



## Economic & Market Perspective | September 2011

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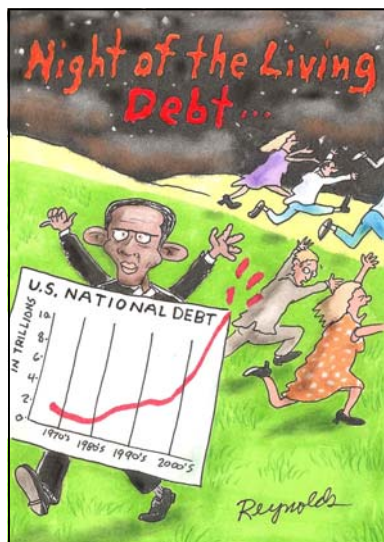
### 1. U.S. Economic Update: Night of the Living Debt

September U.S. economic data releases did little to reverse the declining trend that has been in place since February, as consumer spending, business activity, and the housing markets all continued to plod along like zombies, with nothing dramatically weaker, but nothing dramatically stronger either. Employment and confidence measures showed some of the more scary repercussions of the near-default and ultimate downgrade of U.S. credit quality as well as an escalation of European sovereign debt woes.

Accordingly, the notion of just a “summer slowdown” may be disappearing like a shimmering apparition, replaced by the gruesome reality of what is likely to be a return to recession. Efforts to forestall this outcome by the White House and the Fed have been bland and uninspired in the first case, and muted in the latter, and belie the difficulty of stimulating an economy overburdened by debt and at the zero bound of interest rates. Whether this horror show has a happy ending remains to be seen, and will depend much on calming the nerves of spooked investors and business owners to break

the negative feedback loop now mirroring financial markets and the economy.

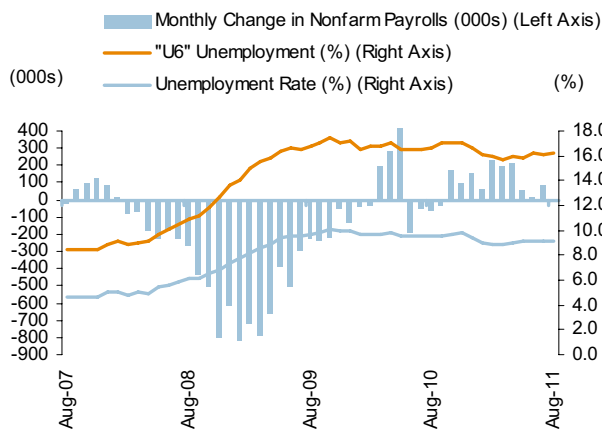
The employment situation is perhaps the most sinister ghoul confounding a stabilization and return to growth in the U.S. economy. Indeed, August payroll data showed zero employment growth, and included a negative revision to June and July figures that subtracted some -58,000 jobs from those already weak



Source: cartoonstock.com

reports. A decline in average hourly earnings, from an annual growth rate of +2.3 % down to +1.9%, as well as a slide in average weekly hours worked, from 34.3 to 34.2 hours, only exacerbated the employment weakness registered in August. While the unemployment rate held steady at 9.1%, the so-called “U6” measure of underemployment, which includes discouraged workers and part-time workers who would prefer a full-time position, increased to 16.2%.

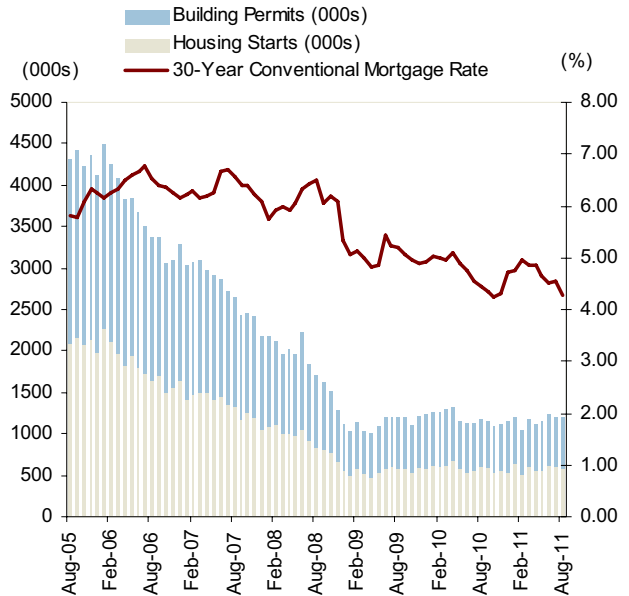
**Employment Growth Flat Lines in August**



This disastrous report is further punctuated by the persistent high level of initial jobless claims, which have continued to trend above the critical 400,000 level in most of the weekly readings since April. It is little wonder, then, that Federal Reserve Chairman Ben Bernanke called the employment situation a “national crisis” during the month, noting, “we’ve had close to 10% unemployment now for a number of years and, of the people unemployed, about 45% have been unemployed for six months or more. This is unheard of.”

Also in national crisis is the housing market, where activity remains lackluster and prices continue to stagnate. To that point, new home sales for the month of August fell -2.3% to a 295,000 annualized rate, though it is notable existing home sales did increase +7.7% to a 5.07 million annualized pace. Even so, the pace of home sales remains just a fraction (about a third) of what had become the norm, despite record low mortgage rates. As such, it is little surprise that housing starts remain in the doldrums, falling another -5.0% in August to a 571,000 annualized rate. Building permits did edge up slightly, climbing +3.2% to a 620,000 annualized pace, perhaps as the increase in refinance activity has allowed homeowners to renovate as an alternative to an upgrade and move.

**Low Borrowing Costs Do Little to Spur Building Activity**



Regarding prices, the S&P Case-Shiller home price index showed only a fractional gain in home prices for the month of July, up +0.05% month-over-month, such that year-over-year prices have now slid -4.11%. The Federal Housing Finance Agency (FHFA) was a little more optimistic, showing a +0.8% month-over-month gain in prices, trimming a year-over-year price decline to only -3.3%.

Homebuilder confidence took another turn for the worse in the month, and statistics on foreclosures and homeowners in negative equity remain daunting. Making matters worse, the market has yet to feel the impact of the expiration of

**Trick-or-Treat Post-Housing Crisis**

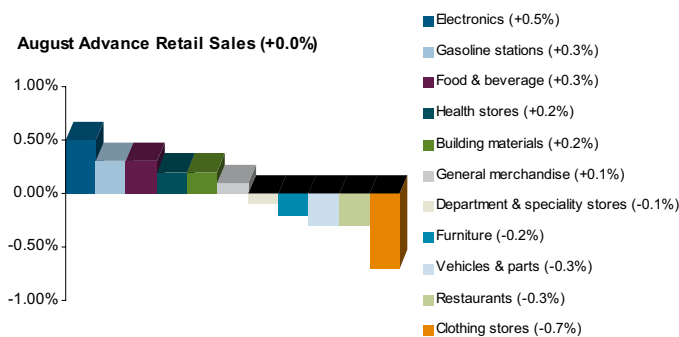


Source: Ed Stein cartoon

increased conforming jumbo loan limits on September 30. In October, the conforming jumbo loan limit will return to its original \$625,500 level from the higher \$729,750 allowed post-2008 crisis, which could be argued will have a further dampening effect on housing market activity.

Slowing spending patterns were clearly evident in the consumer data released in the month of September. Advance retail sales for August came in flat, missing already low expectations for a +0.2% print. But even excluding the volatile automobile and gasoline station categories, sales advanced only +0.1%. Making matters worse, July's data was revised lower, from an increase of +0.5% to +0.3%, tempering some of the enthusiasm we might have had for a resilient consumer. The weakness in August sales was fairly widespread, led by declines in clothing, restaurant, and automobile sales. On the discretionary side, only sales of electronics were notably higher in the month.

### Back-to-School a Bust This Year

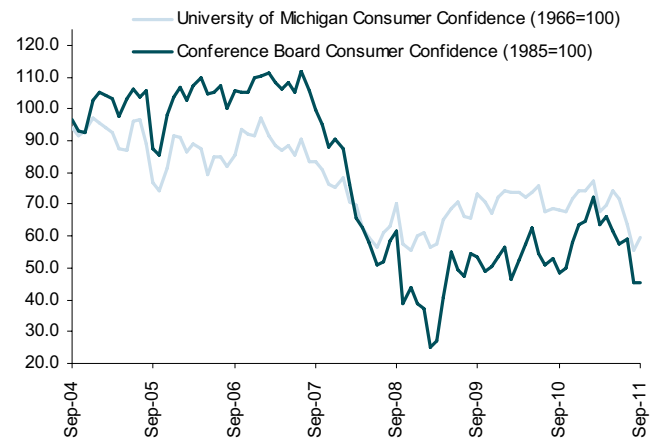


Bad weather clearly had a role to play in the weakness in August sales, but the personal outlays report from the Bureau of Economic Analysis (BEA) suggests weakness in spending might also be the result of persistent weak income growth against a backdrop of high unemployment. Indeed, personal income fell -0.1% for the month of August, the first outright monthly decline since October 2009. Real disposable income fell -0.3%, representing the second monthly drop in a row. While personal spending did grow in August by +0.2% month-over-month, after inflation it was flat. Therefore, households had to dip into their savings, such that the personal savings rate dipped from 4.7% to 4.5%, behavior that is unsustainable in the long run.

