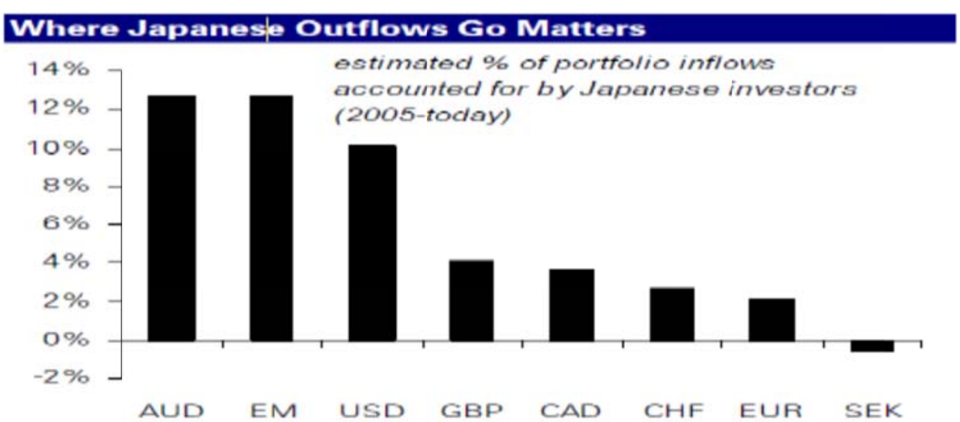
PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

Portfolio management at the multi-asset class level is, at its core, an exercise in probability analysis. An effort to make strategic allocation decisions is rooted in a process of evaluating signals provided by markets and the economy that are often in conflict. We addressed this dynamic in a letter to investors in August of 2011, when we talked about the importance of separating 'signal' from 'noise', and are reminded of it again today, as we think about investing in a world governed by bodies that seem to be determined to make sure that conflicting signals remain in place. In its simplest form, the disconnect in today's world lies between inflationary and deflationary actions and outcomes.

Central banks around the world have passed the baton to one another in an effort to collectively inflate global assets, and ultimately the global economy, by ensuring that the financial system stays awash with more liquidity than it can easily digest. While the liquidity has indeed propelled asset prices higher, particularly those with a growth or income profile that is too hard for an investor backed by way-too-easy-and-cheap leverage to eschew, it has failed to produce a traditional recovery growth profile while creating a credit market that is seemingly as easy as it has ever been. On the deflationary side, commodity prices have wilted and longer bonds have rallied, as the yield on 10-year Treasuries has fallen from 2.06% to 1.74% since mid-March. Not only bonds of corporations with strong balance sheets and cash stockpiles, but those of indebted governments as well, including Slovenia which recently had its credit rating cut below investment grade, yet received $16 billion (equal to nearly one-third of its gross domestic product) in bids for bonds yielding under 5% for five years.[i] It is an environment, as reflected by spreads and a lack of volatility, that feels eerily similar to that of 2007 – leading those that worry about history repeating itself to lament the market's lack of institutional memory.



Source: Deutsche Bank, Bloomberg Finance, LP, GaveKal Research

One lesson that we have learned as investors over the years is taken from a design principle first noted by the U.S. Navy in 1960, and that is "Keep it Simple, Stupid". One of the most simple strategies for an investor to follow over the past decade has been to buy what the Chinese bought – gold, wine, real estate, you name the asset and Chinese purchasing power drove its pricing to new heights. A decade from now we may look back to today and observe that the simple strategy to have followed would have been to buy

