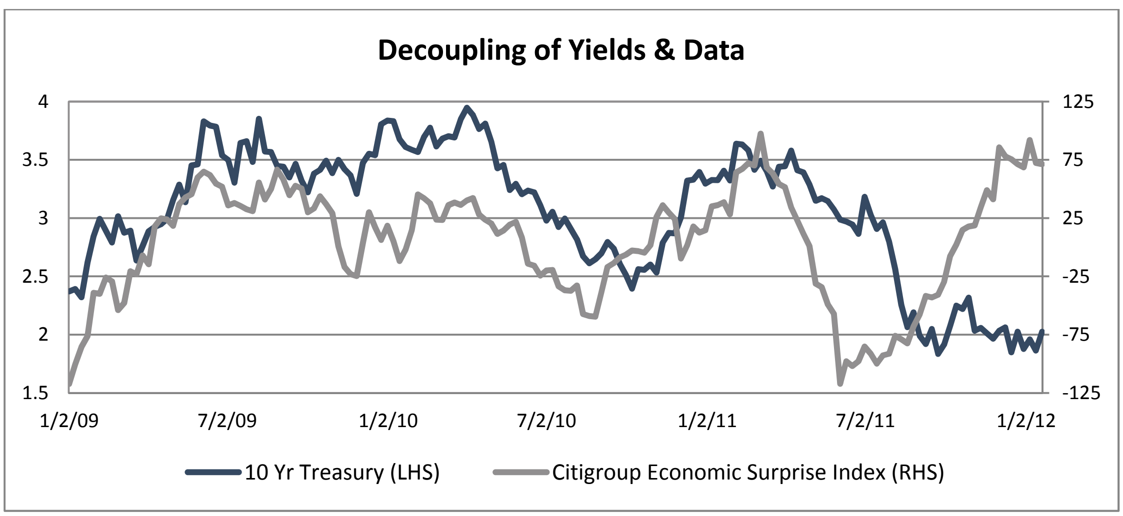
PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

Permit Capital Advisors, LLC

Last Monday marked the Chinese New Year and began the Year of the Dragon, considered to be the mightiest and luckiest symbol of the Chinese zodiac. For the sake of global financial markets we hope that proves to be an accurate harbinger, as it is our belief that in 2012 the fortunes of China will replace the Eurozone crisis in the crosshairs of market participants. Recent currency market behavior supports this notion. Throughout 2011, yuan moves tended to track those of the euro on a lagged basis, however since the beginning of December that relationship has been reversed. This suggests that the focal point of market risk is moving eastward, from Europe to China.

Among the macroeconomic concerns that have gripped the market, a "hard landing" in China has stood prominently. This fear, and its impact on investor psychology, was on display recently when the imperial power reported 8.9% economic growth for the fourth quarter, its slowest pace in more than two years, and markets rallied, assuaged by the indication that a "soft landing" had been successfully engineered. Policymakers in China have controlled inflation (and stifled growth) by implementing a policy of increased reserve requirements along with direct curbs on lending through the imposition of lending quotas. While there is much grumbling about the unfairness of China's trade and investment surpluses, there must also be recognition of the role those surpluses play in sustaining global growth, particularly in the U.S. China takes these accumulated dollars and buys huge quantities of U.S. Treasuries. This is an indirect form of "vendor financing", as with these purchases China helps to hold down interest rates for U.S. consumers, who also happen to be China's main customer, making the situation one of delicate co-dependency.[i]



Source: Bloomberg

For now, however, investors and advisors are still laser focused on developments in Europe. One manifestation of this stance can be seen in the bond market, as reflected in the graph above. It depicts the recent relationship between the Citigroup Economic Surprise Index[ii] and the 10-year Treasury yield. This very tight relationship (a nearly 70% correlation historically) has completely diverged since the summer, as concerns about contagion from funding strains in the European banking system have stoked a flight to perceived safety. If a true turning point in the European saga is reached, a sharp move up in rates of up to 150 basis points could occur quickly based on a reversion towards the level consistent with recent positive surprises in economic activity. This could be enough to spur the Fed to launch into QE3, which in turn could provide support for a rally in risk assets.