It is no wonder then that consumer confidence continues to be terribly low. Unfortunately, it may be headed even lower,

now that stocks have just closed the books on their worst quarter since 2009, the headlines are covered with growing fears of recessions, and the debt ceiling debate brought the troublesome reality of the country's finances to the national attention. For now, the Conference Board's measure of consumer optimism revealed that confidence has yet to rebound from the precipitous fall made in August post-downgrade, improving to only a 45.4 reading in September. Meanwhile, the University of Michigan's reading for September likewise remained at the very low level of 59.4 at month-end, though that did reflect a slight improvement from the 57.8 level reported in August. Worryingly, the reading on future expectations within the September report was as low as it has been since 1980.

### Crisis of Confidence



Business activity has correspondingly slowed in reflection of this uncertain economic environment. The Institute of Supply Management (ISM) manufacturing index slid a little more from 50.9 in August to 50.6 in September, while regional surveys of activity were mixed, with some regions improving like Philadelphia and Chicago, and others like Milwaukee and New York declining. Meanwhile, the pick-up that had been witnessed in production activity following the earthquake in Japan stalled out, with month-over-month growth in industrial production sliding from +0.9% to +0.2%, and capacity utilization plateauing at 77.3%. For their part, durable goods orders were down -0.1% month-over-month, and both wholesale and business inventory growth remained subdued.

On a brighter note, service sector activity as reported by the ISM ticked up from 52.7 in August to 53.3. There was an upward revision to second quarter GDP from a +1.0%

growth rate to +1.3%, on the heels of an improvement in personal consumption expenditures from +0.4% to +0.7%. Looking forward, a sharper-than-expected drop in July's international trade balance from -\$53.0 billion to -\$44.8 billion has some economists forecasting third quarter GDP could post growth as high as +2.0%.

Yet, despite the welcome gains in these data points, the overall picture still reflects a very weak growth environment. One of the biggest reasons for this weakness has been the failure of small businesses to fully participate in the economic recovery post-2008. In addition to the uncertainty of sales from a consumer struggling with high unemployment and a broken housing market, the small business owner continues to be constrained by limited and cost-prohibitive access to credit, as well as the unsupportive tax and regulatory environment. Whatever small momentum has been generated for the small businesses in this recovery has now stalled out, as evidenced by the decline in the National Federation of Independent Business (NFIB) small business optimism index from 89.9 to 88.1 in September.

Also troubling for businesses and consumers has been the unfortunate uptick in inflation that is occurring coincident with this renewed slowdown. Besides the increase in input costs as recorded by the year-over-year +6.5% gain in producer prices (+2.5% excluding food and energy), business owners are also grappling with a slide in productivity, which

dropped -0.7% in the second quarter. Weaker productivity is troubling for inflation as it implies higher costs to produce a product or service, which was evidenced in the increase in unit labor costs from +2.2% to +3.3% in the quarter.

Consumer inflation is jumping up as a result, with an increase in the Consumer Price Index (CPI) of +0.4% for the month of August, though only +0.2% excluding food and energy. This jump brings the year-over-year growth in consumer inflation to +3.8%, and +2.0% core. While these levels of consumer inflation remain well within the range desired by the Federal Reserve, they are still troublesome to absorb for a consumer already struggling with so much.

The Fed, recognizing the difficult situation we are facing, took additional accommodative action at the September FOMC meeting, announcing moves to lengthen the duration of \$400 billion worth of their balance sheet holdings by selling short-term Treasuries and reinvesting them into 6- to

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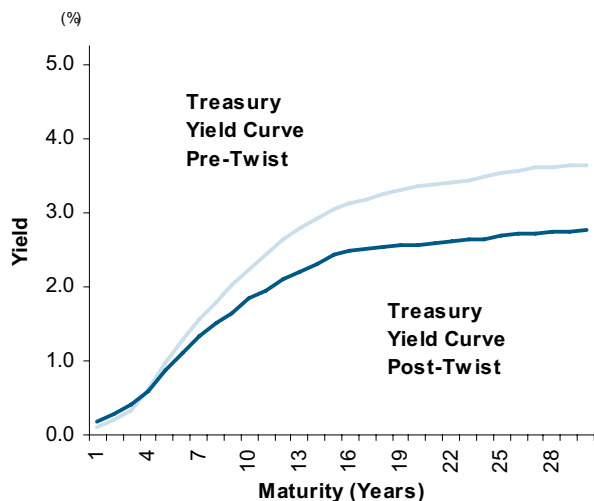
#### NFIB Small Business Optimism Index Sinks in September

Index Component	Seasonally Adjusted Level	% Change from Last Month
Plans to Increase Employment	5%	3
Plans to Make Capital Outlays	21%	1
Plans to Increase Inventories	-5%	-2
Expect Economy to Improve	-26%	-11
Expect Real Sales Higher	-12%	-10
Current Inventory	1%	1
Current Job Openings	15%	-3
Expected Credit Conditions	-13%	-2
Now a Good Time to Expand	5%	-1
Earnings Trend	-26%	-2
Total Change		-20

30-year maturity bonds. Dubbed “Operation Twist” after similar action was taken in the 1960s, this program is designed to bring down intermediate and long-term rates without having to increase the size of the Fed's balance sheet. The “Twist” will be executed over the next nine months, and complemented by a move to reinvest maturing agency bond principal back into the agency-backed mortgage bond market.

In announcing these actions, the Fed also updated their view of the economy, noting they now see, "significant downside risks to the economic outlook, including strains in global financial markets," in a nod to the continuing issues in Europe. For now, they held off on additional quantitative easing or implementing a cut on the interest paid on excess reserves, though such actions could be forthcoming should conditions worsen. However, the bar for additional action remains high in light of the growing divide among FOMC voting members. While Bernanke still rules the roost, it is notable that there were three dissenters (Philadelphia Fed President Charles Plosser, Dallas Fed President Richard Fisher, and Minneapolis Fed President Narayana Kocherlakota) to the Fed's policy stance for the second time in a row.

**The "Twist" Brings Down Long-Term Yields, but Off Already Low Rates**



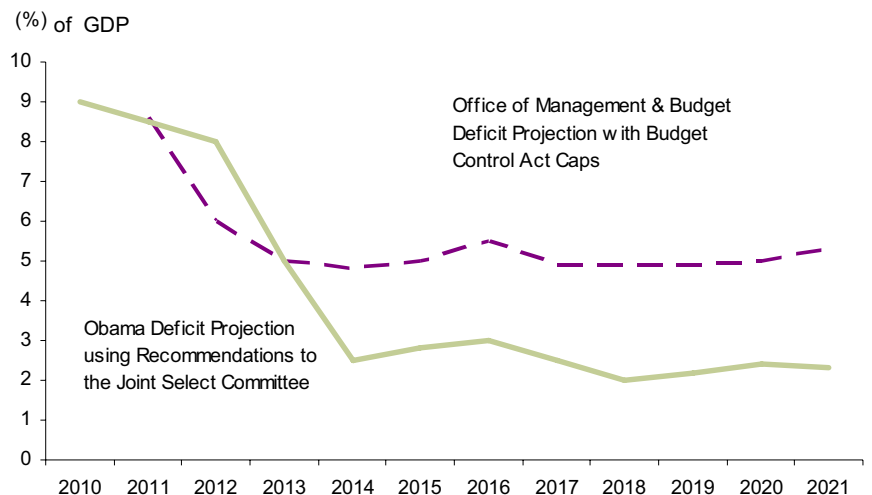
Of course, the dissension at the Fed is marginal compared to the total dysfunction still being played out in Washington. In September, President Obama announced a politically contentious plan for economic growth and deficit reduction, titled "Living Within Our Means and Investing in the Future." The plan follows up on the American Jobs Act, with guidelines on how the President would like to reduce future spending over the next decade to bring total debt down to a more sustainable level, while still

passing \$447 billion in new stimulus spending for 2012. The stimulus spending would cover an extension of the payroll tax cut with a matching cut for employers, aid to state and local governments to help preserve education jobs, as well as a public-private partnership for investment in infrastructure like schools, bridges, roads, etc. According to the administration, infrastructure projects are just what this country needs to get construction workers back to work, preventing the skills erosion that comes with long-term unemployment. While speculation had been brewing for some kind of announcement related to a nationwide mortgage refinance stimulus, no new plans or programs were revealed.

