close to their long-term average of 35% to 40%. These funds continue to have a high quality, large cap, growth tilt and have begun mitigating inflation trades. Equity market neutral funds reduced their equity market exposure to their long-term average (slightly positive), and these managers are currently favoring small cap, low quality, and value stocks. Macro funds have continued their steady short to equities, commodities and the 10-year U.S. Treasury trades.

Real Estate

Like many other equity investments, publicly traded real estate (as measured by the FTSE NAREIT All Equity Index) fell during the quarter, losing 4.1%. However, this asset class has been able to maintain positive returns for the year, gaining 5.5% through June 30th. Over the trailing ten-years, REITS have been the best performing asset class (+9.8% annually), which included the worst drawdown in their history (-68.3% peak-to-trough). While market value of the equity has increased, the intrinsic value of the underlying real estate has been experiencing a steady decline, leading to these securities trading at a premium-to-net asset value of 4.1% (according to Cohen & Steers). This combined with low dividend yields leads to a reduction in overall return expectations on publicly traded real estate.

As for private real estate, the NCREIF Property Index increased 3.3% for the second quarter. This was the second straight quarter of positive returns and the first quarter with price appreciation (+1.6%). Year-to-date, private real estate investments have gained 5.2% and have been one of the better performing assets classes in the capital markets. Looking back, private real estate experienced its largest draw down since the NCREIF's inception in 1978, losing 37.8% from the third quarter 2008 to the fourth quarter 2009. Most of this loss was based on property valuations derived from independent property appraisers. While most of these appraisals were the best estimate of market valuations, the lack of transaction volumes made these valuations

unobservable. Now that transaction volumes have increased once again, actual market clearing prices have been transacting at higher than appraisal valuations, thus leading to a positive appraisal/market valuation gap. This gap in valuation has resulted in a sharp increase in price appreciation during the quarter and could lead to the possibility of more price appreciation throughout the remainder of the year.

Outlook

Increased volatility and lower return environments in traditional stock and bond markets increase the opportunity set for alternative managers. As a result, hedge fund managers should have the ability and the opportunity to earn similar returns to equity markets with much lower overall volatility. This can prove extremely beneficial to investors willing to take on the increased risks (i.e. liquidity, headline, transparency, etc.). As for real estate, this asset class experienced its worst decline since the 1970s and continues to provide income returns well in excess of traditional bonds. At the same time, the appraisal/market valuation gap and lack of construction volume leads to the possibility of an attractive substitute for low yielding bond investments.

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Capital Markets Quarterly

KEY INDICATORS:

ECONOMY:

Stat	Qtr	1-Year
GDP*	1.1%	2.9%
Real GDP*	0.8%	2.2%
CPI	0.2%	1.1%
Core CPI	0.3%	0.8%

FIXED INCOME:

Index	Qtr	1-Year
BC Agg	2.5%	8.2%
BC Gov't	2.5%	7.0%
BC Credit	4.6%	11.7%
BC MBS	0.6%	5.7%

EQUITIES:

Index	Qtr	1-Year
S&P 500	11.3%	10.2%
EAFE	16.5%	3.3%
Em. Markets	18.0%	20.2%
AC World	14.5%	8.9%

ALTERNATIVES:

Index	Qtr	1-Year
HFRI FOF	3.2%	3.5%
NAREIT	12.8%	30.3%
NCREIF	3.9%	5.8%

** Trailing Twelve Months*

Introduction

Mark Twain once said, "If you don't like the weather in New England, just wait a few minutes." This can also be said about the economic and capital market environments that we have recently experienced. The year began with much optimism with equity markets around the globe continuing an impressive rebound from market lows experienced in early 2009. Global economies (though technically in recession) were telegraphing improvement and consumer confidence was improving. However, a sovereign debt crisis in May changed all of this. Equity markets sold off and much of the world began wondering what the effect of a sovereign default would have on the economic recovery. Enter a patch-work "bail-out" package in June, and the world was back on track, but not for long as trouble was right around the corner. Late summer brought news of a deceleration in the U.S. economy, pointing to an increasing probability of the dreaded "double-dip" recession. Equity markets once again fell and investors took flight to higher quality securities. Enter the Federal Reserve with signals of another round of quantitative easing and a possible shift in political power in the U.S. and markets resumed their optimism.

This year's pattern is similar to ones which often follow global slowdowns caused by over-indebtedness. The pattern can be characterized by high volatility in capital markets as investors try to position themselves during rapidly changing political and economic landscapes. This can be an extremely difficult proposition for investors, as undercurrents are constantly changing.

U.S. Economy

The economy in the U.S. has officially come out of recession; however, there remains several key areas which need to be addressed (e.g. employment, leverage, government budgets, taxes, etc.) in order for the economy to transition to a more sustained growth mode. While the government cannot control or fix all of these issues, the current political arena has left individuals and business with a high level of uncertainty. Once some this uncertainty has been removed (regardless of the actual action taken), then investors and business leaders can begin to make plans for the future and take the steps necessary to grow the economy.

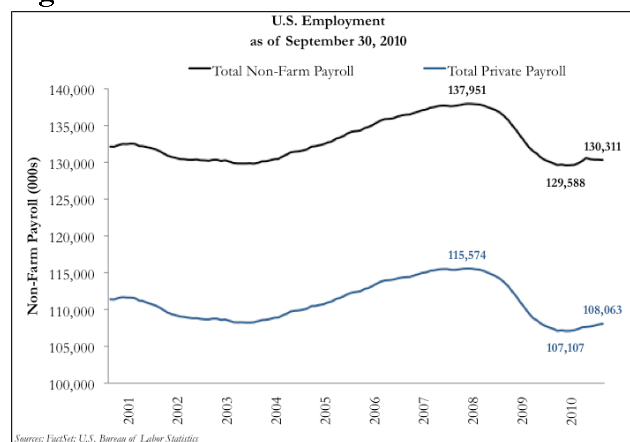
Gross Domestic Product

The U.S. economy's recovery from the Great Recession stayed positive during the third quarter, even though many indicators were pointing to a deceleration in growth. The advance estimate for the third quarter had GDP expanding 2.0% on an annualized basis. The largest contributor to growth was personal consumption, which added 1.8%. While this number is significant, it is still muted when compared to previous recoveries due to a benign employment situation. Private investment was also a strong contributor, adding 1.5%. Most of the growth was due to business es restocking inventories (contributing 1.4%). Although expanding inventories was a positive, this was the fifth straight quarter of expansion and all indications point to this component running out of steam in the near future. The largest detractor from GDP was net exports, which subtracted 2.0% for the quarter. The decline in the U.S. dollar was positive for the U.S. trade gap (as it narrowed during the quarter), but the depreciation was not enough to turn this component positive. Although growth was positive, the pace has been muted (compared to historical recoveries) and will most likely continue down this path until businesses can become confident enough in the future to expand.

