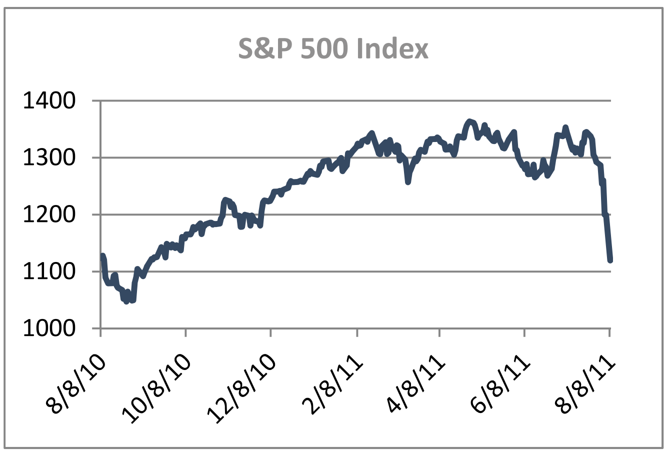
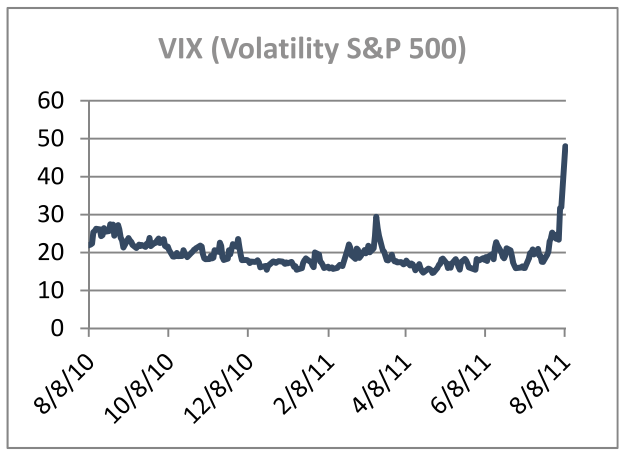
PCA PERSPECTIVES

Permit Capital Advisors Monthly Thoughts on the Investing Landscape

PERMIT CAPITAL ADVISORS, LLC

Any investment professional charged with making capital allocation decisions for clients must deal with the challenge of separating ‘signal’ from ‘noise’ when it comes to understanding the landscape in which such factors are evaluated. This requires discipline when the world is in a “steady state.” In today’s world where the noise has reached a level best described as cacophony, investors must take extra caution to stay focused. We recognize that is easier said than done when the market has fallen nearly uninterrupted for eleven days running, and yesterday marked the first day in the history of the S&P 500 that every single stock declined. What we are not going to do is try to time the market, though there are periods in which we think fundamentals reach a point where certain asset classes become more or less attractive than normal. What we have and will continue to do for clients is build portfolios designed to weather various turns in the market cycle with an eye towards hedging tail risks when market volatility surges as it has of late.





Leaders on both sides of the Atlantic are doing their best to perpetuate that difficulty, as political and fiscal debates rage throughout both Capitol Hill and Europe, with decisions made that can most often be described as “shooting oneself in the foot”. In Washington, the immediate nature of the debt ceiling debate has quelled as the Administration and Congress reached an agreement late last weekend. The Lex Column in the Financial Times offered this opinion about where the agreement ranks in historical context, *“The latest US budget accord is not the worst last-minute agreement in history. President Obama may be weak, the leaders of Congress foolishly stubborn, and the agreement is not enough to calm markets for long, but Sunday’s piece of paper has more going for it than, say, the 1938 Munich Agreement, which failed to prevent World War II.”* High praise indeed. However, while the ineffectual agreement led directly and swiftly to Friday’s announcement by Standard & Poor’s that the long-term credit rating of the country was being downgraded for the first time in history, to AA+ from AAA, the circus in DC may still prove to be more noise than signal in the long run. After all, it came as no surprise (as we noted the likelihood in last month’s Perspectives) and it came in the midst of a huge run-up in Treasury prices.