To pay for these outlays and meet the goal of reducing the deficit to 2.3% of GDP by 2021, the President plans to save \$1.1 trillion from a troop drawdown of military operations in Iraq and Afghanistan, \$866 billion for allowing George Bush's tax cuts on the wealthiest households to expire, and \$577 billion from spending cuts, including the scaling back of agricultural subsidies and reduced retirement contributions for civil servants and veterans. Social security remains untouched under the proposal, and Medicare and Medicaid were targeted for only modest trims.

Additional revenue would be raised by curbing deductions, including those for municipal-bond interest, mortgages and charitable giving. The President also proposed a new so-called "Buffett" tax, named for legendary investor Warren Buffett, which would require anyone earning more than \$1 million to pay a tax rate equal to that of the middle class.

**"Living Within Our Means" Makes Some Lofty Deficit Reduction Projections**



Warren Buffett has often expressed outrage that his secretary has a higher tax rate than he does.

As one would expect, the plan appears dead on arrival, and in fact may have served to only incite further division between the two political parties. Republicans immediately accused President Obama of class warfare; to which he responded that “this is not class warfare. It’s math.

*“The clouds that are the European sovereign debt crisis, once on a distant horizon, rolled in during the month of September and threaten to dominate the macroeconomic landscape for months to come.”*

The money is going to have to come from someplace.”

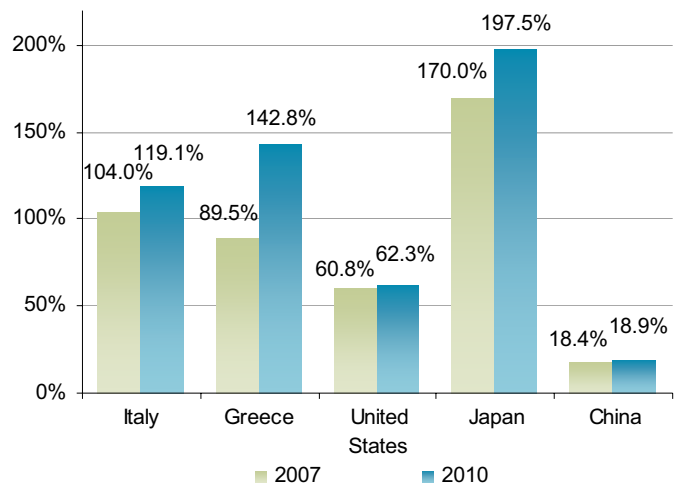
Unfortunately, it would seem that current political leadership is incapable of getting anything significant done and the nation may have to wait at least through 2012 to find any clear direction. In the meantime, the debate goes on---from the debt ceiling to jobs to housing market legislation--dragging down consumer and business confidence and damaging an economy that is already in, or perilously near, a double-dip recession.

## 2. International Economic Update: One Step Forward, Two Steps Back

The clouds that are the European sovereign debt crisis, once on a distant horizon, rolled in during the month of September and threaten to dominate the macroeconomic landscape for months to come. September was supposed to be the month in which the euro region countries approved a July agreement which would grant Greece a second bailout while expanding the mandate of the European Financial Stability Facility. Indeed, there were early indications that things could be moving towards a resolution, as constitutional challenges to Germany’s participation in the euro region rescue(s) were rejected by the country’s top court and French President Nicholas Sarkozy and German Chancellor Angela Merkel stated that they were “convinced” Greece would remain in the European Union. Even Italy’s parliament relented and approved a new, albeit watered down, austerity package.

However, as events unfolded throughout the month, it became clear that a second aid package for Greece did not have the firepower to shore up confidence around the periphery. Italy’s credit rating was cut to A with a negative outlook by S&P, which cited weakening economic growth and a “fragile” government as rationale for the decision. In fact, Italy’s debt-to-GDP ratio is now expected to rise this year and next, contrary to original expectations of a peak in 2011; estimates now put the ratio at 119.9% by 2014, up from 117.6% in 2010. Italy is not the only country likely to face pressure as European policy makers dither; Portuguese Prime Minister Pedro Passos Coelho said he could not preclude the possibility of a second aid plan for his country if something “very serious” were to transpire in Greece.

### Sovereign Debt Burdens on the Rise Worldwide



In the hopes of assuring passage of their second lifeline, Greek officials pledged (once again!) to accelerate the pace of their budget cuts, targeting civil servant wages and pensions, with particular pain meted out to those pensioners under 55 and making in excess of 1,200 euros per month. Greece’s government denied a report mid-month that they were considering holding a referendum to leave the euro zone, and to that point, Finance Minister Evangelos Venizelos said his country will do “whatever it takes” to meet its budget goals, and cautioned against making the country a “scapegoat” for global economic woes.

On some level, Venizelos has a point – Greece is hardly a big enough economic power to justify the current crisis. It is instead the lack of leadership exhibited by European policy makers that is frustrating investors, calling into question the

likelihood that the fragile monetary union can be held together under so much pressure. Even the Group of 20, which pledged to provide a “strong and coordinated response” to the debt crisis, appears stymied as many of the tools at their disposal during the 2008 financial crisis have now dulled.

The European Central Bank, for its part, took several steps in the month to help provide liquidity and in turn confidence to the faltering European financial system. With the help of the Federal Reserve, the ECB restarted its three month dollar lending program, offering banks three opportunities over the course of the fourth quarter to tap the funds. The central bank also announced an expansion of the universe of assets which will be permitted as collateral beginning on January 1, 2012 – another example of a program used during the initial financial crisis. In addition, the ECB continued to purchase assets into September, and managed to keep yields on Italian and Spanish debt from skyrocketing amid the chaos, though members of the Governing Council are certainly concerned that these purchases may act as a disincentive for these governments to undertake the necessary fiscal adjustments.

As for their current policy stance, although the ECB made no changes in their September meeting, and are unlikely to make any in October, there is an increasing probability of an expansion of asset purchases of covered bonds, a reintroduction of 12 month loans, or even an interest rate cut come November. In fact, one needs only to read Jean-Claude Trichet’s post-meeting statement in early September to see the proverbial writing on the wall. In it, he signaled a bias towards easing monetary policy, saying the outlook for the

### Trichet to Leave ECB at a Critical Juncture



Source: Getty Images

real economy had deteriorated and there were “downside risks to growth.” He also said that while “in July there were upside risks to inflation, now they are balanced.” It is important to note, however, that October’s meeting will mark the last that Trichet will preside over, as Mario Draghi takes over as President in November.

As much as these measures are helpful, the ECB can do little but sit back and watch as European policymakers appear almost helpless to stem the tide of contagion, which is now threatening to bring the entire Southern periphery down. Talks continued throughout the month around how the 440 billion euro EFSF could be leveraged to create what is being termed a “firewall” around the crisis countries, even as the proposal expanding the fund’s mandate has yet to be approved widely in the euro area. There is also talk of increasing the magnitude of the haircut for private sector bondholders as the situation in Greece continues to deteriorate, with estimates ranging as high as 50%.

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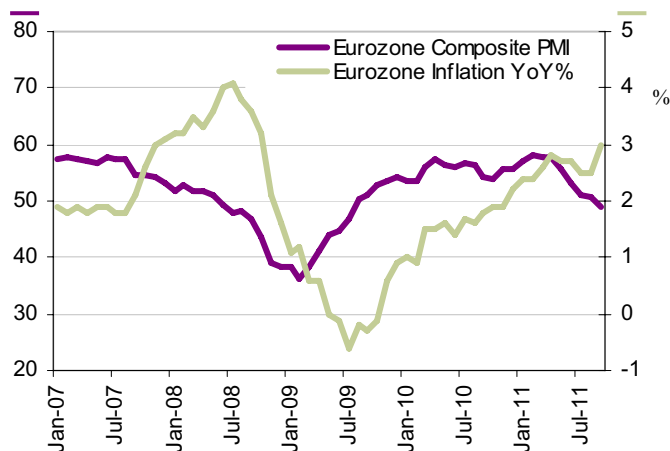
Haircuts of that magnitude would prove devastating to European banks; the International Monetary Fund estimates that the current crisis has generated as much as 300 billion euros in credit risk for these institutions. As a result, rumors of a potential bank backstop, or a European “TARP,” gained traction as the month wore on. Yet, as conditions worsened, policymakers once again delayed in granting Greece the funding it so desperately needs, pushing the decision into October and potentially beyond.

Reflecting the uncertainty in the region, economic data released for the months of August and September was lackluster at best, downright dismal at worst. Consumer confidence readings continued to tick down in September, falling across the board save the United Kingdom, which experienced an increase from -31 in August to -30 in

September – not enough to warrant even a Bronx cheer. The euro area as a whole experienced a fairly significant decline to 95 in September from 98.4 in August. Retail sales reflected the dour mood of consumers, as consumers retrenched across the board in August, although in most cases the month-over-month declines were less than those experienced in July. Employers were no better off, as business confidence readings were also down from August to September.

