



Economic & Market Perspective | October 2011

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1. U.S. Economic Update: Debt Deal Dilemma

The fever pitch of the European debt crisis had moderated slightly by October month-end, as signs of convergence were beginning to emerge on how to provide support to debt makers and bolster bank capital levels. While questions of long-term solvency remained very much unanswered, the markets were focused on any signs of progress, and European policy makers had delivered, at least for the moment. Unfortunately, that euphoria was short-lived, as on the last day of the month, Greek Prime Minister George Papandreou called for a vote of confidence and a referendum of his country's bailout package, sending global markets into a tailspin and resurrecting fears about a disorderly default of Greek debt. Oh, if only the ultimate dealmaker Monty Hall could broker this impasse!

Adding to investor anxiety is the looming round of contentious negotiations over the budget and appropriations here at home. Over the next two and a half weeks, both houses of Congress will be in session and must pass appropriations bills to allow the government to continue operating beyond



Source: www.apimages.com

November 18. A government shutdown over this issue was only narrowly avoided in April, and the markets are bracing for yet another round of tough talks. In addition, the Congressional Super Committee

will negotiate the second phase of the Budget Control Act. According to the terms of the summer negotiation, the committee is required to produce its recommendations by November 23, Congress must vote on their plan by December 23, and President Obama must sign it into law by January 15. Early reports indicate the committee remains deadlocked on the elimination of certain deductions and tax increases for high income earners, but have found common ground on cuts to some entitlements, including increasing the Medicare eligibility age from 65 to 67, lowering cost-of-living increases for pensioners and Social Security recipients, and capping discretionary spending for the next decade.

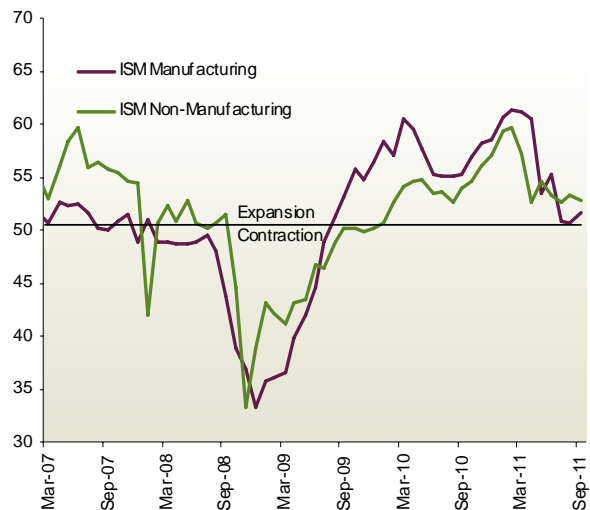
“Early reports indicate the committee remains deadlocked on the elimination of certain deductions and tax increases for high income earners...”

With politics continuing to take center stage, market volatility has yet to diminish, though it was a welcome development to see risk appetite return in the month of October after the relentless sell-off that characterized the summer. Besides the optimism created by a newer, bigger plan to address the European sovereign debt crisis, markets were also reacting to improving U.S. economic data. For now, a return to recession appears off the table in the U.S., a blessing to be sure, though the course of a slow and weak U.S. economic recovery remains unaltered.

Manufacturing data released during the month of October confirms this view of a modestly expanding, but not recessionary, economy. The September Institute of Supply Management (ISM) manufacturing index was reported at 51.6, following two months of just barely clearing the reading of 50, which is the dividing line between expansion and contraction. Regional surveys also bounced higher after weak summer readings, with notable improvement from the Philadelphia, Kansas City, and Dallas areas. As for service sector activity, the

September ISM non-manufacturing index declined only slightly to 53.0 from 53.3 in August. With service sector activity now above the 50 expansion line for 22 consecutive months, a double dip recession seems unlikely.

Business Activity Expansion Hanging in There, Says ISM



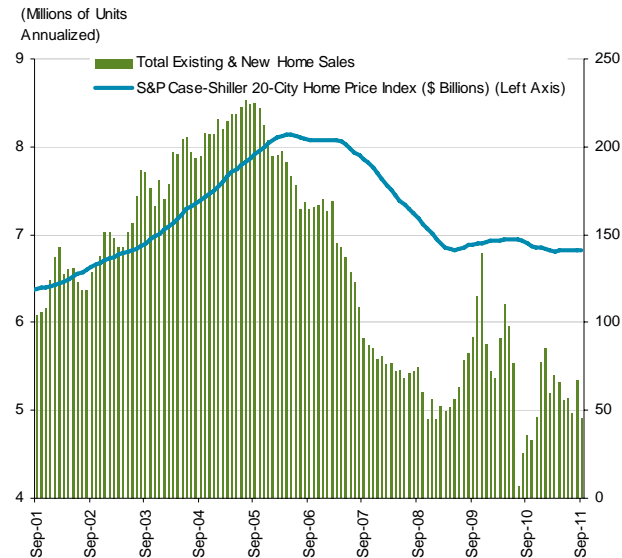
Meanwhile, U.S. housing statistics remained fairly level. While existing home sales for September showed a decline of -3.0% to an annualized pace of 4.91 million, August's data was revised higher to a 5.06 million unit selling rate. New home sales were up +5.7% to a 313,000 annualized rate; better, but nowhere near their 2006 peak. While September housing starts rose +15.0% to a 658,000 annualized pace, nicely above expectations, those gains were aided by summer weather, and may have been skewed higher by rebuilding efforts in the aftermath of Hurricane Irene. Offsetting the gains in housing starts was a -5.0% decline in building permits, to a 594,000 annualized rate. As for construction activity, it enjoyed a nice +1.4% bounce in August, following a -3.3% dip in July.

Home prices, according to the S&P Case-Shiller Home Composite Price Index, fell only slightly by -0.05% month-over-month, bringing the year-over-year decline to -3.8%. Similarly, the Federal Housing Finance Agency (FHFA) home price index reported a decline of -0.1%, for a year-over-year slide of -4.0%. Overall, housing data confirms the theme of an economy for

whom the worst is probably over, but one which lacks momentum moving forward.

Turning to the job market, employment statistics continue to show only mediocre improvement, with September non-farm payrolls growing just +103,000 in

Pace of Home Price Declines Slowing, Housing Market Finding A Bottom



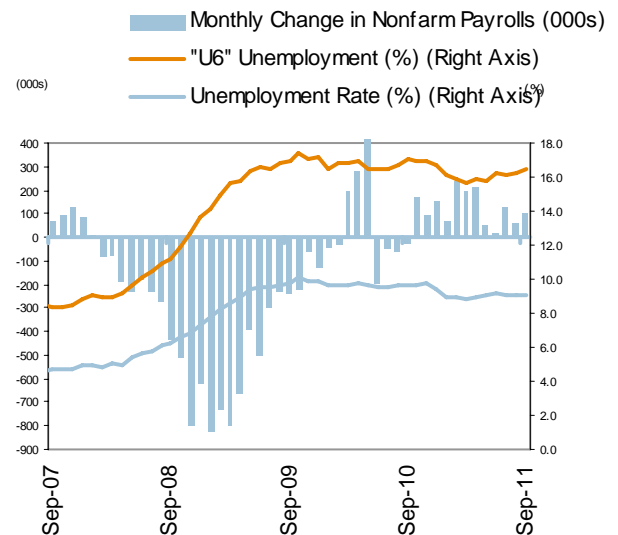
September. While most of these gains were in service sector jobs like business services and information technology, it was notable that the construction and mining sectors contributed to a net increase of +18,000 jobs from the goods-producing sector. Unsurprisingly, the government continues to reduce its own payrolls.

Perhaps the best news about the September employment report was that August's goose egg of a number was revised higher to show job gains of +57,000.

Unfortunately, these modest payroll additions have done little to improve the unemployment rate, which held steady at 9.1%. Even worse, the "U6" measure of employment, or the so-called underemployment rate which includes discouraged workers and those working part-time for economic reasons, rose from 16.2% to 16.5% in September. Also alarming was the news that the average duration of unemployment hit a new high at 40.5 weeks, and that average hourly earnings continue to stagnate, up only +1.9% year-over-year, a rate that does not keep pace with inflation.

So while monthly employment gains are welcome news, and encouraging considering the alternative, the bottom line is that the economy is creating jobs at a six-month average of only +96,000 per month, which is not enough to lower the unemployment rate (+200,000 in job gains per month would be necessary).

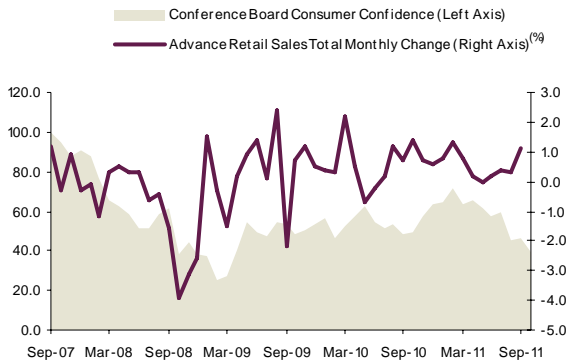
Minimal Employment Gains Means Still Elevated Unemployment Rate



Without material improvement in either employment or housing, our expectations from the consumer should necessarily be modest, with tolerance for choppy patterns in spending. Such has been the case for the American consumer, who came out strong in September after a concerning zero-growth sales reading in August. Indeed, retail sales rose +1.1% in the month, their biggest move in seven months, with auto sales leading the way, up a whopping +3.6%. But car sales were not the only strong component, for excluding automobiles, sales still rose +0.6%, with ten of the thirteen total retail sales categories in positive territory. Granted, +1.1% is not itself an overly impressive rate of growth, especially after a flat August that should have created some pent-up demand. Nevertheless, this reading was a welcome sign that consumers returned to stores during a rocky September in the markets.