Employment

The employment picture in the U.S. continues to look bleak, with the unemployment level remaining elevated (currently 9.6%). The U.S. lost approximately 8.3 million jobs during the recession and just over 720 thousand have been added back (see **Figure 1.1**). This number of new jobs has been muted due to the decennial census which has been a drag on the employment numbers (due to the layoff of part-time workers as the census wound down). The private sector has also struggled to add more jobs, adding roughly 950 thousand from the trough. As discussed in previous quarters, the increased earnings of corporations should eventually translate into more jobs. However, with uncertainty surrounding everything from healthcare to taxes, businesses have been extremely reluctant to increase payrolls. Until they can get more comfortable with the future, unemployment will continue to be elevated.

Figure 1.1



Leverage

While the U.S. is not in a technical deflationary period, the U.S. public is exhibiting the psychological effects of deflation. All segments of the private market (excluding governments) have behaved in a manner that mirrors a typical deflationary period by cutting spending and deleveraging as quickly as possible. Total private debt has declined in excess of $3.0 trillion; however, total debt outstanding has only declined by $700 million due to net new issuance by federal, state, and local governments. While these improvements are tremendous, the U.S. continues to be a society of over indebtedness and will need to keep up the deleveraging process into the future.

Fiscal Policy

Full of future entitlements, the U.S. federal budget has a number of issues to address before the nation can reduce its debt burden. Although the current interest rate environment is not punitive, it is only a matter of time before bond investors lose patience and begin to demand higher rates of interest for ever-increasing levels of debt. Therefore, the federal government has an extremely difficult task at hand: balance the budget without upsetting the masses (Medicare and Social Security are the biggest culprits which also have the most emotion attached to them by the voting public). The task seems impossible, but difficult decisions will have to be made and will likely be made when forced (i.e. when punitive interest rates take hold and make the budget unfundable).

Monetary Policy

The Federal Reserve's dual mandate of full employment and steady prices has been a difficult one to fulfill. The economy is currently struggling to find its way after an extreme balance sheet induced recession, which has led to massive balance sheet repair by both individuals and businesses alike. Unlike business cycle induced recessions, balance sheet recessions (caused by overspending and over indebtedness) are less likely solved by monetary policy. Instead, these recessions usually take a great deal of time in order for asset prices to find their natural equilibrium and for everyone in the economy to adjust their balance sheets to levels that require less debt.

Therefore, the role of the Federal Reserve is to be the lender of last resort and provide a level of interest rates that will be less punitive once demand for debt returns. It is vitally important to understand that the level of interest rates should not induce demand, but should be low enough to not make debt over burdensome when demand returns. Currently, the Fed maintains that short-term interest rates will be zero bound for an "extended period" and that they will take additional steps to keep the long end of the yield curve less punitive by resuming quantitative easing.

Most critics of the Fed point to the resumption of quantitative easing as one that will fail and not stimulate the demand needed to catapult the economy into additional growth. These opponents are absolutely correct in that this action will not stimulate any action; however, this action will have a desired benefit to sustain low interest rates until the demand does return. Once it returns, it will be extremely difficult to retract the liquidity from the market and could add to the risk of inflation above the targeted levels.

Fixed Income

Broad Market

Uncertainty surrounding the global economy resulted in decreasing yields in the bond markets. The result has been continued strong performance for the Barclay's Capital Aggregate Index, which has increased 7.9% year-to-date. The yield decline is far from a recent activity (see **Figure 2.1**) as the yield on the Barclay's Capital Aggregate Index has declined 440 basis points over the past ten years, resulting in a annualized return of +6.4%. While credit spreads have expanded over the past five years (+15 basis points for 2010 and +36 basis points for the past five years), the magnitude has been minimal compared to the overall decline in yields.

Figure 2.1

US Treasury Market

The well publicized deceleration in the U.S. economic recovery led to decreasing yields during the quarter (see **Figure 2.2**). The FOMC's continued stance on short-term rates (0 to 25 basis points) combined with their resumption of quantitative easing (QE2) contributed to the yield curve flattening slightly (see **Figure 2.3**). In this yield environment, U.S. Treasuries have performed well, gaining 2.7% for the quarter and 8.7% year-to-date. Over longer time periods, the persistent decline in yields has propelled returns, as U.S. Treasuries have gained 6.2% over the past ten years and 7.1% for the last twenty years.