One bright spot has been the unemployment picture in Europe. Although levels remain elevated, there has been evidence of a modest decline in the unemployment rate over the past few months in many countries, although the euro area appears stuck at the 10% mark. Interestingly, inflation actually ticked up across much of the region in September, despite evidence of a slowdown borne out by manufacturing and services data. Most notable were increases in Italy and Spain of +3.5% and +3%, respectively; both of these contributed to a rise in euro area inflation to +3% from +2.5% in August, marking the biggest year-over-year increase since October 2008.

#### With Manufacturing Slowing, Will Inflation Follow?

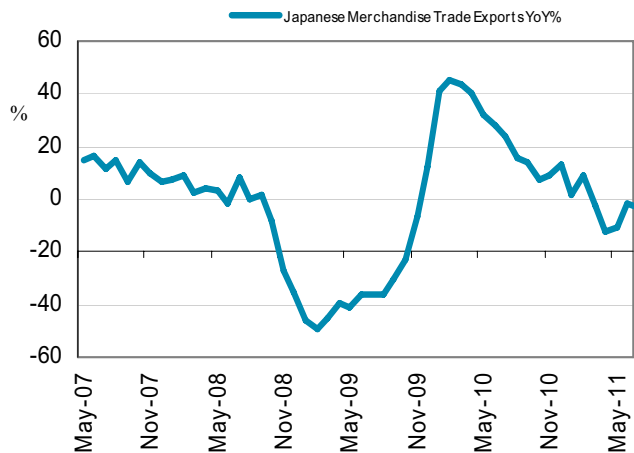


Pricing pressures should continue to subside, however, as the euro area Purchasing Managers' Index fell into contraction territory in the month of September, dropping to 49.2 from 50.7 in August. This was the fifth straight monthly drop, and is additional evidence of a potential contraction in Q3 GDP for the region. Unfortunately, weakness in the economy is likely to persist for at least the near term, as the inability of European policy makers to tackle the sovereign debt crisis

will do nothing to shore up confidence.

For its part, Japan has moved out of focus over the past several months as the crisis in Europe has escalated, but they too have been grappling with challenges related to March's devastating natural disaster. Japan's ruling party has proposed a 12 trillion yen rebuilding effort – the third of its kind – and intends to fund it through a 9.2 trillion yen temporary tax increase and the sale of the government's stake in Japan Tobacco. Weighing on prospects for a recovery in Japan is the continued upward move in the yen, as investors seek safety in the currency. Indeed, Japan's exports rose only +2.8% year-over-year in August, much less than the +8% gain expected, and exports to their largest markets, including China, are being undercut by other countries such as South Korea.

#### A Stronger Yen = Weaker Exports



In addition, machinery orders posted a decline of -8.2% in July from June, when they rose +7.7%, and the Japanese economy reportedly contracted at -2.1%, worse than the initial estimate of a -1.3% contraction. Although it is likely that the Japanese government will continue efforts to intervene in the currency markets, absent stabilization in Europe, government officials are likely fighting a losing battle in the near term.

Emerging market economies are feeling pain as well from the issues in the developed world, and in fact, have begun to modify their policies as a result of this ripple effect. Whereas just months ago almost all emerging market governments

and central banks were moving towards less accommodative policies, most of those plans have now been put on hold, and in some cases, reversed. For example, central banks in Russia, China, South Korea, Thailand and Taiwan all held interest rates steady at their most recent meetings, while Brazil took the bold step of cutting rates in order to counteract the impact of declines in commodity prices on their economy. The one glaring exception is India, as spiking food prices make continued interest rate cuts a necessity. Central banks have instead shifted their attention to their currencies, as emerging market currencies, particularly in Asia, came under intense selling pressure in September as the risk-off trade proliferated.

Meanwhile, concerns over the growing bubble in Chinese real estate resurfaced in the month. Although core inflation had started to tick lower, rising just +6.2% in August year-over-year versus a +6.5% gain in July, property prices rose on an annual basis in all 70 of the cities monitored in August. 40 of these cities did exhibit moderating growth rates, and on a month-over-month basis, prices in 16 of the cities declined. However, given all of the measures enacted over the last two years to target property prices, it is of significant concern that prices are still moving higher. Unfortunately, that trend may be poised to continue, especially if China looks to counteract lower demand from its trading partners by increasing state spending.

In a final note on emerging markets, significant efforts have been undertaken, particularly over the last decade, to help

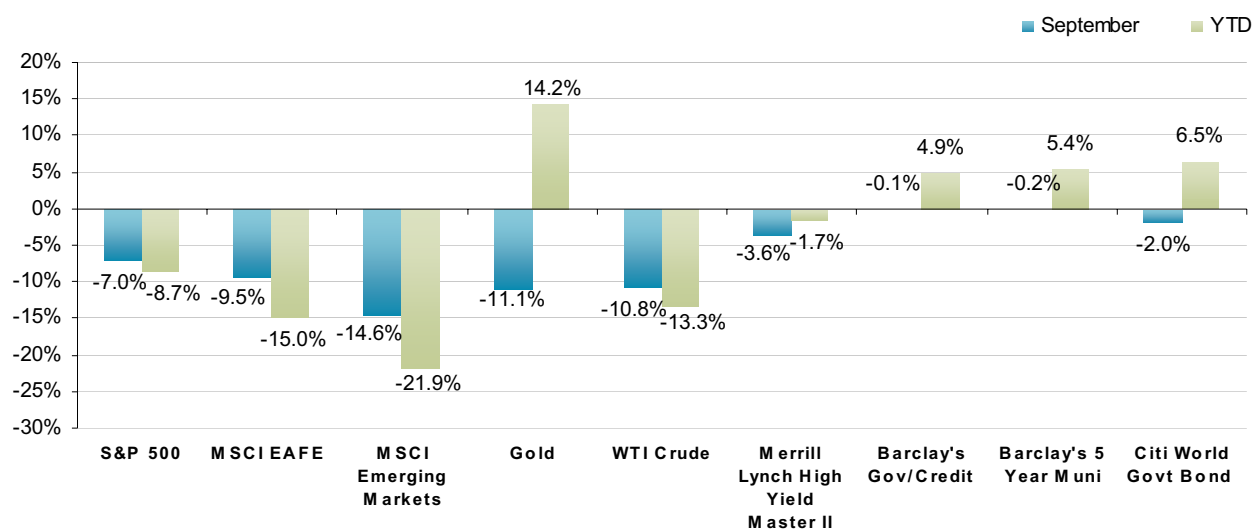
position Russia as an open, capitalist society in order to encourage foreign investment. However, the announcement in September that the current President, Dmitry Medvedev, would be switching positions with the current Prime Minister, Vladimir Putin, as of March seems to indicate that despite the progress, there are still decisions made that appear inconsistent with that goal. Perhaps even more concerning was the departure of Finance Minister Alexei Kudrin after a disagreement with Medvedev regarding defense spending. Kudrin has been in his position for over a decade, and helped engineer the company's recovery from default. His departure leaves the Finance Ministry in a precarious position in an already tenuous economic environment.

### 3. Global Markets Overview: Nowhere to Hide

September proved to be quite the rocky ride for investors, and once again the equity, bond (ex-US treasuries) and commodity markets offered few safe harbors for investors looking to ride out the storm. Equities, not surprisingly, suffered greatly as investors jettisoned risk positions from their portfolios amidst fears of a new financial crisis led not by sub-prime mortgages but instead by European sovereigns.

Admittedly, U.S. equities fared better than their international counterparts, with particular pain meted out to those banking on the emerging markets to lead the way out of this slowdown. Small cap stocks also underperformed, as the potential to slip back into global recession weighed on the prospects for smaller, less nimble companies. Even defensive

#### Global Market Returns



names in sectors such as utilities, health care and telecommunication services posted negative returns for the month, although on a relative basis they outperformed.

U.S. Treasuries, on the other hand, maintained their status as “the” quality asset in times of distress. Holders in the long end of the curve benefited from the Fed’s Operation Twist, which succeeded in producing a significant flattening of the yield curve. Municipals also performed well in September, while massive flows out of non-U.S. dollar denominated debt resulted in significant declines in both developed and emerging market issues. Publicly traded real estate stocks, which had been buoyed by investors on the hunt for yield, finally experienced a pullback in September, as a backdrop of a potential global recession and slower growth in China caused investors to question current valuations in the space.

Commodities, not surprisingly, also fell hard on these same fears; of particular note was the downdraft in precious metals, which had up to this point been on par with Treasuries as a safe haven. Finally, hedge fund managers continue to struggle, as above average volatility has once again created an environment of rising correlations, and therefore one in which many hedge fund managers have experienced difficulty producing positive returns.