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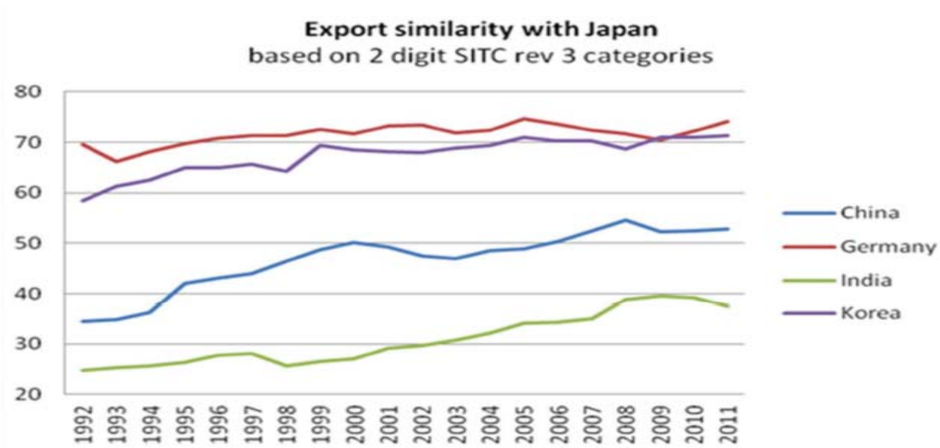
what the Japanese are buying. The Bank of Japan is a fairly late comer to the global currency war, but as an institution it is making up for lost time. Since the beginning of 2013, monetary stimulus from the BOJ has amounted to 13.7% of GDP, compared to Fed stimulus over the same period of 3.2% of GDP. They have purchased 46.9% of government issuance, for a figure that equates to 134.4% of the country's deficit. In the U.S., the Fed has purchased 24.2% of Treasury issuance, or 39.5% of the level of our country's deficit.[ii]

The chart above is indicative of the fact that Japanese investment has been a significant driver of portfolio inflows around the world for quite some time. The recent bout of balance sheet expansion should take that to another level, and could very well be a dynamic that plays out for many years. The shift from tight to loose monetary policy is largely political in nature. Two rules to remember when investing in Japan, are: 1) never underestimate the willingness of the population to share pain, and 2) never underestimate the willingness of Japanese policy makers to apply the first rule. These two rules mean that Japan will act in the country's overarching national interest and security at all times. In recent years, the primary national interest has centered on the fact that it is a rapidly ageing country with more than half of voters either retired or within five years of retirement. A currency debasement that stirred inflation would not have been popular. Mild deflation and a strong currency are good for retirees.

Recently, the dual threat perceived to emanate from China, on both political and monetary fronts, has caused a 180-degree shift with respect to a structurally weak yen policy. With China holding significant levels of JGBs (Japanese government bonds), and tensions stirring over the Senkaku (as they are known in China)/Diayou (as they are known in Japan) islands, a weak yen is indeed seen as a matter of national security. With a lot of debt and xenophobia, you don't want to continue to run large current account deficits. This need to boost Japanese exports is why Prime Minister Abe has a 72% approval rating despite declaring a weak yen policy, a concept considered anathema to policy makers until now.

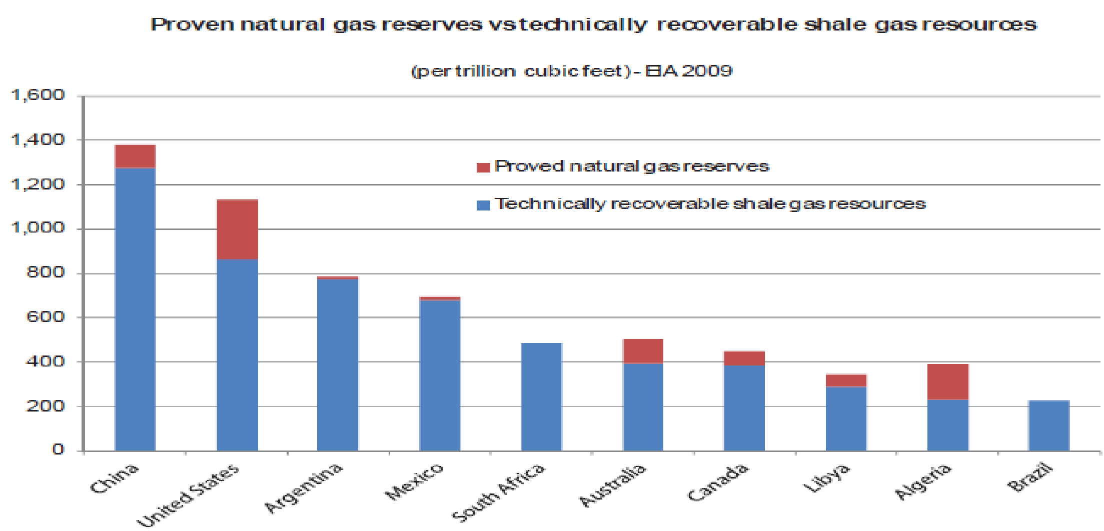
The relationship between Japan and China is based on trust and understanding – but Japan doesn't trust China and China doesn't understand Japan. Fallout from the policy will be felt for years to come. With policy rates kept down, yield hungry Japanese investors will turn anywhere and everywhere. Historically, Japanese investors love REITs, emerging market bonds, high yield bonds and loans, and equities, with a particular fondness for the markets of India and Brazil. On the trade side, Germany and Korea will likely be hurt, as they have very tight export profiles to Japan.