Unfortunately, confidence readings would suggest that spending could be at risk of future declines off of already very low levels, as the Conference Board index

Retail Sales High, Confidence Low



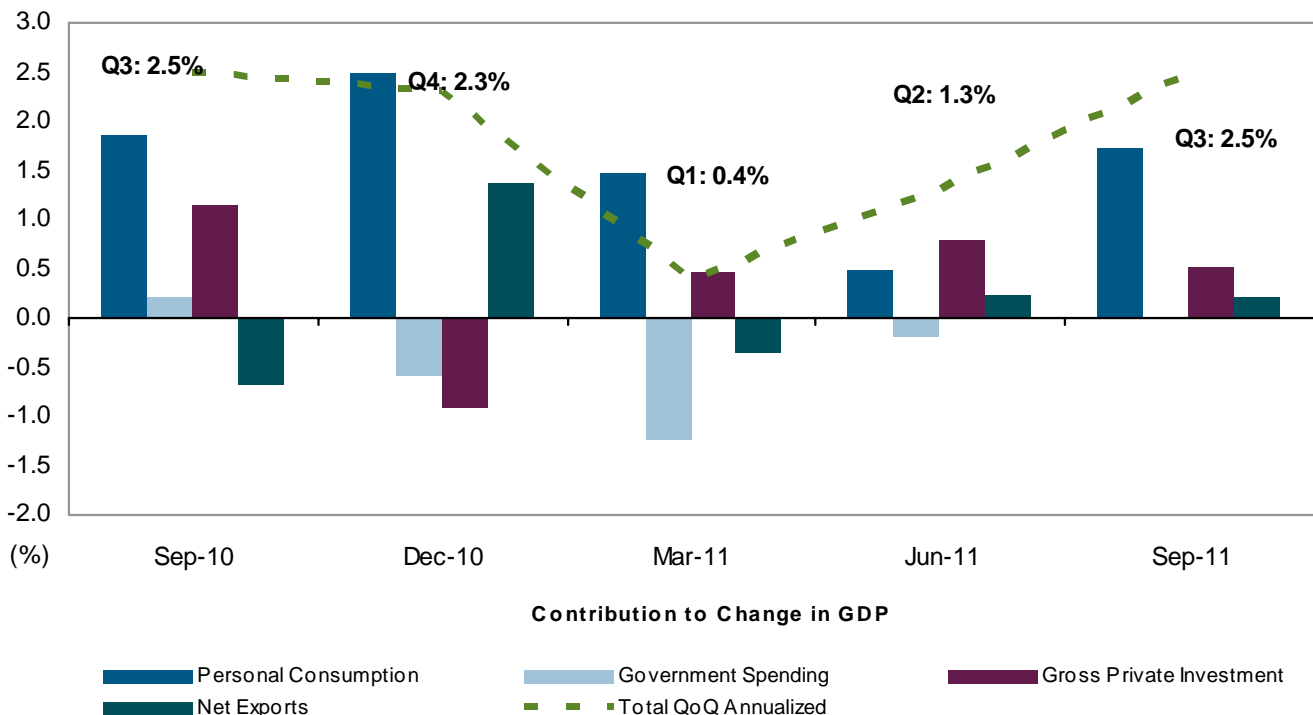
faded notably lower to a 39.8 reading. The University of Michigan consumer sentiment index was not quite as bad---clocking in at 60.9 in October. In both cases, assessments of the present situation and future outlook were still well-below other post-recession readings. Indeed, confidence readings today are akin to those levels reported in early 2009 during the height of the credit crisis, and 1980 post savings-and-loan scandal. Although the correlation between consumer confidence and consumer spending is not as strong as one would think, this report does not bode particularly well for holiday spending.

Neither does the trend in income growth, which rose

only +0.1% in September, following a decline of -0.1% the prior month. As we noted, spending accelerated in September, at a +0.6% rate according to the outlays report, but this growth was financed by a reduction in the savings rate of -0.5% to a four-year low of 3.6%. Such behavior is not sustainable in the long-term, and makes us wary of any bold calls for above-trend growth in 2012.

Regarding GDP growth, the first release of Q3 GDP showed a recovery from Q2's abysmal rate of just +1.3% to a more solid +2.5% pace. This growth was especially impressive given the backdrop of a U.S. sovereign debt downgrade and in the context of a severe equity market correction. On the plus side, personal consumption rose +2.4%, after a more modest rise of +0.7% in Q2. Fixed investment spending rose +13.7%, after a +9.2% increase in Q2. However, net exports were lackluster, rising only +2.4% for the second slowest quarter of growth since the recession. Meanwhile, government spending flat lined, which is probably good news since it had represented a significant drag on growth in the prior three quarters. Indeed, only the more choppy category of inventory accumulation was a net detractor from GDP, rising only +\$5.4 billion and clipping GDP growth by -1.08%. However, this more

GDP Rebounds Nicely in Q3, Double-Dip Recession Off the Table



volatile category could be poised for a rebound in Q4 in accordance with the business cycle as much as anything else.

While a +2.5% GDP growth rate is nothing to write home about, it is significantly better than the outlook for recession that many had. Meanwhile, the rising trend in inflation appears to have tapered, as the September Consumer Price Index (CPI) roughly equaled expectations with the overall rate rising +0.3% month-over-month, and +3.9% year-over-year, while the core was up slightly less-than-expected at +0.1% month-over-month, and +2.0% year-over-year. In this context, the Fed should be able to continue its extraordinarily accommodative monetary policies, but not feel the full brunt of pressure to introduce more.

Not that they are not thinking about more. The September FOMC meeting minutes revealed a detailed discussion of policy options from which they ultimately chose "Operation Twist." The three options discussed were: 1) reinvesting maturing securities in the System Open Market Account (SOMA) at longer maturities; 2) selling shorter maturity securities from the SOMA to reinvest at longer maturities-"Operation Twist"; and 3) buying longer-maturity securities outright...a "QE3."

Regarding the possibility of a QE3, the minutes revealed worries that such action would lift inflation and inflation expectations more than it would lift growth. It is noteworthy, however, that the committee did not see this as cause to dismiss further quantitative easing outright. Rather, they felt QE3 should be reserved for a time when deflation is a risk again. While there were some discussions about setting policy targets on inflation and employment, as well as cutting the interest payable on reserves, those options were dismissed, at least for the

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moment, on the grounds of the questionable/controversial nature of their effect.

Nevertheless, going into November, expectations appeared to be building within the market for a QE3, especially as the European sovereign debt crisis weighed on the outlook for growth. Even the Fed's own Beige Book release, a survey of the economic situation across the Fed's twelve reporting districts, showed subpar expansion at a time in a recovery when one might expect more robust gains. Businesses were reported as holding back on spending, as "a weaker and more uncertain economic outlook had increased caution and was weighing on future spending plans." Meanwhile, some retailers planned to build smaller pre-holiday inventories as a result of their concerns and uncertainty. Also noteworthy, credit availability and demand appeared to have weakened broadly.

As the Fed at least considers a QE3, Washington remained mired in their budget negotiations, though President Obama did make a notable splash in the month with some attempts to stimulate the U.S. economy, at least at the periphery. Most notably, the Federal Housing Finance Agency (FHFA), under the President's direction, announced some changes to the HARP (Home Affordable Refinance Program) in an attempt to raise the program's reach by 20%, or 1 million borrowers. Along with broader qualification requirements, other adjustments announced included lower fees, removal of loan-to-value limitations, a reduction in appraisal requirements, unified delinquency standards, and a waiver of certain reps and warranties. The President also announced a plan to ease the burden of student loans on college graduates by capping federal student loan repayments at 10% of discretionary income. In addition, any debt still owed under the federal student loan program will be forgiven after 20 years. Finally, the President declared an end to the Iraq war, announcing all American troops would be withdrawn from the country by year's end, making a promise that "after a decade of war, the nation that we need to build and the nation that we will build is our own, an America that sees its economic strength restored just as we've restored our leadership around the globe."

Let's hope he can convince the members of the Occupy Movement that policymakers are focused on this goal, as across the country demonstrations, protests, and activist communities are springing up in rebellion about social and economic inequality, corporate greed, and corruption. While the movement as yet remains unorganized and with only nebulously-defined goals, the spirit of what they stand for is a clear and direct result of an economy whose so-called recovery has left many disappointed and disenfranchised. While a return to recession may not be in the cards, a continuation of the current muted recovery is unlikely to alleviate any of these pressures. Furthermore, it cannot be understated how vulnerable to shocks our path forward has become.