In short, it remains difficult to predict how events will unfold over the next several months. Although we acknowledge that the market declines and volatility have created a number of opportunities, we believe that the markets have become quite impatient with global leadership (or lack thereof) as it relates to resolving debt crises both in Europe and to some extent here in the United States. Therefore, we believe that investors should remain patient with their capital and wait for evidence that some of the looming questions around Europe and the potential for a global recession are answered.

#### 4. Domestic Equities: Banks in the Crosshairs

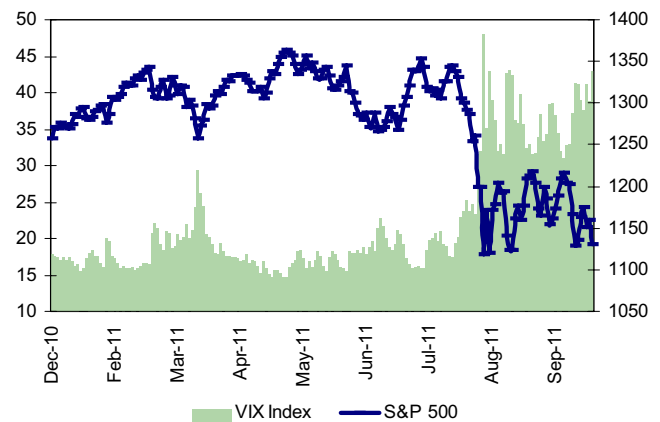
Equity market volatility persisted throughout the month as the VIX Index spiked back above 40 and stock prices sank to the low end of their recent trading range. The S&P 500 Stock Index declined by -7.0% in September and now stands down -8.7% for the year, while the more volatile small cap Russell 2000 Stock Index lost -11.2% in the month and is nearing bear market territory, down -17.0% year-to-date.

This most recent precipitous decline came as the markets began to worry anew about the prospects of a sovereign debt contagion and its implications not just for European growth and stability, but for the financial markets generally. Fears regarding the size of Morgan Stanley’s European sovereign

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debt holdings and Bank of America’s seeming struggle for survival pushed both stocks within breathing distance of their 2009 financial crisis lows. While we do not believe the solvency of either company is in jeopardy, the specter of Bear Stearns and Lehman Brothers certainly seemed to be lurking nearby during the closing days of the month.

#### VIX Spikes as S&P 500 Plummets

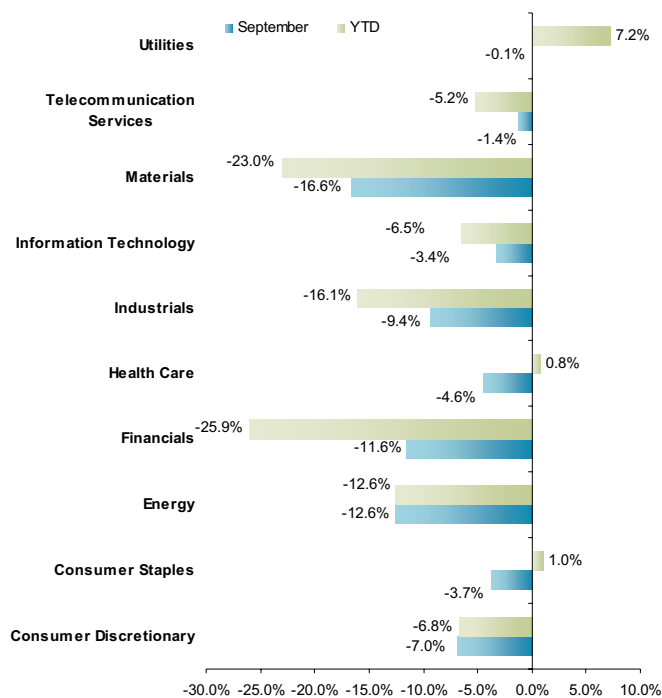


To make matters worse for the banking industry, the Federal Housing Finance Agency (FHFA), the conservator for Freddie Mac and Fannie Mae, filed suit against 17 major U.S. banks for failing to adequately represent the characteristics of mortgages that comprised their private-label mortgage-backed securities. While many market pundits decried these suits for fear that potential awards issued against the banks could further impair their capital

structures, those protests were dismissed by the regulatory agency. Indeed, the FHFA responded by saying, “Some have claimed that these suits will disrupt economic recovery, or endanger the targeted banks, or increase their cost of capital. While everyone is concerned with these important issues, the long-term stability and resilience of the nation’s financial system depends on investors being able to trust that the securities sold in this country adhere to applicable laws. We cannot overlook compliance with such requirements during periods of economic difficulty as they form the foundation for our nation’s financial system.”

By the end of the month, financials had fallen nearly -11.6%, and a full -26.0% year-to-date. But they were not alone, as all sectors of the S&P slumped during the month. Basic materials and energy stocks were even more pressured, declining -16.6% and -12.6%, respectively, as the commodities markets registered fear that faltering economic growth in developed economies as well as China could have the makings of a global recession. Even utilities, the primary safe haven for equity investors year-to-date, saw their prices fall. While the decline in the utilities sector was minimal, only -0.1%, it served to showcase the broad-based decline in the domestic equity markets.

### S&P 500 Sector Returns

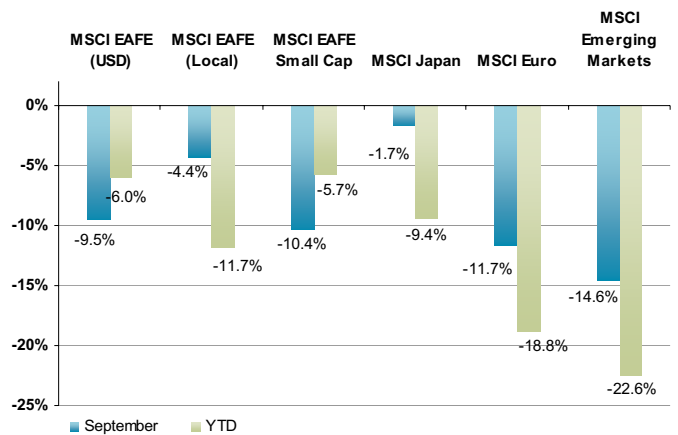


### 5. International Equities: The Pain Intensifies

September proved to be even more painful for international equity investors than August, and European stocks continued to lead the way lower as a resolution to the sovereign debt crisis remained out of reach. The risk-off nature of the global investor was reflected in the sector performance for the MSCI EAFE index, as historically defensive sectors such as consumer staples, telecommunications, utilities and health care fared better than the benchmark’s -9.5% decline.

Materials and industrials, not surprisingly, were the two worst performing sectors for the month of September, as global economic data continued to deteriorate; the sectors lost -16.9% and -11.4% respectively. Financials rounded out the losers for the month, as European banks remained under pressure while European policy makers discussed a potential increase in the magnitude of the haircut that investors might be forced to take in the event of a Greek default.

### International Equity Returns

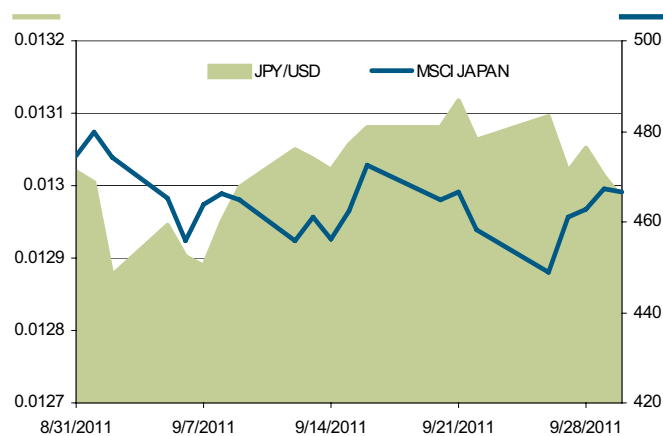


All developed regions posted negative returns during the month, although interestingly, it was not Europe but rather the Pacific region excluding Japan which posted the worst regional return for September. Hong Kong equities, which were down -16.4%, were particularly pressured as investors used the market to short Chinese equity exposure due to fears of slowing growth rates for the Chinese economy. Investors were also unnerved by the continued scrutiny of Chinese company accounting practices by the U.S. Department of Justice. In the commodities rout, natural resource heavy Australian equities were hit hard, losing -14.9% in the month, on expectations of lowered demand from both the developed and emerging world. Other laggards for the month

included Austria and Greece, both of which lost over -20%.