Source: GaveKal Research

The notion of an investment pivot from China to Japan is not meant to suggest that China's impact on the world economy will be diminished going forward. In fact, the transition taking place within the Chinese economy is likely to be a huge driver of macroeconomic inputs such as energy and agriculture prices, as well as global trade balances. While the shift from an export-driven profile to one of domestic consumption has garnered the majority of critical thought, the real sea change to monitor deals with the allocation of China's most precious resource, water.

Many people are familiar with the fact that China is the world's biggest importer of energy. Fewer are familiar with the fact that China has more shale gas resources than any other country, including the U.S. While China's shale gas is deeper in the ground and harder to recover than ours, the primary reason that they have produced fewer natural gas reserves than the U.S. is their allocation of water as a natural resource. For generations, water in China has gone largely to the farming industry, as the Chinese have insisted on farming things that don't need to be farmed. Items that can be imported at a spread much more narrow to domestic production when compared to the cost of energy importation. That allocation decision has left an inadequate supply of water for fracking, leaving the vast majority of natural gas sitting underground. With that policy change in the works, the impact of lower energy prices around the world could have dramatic implications on developed and developing economies.

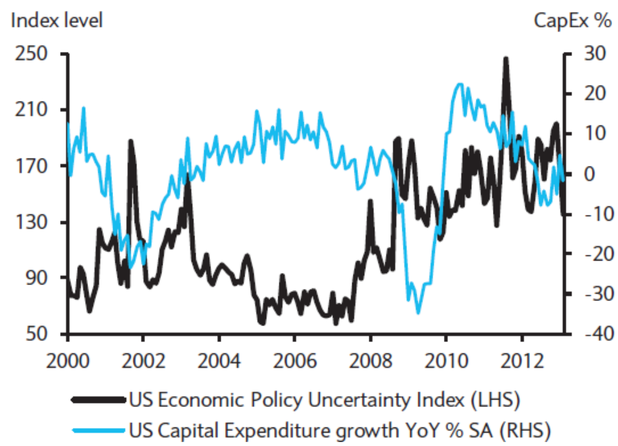


Source: MLR, EIA, US Geological Survey, GaveKal Research

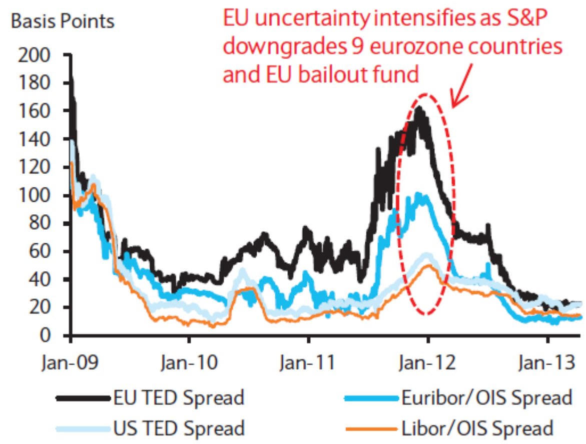
It is this very emphasis on the technology of energy production that has led to what is being called an energy revolution in the U.S., and along with a nascent recovery in housing and the tangential benefits attached to housing as an industry, have kept the U.S. economy growing at a moderate pace. Headline GDP would be higher if not for a retrenchment in public sector spending. Private sector GDP excluding inventories has been running at a 3.5%-4.0% clip for the last several years.