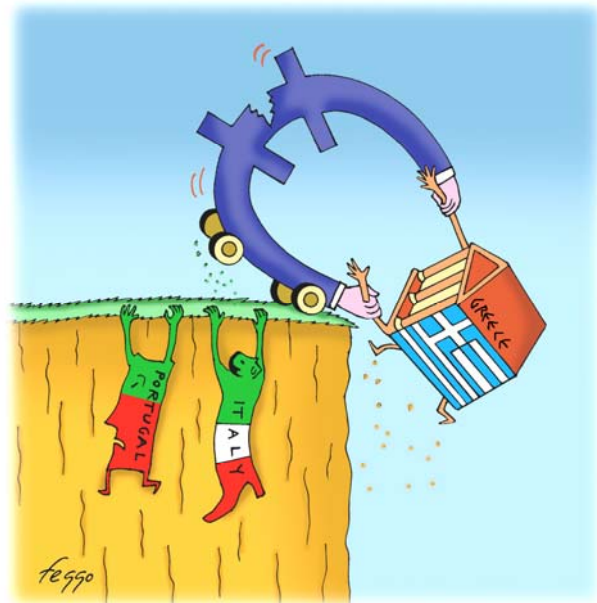
Source: www.iStock.com

2. International & Emerging Markets Economic Update: Please, No More Dra(ch)ma!

October began with little of the enthusiasm typically associated with earnings season, as macroeconomic data and geopolitical concerns - typically pushed to the back burner - instead commanded the full attention of investors. Much of the concern was focused across the Atlantic, as European policymakers spent the month in the throes of negotiating a plan which they hope will save their monetary union from a meltdown of truly epic proportions. News out of the pre-summit meetings proved spotty, scattered, contradictory and for investors, certainly frustrating, as the axis of power

continued to rotate around the unlikely, and clearly uneasy, partnership of Germany and France. A shifting timeline also made the situation even more volatile, as supposed “deadlines” were moved throughout the month as an agreement hung in the balance.

Adding to the challenges was the fact that unlike previous agreements, policymakers were tasked with finding a specific solution for Greece, while also laying the groundwork for large scale changes to the current support mechanism (the European Financial Stability Facility), outlining a plan to recapitalize Europe's banking sector, and defining a new path forward as it relates to fiscal governance within the euro zone.



Source: www.cartoonstock.com

Complicating matters further were reports out of the Troika that indicated that Greek finances are in even worse shape than they were just weeks prior - not surprising considering the number of citizens on strike. It was very clear that the 21% haircut for private sector bondholders discussed in July was far from sufficient. In fact, the auditors' report stated, “Given still-delayed market access, large scale additional official financing requirements would remain, estimated at some 114 billion euros. To get the debt down further would require a larger private sector contribution” of at least 60% to reduce debt below 110% of gross domestic product by 2020.

Despite these challenges, and a good number of fits and starts, European policymakers did deliver their long awaited proposal on October 26, and although it addressed some of the questions raised over the past year, a panacea it is not. First of all, banks have agreed to accept a 50% write-down on their Greek debt holdings. Although there was significant pushback on the part of the banks - who after all, had agreed to a much less onerous write-down back in July - it became clear during the course of the negotiations that if the banks did not accept the deal, a disorderly default was almost certain. With this agreement, Greece will receive an additional 130 billion euros of official aid, up from the 109 billion euros promised in July. Against the backdrop of the proposal, the International Monetary Fund also agreed to distribute its 2.2 billion euro share of the next installment of the initial Greek bailout, joining euro zone leaders who approved their 5.8 billion euro share in mid-October. For their part, banks will receive about 30 billion euros in "credit enhancements," and because the agreement is being perceived as voluntary, it is unlikely to trigger a "credit event" in the credit swap market.

Second, the agreement calls for the European Financial Stability Facility's firepower to increase from 440 billion euros to 1 trillion euros, reflecting a leveraging up of four to five times. The details are spotty at this juncture, but it appears that the current facility will be leveraged up through two avenues: one, the fund will be used to insure bond sales; and two, a special purpose investment vehicle (SPIV) will be created that would attempt to entice investments from both public and private institutions and investors. This second avenue created quite a bit of buzz, as it is widely speculated that developing economies such as China and Brazil would be the main targets for this type of vehicle, and both countries certainly have cash to spend.

Third, member governments agreed on 10 measures to strengthen fiscal discipline and "economic union" through limited Treaty changes; these measures are based on a desire for the group to maintain greater control of budgets, and offer the latitude to enact sanctions more swiftly if necessary. This portion of the

Broad Outline of the Debt Plan

- **Greece (voluntary) private sector participation (PSI):** The PSI was set at 50% for all Greek debtholders excluding the ECB and IMF.
- **EFSF leverage:** Leverage, in the form of insurance and the creation of a SPIV with private sector funding, is set to be 4x to 5x, bringing potentially available funds to up to 1 trillion euro.
- **Eurozone governance:** Member governments have agreed on 10 measures (e.g., more control of budgets and faster and swifter sanctions if necessary) to strengthen fiscal discipline and "economic union" through limited Treaty changes.
- **Bank Recapitalization:** Deadline of June 30, 2012 for banks to increase their core Tier 1 capital ratio to 9%, either by their own means or with national backstops.

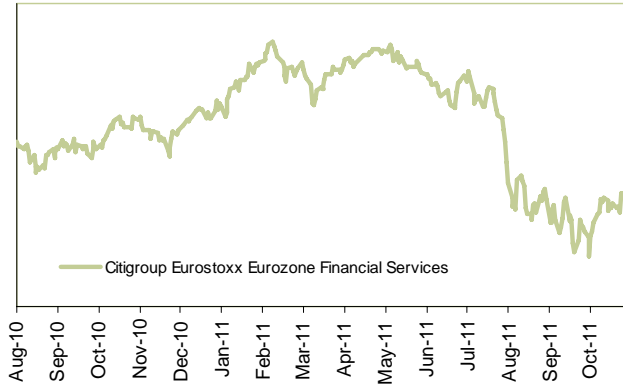
agreement appears to be directed at Italy and Spain, for although they have not received official aid as of yet, the threat of contagion, particularly for Italy, is very real. (In fact, Prime Minister Silvio Berlusconi has been locked in a political battle for months as he attempts to push through meaningful austerity measures in response to pressure from other members of the euro zone.)

Finally, an agreement was struck on parameters for the recapitalization of banks. Banks will have until June 30, 2012 to reach core capital reserves of 9% following a write-down of their sovereign debt holdings. Any bank who does not hit the target will face "constraints" on bonuses and dividend payments. The European Banking Authority has estimated that banks will need 106 billion euros to reach this target, with Spanish and Italian banks together accounting for a little over a third of that figure. National governments will be on the hook initially to help banks recapitalize, and the EFSF will step in only as a last resort option.

Announcement of the agreement pushed equity markets higher and periphery sovereign yields lower, and it appeared that the sovereign debt crisis, although clearly still on the front burner, had at least been turned down to a simmer. Details on implementation and execution – certainly the Achilles heel of European policymakers

over the past year – were lacking, but it appeared that the proposal would be enough to calm fears at the upcoming Group of 20 meeting.

Eurozone Financials Beset by Debt Woes



Greece, unfortunately, had other plans. In fact, just prior to the summit, Greek Prime Minister George Papandreou shocked his European Union brethren by calling for a referendum vote by Greek citizens to once and for all determine the status of Greece as a member of the euro zone. Widespread condemnation in both his country and around the world forced Papandreou to redefine his proposal, and then drop the idea altogether as it became clear that his Pasok party would not afford him enough support to win yet another confidence vote while he remained committed to such a measure.

Instead, he convinced party members to back him in an early November vote by vowing to resign his position and seek a unity government, thereby bowing to opposition pressure to offer them a seat at the negotiating table in exchange for dropping the referendum and committing to new elections.

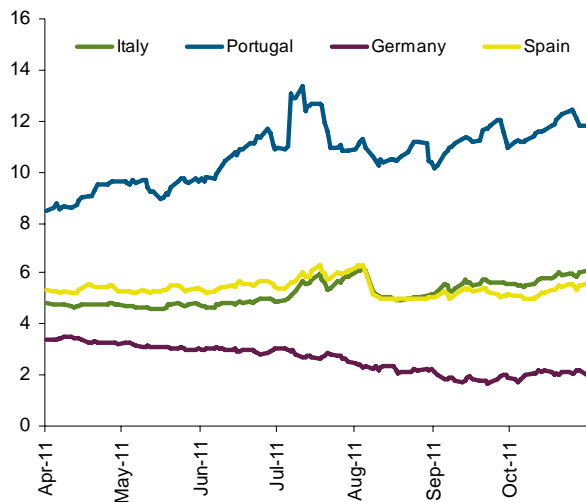
Certainly, the move appeared ill-timed, given that finance ministers from around the euro zone were scheduled to meet November 7 to discuss the implementation of the October 26 agreement; without a government, the portions of this agreement related to Greece are most certainly off the table. Yet, it appears Papandreou has achieved his aim to secure support for the agreement. By offering to resign, Antonis Samaras, the leader of the main opposition party “agreed to form a new government with the aim of leading the country to elections immediately after the implementation of European Council decisions on October 26.” At this juncture, the October 26 agreement appears to be in limbo as the political situation in Greece will most certainly need to firm up before any more checks will be written to shore up their debt. This may include the next tranche of previously approved support, which was slated to be released by the Troika during the first half of November.