There were few bright spots in the month, and not one of the country sub-indices which constitute the MSCI EAFE index posted a positive return. However, Japanese equities came close to at least breaking even, losing only -1.7%, as a combination of modestly improving economic data and a currency flight-to-quality enticed investors from riskier segments of the equity markets. New Zealand also outperformed the broad benchmark in September, as it has done for much of the year. However, following a downgrade of its debt to close the month, a reversal of this trend could occur in the fourth quarter. Interestingly, both Ireland and Spain outperformed the MSCI EAFE index in September, as it appears investors are attempting to differentiate among the periphery nations.

#### Flight Towards the Yen Helps Stocks Hang In



#### 6. Emerging Market Equities: Definitely Not Decoupled

Emerging markets equities, as they have historically during periods of significant global equity market declines, underperformed developed markets in the month as investors fled risky assets amidst fears of another financial crisis. Central European nations significantly underperformed as they were in the unique and unenviable position of belonging to the two areas of the market from which investors were fleeing the fastest - Europe and the emerging markets.

Hungarian and Polish stocks lost over -20% in September alone; Russian stocks also experienced significant outflows, as political upheaval provided an additional catalyst for investors to shed risk. South American stocks, although

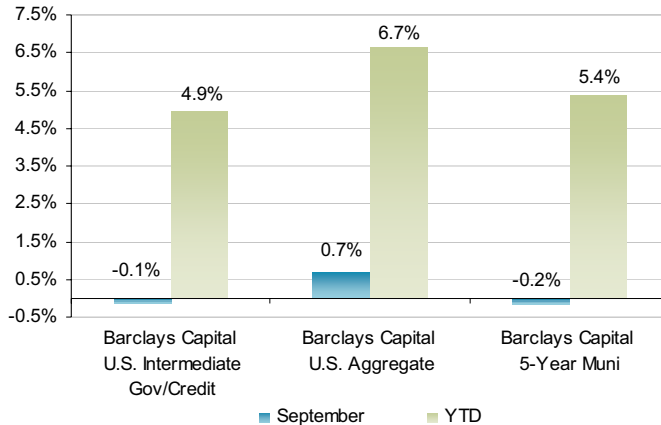
largely insulated from direct exposure to the European sovereign debt crisis, pulled back sharply as renewed concerns of a global recession sent commodities plunging. Brazilian stocks lost -18.4% in the month even as the central bank took steps to loosen monetary policy by cutting the country's benchmark interest rate.

Far and away the best performing country for the month was Turkey. Turkish stocks actually posted gains in September, advancing +3.5% as S&P upgraded the country's local currency rating. The move sent Turkish bank stocks significantly higher to close the month, and other sectors followed suit as investors poured money back into Turkish equities. This is particularly meaningful given the dismal performance of the country's stocks prior to the announcement, as Turkish central bank and government officials had spent much of the year enacting policies to deter foreign investment. Other notable outperformers were India and the Northern African nations of Egypt and Morocco, which were down -6.52%, -8.39% and -9.47%, respectively, versus the MSCI Emerging Markets index return of -14.58%. Indian stocks, for their part, saw moderating losses on the back of an aggressive benchmark interest rate hike program. However, the respite may be short-lived for India, as stubbornly high inflation rates in the country may cause their underperformance to resume.

#### 7. Fixed Income: Getting Twisted

The summer's grim realities of economic slowdown and the debt disasters of developed economies sank in even deeper in September, further extending the flight-to-quality sentiment within the market. U.S. Treasuries continued their seemingly relentless dive lower in yield, with long rates appreciably benefitting from the September FOMC announcement of Operation Twist. Indeed, the news that the Fed would be selling short-term Treasuries to buy intermediate- and long-term maturities caused an immediate flattening in the shape of the yield curve, with the 30-year Treasury bond yield falling a full -69 basis points in the month, and staging a 6-point rally in the final ten days of the period. In contrast, Treasury Inflation Protected Securities (TIPs) had a tough month, as deflation fears trumped the actual uptick witnessed in core and headline inflation data.

## Longer Maturity Benchmarks Shine in September



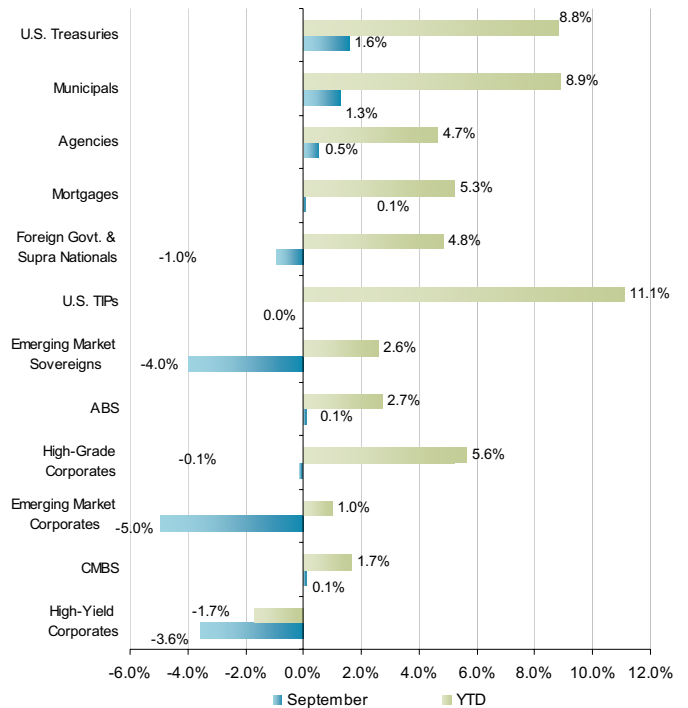
Against a backdrop of the biggest one-month curve flattening since February 1986, major bond market indices with longer duration exposure like the U.S. Aggregate were able to post strong relative returns, while shorter-duration and more credit-oriented benchmarks showed modest losses. Even so, major bond market indices have garnered solid across-the-board year-to-date gains, marking what is likely to be yet another year of outperformance relative to other asset classes.

In terms of specific sector performance, U.S. Treasury bonds led the way, but mortgage-backed securities were likewise the beneficiary of the Fed's benevolence. The sector was able to recover most of its earlier month spread-widening, when Fed Chairman Ben Bernanke made a surprise announcement that the Fed will reinvest principal paydowns from their mortgage-backed securities portfolio. U.S. government agency spreads held in given their close association with U.S. Treasuries; however, since the sector is concentrated in shorter maturities, it did not get the full benefit of Operation Twist's curve flattening. Commercial-mortgage backed securities staged a modest comeback after last month's debacle.

While corporate credit tried to gain traction in the first half of the month even as equities sputtered, returns sank in direct proportion to ratings quality over the course of September. Additional coupon cushion could barely produce a positive total return in September, with junk bonds deep in negative territory, BBBs averaging a zero return, and single-A credits only just above 25 basis points. Pharmaceuticals were the only corporate credit sector to generate excess

return versus Treasuries as even the ever-stable utilities and consumer staples sectors were washed out. Financials and media companies delivered disastrous results as their 2011 struggles continue.

## Fixed Income Cross-Asset Returns



Municipals were solidly in the black, supported by light supply, strong demand, high coupon income relative to taxable alternatives, and a maturity skew to the long end of the curve. Taxable municipals gained more than +4%, well exceeding U.S. Treasuries for the second time in the last three months, as the Fed's Operation Twist was a boon for these predominantly long duration securities.

*“The summer’s grim realities of economic slowdown and the debt disasters of developed economies sank in even deeper in September, further extending the flight-to-quality sentiment within the market.”*

In contrast, it is worth noting the dramatic nature of the sell-off in non-U.S. denominated investments, both high quality

and emerging market. September offered no place to hide, with returns in most cases even worse than equities. Indeed, losses expressed in dollars to AAA sovereign borrowers were anywhere from 4 to 8 points on an absolute basis, and much worse for emerging market and European sovereign credits. This dramatic sell-off reflects the escalating concerns of market participants of the prospect for a full-blown financial market crisis emanating from Europe and spreading across the globe, as well as the implications it has for liquidity in the more thinly-traded corners of the bond market.