Figure 2.2

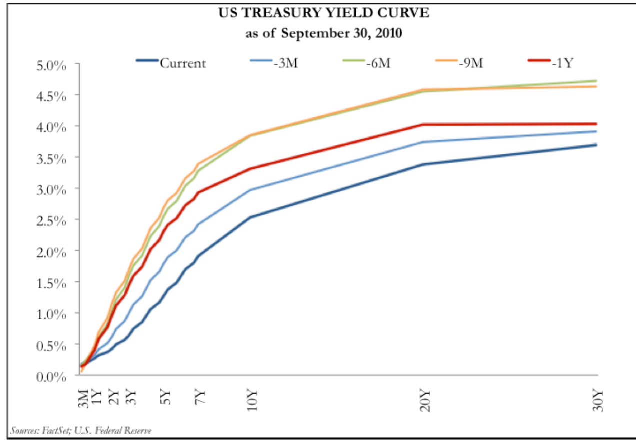


Figure 2.3

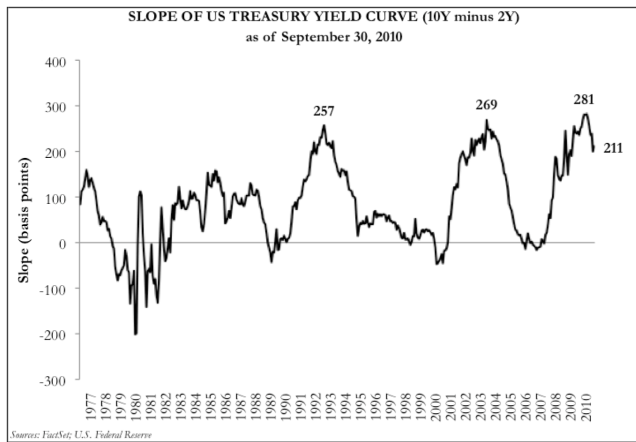


Figure 2.4

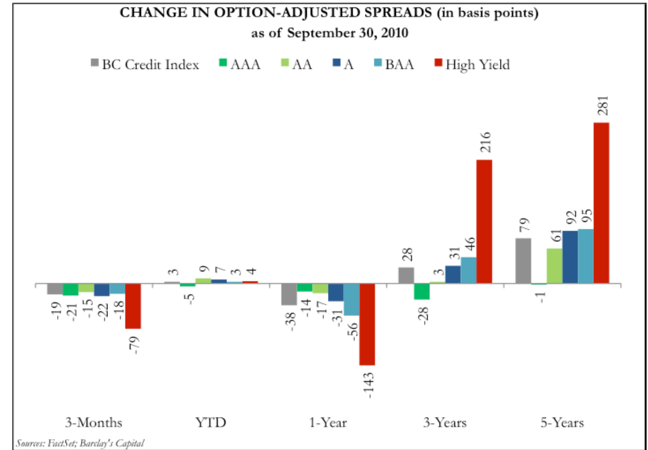
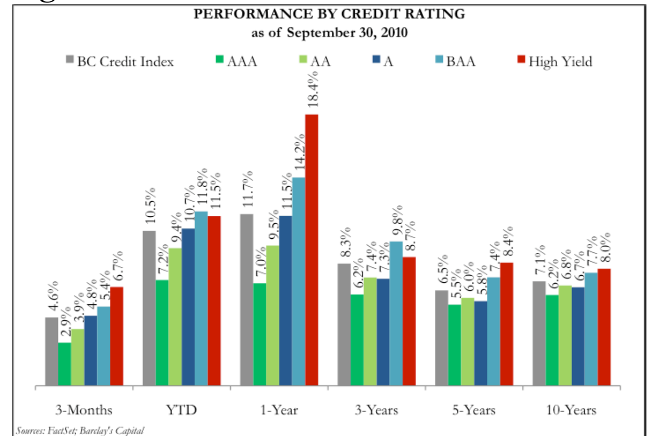


Figure 2.5



Credit Markets

The low yield environment in U.S. Treasuries combined with uncertain economic conditions has left investors with an appetite for safety, but a need for higher yield. This has led to investors staying with fixed income securities, but reaching for yield by purchasing credit bonds. Two examples are: (1) declining credit spreads over the quarter and past year (see **Figure 2.4**) and (2) $117.5 billion in investment grade net new issuance. The new issuance was met with strong demand, as most deals were oversubscribed (per BlackRock). The Barclay's Capital Credit Index gained 4.6% for the quarter and 10.5% for the year-to-date. Breaking down the returns of the index, the further down the risk spectrum, the better the returns (see **Figure 2.5**).

Securitized Markets

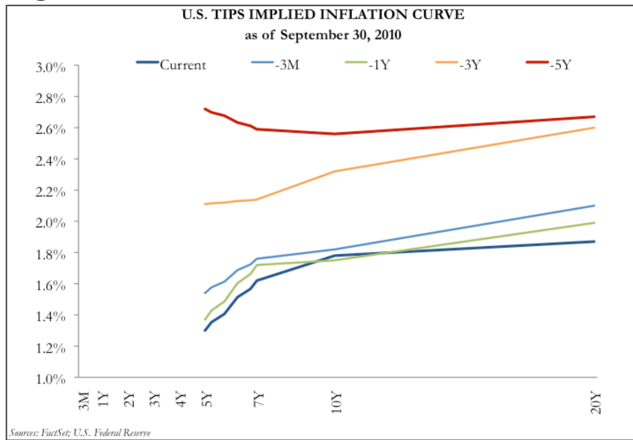
Mortgage-Backed Securities (MBS) have faced increased headwinds, as the Federal Reserve announced (August meeting) that all cash flows from their MBS holdings will be reinvested into longer-dated U.S. Treasuries. The announcement by the Fed signaled to the market approximately $300 billion of demand leaving the MBS market over the next year. Before the announcement, MBS yields were actually lower than U.S. Treasuries (-13 basis points), but quickly reversed and ended the quarter 74 basis points higher. Given these events, MBS were the laggard for the quarter (+0.6%) and year-to-date (+5.1%).

Inflation-Linked Bonds

Persistent high unemployment combined with low capacity utilization has produced a significant "output gap", reducing the effectiveness of the

Fed's inflation targeting strategy. It seems that no amount of monetary stimulus has been able to spur on inflation; therefore, the Fed has begun QE2. The Fed has even gone as far as to announce that they intend on counteracting the recent low levels of inflation with a period of higher-than-targeted inflation in the future. These actions led to a rally in inflation-linked bonds during the month of September. As a result, the Barclay's Capital U.S. TIPS Index return +2.5% for the quarter and +7.0% for the year-to-date. Even with the Fed announcements, TIPS ended the quarter with low implied inflation levels (see **Figure 2.6**).

Figure 2.6



Equities

U.S. Equities

The S&P 500 rebounded in the third quarter (+11.3%) and crossed back over into positive territory for the year-to-date (+3.9%); however, the volatility in the returns has been elevated (see **Figure 3.1**) as markets have been reacting to mixed news throughout the year. Since the market's bottom (**see Figure 3.2**), the market has returned +60.6%. Although the strength of the rebound is impressive, the market still needs another 28.2% gain to recoup losses sustained during the market decline.

Figure 3.1

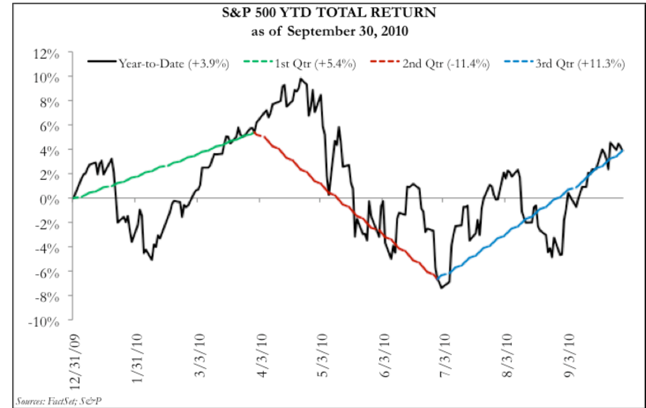
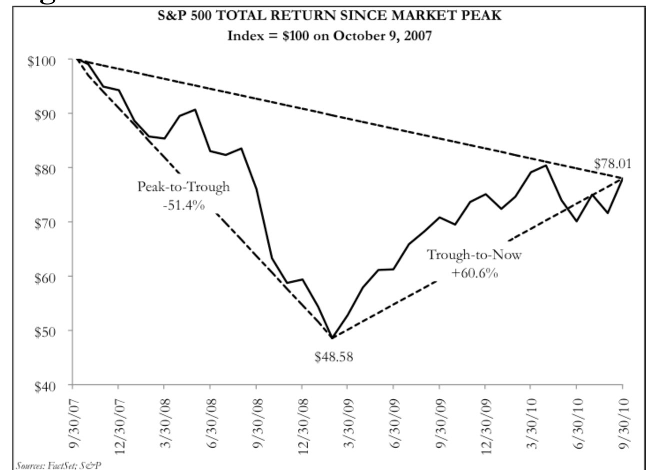