Source: www.apimages.com

A change in the guard in Greece was not the only meaningful shift in power in the early days of November; leadership of the European Central Bank passed, as planned, from Jean-Claude Trichet to Mario Draghi. Draghi wasted no time in making his mark, unexpectedly lowering interest rates to 1.25% from 1.50% in response to indications that growth is slowing and inflation is on a downward trend. He went even further, hinting that continued economic deterioration, and in turn, deflationary pressures, could result in benchmark interest rates under the 1% mark. This represents a shift in tack for the governing body, which has been accused of being quite narrow minded, focusing on transitory inflation while ignoring the effects of the debt crisis on the economy. What has not changed, however, is the ECB's opinion on its role as it relates to sovereign debt yields, indicating that some sovereign debt (i.e. Italy, Portugal, Spain) deserve to be trading at higher yields than others, and that it will intervene in the secondary market as necessary to avoid dislocation, but not to maintain some sort of implicit target yield.

Periphery Spreads Continue to Widen

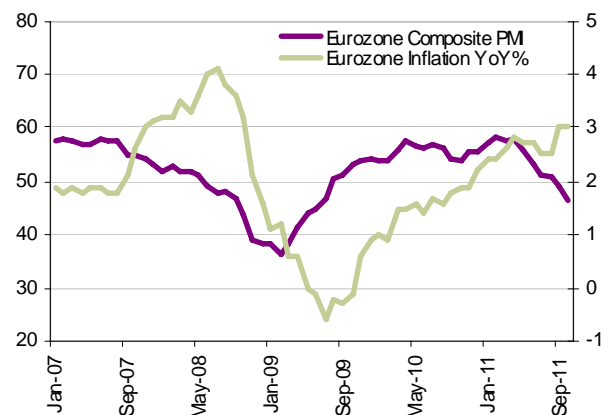


With the specter of default looming, and austerity programs full speed ahead, the deterioration in economic data in Europe comes as no real surprise. Euro zone unemployment in October rose to 10.2%, up from 10.1% and the highest reading in over a year. The euro zone Economic Sentiment Indicator, the European Commission's monthly survey measuring confidence

among industrial, retail and consumer participants, indicated a decline to 94.8 in October from 95. The reading, although slightly better than the anticipated 94 print, indicates that the best case scenario for the fourth quarter is likely flat GDP, with a very real possibility of a contraction. Inflation also remains above the ECB's target of 2%, although the 3% year-over-year increase experienced in October was flat versus September. Two regions that are of particular concern are Germany and Italy. The German recovery, which had been helping to prop up the region, appears to be all but kaput, as October brought weaker retail sales, higher unemployment and lower confidence readings as represented by both the ZEW and IFO surveys. Italy is also under pressure, with unemployment rising to 8.3%, while inflation continues to trend well above 3% year-over-year. Couple this deterioration with a renewed focus on austerity and the stage is set for an accelerated slowdown at a time when Italy can ill afford to appear weak in the eyes of investors.

Asian countries, for their part, remain conscious of the activity in Europe but appear comfortable at this juncture to focus primarily on domestic concerns. Japanese policymakers continue to wage war on the appreciating yen, as the safe haven currency's sharp rise is a very real threat to the Japanese recovery. However, efforts to intervene, of which the most recent occurred on the last day of October, have resulted in only small, unsustained movements downward in the yen, and the

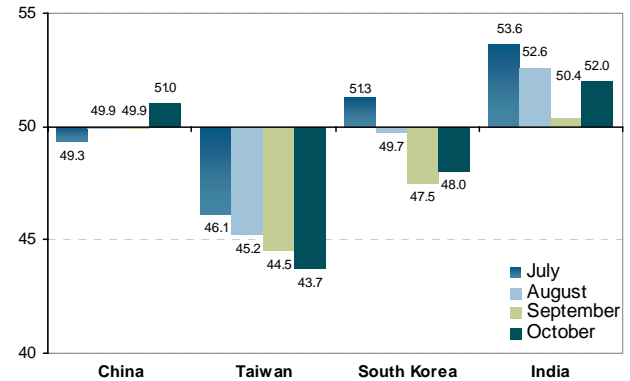
Inflation Stable as Manufacturing and Services Deteriorate



Bank of Japan has therefore also been easing monetary policy in tandem to prevent a backslide. For example, the BOJ announced that it would keep interest rates on hold, but that it would increase its asset purchase program from 5 trillion yen to 20 trillion yen, which will be used to purchase JGBs in the secondary market. Although the BOJ is still expecting +2.2% growth for fiscal 2012, that is down markedly from its initial +2.9% forecast. The forecast for inflation was also revised following the October meeting, with CPI now expected to rise only +0.1% for 2012, also lower than the previous forecast of +0.7%. These numbers may not be enough to counteract what appears to be a limitless desire by investors to seek shelter in the yen, despite Japan's astounding 205% debt-to-GDP ratio.

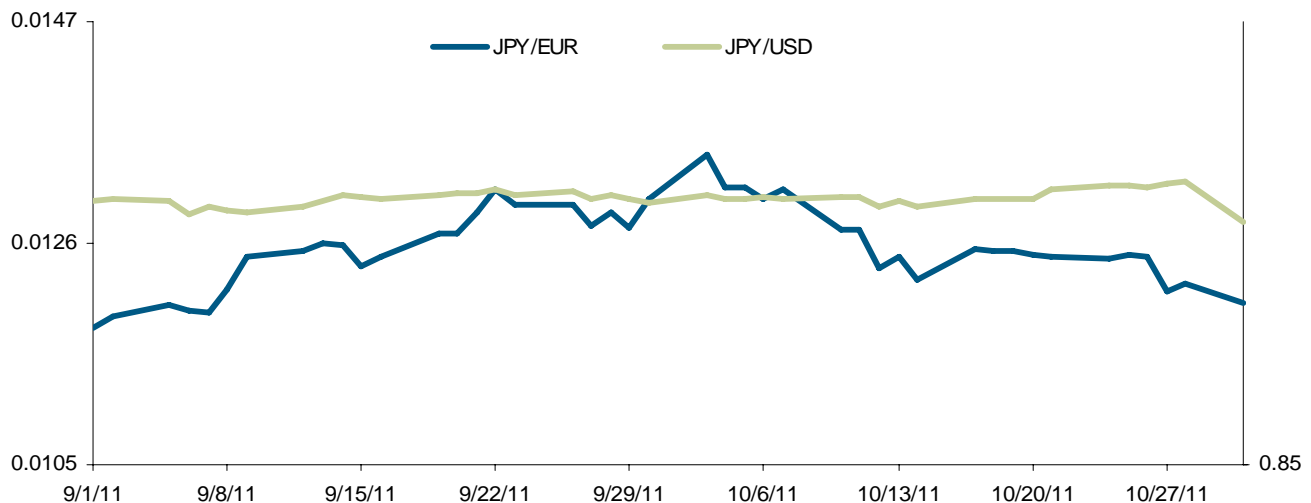
As for emerging Asia, moves to tighten monetary and fiscal policy over the course of the last 18 months appear to be bearing fruit. Manufacturing PMI prints out of Taiwan and Korea have been trending lower over the course of the past several months. China and India experienced a moderate increase in manufacturing activity in October, although readings in both countries are still off recent 2010 highs. Inflation in countries such as China, Indonesia and Korea is also trending down, although it did tick higher in Thailand as the country struggles with widespread flooding. Indeed, these readings make the next move by central banks in these countries – other than India - likely to be a rate cut,

Exporters Feeling the Pain of European and U.S. Slowdown



rather than another rate hike. In fact, Indonesia's central bank cut its benchmark interest rate unexpectedly in its last meeting, and others are likely to follow suit in the near term. India, unfortunately, does not have the flexibility to cut its interest rates despite evidence of a slowing in export demand, as inflation remains the number one concern in one of the poorest countries per capita in the world. The central bank of India actually raised rates in October by 25 basis points, the 13th such increase since March, and could be forced to continue tightening as rural food prices remain elevated. Of course, it is naïve to assume that the cooling of these economies is entirely due to policy moves, as obviously weakness in Europe and the United States has been a significant contributor. In fact, one consistent trend through much of both the developed and emerging

Intervention Meaningful in Short Term, But Appreciation Likely to Persist



manufacturing data over the last couple of months has been a deceleration in new orders and export orders, indicating that the global economy at large could remain soft for several months to come.

3. Global Market Overview: Shock-tober Becomes Rock-tober

As investors became hopeful that a comprehensive solution to the European sovereign debt crisis would finally be reached, markets turned on a dime in a classic “risk on” move such that global equities and various commodities scored double-digit returns in October for one of the strongest months of performance in recent memory. Safe haven investments such as U.S. Treasuries and the greenback understandably sold off in such a “risk on” environment; but, in a point of distinction, safe haven investments with a perceived inflation hedge like gold and U.S. TIPs surged as investors contemplated the inflationary impact of the extraordinary monetary and fiscal intervention taking place around the globe. Credit-oriented fixed income rallied in solidarity with equities, with the exception of the municipal bond market, which experienced a minor sell-off in sympathy with Treasuries. While hedge fund managers were able to bounce back after a difficult year of fits and starts, the choppiness of the market has given even the most nimble traders trouble these first 10 months of the year.