### 8. Real Estate: Back to Reality

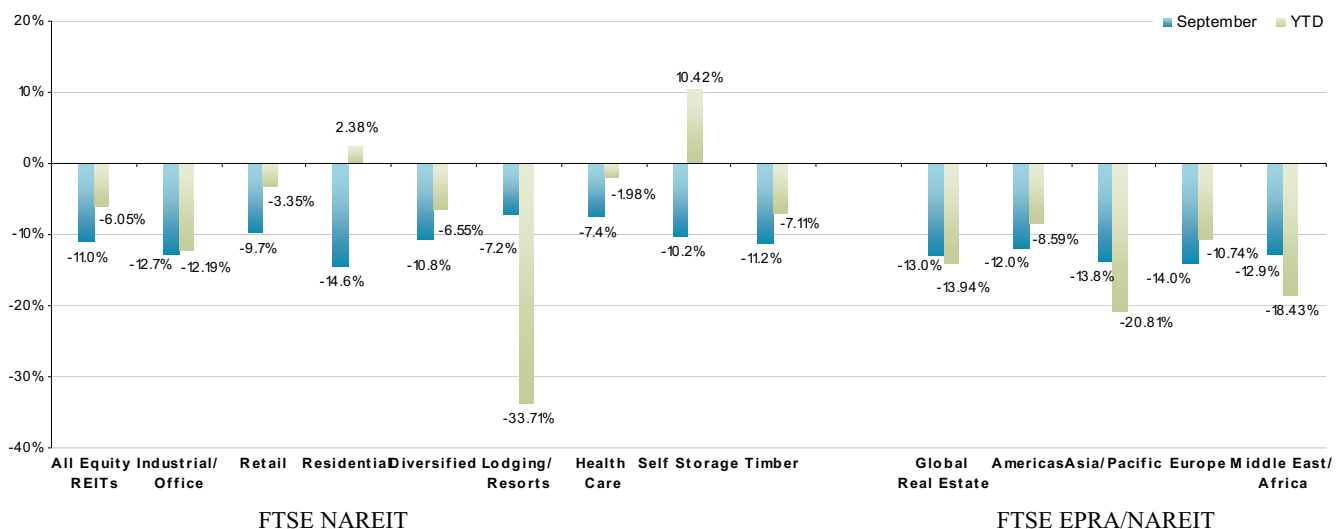
Commercial real estate, and more specifically, publicly traded REITs and REOCs, suffered along with equity markets during the sub-prime mortgage crisis, but have bested broad market returns since the markets stabilized in the first half of 2009. Indeed, despite growing expectations of a follow-on crisis in the commercial real estate space, investors continued to flock towards these companies as they offer a rare source of income in an increasingly low yield environment. As a result, even as the sovereign debt crisis took hold and equities broadly began to falter, real estate companies showed resolve, surprising investors given the less-than-stellar macroeconomic fundamentals of the space.

September brought an end to that trend, however, as the income generated by the asset class, which has helped to provide a floor for prices over the last several quarters, was

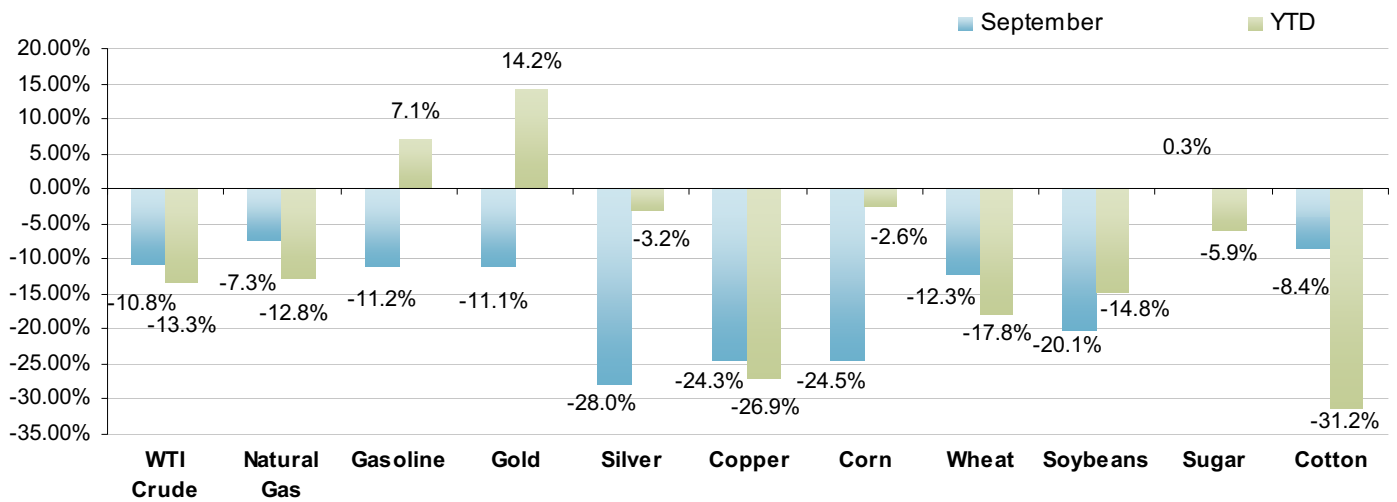
no longer enough to prevent an exodus by investors in the month. The FTSE NAREIT All Equity REITs index underperformed the broad market significantly, losing -11.0% versus a -7.0% for the S&P 500. Particularly hard hit were office properties, dropping over -14% as unemployment remains elevated with no clear catalyst for a rebound in hiring. Interestingly, apartment REITs also took it on the chin, dropping almost -15% as analysts began to question the valuations of these companies given their prior strong performance. Although fundamentals for the apartment market have not changed, should low rates induce any improvement in mortgage origination, prices for these securities could continue to tick downward. Other laggards included shopping centers and timber, while on a relative basis health care and lodging/resorts held up fairly well.

Globally, the story was slightly different, as REITs actually held up better than the broad equity markets outside of the United States. Of course, this is all relative, as all four major geographic regions posted double digit negative returns for the month. European REITs were hit hardest as attractive valuations and resilience in certain major markets in Northern Europe were no longer enough to counteract the weakness rippling from the periphery. Asian REITs also pulled back in the month on concerns that weakening demand in the developed world could affect cash flows in certain segments of the Asian real estate market. The next several months could bring more of the same, as investors seek stabilization in Europe and evidence that a double dip recession can be avoided prior to committing additional capital to the space.

### Real Estate Returns



## Commodity Returns



### 9. Commodities: Crash and Burn

September proved a devastating month for the broad commodity markets. Only sugar saw rising prices as supply constraints held prices steady from the prior month, despite double digit declines across the board in virtually all other commodities. Even gold (-11.1%) and silver (-28.0%) lost ground, after previously providing an almost fool-proof safe haven for investors. While sovereign debt issues and renewed fears of recession in the U.S. certainly served to spook commodity investors, signs out of China that growth is moderating likely had a larger impact, particularly on oil prices. Going forward, price moves in oil are likely to be especially sensitive to perceived Chinese demand, as perhaps the one economy globally not in a growth recession.

With the obvious exception of gold and silver, which investors had flocked to in order to avoid the volatility of the equity markets, commodity price declines are welcome news for consumers and businesses that are struggling with commodity price inflation. Interestingly, despite the declines we have seen in crude and natural gas prices year-to-date, gasoline prices, while having fallen in the month of September, remain stubbornly higher than they were at the beginning of the year.

### 10. Hedge Funds: Long and Wrong

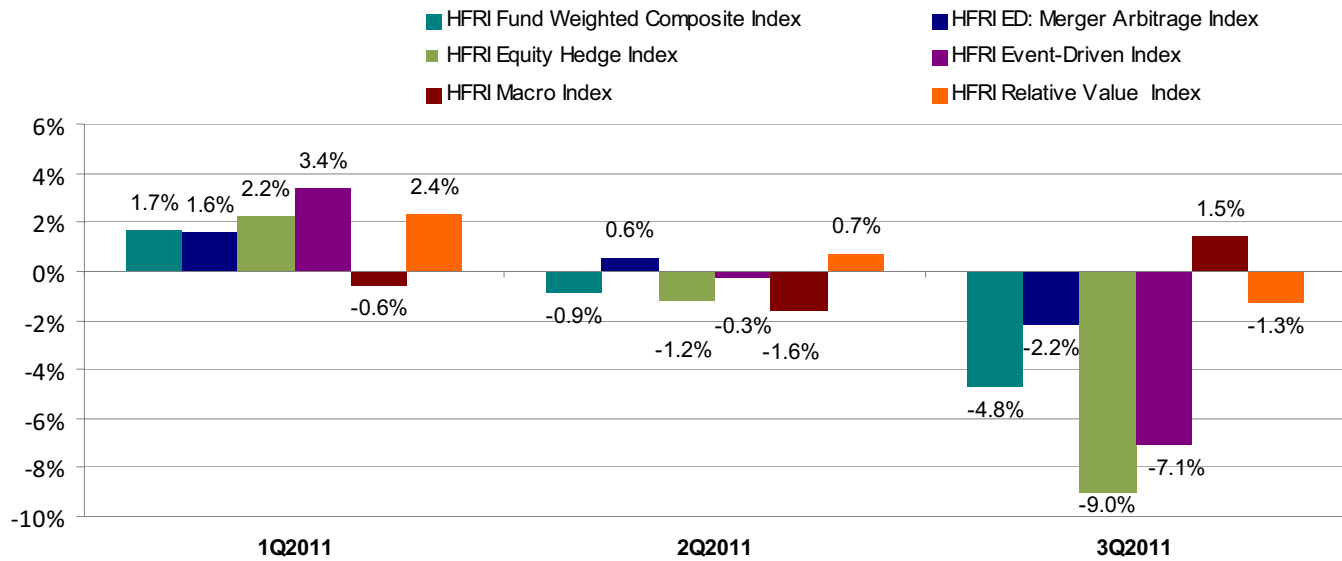
Much like the prior two months of the third quarter, September was a story of continued volatility in the equity, commodity and bond markets. Ongoing fears of a worsening European sovereign debt crisis, along with deflationary

concerns and a China slowdown continue to weigh heavily on investors. Volatility has plagued markets for several months with investors looking to limit risk while keeping liquidity high. As such, correlations have skyrocketed as nearly all of the major risk markets simultaneously trade together. Hedge funds continue to struggle, along with most other asset classes with exposure to risk, as evidenced by the dismal performance of the HFRI Fund Weighted Composite which finished September down -2.81%, dragging year-to-date losses to -4.7%.