Three years on, however, one of the surprising features of this recovery has been the low level of U.S. business investment despite companies having plenty of cash to spend. At 53% of corporate profits, capital expenditure is well below its long-term (dating back to 1951) average of 88% as well as its short-term (dating back to 2002) average of 68%. Corporate earnings are rising but profit growth is all through cost cutting. The post-crisis level of business investment has been uneven. While spending on information technology has grown by an average of 8.8% per quarter, spending on physical structures has grown by only 0.8% per quarter.[iii] Economic uncertainty has been a huge impediment to capital spending. When economic policy uncertainty rises, companies become reluctant to make capital outlays which are long-term in nature. Some of this uncertainty has declined since the beginning of the year, as "fiscal cliff" concerns were largely allayed. Also, the perception of tail risk has come down, as evidenced by the reduction in money market spreads in both the U.S. and Eurozone.

US Economic policy uncertainty and capital expenditure



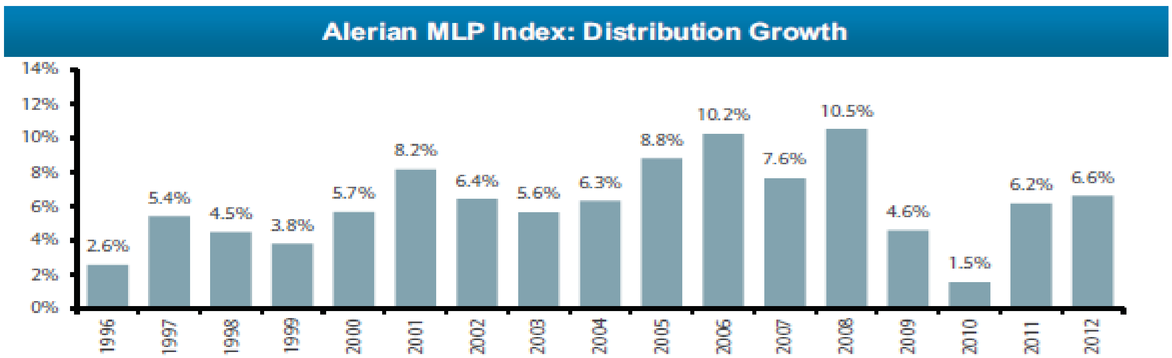
US and Eurozone money market spreads



Source: Barclays

This perceived reduction in macro risks, along with the continued cooperation of central bank actions, may continue to provide a tailwind to financial assets as we continue through 2013. In fact, the Fed is gambling on just such an occurrence. The gamble lies in the fact that 75% of global market capitalization sits in fixed income assets, which the Fed is systematically putting at risk and at a disadvantage with its zero interest rate policy. The Fed is counting on the gains generated in the 25% of the global market invested in equities to produce the 5% real rate of return that is likely required to offset fixed income losses. One manifestation of this Fed-induced capital market assumption has been a shift in how yield makes its way into investment portfolios. In 2007, 64.3% of the yield in a portfolio consisting of U.S. stocks and bonds came from the Barclays Aggregate Bond Index, versus 35.7% which came from the S&P 500. In 2012 that figure dipped to 51.6%, and in 2013 the estimated yield from bonds is 49.2%, while over half of the market yield comes from equities.[iv]