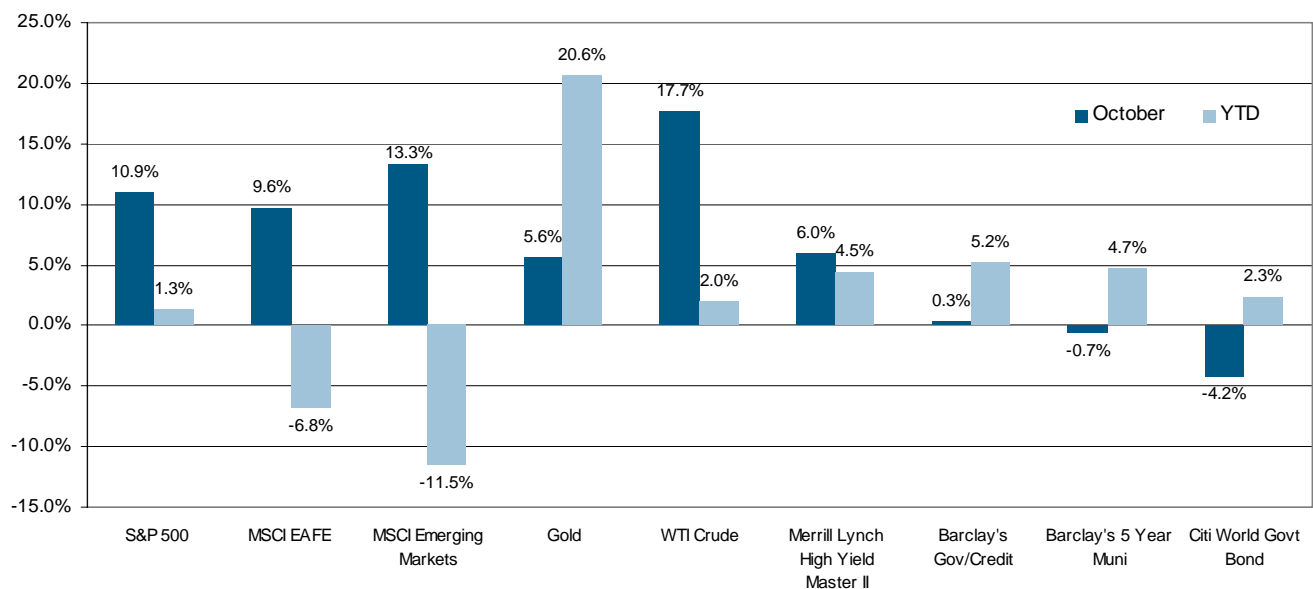
Beyond the European debt deal, a strong corporate earnings season and the +2.5% print of U.S. GDP growth gave legs to this rally, which has caused fears of a domestic double-dip recession to abate. Indeed, investors in U.S. equities feel emboldened now that we have successfully weathered several storms—surging oil prices in the spring, the tsunami in Japan, and political gridlock in Washington. A +9.1% print on Chinese GDP growth, although a little lower than expectations, did not hurt investor sentiment either.

However, by October month-end, some of the euphoria around the European sovereign debt deal was beginning to dissipate, as many of the details of the plan remained in flux, and Italian and Spanish bond yields came under siege. While October’s returns delivered a welcome respite, it is no surprise that the market has reverted back to its volatile but slightly wider trading range as investors await the next catalysts, which include central bank policies as well as political wrangling both here and abroad.

4. Domestic Equities: Comeback Kids

The September swoon continued into the first trading day of October as the market fell to fresh lows for the year and knocked out the bottom of the trading range that had been in effect since July. However, by the time the month ended, September’s dismal returns were long

Global Market Returns



forgotten as October 2011 marked the best single month of equity market performance since 1974. Indeed, the S&P 500 Index returned +10.9% in October, bringing year-to-date returns back into positive territory (+1.3%), though just barely. The Russell 2000 Small Cap Index posted an eye-popping +15.1% gain for the month, however that index was not able to recoup all its losses and is still down on the year (-4.5%).

Worries about Europe were temporarily set aside as markets rallied globally on the news that European officials had not only recognized their problems but were prepared to do something about them. Meanwhile, back at home, investors turned their focus to a revival in U.S. GDP growth and what turned out to be another surprisingly good earnings season.

Indeed, through the end of October, over 69% of companies within the S&P 500 Index reported positive earnings surprises, continuing a trend that has been in place the last eight quarters. Interestingly, analysts continue to be pessimistic about earnings expectations, and are all still reducing forecasts even as corporations have delivered fairly stellar results.

While swirling macro-economic headwinds are surely a distraction, large U.S. corporations continue to make great strides to improve their balance sheets, but equity market valuations have continued to fall as earnings improvements have surpassed stock price movements.

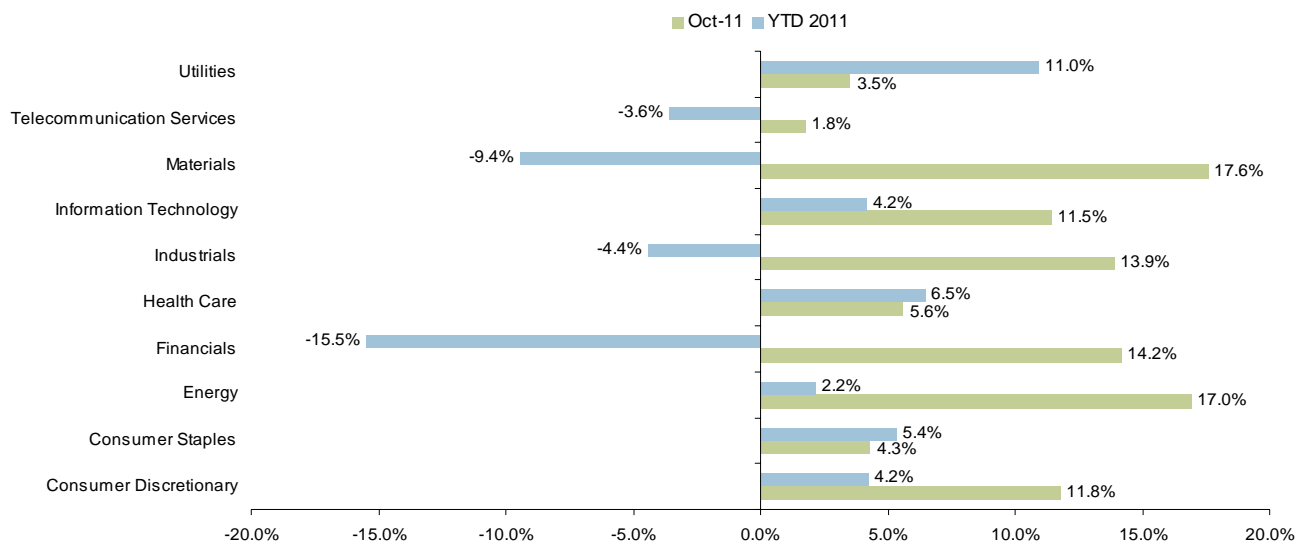
As such, for long-term investors, equity prices look quite attractive at this juncture, and could be poised for a dramatic move higher if a credible solution to the European debt crisis ever materializes.

	Q3 2011	Q3 2010
Positive Surprises	288/415 = 69.4%	353/499 = 70.7%
0% Surprises	38/415 = 9.2%	51/499 = 10.2%
Negative Surprises	89/415 = 21.4%	95/499 = 19.0%

Such a move was definitely evident in October, when every sector in the S&P 500 Index gained during the month, though the more cyclical companies in the materials and energy sectors provided the biggest returns as one might expect. Industrials and business services, financials, consumer discretionary, and information technology also generated double-digit gains. Health care, consumer staples, utilities, and telecommunication services lagged but still ended the month in positive territory.

For now, the beat goes on, with volatility ruling the day in this environment of uncertainty. It should be noted that growth and value stocks were fairly evenly matched in all capitalization segments, registering similar double-digit gains for the month. For the year-to-date, growth has outpaced value in all areas, and large-cap stocks have outperformed both mid- and small-capitalization equities.

S&P 500 Index Sector Returns

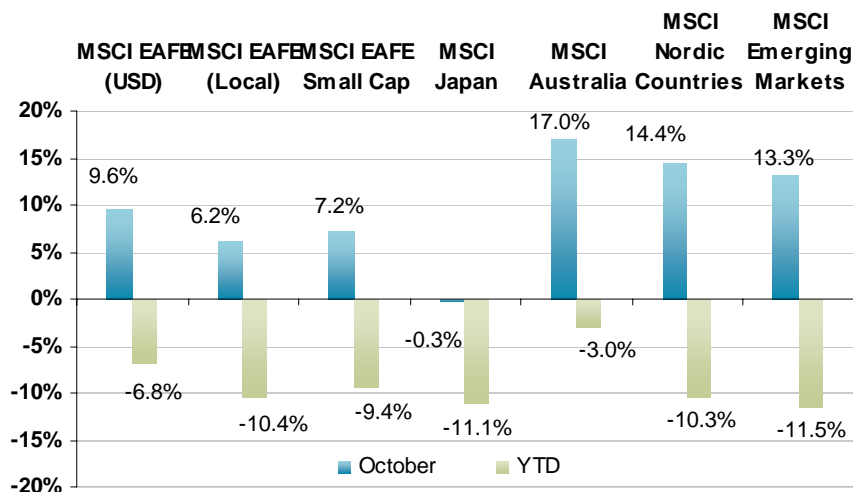


5. International Equities: Reversal of Fortune

After enduring an incredibly painful month of September, which topped off an altogether depressing third quarter, international equity investors saw a true reversal of fortune in the month of October. Many major developed equity markets posted double digit returns as economic data releases proved a bit less foreboding, while optimism around a new and improved plan to staunch a European sovereign debt contagion pushed equities higher towards the latter half of October.