Figure 3.2



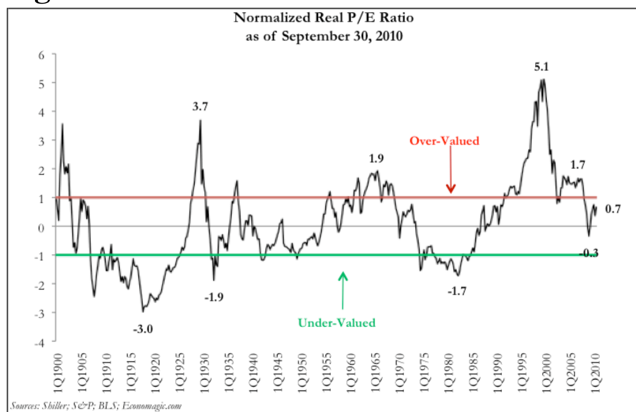
U.S. corporations remain extremely sound fundamentally. Cash on balance sheets remains high. Leverage (ex. Financials) is loitering at historically low levels. The cost of debt continues to decline due to the Fed's stance on interest rates. Sales and earnings have continued on a path of acceleration. All of these factors combined have U.S. businesses on solid financial ground; however, this is only part of the equation when equity investing. The price paid for stocks is by far the most important factor; therefore, a thorough look at valuation metrics is needed.

When looking at stock market valuations, it is important to examine several different factors because the overall valuation is difficult to gauge and investors can very easily be misled. In order to gain an understanding on the long-term direction of the market (secular trend), the normalized real price-to-earnings ratio is utilized. By utilizing data provided by Robert Shiller, a very long history of

the stock market's valuation can be formed and then used to determine today's valuation.

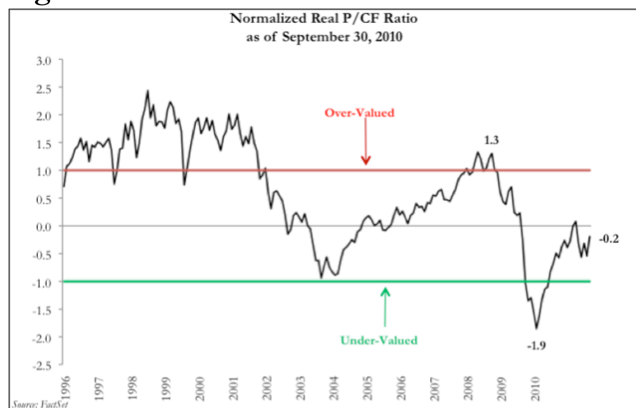
Figure 3.3 graphs the normalized real price-to-earnings data in a z-score format. The z-score is a data point's distance from the mean measured in standard deviations. For example, a z-score of 1.0 indicates that the current measure is one standard deviation above the mean. Currently, the normalized price-to-earnings ratio has a z-score of 0.7, which would put the valuation above fair value but below over-valuation (i.e. 1.0).

Figure 3.3



Looking at the earnings trend is very important; however, concentrating on earnings alone could be misleading as earnings can deviate from the amount of cash received from operating a business. Therefore, normalized real price-to-cash flow can also be examined. **Figure 3.4** shows that this measure shows that the market is currently has a z-score of -0.2, which shows that it is currently between fair value and under-valued.

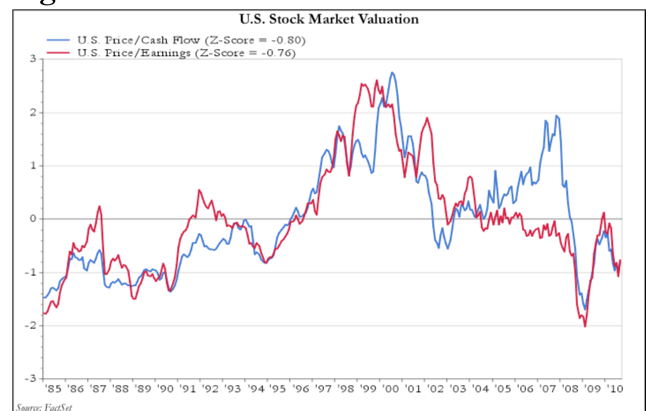
Figure 3.4



Although the normalized real price-to-earnings and normalized price-to-cash flow are producing different levels of valuation, neither one is producing a significant over or under-valuation. Therefore, the secular outlook cannot be characterized by a period of significant expansion (or contraction) of price multiples. This would mean that the long-term return will need to be based on earnings growth and the dividends paid.

Turning to the shorter-term environment (cyclical), **Figure 3.5** illustrates the trailing twelve month price-to-earnings (**red line**) and the price-to-cash flow (**blue line**). This graph is also a z-score graph and shows how earnings and cash flow can differ significantly, as the period of 2004 through 2007 shows. This period was the proliferation of financial institutions that were able to show increasing earnings that were generated by loans that would not generate cash flow. Therefore, on an earnings basis, the market appeared fairly valued, but was over-valued on a cash flow basis. Currently both figures point to under-valuation which could be beneficial in the short-term.

Figure 3.5

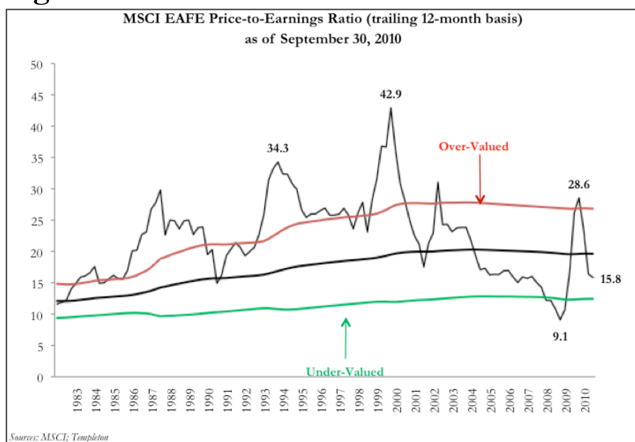


International Equities

Developed countries (as measured by the MSCI EAFE Index have underperformed the U.S. markets (+1.5% vs. +3.9%) year-to-date due to the lingering effects of Europe's sovereign debt crisis. Developing economies (as measured by the MSCI Emerging Markets Index) continue to be the best performing equity markets (+12.9% for the quarter and +11.0% for the year-to-date).