This recalibration of investor behavior with respect to yield continues to benefit equity income categories like master limited partnerships. In addition to the favorable demographics of income-oriented investments, MLPs benefit from a strong fundamental backdrop. As institutional investors like defined benefit plans and insurance carriers are poised to migrate away from bonds, the low correlation of MLPs (5-year average correlation of -0.01 relative to US Treasuries) should be supportive of the asset class. Historically, yield compression occurs as rates rise which is why the correlation to bonds is low. Going back to 1996, in periods of at least four months in which rates rose (by an average of 156 basis points), the spread over Treasuries compressed each time (by an average of 194 basis points).[v] On the fundamental side, distribution growth as measured by the Alerian MLP Index has been consistently up every year, including a 10.5% jump in 2008. Capital spending drives distribution growth, and provides the tax deferral, and cash flow is a function of assets in service and the level of utilization. Organic spending is being supported by shale economics, with a long duration inventory. Not only is M&A activity very strong, but with shale development a higher percentage of the energy value chain is being priced on a fee basis. Many Shales, including the Marcellus, Eagle Ford, and Bakken, begin with very limited infrastructure requiring a build out from scratch.



Source: Alerian Capital, Barclays

The length and visibility of the development cycle is unprecedented, and the resultant cash flows are highly durable. This level of infrastructure spending leads to both a supply push and a demand pull. The abundant, low cost supply is invigorating demand. And a set of changing logistics is leading to an emphasis on supply, as flows are shifting which impact the value of traditional transportation corridors. Meanwhile, refineries have spent a decade configuring for heavy crudes, while the new supply tends to be light. Valuations are attractive on both an absolute and relative basis. Excluding the period immediately following the Lehman bankruptcy, the current cash flow multiple is 92% of the historical average, while the weighted average cost of capital multiple is near a record – assets are very cheap and the spread versus credit is wide. We're buying defensive names at 5-7% yield levels, which makes for a nice portfolio holding with equity like beta coupled with tax efficient cash flow characteristics, and an opportunity to benefit from the country's push for energy independence.

Other parts of the domestic equity and credit markets offer opportunity on a selected basis as well. Within equities there continues to be a significant deviation from normal valuation multiples on defensive names, which have gotten very expensive, and cyclical names, which have largely lagged. In credit we continue to favor spread-oriented investments like floating rate loans, which should benefit from the influx of Japanese investment dollars. We also see value in event driven investments that can take advantage of the type of idiosyncratic events within corporate credits that exist throughout credit cycles. In other words, while there are alpha opportunities to harvest, there is little left to be gained from pure beta. This may continue for some time as the "tail" to this credit cycle is particularly long because of the depth of the previous crisis. Every time there is a financial crisis, financial institutions look to exit positions they hold but they must do so slowly so that an appropriate level of capital adequacy is maintained. That dynamic has been magnified this time around because of the cutback in financial institutions proprietary trading activity.

Outside the U.S. we continue to boost our exposure to emerging market equities, as the performance lag over the twelve-month period ending at the end of the first quarter (2.3% for the MSCI Emerging Markets Index versus 14.0% for the S&P 500 and 11.8% for MSCI EAFE), has been largely driven by an overreaction to slowing growth in China, leaving the fundamental picture going forward well aligned with current valuations. Recent GDP reports show the Chinese economy growing at 7.7%. This is lower than the previous quarter but not very troubling when you consider the fact that the current $8 trillion economy is almost four times larger than it was a decade ago when it was growing at 10%. Another perspective holds that in 1997, when the US economy was the same size that the Chinese economy is today, it was growing at 4%.

What really keeps us up at night is as much attributable to muscle memory as it is to anything else. There is a worrisome seasonality at work, with the spring of 2013 seemingly following script from 2010, 2011, and 2012. Everything from purchasing manager surveys and retail sales, to hours worked and income figures, to durable goods and consumer sentiment, have turned for the worse. In each of those periods what followed was a sudden and sharp slide in the stock market. With an equity market feeling like August of 2011 and a credit market that feels like 2007, it can be difficult to remain fully invested. We prefer to combat this dilemma by maintaining well balanced and diversified portfolios in most instances, with thoughtful allocation decisions centered around putting uninvested cash to work and decreasing leverage where applicable. We look forward to continuing these discussions with you.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

As of March 31, 2013

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	3.8	10.6	14.0	5.8
Russell 2000	Small Cap Equities	4.6	12.4	16.3	8.2
Russell 3000 Growth	US Growth Equities	3.9	9.8	10.4	7.4
Russell 3000 Value	US Value Equities	4.0	12.3	18.7	5.0