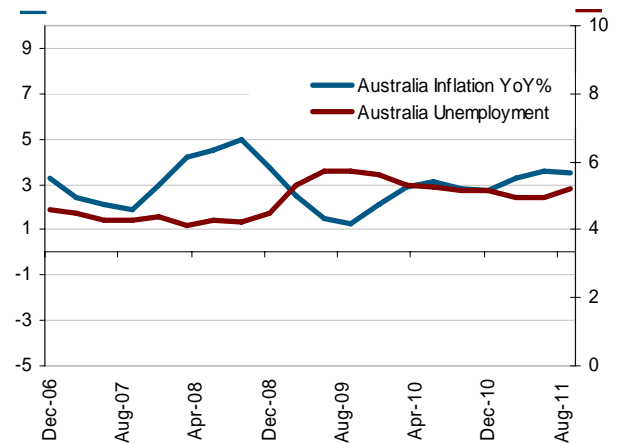
Specifically, the MSCI EAFE index came roaring back from its -9.5% loss in September to post a more than respectable gain of +9.6% in October. From a regional perspective, the Nordic countries, and specifically Sweden and Finland, were some of the best performing countries in the index, as their relatively strong financial position attracted assets set in motion by the month's events. In fact, Moody's reaffirmed Sweden's Aaa rating in a publication during the month, pointing out the country's "very high" economic strength coupled with "very high" institutional strength. Norway was even included in a discussion of potential sovereign wealth investors (along with Brazil and China) who might be tapped to purchase debt through the EFSF's special purpose investment vehicle, although the country's government appeared at first blush less enthused than its emerging market counterparts.

International Equity Market Returns



In another sign that tastes are becoming a bit more discriminating, German stocks also rose substantially, posting gains of +16.1% despite less-than-stellar economic data released during the month. Although Germany will clearly continue to carry the heaviest burden as it relates to aid to the struggling periphery, German stocks have suffered over the past several months, in part because of the perceived additional pressure, but also as a result of short selling by investors precluded from shorting in less stable markets by short selling bans. This short covering certainly helped to move stocks higher.

Australian Inflation Easing Slightly, While Unemployment Climbs



Australian stocks, hit extremely hard in last month's commodities rout, were also higher on the month, primarily on speculation that the

Reserve Bank of Australia would shift to a more accommodative policy stance given indications of slower growth both domestically and for its resource exports. (The RBA did fulfill expectations, cutting rates by 25 basis points for the first time since April 2009 in their November 1st meeting.) However, it remains to be seen whether or not the RBA can continue this course of action, for even as government officials are concerned about rising unemployment, inflation remains

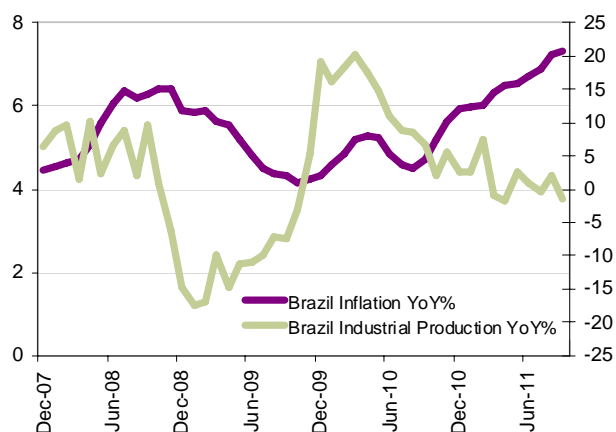
high, although admittedly lower than pre-financial crisis levels.

Laggards for the month included a number of the countries most exposed to the ongoing sovereign debt crisis, including Greece and Portugal. The former lost -4.2% in the month, bringing the year-to-date decline to over -50%, while the latter gained a paltry +3.8%, leaving Portuguese stocks down -12% for 2011. Japanese stocks were essentially flat on the month, despite a rally to close the month led by exporters following the government's intervention in the currency market. Insurers were also weak, as casualty insurers may face upwards of 190 billion yen (\$2.4 billion) related to Thai flooding.

6. Emerging Markets Equities: Pedal to the Metal

Emerging markets equities, for the most part, outperformed their developed counterparts during October's sharp rally. Leading the way were Brazil and Russia, which posted gains of +19.4% and +19.1%, respectively. Both countries benefited from a rally in cyclical names, particularly those in the energy and materials sectors. In addition, Brazil's central bank has continued to push forward with interest rate cuts intended to keep the country moving full steam ahead. Of course, this push to counteract the effect of a global soft patch is not without risk, as Brazil's inflation rate is at near term highs, and these pressures show no signs of abating. Indeed, Brazil's policies have been likened in

Brazilians See Higher Prices Even as Production Softens



the past to a driver who has both a foot on the brake – monetary policy – and a foot on the gas – fiscal policy, and yet with recent rate cuts it appears that the government is willing to move full speed ahead at this point.

Chinese stocks also performed fairly well during the month, picking up +15.2% versus the broad MSCI Emerging Markets index return of +13.3%. The gain was led by Chinese banks, which rallied strongly throughout the second half of the month after a unit of China's sovereign wealth fund, Central Huijin Investment, bought shares of the country's four biggest banks as a means to instill confidence in the country's stock market. Although the size of the purchases represented a small change to the fund's holdings, the purchases indicate that at least portions of the Chinese equity market may be undervalued. Developers were also hoping for some help, and rose through much of the month before falling off a bit on Premier Wen Jiabao's announcement that the government has no plans to loosen restrictions on real estate.

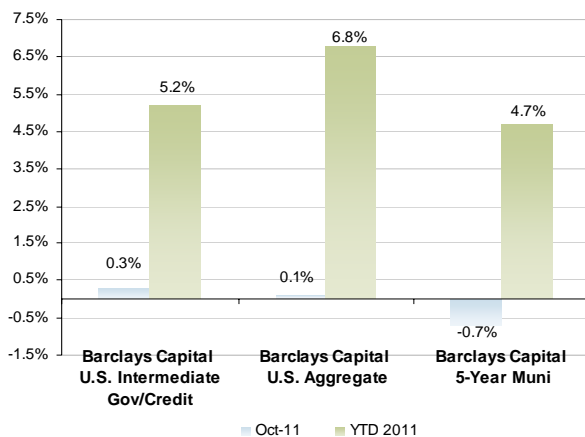
Tightening Spreads Combat Rising Bond Yields; Munis Falter

Trailing the broad benchmark were Turkey, Morocco and Columbia, which posted returns of -2.4%, +1.35% and +6.7% respectively. All three countries had been performing well over the past several months, with Columbian stocks barely in negative territory for 2011, down -1%. Moroccan stocks are also down much less than the benchmark for the year, off -4.5%. Turkey, on the other hand, has faced significant challenges this year as the country attempts to better control capital inflows into the country. However, these policies have been extremely shareholder unfriendly, and have put Turkey in the unenviable position of relying on sales of the dollar to control its currency; it is also very exposed to a slowdown in Western Europe, as the area accounts for over half of the country's exports.

7. Fixed Income: Risk-Free Rally Roiled as Credit Climbs

Fixed income investors were able to take advantage of two trends in the month that should rarely converge.

First, the rising tide in Europe lifted all credit assets to the tightest spreads in more than two months. Second, the Fed's extraordinarily accommodative monetary policy moves made largely because of fears of contagion spreading from Europe to the world economy helped to keep a lid on Treasury prices. In other environments, without the Fed's Operation Twist in play, rising interest rates would have counteracted credit spread tightening, leading to negative price returns, but this October we enjoyed the best of both worlds in most sectors of the marketplace.



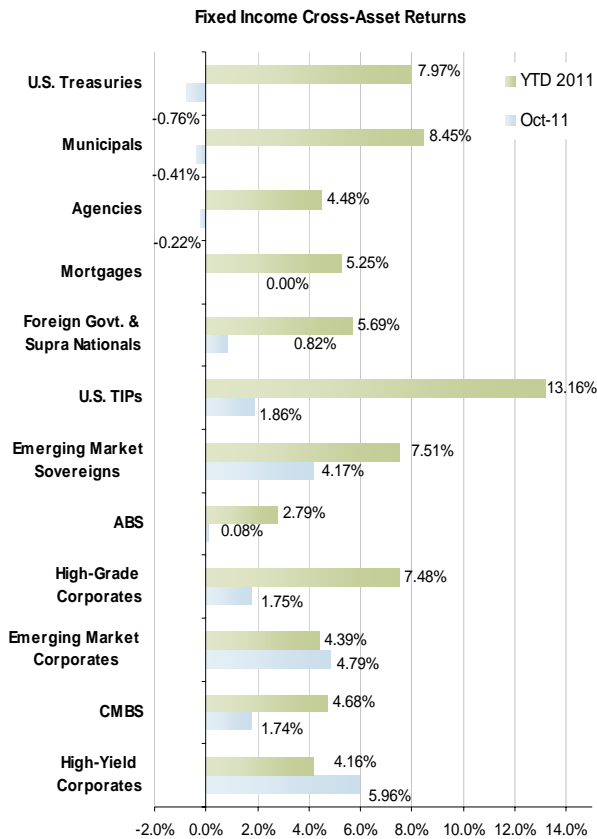
One notable exception was the municipal bond market, which gave up a small portion of recent gains, due to increased supply, investor aversion to low absolute yield levels, and the reemergence of risk appetite that favored higher-yielding sectors of the market. The market also had to absorb the news that Pennsylvania's capital Harrisburg finally filed for bankruptcy, after teetering on the edge of financial ruin for about a year. While one of the largest municipal bankruptcies in history, this news came as no surprise, as the city's problems started long ago, back in the 1990s, when elected officials went on a spending binge--\$125 million for improvements to a trash incinerator, tens of millions for a Civil War museum, and millions more for parking garages and baseball stadiums. Harrisburg's gross financial mismanagement is not characteristic of the broader municipal market, but investors nevertheless got a little spooked during the month. Even so, year-to-date returns remain robust, especially when considered in comparison to the after-tax returns of taxable fixed income investments.