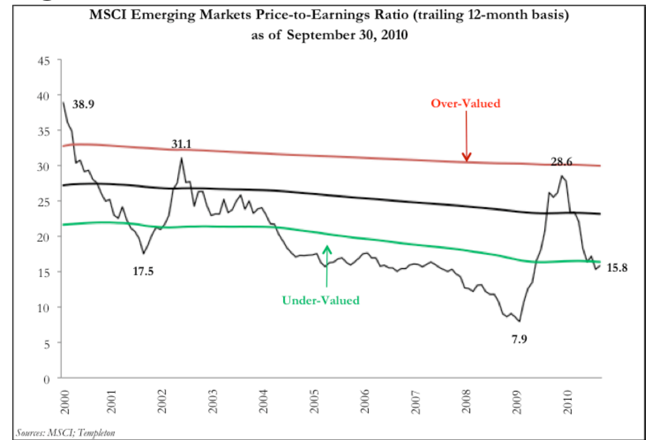
The companies in the developed markets continue to have fundamentals that echo their domestic brethren, but due to heightened fears over sovereign balance sheets (and the ability for the governments to deal with their finances in such a way that doesn't seriously hinder the business environment) there is more uncertainty surrounding the future prospects of these companies. This can be seen in the valuation metrics of the MSCI EAFE. **Figure 3.6** graphs the price-to-earnings ratio for the MSCI EAFE (on a trailing-twelve month basis), which illustrates how these markets are currently priced at a much cheaper valuation than the U.S. This is simply a reflection of the undercurrents present in these markets and shows how investors demanding a cheaper price in order to take on the heightened uncertainty.

Figure 3.6



As for developing markets, price-to-earnings ratio for the MSCI Emerging Markets Index is trading in a very similar range (see **Figure 3.7**); however, for a very different reason. These underlying markets are experiencing growth that is much faster than the developed world. According to the International Monetary Fund, these markets should experience growth rates over the next five years that are nearly double that of international developed markets. This growth has led to stock price appreciation and the appreciation of underlying fundamentals, which has valuations staying in the lower end of the range. It should also be noted that the expected volatility of these markets is expected to remain higher than developed markets due to their relative size and their higher degree of political uncertainty.

Figure 3.7



Alternatives

Hedge Funds

During 2010, hedge funds have been able to match equity market returns (HFRI Fund Weighted Index +4.7% YTD vs. Russell 3000 +4.8% YTD) without a great deal of the volatility (6.7% vs. 21.9%). This positive performance in a volatile market has led to positive capital flows for hedge funds. According to HFRI, hedge funds have taken in approximately $19 billion. This was the strongest capital in-flow since the fourth quarter of 2007. Fund of funds have also experienced positive capital flows of $250 million, which was only the second quarter of positive cash flow for fund of funds since the second quarter of 2008.

As for positioning, the Fund Manager Survey (published by Bank of America Merrill Lynch) showed that risk appetites among hedge fund managers are cautiously increasing. The survey shows that fund managers are positioned with higher net exposures than one year ago; however, they remain slightly overweight to cash. The managers that participated in the survey (over 230 managers with $667 billion in AUM) are beginning to gradually embrace the global economic recovery, but many still see the recovery as one with lower growth than recoveries in the past.

Real Estate

Publicly traded real estate (REITs) has benefited from both increasing fundamentals in commercial real estate as well as increasing investor sentiment

(tied to the equity markets). These two factors have led to these securities gaining 19.1% year-to-date, as measured by the FTSE NAREIT All Equity Index. Due to the investor base (mostly retail) and size of the market (fraction of market capitalization of the equity market) this market can experience wide price fluctuations. For example, over the past ten years, REITs have compounded at an annualized rate of 10.4% even though these securities declined nearly 70% from January 2007 to February 2009. The cash flow generated by the underlying properties and distributed through dividends makes these securities attractive; however, the current dividend yield of 3.8% (historical average is 7.3%) makes today a difficult entry point.

Private real estate has experienced a turnaround from the lows experienced in 2009. Year-to-date, private real estate (as measured by the NCREIF National Property Index) has gained 8.1%. Investment income has generated a +6.8% return over the past year, and has been increasing closer to its historical average (+7.7%). However, due to a historically low number of transactions during the past year, price appraisals have been marked down to levels that have not been observed in the marketplace. This has caused a valuation gap between market clearing prices and valuations held on the books (i.e. book value is lower than market transactions). This gap has started to close, as prices have increased 2.9% year-to-date. Although the valuation gap is a short-term tail wind for this market, it is not sustainable as transaction volume increases.

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Capital Markets Quarterly

KEY INDICATORS:

ECONOMY:

Stat	Qtr	1-Year
GDP*	3.4%	3.8%
Real GDP*	3.2%	2.9%
CPI	0.8%	1.5%
Core CPI	0.2%	0.8%

FIXED INCOME:

Index	Qtr	1-Year
BC Agg	-1.3%	6.5%
BC Treas	-2.6%	559.0%
BC Credit	-1.9%	8.5%
BC MBS	0.2%	5.4%

EQUITIES:

Index	Qtr	1-Year
S&P 500	10.8%	15.1%
EAFE	6.6%	7.8%
Em. Markets	7.3%	18.9%
AC World	8.7%	12.7%

ALTERNATIVES:

Index	Qtr	1-Year
HFRI FOF	3.6%	5.7%
NAREIT	6.2%	20.4%
NCREIF	5.0%	16.4%

**annual rate*

Introduction

Fears of a double dip recession in the US faded in late 2010 in the wake of a dramatic shift in the political landscape in Washington, indications of an accelerating economic recovery, and affirmation of the Federal Reserve's commitment to extraordinary policy measures aimed at fostering continued economic expansion. Republicans gained control of the US House and narrowed the Democrats' edge in the Senate in the November midterm elections, setting the stage for an eventual compromise on the expiring Bush tax cuts and fueling optimism for a more fiscally responsible 112th Congress. The Conference Board's Leading Economic Index posted better than expected results in November and December, and retail sales, industrial production, business survey, and even unemployment data pointed to an increasing growth trajectory for the US economy. The fourth quarter GDP advance estimate confirmed the US economy's momentum reflecting a 3.2% rate of expansion. In November, the Federal Reserve officially announced its Quantitative Easing (QE) II program, a plan to purchase $600b of longer dated US Treasuries by June 2011 in an attempt to influence interest rates in the longer portion of the yield curve. While equity markets cheered the Fed's QE II announcement and finished the quarter up 10.8% (as measured by the S&P 500), interest rates rose sharply leaving the bond market down 1.3%, the worst quarter for the Barclay's US Aggregate Bond index since 2004. While the economic improvement implied by recent indicators is cause for optimism, a persistently high unemployment rate could undermine any sustained economic expansion. Even with the US economy gaining firm footing, recovery is likely to remain uneven with expansion coming in fits and starts.