This gives us insight regarding several important points. First, the US government does not face an immediate solvency problem. It will have no problem making principal payments and even less problem with interest payments that have been kept low by the benign interest rate environment. In fact, interest payments as a share of revenue are only 9.6%[1], extremely low by historical standards. Further, as perverse as it may appear there will be continued demand for Treasuries as a safe haven investment, even in periods of tumult caused by their issuer. While certain bonds issued by corporations and other sovereign entities may be considered "safer" by credit default swap standards, there is not nearly the float in these issuers nor the ability to indiscriminately print money or raise revenues. Even S&P, in their statement about the downgrade (which failed to reference their $2 trillion miscalculation of discretionary spending caps), acknowledged that their concerns were more about political willpower than current balance sheet considerations. We can also look to Japan as a bellwether of what can happen when an industrial power loses its top credit rating. Even in the face of a 1998 Moody's cut, yearly budget deficits since 1993, and a debt-to-GDP level of 225%, yields on Japan's 10-year bond have hovered around 1%.[2] The country's growth fortunes are another story.

Second, the recent behavior of the Treasury market in the midst of this general dysfunction serves as a reminder that trends within the economy and the outlook for inflation are what ultimately matter most to bond market participants. The wind-down of the debt ceiling circus has forced investors to refocus on the stability of the economy and the strength of the recovery, and so far they haven't much liked what they've seen. Fresh data points are clearly interpreted by markets as signals, strong ones, regarding the future direction of investment decisions made today. In the last several weeks economic releases have pointed more towards a significant slowdown in the economic recovery than a soft patch as most have been calling it. Recently we learned that the 2007-2009 recession was deeper than originally thought with GDP falling by 5.1% rather than 4.1%, and revisions to GDP took the first quarter 2011 number from 1.9% to 0.4%. The second quarter was also slower than expected with US growth of 1.3% versus consensus expectation of 1.8%.

The July ISM report (a survey from the Institute for Supply Management that assesses the state of US manufacturing) added fuel to the fire, as a drop from 55.3 to 50.9 took manufacturing perilously close to the no-change level of 50 (actually closer to 46), with the drop in new orders most alarming based on the forward looking nature of this component. Even Friday's employment report which bested consensus and included upward revisions for the past two months doesn't improve the outlook. The alternative household measure of employment declined indicating that the unemployment rate only fell because of a significant decrease in the labor force, most likely the result of discouraged would-be workers. The employment to population rate which is not affected by labor force changes fell to a 28-year low.[3] Two years after the recession ended the labor market has not recovered in any meaningful way. While the economic landscape isn't encouraging, we must remind ourselves that it's also not unprecedented in the context of recoveries in countries that experienced crises in both banking and housing. The Federal Open Market Committee showed concern about conditions in its release today in which it stated that "economic growth so far this year has been considerably slower than the Committee had expected", and indicated that it would likely keep the federal funds rate exceptionally low through mid-2013.

The other significant signal to monitor is being sent in the form of widening spreads and virulent rhetoric regarding European sovereign debt. In the latest round attention has focused on Italy. With a debt-to-GDP ratio of approximately 120%, the euro zone's third largest economy is incurring the wrath of bond market vigilantes. While markets were temporarily assuaged by the announcement that Italy would speed up austerity measures and produce a balanced budget a year ahead of schedule, the contagion risks from an Italian debt crisis are too significant to ignore. European policymakers failed to construct a firewall for such contagion risk, forcing Italy as well as Spain to become firewalls themselves. The European Financial Stability Facility (EFSF), which is really as close to a central fiscal mechanism as the euro zone can claim, would need to be expanded significantly if it needs to fund the two countries in the event they can't access debt markets. This is unlikely considering the current state of affairs. EU Commission President Barroso berated policymakers last week for "undisciplined communication and the complexity and incompleteness of the 21st July package" which addressed the Greek crisis. There will be intense pressure on the ECB in the coming weeks to continue to buy Italian government bonds. If the crises in Italy and Spain are not addressed in an orderly fashion, the enormity of the problem created will reverberate throughout global markets and economies in a way that dwarfs the impact of Greece.

