Investment Outlook and Strategy 2011 2H

Investors have short memories. While the reasons for the 2008 financial crisis have not gone away or been adequately addressed, markets have recovered nicely.

Some history:

- 2007, US house prices and Mortgage Backed Securities fall.
- 2008, a global credit crisis, Bear Stearns, Merrill Lynch, AIG, Lehman disappear.
- TARP, TALF, PPIP, HAMP, QE.
- So that more banks would not fail.
- 2009, equity and credit markets bottom 2Q, Libor market stabilizes, equity bull market begins.
- 2010, European sovereign debt spreads widen on PIGS default probability.
- 2010, Fed begins monetizing government debt under QE2, risk assets resume second leg of bull run.
- 2011 Gold reaches over 1550 USD per oz in an indictment of fiat currencies.

It has been a period of high volatility, of a credit crisis followed by a massive concerted effort at reflation and recovery. How could a problem of such scale have been dealt with in so short a time frame with such (relatively) little pain?

A few questions:

- Where is all the debt that precipitated the 2008 financial crisis?

- What is the status of that debt?

These are inconvenient questions but worth asking. Debt cannot be destroyed it has to be paid down, restructured or defaulted on.

<u>The issues in 2011:</u>

- Inflation
- Middle East North Africa political instability
- Japan Quake and Tsunami
- European sovereign debt crisis

Developed ma
rkets equities have shrugged of all of these events. Emerging markets equities began to correct on the inflation issue well before 2011, around November 2010. Otherwise investors have simply discounted these events and pushed equities further ahead.

<u>More questions:</u>

- Where are the housing markets in Europe and US?
- How will debt be paid down? Sovereign debt? Mortgage and consumer debt?
- Will any of the PIGS default?
- What are the prospects for economic growth globally?
- What are the prospects for asset markets?

<u>Some answers:</u>

- Housing markets have been slow to recover in the US and Europe (in the bubble markets).

    - This is a big drag on their economies – No more HELOC.
    - And on central bank balance sheets being the largest holders of mortgage debt.
    - In total a massive destruction of wealth from which there has yet to be a recovery.

- Central banks have attempted to inflate the debt away with limited success. Inflation filtering into core CPI has curtailed efforts to further debase currency and debt.
    - No more ability to monetize government debt.
    - Or private debt.
    - More creative means may be found.
- Non USD based investors in USD debt have already faced de facto default. PIGS are either cash flow or balance sheet insolvent.
    - Major central banks may be facing insolvency as well.
    - And may need to print
      money to remain solvent.
    - Which is highly inflationary.
    - And may not stave off default

<u>A few observations:</u>

- Assets such as assets and high yield bonds deemed too expensive too hold in 2008 are deemed cheap today.
- LBO activity has recovered with leverage levels now approaching 2005-2009 levels.

- The leveraged loan market has revived with increasing examples of covenant lite issues being done.

- Approaching the end of QE US treasuries rally. What does this say about investor risk aversion?

- The VIX has gone below 2007 levels to 2003 -2004 levels.

- The MOVE has gone to late 2007, 2004 levels.

- US corporate credits yield less than they did pre 2007.

- The S&P500 rose through the Japan Quake and the MENA revolutions.

<u>A few conclusions:</u>

- The debt overhang from 2007/2008 has not been paid down, defaulted, reorganized or otherwise addressed.

- Central bank and government policy has been the marginal driver of economies and markets. These policies have led to highly stressed sovereign balance sheets which mean that these policies cannot continue.

- In the long run the outperformance of creditor nations versus debtor nations will take hold.

- The issues of the great financial crisis have not been solved or adequately addressed. They have been transferred out of sight.

- Risk aversion is too low. The market price of risk is too low.

- Human nature drives humans to buy high and sell low. It pays to disconnect this natural tendency and prepare to buy low and sell high. Thi
s takes discipline and patience. The risk that markets wake up to the unresolved nature of the 2008 crisis and sell risk assets down sharply is high.