US Economy

The January 28th advance estimate of 4th quarter GDP growth reflected a 3.2% annualized growth rate as illustrated in **Figure 1**. Consumer spending grew by 4.4% (the most since 2006), contributing 3% to the overall rate. Excluding a slowdown in inventories the economy grew by 7.1%, the most since 1984 (Bloomberg). For the full year, the US economy expanded 2.9% reaching an all-time high in output of $13.4 trillion.

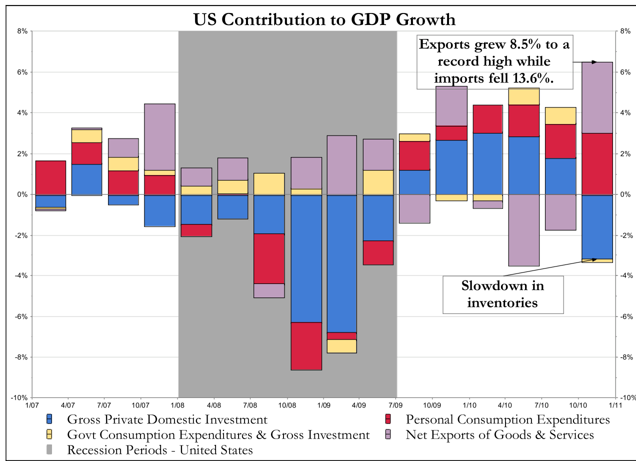

Figure 1

Full year 2011 growth estimates have been boosted 0.5 to 1% in the wake of the Bush era tax cut compromise. The economy is now poised to grow another 3-4% in 2011 according to most economists. If expectations are met, unemployment is likely to fall below 9% by year end. However, the employment picture will continue to face the lingering challenge of a sluggish housing market and improvement will rely on finding alternative sources of economic output and job creation. Despite the well publicized troubles in the automotive industry, automobile output surpassed housing (residential fixed investment) as a component of GDP in the 3rd quarter for the first time since 1985 (Source: Ned Davis Research) (**Figure 2**).

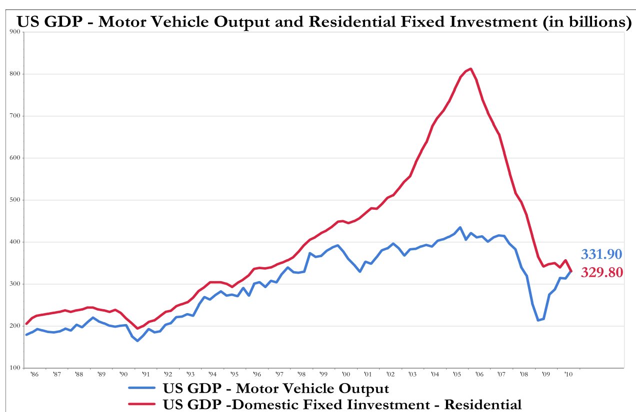

Figure 2

By the height of the housing market bubble in mid 2006, the market and related industries were responsible for over 30% of total jobs and 40% private sector jobs created since 2000 (Source: BLS, Highland estimates) (**Figure 3**). This very conservative estimate only includes sectors directly related to housing construction and sales, but does not include other industries that are closely related such as appliance and electronics manufacturing and sales. Without a rebound in housing, a job recovery would seem far fetched.

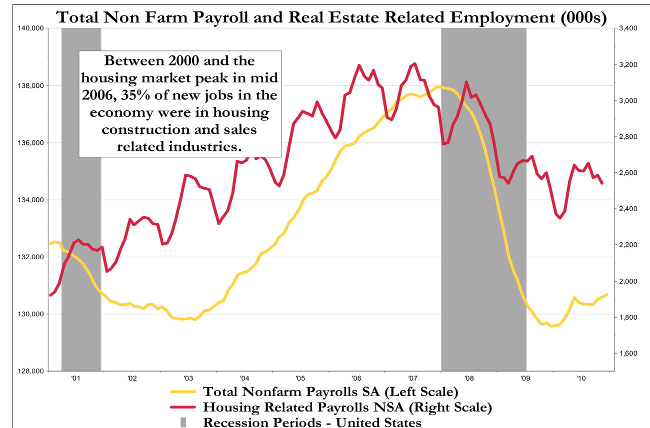

Figure 3

However, with manufacturing activity accelerating in the US, we may be witnessing a resurgence of manufacturing employment. According the Grant Thornton Business Optimism Index, 49% of manufacturing companies surveyed in November indicated that they planned to increase hiring in the next six months. January's ISM monthly index of manufacturers registered its highest level since May 2004. Anecdotal evidence seems to confirm manufacturing's resurgence, particularly in the auto industry. Ford recently announced that it plans to hire 7,000 US workers over the next two years, including nearly 5,000 in 2011.

Even with above average growth, full employment (currently assumed to be characterized by an unemployment rate of around 5%) may not be reached for several years with some estimating a sustained 4% rate of economic growth required to reach full employment by 2015. On a ten year rolling period basis, US GDP has not grown at an annualized rate approaching 4% since the early 1970's.

Bond Market

Despite a poor 4th quarter, the Barclays US Aggregate Bond index managed a 6.5% gain for the year. While short term rates remained anchored near zero, longer term rates were volatile in 2010. The ten year US Treasury yield opened the year at 3.9%, rose to just over 4% in April, before falling to a low of 2.4% in October. Spurred by the Fed's QE II announcement and signs of accelerating economic growth (and potential follow - on inflation), the yield on the 10yr Treasury note rose sharply, ending the year at 3.3%. Within the index, Corporate bonds (+8.5%) led US Treasuries (+5.9%) as spreads tightened 347 basis points for the year. By year end, spreads on corporate bonds were within 26 bps of their long term averages. Flat to rising interest rates coupled with little room for spreads to compress, point to return prospects for corporate bonds that should approximate current yields. The end result is only modest return potential going forward.