As of July 31, 2011

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	-2.0	3.9	19.7	2.4
Russell 2000	Small Cap Equities	-3.6	2.4	23.9	4.0
Russell 3000 Growth	US Growth Equities	-1.2	5.6	25.1	5.6
Russell 3000 Value	US Value Equities	-3.3	2.2	16.9	0.1

* 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 YEAR (Annlzd)
INTERNATIONAL EQUITY					
MSCI World ex US	Global ex US Equities	-1.7	1.1	14.2	-1.2
MSCI EAFE GR	Developed ex US Equities	-1.6	3.7	17.7	1.4
MSCI Europe GR	European Equities	-3.4	5.9	18.4	1.6
MSCI Japan GR	Japanese Equities	3.5	-1.3	13.2	-2.9
MSCI EM GR	Emerging Mrkts Equities	-0.4	0.7	17.8	11.3

The decision points about investing in equities, bonds, and alternative investments in such turbulent times are similarly scrambled in nature. Last month we focused on concerns about a stock market fresh off its biggest two-week rally in 21 months. This month we examine the opportunity surrounding a market down almost 17% in the span of eleven trading sessions. Here we spin the discussion about deficit reduction and the need for domestic austerity away from its fixed income implications and focus on the impact it may have on equities. National accounts must sum to zero, meaning that falling public deficits come from private sector surpluses which could lead to lower corporate profits. There is also vulnerability to record profit margins, which have helped move equities higher. These risks stem from factors that include; increasing commodity prices, higher taxes as governments try to balance their budgets, higher labor costs as weak-dollar policies raise the cost of foreign manufacturing, deflation which would force companies to compete by cutting prices, and the looming potential of a recession.

Those concerns must be balanced, however, by recognition of the fact that equities are now pricing in a significant amount of bad news. The Dow Jones Industrial Average trades for 11.6x this year's earnings with a dividend yield that exceeds that of the 10-year Treasury note.[4] American corporations have concerns to worry about but they also have generally robust profits and balance sheets flush with more than $1 trillion in cash. Certain sectors appear particularly attractive from a valuation perspective, including financials. The top fifty US banks trade on average at around book value. They have been cheaper only twice in the last 25 years, during the deep recession of 1990 and in early-2009, and both were buying opportunities. This time around the industry's capital ratios are appreciably higher and leverage is lower, which should mitigate some of the macro risks. It does feel somewhat reminiscent of a year ago when the S&P 500 had a tough summer, dropping 15% from its spring high to a low in late-August. Then Fed Chairman Bernanke told the world that QE2 was coming and stocks rose 20% by year-end. We'll likely have more clarity about how deep the parallel runs in the next several weeks when the Fed heads to Jackson Hole.

We believe that US equities should be maintained at target weights in portfolios, though care must be given to where investments are focused. Fortunately we have more confidence in our stable of active managers than we do in markets themselves. We feel those with the ability to invest smartly in large capitalization value stocks will outperform, as value indices are still significantly below their 2007 peak and the opportunity exists within financials and healthcare to find attractive companies with a genuine margin of safety built in. We continue to believe that small capitalization companies will face more difficulties even after last week's sharp sell-off, as they were extremely expensive through the end of the second quarter. The ratio of the price/earnings level of the Russell 2000 (small caps) to the Russell 1000 (large caps) at that point was at a twenty year high.[5]