Long/short equity hedge fund managers faced the brunt of the drawdown as many managers remain long-biased and true to their fundamental roots. As equity markets sold off, long/short managers suffered as long portfolios sold off faster than the short books could help them. That said, most equity fund managers, who typically try to buy equities trading at significant discounts to earnings multiples, are using the volatility to add to existing high conviction positions, and as a result, equity fund manager overall gross and net exposure is down significantly across the board.

Based on our anecdotal observations, long/short equity managers have raised cash aggressively while trying to remove beta from their portfolios through either a reduction in direct net exposure or through the purchase of volatility protection. Predictably, short-biased managers flourished in September, with the HFRI Equity Hedge Short Index up +6.9%, pulling year-to-date performance into positive territory (+6.6%). Conversely, the broader (and longer-biased) HFRI Equity Hedge Index was down -4.9% on the

## Hedge Fund Returns



month, and – 8.7% in 2011. Leading the way down were the energy and technology sectors, as the HFRI EH Energy/Basic Materials Index and the HFRI EH Technology/Healthcare Index suffered a particularly difficult month, losing -9.5% and -3.6% respectively.

Event Driven and Relative Value hedge fund strategies continued their struggle with global uncertainty and a lack of significant deal activity in the space. The HFRI Event-Driven Index was down a surprising -3.3% in September, and is now off -4.1% in 2011. However, M&A activity, which had been largely dormant throughout the summer, is showing some signs of life with several large deals being announced in September. That said, widening spreads in high yield and a general absence of meaningful bid activity in distressed areas wrought havoc for event-driven managers. In relative value strategies, heightened correlations and spiking volatility have not helped some of the mean-reversion trades that typify the space, and most strategies suffered in September. The HFRI Relative Value Index was down -1.2% for the month, and is down -0.2% year-to-date.

Macro strategies, particularly those in the shorter-term quantitative CTA space, showed a few bright spots despite the continued turmoil. Discretionary as well as systematic strategies that were positioned for continued U.S. dollar strength and falling U.S. Treasury yields did well, as did those that were largely short commodities and playing for continued downward moves in soybeans, corn, wheat and

cocoa. Copper also factored into performance as it continued to march lower on fears of a China slowdown, bringing the macro-sensitive metal down -25% from highs set in early March 2011. Similar to August, WTI Crude remained range bound between \$80 and \$90, but did flirt with and go through the \$80 resistance level at the end of September. Gold sold off dramatically in the second half of September on deflationary concerns and lower volume before finding a bottom close to \$1,600. Silver and palladium also sold off in a similar manner. The HFRI Macro Index finished the month down -0.4%, bringing 2011 performance to -1.3%. Systematic strategies, which tend to be long market volatility, fared slightly better, finishing September up +0.2%, with year-to-date performance of +0.7%.

In summary, the third quarter was among the worst for hedge fund strategies, as most tend to be long risk assets, long-biased, and as a result, implicitly short volatility. They are also positioned to take advantage of correlation divergence, not convergence, across asset classes. With that said, we have seen certain hedge fund strategies weather the summer's storm well, primarily the macro trading strategies. As markets have traded largely independent of company fundamentals for some time now, managers who have gotten the top-down picture right and been long volatility while purchasing the right types of protection have fared well. Often we see hedge funds experience success on a rotating basis across strategies and sectors, and the current period is

no exception. How this dynamic will progress is uncertain in the near-term, but we do know that hedge fund managers have largely removed risk across the board, both on an absolute leverage level as well as in terms of directionality, and we expect relatively muted returns until some semblance of normalcy returns to equity and credit markets.

### 11. A Final Word: It's All Greek to Me

Much of the volatility experienced in the markets over the last year and a half has been a result of the fits and starts associated with the European sovereign debt crisis. What began as concern around the soundness of the Greek government's guarantee to their debtors has grown and spread, both to countries which share its Mediterranean coast and to countries which inhabit the upper reaches of the continent. Yet, even as it has become increasingly clear that the importance of Greece in the mind of the average investor has grown well beyond its significance to the global economy, European policymakers have been unwilling, and, in some ways, unable to find the right combination of solutions to reverse the tide.

One must ask then, where do we go from here? At this juncture, there are potentially three different paths the situation in Greece could take. First, things could remain much as they are now, with Greece continuing to take steps towards austerity while the ECB supports its debt in the secondary market, and its fellow euro zone members provide the cash necessary to meet bond maturities for the foreseeable future. This outcome appears less and less likely by the day, as long term investors have grown tired of waiting for a resolution and they, along with speculators, continue to drive yields higher. Evidence of a renewed economic slowdown also makes austerity even more difficult, as revenues are lighter and spending cuts in turn must be deeper.



Source: cnn.com

Another option would be for Greece to receive assistance to engineer an orderly default, whereby creditors would be forced to endure a haircut on outstanding debt. Creditors – primarily banks - would be incented to accept the proposal as they would in turn be offered a guarantee by the other euro zone governments on the restructured debt, and frankly, a recovery of even half of their principal might be the best that can be expected in the current environment. Fiscal support would be provided to Greece, and their banks would likely be recapitalized as well. What remains a bit of a question is what the Greeks would need to offer in return, either their departure from the euro zone or acceptance of long term involvement by the European Commission and/or the International Monetary Fund as it relates to fiscal policy are the apparent choices.

### A House Built on a Sandy Foundation



Source: cartoonstock.com

The final path, and the one keeping everyone up at night, is a disorderly default by Greece. A disorderly default would be devastating not only for Greece, but for the European Union as a whole, as it would indicate that the monetary union has no means by which to police the fiscal policies of its constituent states, and is unable to provide a backstop for countries struggling economically. It would almost certainly plunge Europe and likely the rest of the world into its second financial crisis in less than three years, as a large proportion of the 485 billion euros of Greek debt is currently held by European banks. These banks, although less exposed than U.S. banks were to sub-prime loans during the recent

financial crisis, certainly suffered significantly as well, and sovereign debt weakness has prevented them from improving their balance sheets over the past several years.

Recall, however, that U.S. banks were righted not through their own actions, but through government assistance in the form of TARP. While an expansion of the mandate of the current European Financial Stability Facility could allow for such a rescue, the amount of money pledged by the participating governments is at this point grossly inadequate should a disorderly default occur. Of even greater concern is that this scenario assumes only a default of Greek debt, which is unrealistic; other countries in the periphery such as Portugal and Italy would likely be the next pillars to fall as their borrowing costs would skyrocket to unmanageable levels.

Obviously, a disorderly default is within the realm of possibility, although consensus is not calling for such an outcome at this time. Bets appear to be on an orderly default, engineered by European policy makers, and this may appear at first blush to be a “best of the worst” option. However, there are some serious questions which arise with this solution, questions which could endanger the very existence of the European Monetary Union. As outlined above, the situation in Greece could conceivably result in their departure from the euro zone. Their departure would be after the country has already received billions of euros in handouts, and a restructuring of debt which would lower its interest burden for years to come. Harsh austerity measures could be repealed, and a reinstatement of the drachma would allow an immediate devaluation of the currency, which would help bring tourists back to Greek shores. One risk is that such a solution may start to seem appealing to other countries such as Portugal and Italy, who may feel that the hurdles set by euro zone policy makers are just too high, and it would be better to go it alone than remain in what a few years could be a failed institution.

Of course, such a move by Greece would be incredibly short-sighted, as exports and imports together account for only 26% of their GDP, and the ability to devalue a currency hardly appears worth the additional borrowing costs their

departure would bring. More important, then, are the prospects for the European Union itself, and how that union might look in ten years. If no coordinated fiscal mechanism is implemented, investors are unlikely to gain comfort that a similar situation could be prevented in the future, which will likely drive up borrowing costs and hinder growth across the region. At some point, the costs of such a structure, particularly for the better positioned countries, may outweigh the benefits. If that decision were ever to be reached, the euro could be rendered obsolete.