At a time when interest rates appear poised to rise, the interest rate risk across the broad bond market is increasing. The duration of the Barclays Aggregate Bond Index has increased to its highest level in over ten years as companies have issued longer term debt to take advantage of low interest rates and the US Treasury has increased the average maturity of its outstanding debt. Also, mortgage backed securities in the index extended 1.6 years in September as the impact of rising mortgage rates was magnified by an updated Barclays prepayment model effecting both duration and the option adjusted spread of the sector. The extension of the MBS portion of the index was responsible for a half year of duration increase for Aggregate index. (Source: Merganser). **Figure 4** shows the historical duration of the aggregate.

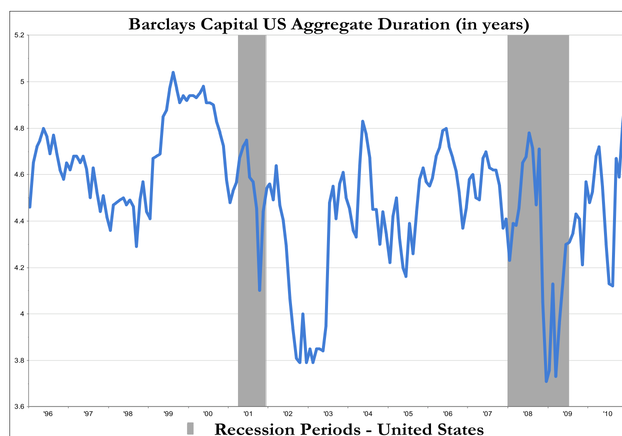

Figure 4

Fixed income investors now face difficult decisions regarding their portfolios. With upward pressure on rates building, establishing an appropriate level of portfolio duration may be a challenging decision made more difficult by the opportunity cost of near zero short term rates. Highland Associates research indicates that historical interest cycles tend to fall into one of two categories. (1) Flight to quality driven interest rate declines tend to be relatively short lived with rates returning to more normal levels rather quickly. While the subsequent increases in interest rates negatively impact bondholders, the detrimental effects are somewhat offset by the ability to reinvest at higher rates in the very near future. (2) Conversely, interest rates can remain very low amid extended rate cycles in which yields hold well below historical averages for extended periods of time. The forces shaping these cycles are more structural in nature and the risk to investors is disappointing (but positive) long term returns, rather than short term mark to market losses. While rising rates would be detrimental to bond investors in the short run, the source and sentiment surrounding any increase is more crucial to the overall capital market environment. An increase in rates associated with economic expansion and money demand would generally be accepted as a positive development, while higher rates driven by doubts surrounding US fiscal health, the US dollar, or inflation brought on by fiscal irresponsibility, loose monetary policy, or commodity prices could create a negative ripple effect that would be felt throughout the capital markets.

Bond market fears are beginning to manifest themselves in mutual fund flows, as investors flee

bond mutual funds and embrace equity funds in a stark reversal from post 2008 trends (**Figure 5**).

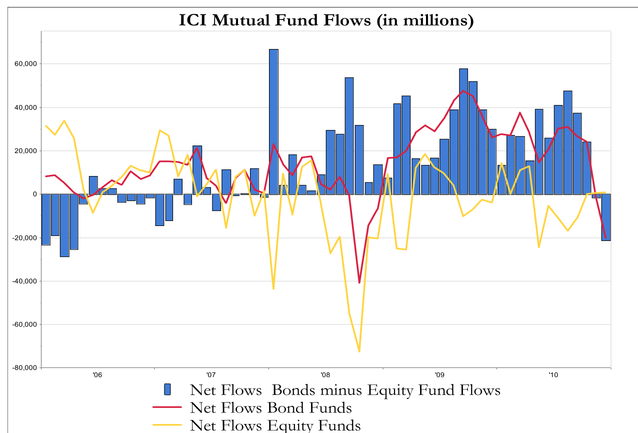

Figure 5

Equities

Equity markets followed up a strong rebound in the 3rd quarter with another double digit return for the S&P 500 in the last three months of 2010. Shaking off a mid year correction of 16%, stocks rose 23.3% in the second half of the year, finishing up 15.1%. In terms of sector leadership, Cyclicals (those most sensitive to economic cycles) led markets higher with Consumer Discretionary, Industrials, Materials, and Energy all posting gains above 20% for the year on prospects for accelerating economic growth and commodity price increases. More defensive sectors such as Health Care and Utilities lagged with returns of only 2.9% and 5.5% respectively. At year end, Technology was the largest sector in the S&P 500 at 18.3% of total market capitalization followed by Financials at 16.1%. Despite a 163% rally from the March 2009 market lows, Financials are still 52% below where they were at the market peak in October 2007. (JP Morgan).

Stock market returns in 2010 were dominated by the so-called "risk-trade" which drove stocks that exhibited higher volatility and riskier attributes to outperform the broad market. Generally stocks with higher or no P/E ratios outperformed those with lower P/Es, stocks with the lowest analysts' opinions outperformed those most liked by street analysts, and smaller companies tended to outperform their larger counterparts by a wide margin. To the detriment of long/short hedge fund returns, stocks with the highest short interest also outperformed. The average stock in the highest short interest decile of S&P 500 rose 29% for the year compared with a return of 19.3% for the average stock in the index. (Bespoke Investment Group).

As illustrated in **Figure 6**, the MSCI All Country World index rose 12.7% largely on strength in the US, Japan, and emerging markets. Two dominant themes remain intact and drove global market returns for the year. First, sovereign debt concerns in the Eurozone weighed heavily on developed country returns and the Euro currency. In US dollar terms, the MSCI Europe Index managed only a 3.9% return. Despite many European based companies exhibiting strong growth and fundamentals as well as penetration in emerging market economies, companies in the region generally struggled. Emerging markets on the other hand, continued to rally (up 18.9% in USD terms) again bolstered by economic growth prospects, favorable demographics, and in some cases rising commodity prices.