Turning to the specifics of the returns of the various fixed income sectors, risk appetite was clearly alive and well in the month, with the most low quality and speculative investments delivering outsized returns, and the highest quality bonds suffering by comparison. Though Operation Twist helped to cap rising interest rates even in such a powerful risk-on market, Treasuries were still the worst-performing fixed income asset class, though only with a loss of -0.8%. U.S. government agencies were weak as well, as their modest incremental income could not offset the underlying drag from rising interest rates. Meanwhile, mortgage returns clearly suffered from doubts, confusion, and concerns about accelerated prepayments that might accompany relaxed standards in the HARP program, introduced on October 24. However, additional spread widening was kept at bay by the rumors of a QE3, with the potential for Fed purchases to be focused in the mortgage-backed security sector.

Other securitized sectors like asset-backed were pressured in the month, mostly as a result of heavy supply. Their recent weakness is likely a buying opportunity, as demand for cash surrogates remains high. Commercial mortgage-backed securities had much stronger performance, as the rush to add risk allowed the focus to return to stabilization of credit fundamentals.

On a hard equity rally, high yield credit rebounded to one of its best single-month performances ever. Investment grade corporate bonds also enjoyed a nice 32 basis point tightening, though it was only one-third the size of the spread tightening seen in high yield. Financials, naturally, did the best given how much they had suffered in the third quarter, but the surprise was industrials recovering two-thirds of what had been lost relative to Treasuries. Utilities did not perform as well as the other sectors, but moved back into positive territory for the year across the yield curve.

As risk appetite recovered, so too did investments in emerging markets corporates and sovereigns, as investors once again looked to the tremendous fundamentals and technicals supporting the asset class. While emerging markets rallied sharply on the news of a European debt deal, developed sovereign credits were



more muted in their response, posting a positive return, but a tentative one in light of the uncertainty about the economic and political landscape in Europe.

8. Real Estate: REIT Resurgence

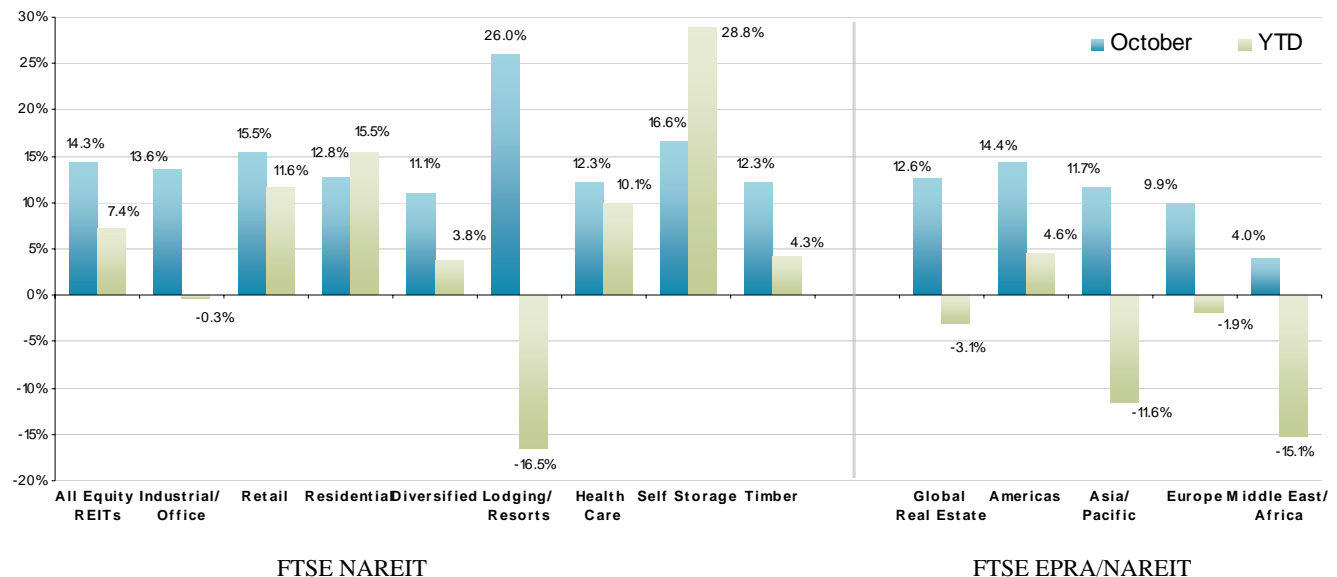
REITs participated along with almost all equities in the

sharp snapback in October. Globally, results were strongest in the Americas, which posted a +14.4% gain in the month. The Middle East/Africa region posted the lowest absolute returns regionally, up only +4.0%. Europe lagged the Americas while still experiencing significant price appreciation of +9.9%. The region still remains in negative territory for the year, however.

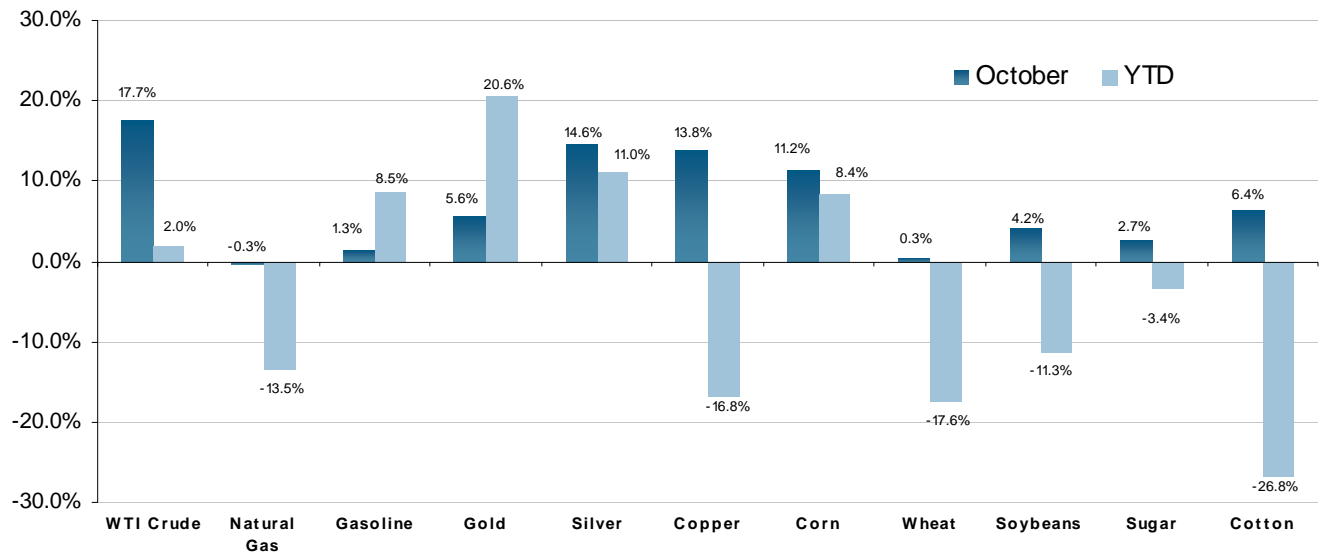
U.S. equity REITs were strong across the board, with all property sectors posting positive returns for the month. Lodging/resort REITs were the strongest performers, yet even with a +26.0% gain in the month, the sector remains down -16.5% in 2011. The self storage sector continues to deliver consistent returns for investors, adding another +16.6% to bring the year-to-date gain to almost +29% - by far the best performing sector in the benchmark. At the sub-sector level, there were a few pockets of weakness. Free standing retail remains under pressure as shopping centers and regional malls have experienced relatively more favorable traffic trends over the last few months.

One segment of the market worth discussing is Mortgage REITs. Mortgage REITs have significantly underperformed equity REITs in 2011, and continued to do so in October, returning +4.0%. Within the sector, home financing posted a +2.9% return for the month, and the sector remains in negative territory for the year. Weighing on prospects for these stocks are proposed

Real Estate Returns



Commodity Market Returns



changes to the HARP program, which should allow more homeowners to refinance their underwater mortgages. This would affect REITs with older, fixed rate MBS securities more than those with hybrid ARMs, but the whole sub-sector could move down in sympathy. Additional information is expected to be released in mid-November, and could provide some color for investors in this space.