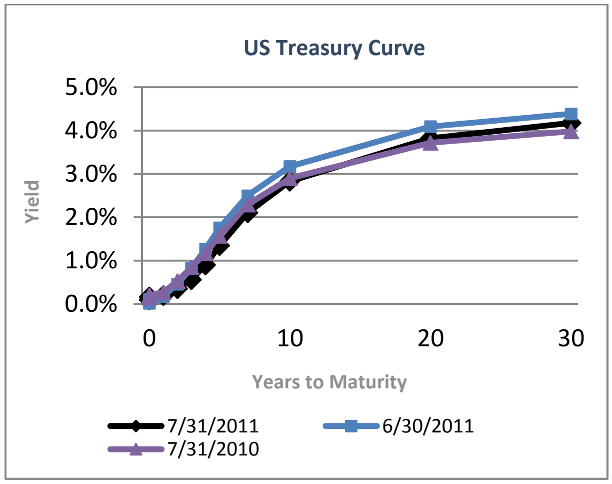
Outside the US we think that Japan has become interesting and that emerging markets are attractive for long-term investors. While Japan's growth prospects are not exciting there does appear to be value by fundamental measures. After two decades of multiple deflation Japanese equities are trading at a price/earnings multiple similar to the global averages. This despite the fact that Japanese corporate profits have averaged 9.4% annual growth since 1998[6] which is better than those in the US. Further, the private sector appears to have deleveraged and no longer faces debt deflation pressures. We recommend investing on a hedged basis, as we think the Ministry of Finance and Bank of Japan will get their wish, and the yen will ultimately depreciate against the dollar with the help of systematic intervention. This has already begun, and will likely continue in the form of both direct yen sales as well as an increase in their asset purchase program.

As we discussed last month, the great transition from the developed to the developing world is well underway. Emerging economies GDP as a percentage of developed economies GDP is almost 145% from a state of parity six years ago, according to the IMF.[7] This despite the fact that output per person in emerging markets is still less than a fifth of the US, which should provide demographic support to that trend. As recently as the 1990s, emerging markets behaved like a highly levered entity prone to liquidity and solvency crises. Today, with 60% of emerging market countries and 70% of emerging market investable corporations having achieved investment grade status[8], the region has moved up the global capital risk structure. Emerging markets still face internal risks and have sensitivity to external shocks in the developed market world, but the math now favors the asset class on a relative basis based on the improved debt sustainability metrics these nations enjoy.

As of July 31, 2011

INDEX	ASSET CLASS	1 MONTH	YTD	1 YEAR	5 YEAR (Annlzd)
FIXED INCOME					
BofAML T-Bills 0-3 Mon	Cash	0.0	0.0	0.1	1.8
BarCap US Agg Bond	Broad US Investment Grade Bonds	1.6	4.4	4.4	6.6
BarCap Municipal	Municipal Bonds	1.0	5.5	3.2	4.9
BarCap Treasury	US Treasury Bonds	1.8	4.1	3.4	6.3
Citi WGBI USD	Global Sovereigns	2.3	6.4	9.1	7.7
BarCap US HY Interm	US High Yield Bonds	1.1	5.9	12.4	8.9
JPM EMBI Plus	Emerging Market Bonds	2.1	7.2	9.3	9.3

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



On the fixed income side we believe that certain risks are manageable while others should be accounted for. In light of the downgrade to the long-term credit of the US, ratings agencies have suggested that as many as 7,000 municipal downgrades may be on the horizon. These would include the obvious, covering securities pre-refunded or collateralized by US Treasuries, and the less obvious, namely states with strong governmental ties. States including South Carolina, Maryland, Tennessee, Virginia and New Mexico have already been put on negative credit watch by Moody's because of exposure to Federal employment, procurement contracts, and Medicaid transfers. Despite these developments municipal yield volatility has fallen in the past month to around half of Treasury levels. In part the market recognizes that of 40 US state downgrades since 2009, 75% have seen spreads widen by less than 5 basis points.[9] We think an allocation to municipal bonds continues to be prudent for clients with appropriate guidelines, but we are more discriminating than ever with respect to what issuers we will consider.