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
INTERNATIONAL EQUITY					
MSCI World exUS GR	Global ex US Equities	0.8	4.8	11.0	-0.2
MSCI EAFE GR	Developed ex US Equities	0.9	5.2	11.8	-0.4
MSCI Europe GR	European Equities	-0.1	2.8	11.3	-1.4
MSCI Japan GR	Japanese Equities	4.9	11.7	8.7	-0.4
MSCI EM GR	Emerging Mrkts Equities	-1.7	-1.6	2.3	1.4

As of March 31, 2013

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
FIXED INCOME					
BofAML T-Bills 0-3 Mon	Cash	0.0	0.0	0.1	0.3
BarCap US Agg Bond	Broad US Investment Grade Bonds	0.1	-0.1	3.8	5.5
BarCap Municipal	Municipal Bonds	-0.4	0.3	5.2	6.1
BarCap Treasury	US Treasury Bonds	0.1	-0.2	3.1	4.4
Citi WGBI USD	Global Sovereigns	-0.3	-2.8	-0.7	2.8
BarCap US HY Interm	US High Yield Bonds	1.0	2.9	12.7	11.2
JPM EMBI Plus	Emerging Market Bonds	-1.0	-3.3	9.7	9.5

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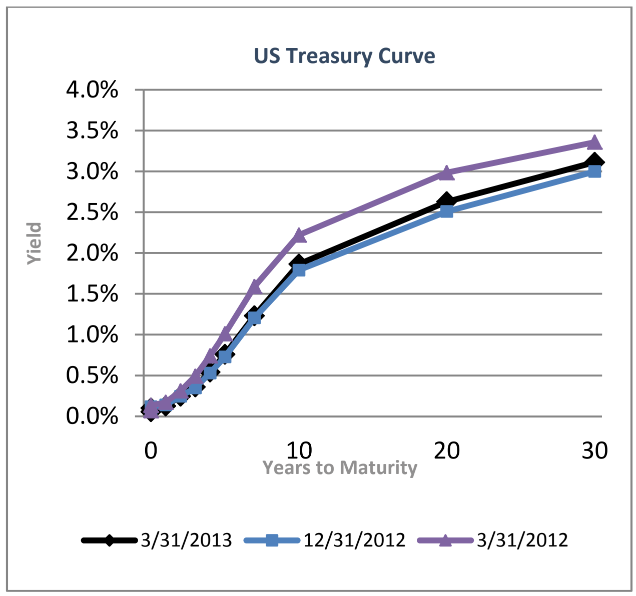

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ALTERNATIVES					
HFRI Fund Wtd. Composite Index	**Broad Hedge Funds**	1.0	3.7	5.3	3.0
MLM Index	**Managed Futures**	-0.2	-1.3	-6.0	1.3
DJ UBS Commodity	**Commodities**	0.7	-1.1	-3.0	-7.1
Wilshire US REIT	**REITs**	2.8	7.4	14.0	6.3

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

	As of 3.31.13	Prior Yr End (12.31.12)	One Year Ago (03.31.12)	Five Years Ago (3.31.08)
CURRENCIES				
US Dollar Index Value	82.98	79.77	79.00	71.80
USD vs. Yen	94.22	86.75	82.87	99.70
Euro vs. USD	1.28	1.32	1.33	1.58
GBP vs. USD	1.52	1.63	1.60	1.98
COMMODITIES				
Gold ($ / ounce)	1598.75	1675.35	1668.35	916.88
Crude Oil ($ / barrel)	97.23	91.82	103.02	101.58
Copper ($ / ton)	7509.75	7907.00	8474.50	8510.00
Corn - Generic (Usd/bu)	695.25	698.25	644.00	567.25

[i] Barron's- 5.6.13
[ii] Goldman Sachs- Kasper Christoffersen- 2013 Silver Point Capital Investor Conference
[iii] Barclays- Compass- May 2013
[iv] BlackRock- Navigating the New Era of Fixed Income- April 2013
[v] Barclays- Master Limited Partnerships Forum- 4.2.13