9. Commodities: Crazy for Crude

Energy, precious metal and agricultural commodities rallied virtually across the board during the month of October, continuing the high level of correlation with the equity markets that has existed for much of the year. With global economic growth seemingly more steady, investors bid up the asset class with a view toward future increased demand. Also helping commodities was a drop in the U.S. dollar, as this “risk on” rally spurred a major rotation out of the currency.

Crude prices rose by over +17% amidst this euphoria, leading the way for all of the major commodity indices in October. Among precious metals, silver and copper prices surged higher as each posted double-digit gains, though gold also continued its upward ascent, adding \$102 to close the month at \$1,722 per troy ounce. Within the agricultural commodities, corn was the notable standout, due to the growth outlook but also because a drought has damaged what was a record crop

such that the U.S. is reaping its smallest corn harvest in three years. In contrast, wheat supply has outpaced demand, as record harvests have boosted global stockpiles. Gains there were more limited, but still in positive territory.

In fact, among the commodities, only natural gas prices retreated during the month, reflecting the rapidly growing supply of natural gas, particularly in the U.S., that is currently unmatched by demand. Unfortunately, without the political will to build the infrastructure to utilize this cheap resource as a means to reduce dependence upon foreign energy, the U.S. is destined to be a net exporter of this commodity, and prices will remain pressured accordingly.

10. Hedge Funds: A Lifeline at Last

As was the case throughout the third quarter, October continued the pattern of broad sell-offs and massive rallies amidst high levels of volatility. This month, with a plan on the table to address the European sovereign debt crisis, investors piled back into the markets. Despite the unresolved macroeconomic issues in Europe, China and the United States, October’s large rally included several days where the market experienced 2% or greater swings with four straight weeks of higher market highs. Of the 21 trading days in October, the market had only one day where the peak-to-trough trading range was less than 1%. Consequently,

the broad universe of hedge funds profited with the HFRI Fund Weighted Composite Index up +2.4% in October, bringing cumulative 2011 performance to -3.50%.

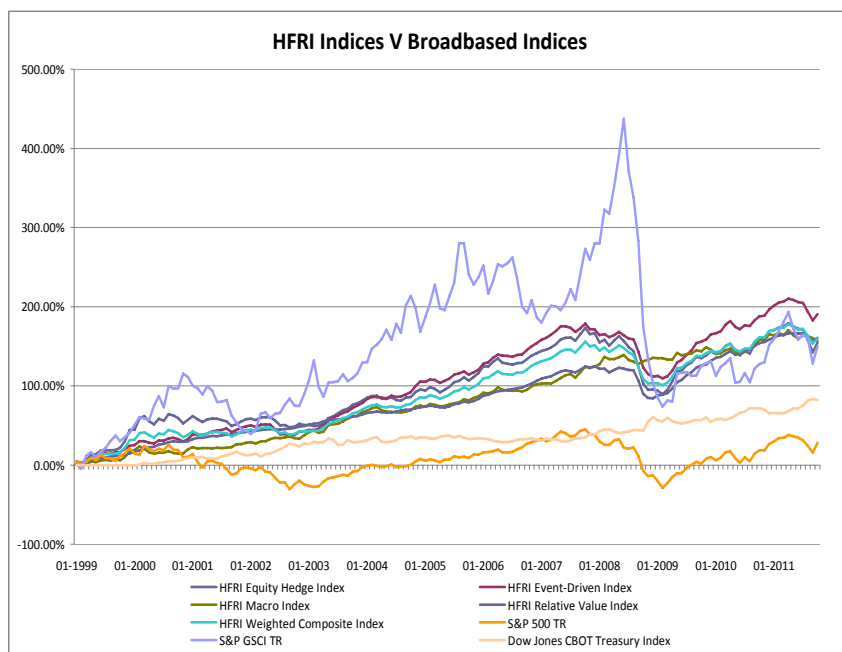
Long/short equity hedge fund strategies were among the most profitable as they rode the equity markets during one of the strongest monthly rallies on record. Many managers spent 3Q11 decreasing gross and net exposures by decreasing longs and increasing shorts. Many managers used the broad sell off to upgrade their long portfolio by adding to or establishing new positions in companies which were trading at substantial discounts to earnings and cash flow multiples. Unfortunately, in 3Q11 this hurt manager performance as valuations generally fell below downside expectations. In addition, high levels of market volatility made option-based hedging more expensive and low quality, more highly leveraged equity shorts more unpredictable. As markets rallied, hedged equity portfolios snapped back. However, low nets and higher than average cash balances caused managers, as expected, to lag the market. For October, the HFRI Equity Hedge Index was up +5.2%, bringing year-to-date performance to -5.2%. Leading the charge up was the battered HFRI EH

Energy/Basic Materials index which returned +8.1% in October for a -10.2% return year-to-date.

Event-Driven hedge fund strategies were able to post positive gains in October with several deals closing in the energy and technology sectors. In 2008, management teams resisted sales of their companies, waiting for valuations to recover. According to several event-driven managers, the current recovery has been sufficient enough that management teams are now willing to entertain deals. As a result, the HFRI Event-driven Index was up +2.7% in October, bringing 2011 performance to -2.2%. As confidence returns, bid activity should continue to increase, though given the macro events still plaguing the world, it may be a bumpy road for the strategy.

Macro hedge fund strategies struggled as several trends reversed, stalled or are in consolidation phases. Strong trends in the bond markets fueled returns in previous months, but many of these trends flattened out or reversed from lows not seen since October 2008. Commodities markets saw several interesting moves during the month which were overshadowed by news out of Europe. While a long-dollar/short-euro position worked well in September as Europe teetered on the

brink, the euro mounted a strong rally versus the dollar on speculation that the European Union would remain intact and Greece would not default. Both copper and gold surged in the final two weeks of the month with copper regaining about half of September's losses, despite continued concerns of a slowdown in China, and gold silently crept steadily higher to a level just shy of \$1,800. WTI Crude rallied from \$76 in early October to the low \$90s by early November, partially closing the spread between WTI and Brent Crude. When all was said and done, the HFRI Macro Index finished October down -1.4%, for a -3.3% year-to-date return.



Ratings Agencies Back Peddle on a Downgrade, for Now

Rating Agency	Current U.S. Sovereign Rating	Comment
S&P	AA+; Negative Outlook	"...if there were another downgrade, it would probably be because something has happened with the Budget Control Act - it has somehow either been watered down subsequently or the Fiscal Committee doesn't deliver the goods, and then, when it comes time for the sequestration mechanism to take effect...it doesn't function. That would...probably be...[a] late 2012-2013 event." John Chambers on Bloomberg Panel, 9/16/11
Moody's	Aaa; Negative Outlook	"The smaller amount triggered by the spending caps is still a step in [a favorable] direction...[that] will not necessarily lead to any change in our rating stance."
Fitch	AAA; Stable Outlook	If the Joint Select Committee is unable to reach an Agreement that can secure support from Congress and the administration, Fitch would be less confident that credible and timely deficit-reduction strategy necessary to underpin the U.S. sovereign rating and Stable Outlook will be forthcoming despite the USD 2.1 trillion of automatic cuts that would follow.

Systematic strategies struggled more with left-tail political events driving markets and the HFRI Macro Systematic Diversified Index declined -3.5% in October for a -3.1% year-to-date return.

Relative Value hedge fund strategies were able to post modest gains in the changing environment as correlations began to come down after surpassing highs set at the end of 2008 and the middle of 2009. While correlations remain near highs, they should begin to fall as confidence returns to the market allowing for the mean-reversion trades that typify the strategy. The HFRI Relative Value Index posted a +1.3% during October, bringing year-to-date performance to +0.9%.

11. A Final Word: Super Stalemate

With less than two weeks to the November 23 deadline set by Congress to present a proposal to shave the deficit, the 12-member, bipartisan, so-called Super Committee continues to meet behind closed doors. As the weeks have progressed, leaks from aides have been unoptimistic about the potential for a grand bargain in light of the wide divide that exists among the members regarding taxes. The Committee's first public hearings were likewise uninspiring, with the only highlight an impassioned appeal to act from Democrat Erskine Bowles, former chief of staff to President Clinton, and co-author of the so-called Bowles-Simpson

Commission, perhaps the only viable bipartisan solution to the debt dilemma we have received to date.

With \$1.2 trillion in automatic discretionary spending cuts that will be triggered regardless of their success, a Super Committee failure to reach an agreement by the deadline may not be catastrophic, as long as those triggers are not circumvented. Indeed, the ratings agencies have recently signaled there will be no further downgrades even if a deal is not reached, though changes in outlook may result. However, without a deal, U.S. fiscal metrics are poised to deteriorate further, with U.S. federal debt-to-GDP scheduled to increase from 73% to 84% in 2021. In order to maintain our debt-to-GDP at current levels, at least \$3 trillion in cuts need to be made.

With most expecting failure, such an outcome is unlikely to move the markets much, though a further demonstration of the dysfunction in Washington, D.C. will hardly engender the much-needed confidence to spur growth and investment. If we are surprised by a last minute deal, risk assets should rally, depending on the context of events overseas. Indeed, if the Committee does find agreement on cutting \$3 trillion or more, it is possible we could see an upward revision in the outlooks of S&P and Moody's, which would be a welcome development to be sure.