Within taxable fixed income we think rising rates, while not necessarily imminent, should be mitigated in a portfolio by the inclusion of floating rate securities including both investment-grade preferred equity securities and below investment-grade bonds such as bank loans. We've been adding both to portfolios of late. We also continue to believe that some exposure outside US issuers and the US dollar is prudent and have been allocating to emerging market currency investments and sovereign issuers such as Australia. While Australian equities have been strangled of late by an overly restrictive Reserve Bank of Australia, the current stance probably calls for more accommodative policy which should prove beneficial to Aussie bonds sitting at 5% yields.

We also continue to believe that a balanced portfolio should have exposure to alternative investments which can be either directional or non-directional in nature. Hedge funds as a group posted a positive return in July, and we think increased flows into the space are finding their way to managers and sectors that will prove valuable to investors. Hedge fund inflows are on track to double the 2010 figure of $35.6 billion[10], with Fixed Income Arbitrage and Global Macro leading the way. This supports our theory that increased volatility heightens the need for portfolio insurance against a "tail event", as both of these strategies if executed properly could profit from a significant shock or a substantial change in government policy.

As of July 31, 2011

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ALTERNATIVES					
HFRI Fund Wtd. Composite Index	Broad Hedge Funds	0.8	1.6	10.6	5.0
MLM Index	Managed Futures	3.1	3.9	8.9	4.4
DJ UBS Commodity	Commodities	3.0	0.3	21.4	-0.1
Wilshire US REIT	REITs	1.7	12.8	25.5	1.4

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

	Latest Month End (7.31.11)	Latest Yr End (12.31.10)	One Year Ago (7.31.10)	Five Years Ago (7.31.06)
CURRENCIES				
US Dollar Index Value	73.90	79.03	81.54	85.30
USD vs. Yen	76.76	81.12	86.47	114.68
Euro vs. USD	1.44	1.34	1.31	1.28
GBP vs. USD	1.64	1.56	1.57	1.87
COMMODITIES				
Gold ($ / ounce)	1627.88	1420.78	1181.00	636.74
Crude Oil ($ / barrel)	95.70	91.38	78.95	74.40
Copper ($ / ton)	9811.25	9650.00	7273.50	8022.00
Corn - Generic (Usd/bu)	665.50	629.00	392.75	239.00

The signals discussed earlier will become clearer over the next several weeks. Last year's Federal Reserve excursion to Jackson Hole brought us the announcement of QE2, and the behavior of equity markets for the remainder of this year may be driven by a similar announcement later this month, or the lack thereof. The fortitude of the ECB in their efforts to support Italy will also crystallize as policymakers battle, with German sources already releasing quotes to the media that it wants no part of an effort to rescue Italy. As for the noise, we'll try to let the politicos fade to the background as the deficit reduction fiasco plays out. We've gone from counting on Simpson-Bowles, to the Gang of Six, to a group that will henceforth be known as the Super Committee. If nothing else, we're less than inspired by the trend in what they call themselves.

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

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[2] Legg Mason, The Bond Markets: Will a U.S. Downgrade to AA Follow Japan's Path?- August 2011 p.1
[3] Capital Economics, United States Data Response- August 5, 2011
[4] Barron's, Attention, Shoppers. It's Time to Buy- August 8, 2011 p.13
[5] JP Morgan, Guide to the Markets- June 30, 2011 p.10
[6] BCA Research, Global Investment Strategy- July 29, 2011 p.3
[7] Financial Times, The Lex Column- August 2, 2011 p.10
[8] Western Asset, How Would a US Downgrade Impact Emerging Markets- July 2011 p.2
[9] BMO Capital Markets, Bond Market Focus- August 1, 2011 p.1
[10] Credit Suisse, H1 2011 Hedge Fund Industry Review, July 2011 p. 3