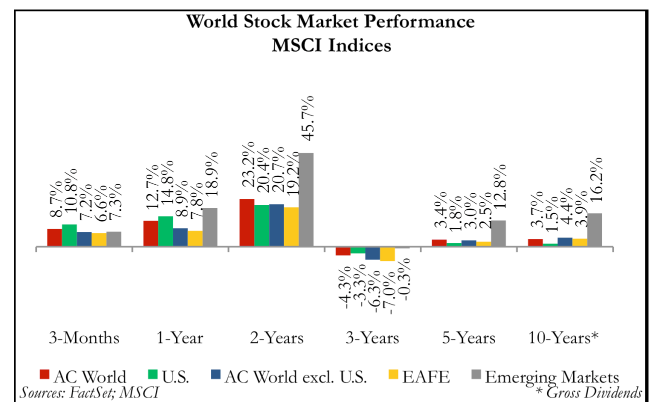

Figure 6

The Chinese economy has grown to become second largest in the world overtaking Japan in 2010. According to ING and quoting the World Bank Group, the largest 8 emerging economies in the world now contribute more to global growth than the European Union, Japan, and the U.S. combined (on a Purchasing Power Parity basis.). Emerging markets now represent 83% of the world's population but only 34% of global GDP and 24% of global equity markets in US dollar terms (Source: Factset, IMF).

Hedge Funds

Hedge funds endured a challenging 2010 with equity based strategies struggling to keep pace with the broad market. Volatility and rapid reversals of market sentiment amid an unexpectedly strong equity market proved difficult to navigate. As managers remained skeptical of the economic recovery and the sustainability of a continued stock market rally, they maintained low gross and net exposure for much of the second half of 2010. Low levels of market exposure and poor performance across short books lead to disappointing returns for many equity long/short funds. With a fundamental quality bias in both long and short portfolios, the "risk trade" described above left many managers on the wrong side of trades when markets moved sharply. Those sharp moves, followed by quick reversals also made it difficult for managers to adjust portfolio exposures at appropriate times. In the end as shown in **Figure 7**, the HFRI Hedged Equity Index managed a respectable 8.2% return for the year. Equity market neutral managers however found markets even more challenging. With no meaningful net market exposure, non-existent short rebates and borrowing costs, managers struggled as the HFRI Equity Market Neutral Index posted a disappointing 2.2% for the year. Fund of funds fared better with event driven, global macro, and credit related trades enhancing returns, but still only managed mid single digit gains for the year.

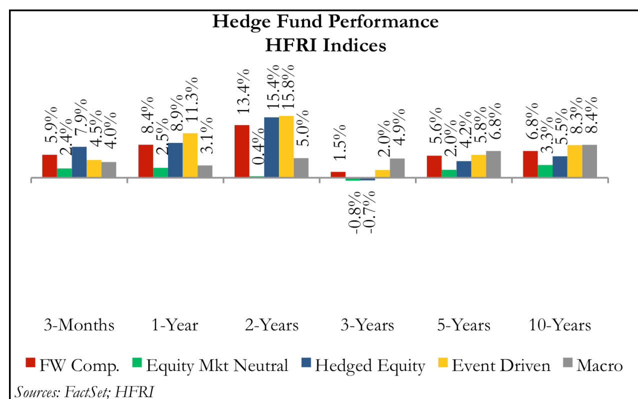

Figure 7

According to the Bank of America Merrill Lynch Hedge Fund Monitor, going into year end equity market neutral managers maintained a slight net short position while neutralizing size and quality factors. Funds appeared to be slightly favoring growth over value but remain near neutral. Long/short managers reduced net exposure to approximately 25% from nearly 30% earlier in the quarter while also exhibiting some growth bias. 2011 should be a more conducive year for fundamentally based equity strategies assuming markets refocus on specific stock fundamentals rather than the headline trading that characterized 2010. Rising volatility within a discerning stock market would create a tailwind for these strategies. While credit strategies have been extremely profitable coming out of the financial crisis of 2008, opportunities appear to be diminishing. However, merger arbitrage and other event driven trades will likely benefit from any increase in corporate merger activity.

Real Estate

Amid a stabilizing US economy, commercial real estate market fundamentals continued to improve in 2010. As transaction volume and liquidity returned to the market, appraisal values increased from very conservative levels the prior year. Through the first 9 months of 2010, transactions were up 88% from the same prior year period (UBS). By late 2010, contribution queues had replaced the redemption queues for many real estate funds earlier in the year as investors suspended redemption requests and allocation additional capital to the asset class. The NCREIF Index gained 13.1% for 2010 including 8.7% in the second half of the year. The full year return was comprised of 6.8% income return in addition to 6.0% from price appreciation. Apartments led all property types for the year gaining over 18%. Apartment vacancy rate declined by a record 7.2% in the third quarter and rent growth continues to improve. The national office vacancy rate, on the other hand, reached a 17 year high of 17.5% in the third quarter and is likely to remain high until the US employment picture improves. As **Figure 8** illustrates, the trends are showing promise. Fundamentals in the retail sector appear to have bottomed, however vacancy remains above 10% and as with office improvement will rely on the overall level of economic growth and job market gains. Finally, industrial properties are showing signs of improvement and now offer attractive income levels compared to other sectors. (Source:

Blackrock). Ultimately the degree and pace of economic expansion will be the primary driver of real estate market returns going forward.

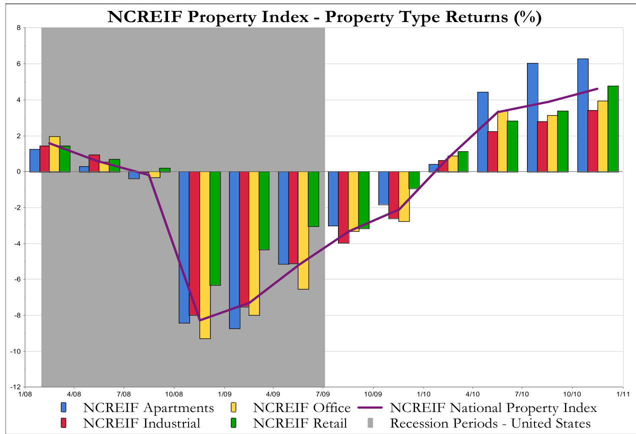

Figure 8

Conclusion

2011 is likely to be a year of transition for the US economy and global capital markets. On the economic front, employment gains will be the key indicator of a sustainable economic expansion. Sources of job growth in the US will not be the same in the future as they have been in the past. New industries or the resurgence and evolution of established sectors will likely have to drive job creation in the future. Fiscal responsibility will be in the spotlight for not only the federal government, but state and local municipalities as well. Monetary policy must be executed perfectly as liquidity must at some point be drained from the system and stimulus removed. Internationally, developed markets must find a way to stabilize their economies and foster growth in the face of their own demographic and fiscal headwinds. Investors are likely to be faced with low forward return prospects for bonds leading them to consider riskier asset classes such as equities or alternative strategies aimed at enhancing return potential. Otherwise, portfolio returns may fall well short of established return objectives and liabilities in the near term. At the same time, portfolio deliberations within the proper risk focused decision framework should maintain prudence and exercise flexibility and patience.

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