The argument in favor of such a positive development rests largely in the belief that eventually the game of chicken currently being played by policymakers and stakeholders in Europe will come to an end before someone gets run over. Recent negotiations with private bondholders of Greek debt have made this bet on common sense seem like a longshot at times. There have been positive steps taken recently, primarily by the ECB which seems to have gained a better grip on affairs since Mario Draghi took over as president. One of these positive developments is the three-year longer-term refinancing operation (LTRO) which will help sovereigns meet their funding needs by helping banks to simply maintain their holdings. Yet a final solution remains at an impasse, as finance chiefs and bondholders quibble over whether new bonds should be issued with a coupon of 3.5% or 4.0%. While 50 basis points of yield is not entirely insignificant in a low-to-no interest rate environment, the savings are too small to jeopardize the deal considering the collateral damage that would be felt by the impact of Spanish and Italian yields surging in reaction to a misstep. While the market appears ready and willing to sacrifice Greece (with Portugal next in line) to save the core countries of Spain and Italy, the sacrifice has to be handled in orderly fashion, which is going to take a degree of cooperation that has been sorely lacking.

While the most immediate tail risk facing markets may be a disorderly unraveling of the European sovereign and financial sector, the biggest tail risk may lie in the burgeoning credit risk that is festering on the ECB's balance sheet. Accompanying its decision to expand its balance sheet, the ECB dramatically relaxed standards of what it will accept as collateral for credit creation. Holding low quality assets can lead to losses for a central bank and eventually to balance sheet insolvency. In that scenario a recapitalization of the central bank involving higher public debt and eventually debt monetization becomes likely. This form of qualitative easing lies in distinct contrast to the approach taken by the Fed. This funding dynamic can buy policymakers time but it is no substitute for enacting credible fiscal reforms that move towards fiscal union. Good news on this front came with the overwhelming support for the German-inspired pact for fiscal discipline, though ratification of pacts of this nature has not always equated to their enforcement throughout the history of the euro.

Of course, none of this uncertainty is new to investors, and month after month we've written that our job as advisors is to filter the news, separate 'signal' from 'noise' and work with our clients to create an investment plan likely to increase terminal wealth in a variety of potential scenarios. We think that John Hussman, Ph.D. , president of Hussman Econometrics Advisors, put it well recently when he said, "When unseen states of the world have to be inferred from imperfect and noisy observable data, there are a few choices when the evidence isn't 100%. You can either choose a side and pound the table, or you can become comfortable dwelling in uncertainty, and take a position in proportion to the evidence, and the extent to which each possible outcome would affect you."

As of December 31, 2011

INDEX	ASSET CLASS	1 Year	3 Years (ann)	5 Years (ann)
DOMESTIC EQUITY				
S&P 500	Large Cap Equities	2.1	14.1	-0.2
Russell 2000	Small Cap Equities	-4.2	15.6	0.2
Russell 3000 Growth	US Growth Equities	2.2	18.1	2.5
Russell 3000 Value	US Value Equities	-0.1	11.6	-2.6

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

INDEX	ASSET CLASS	1 Year	3 Years (ann)	5 Years (ann)
INTERNATIONAL EQUITY				
MSCI World ex US	Global ex US Equities	-14.8	5.5	-6.7
MSCI EAFE GR	Developed ex US Equities	-11.7	8.2	-4.3
MSCI Europe GR	European Equities	-10.5	8.6	-4.6
MSCI Japan GR	Japanese Equities	-14.2	1.8	-6.4
MSCI EM GR	Emerging Mrkts Equities	-18.2	20.4	2.7

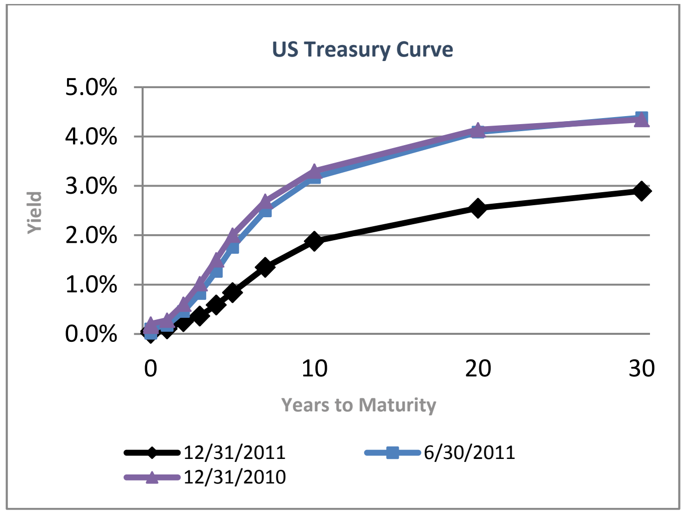
We believe that while the likelihood of a tail risk event in Europe or a recession in the U.S. is remote, the risks do exist. We've expressed our fears about Europe, but the fragility of the recovery in the U.S. cannot be overlooked. Recognizing the importance of the employment picture, it is sobering to think about the fact that if the labor market participation rate were to move back to its long-term average of 66.3% from the current 64%, all else equal, the unemployment rate today would be roughly 12%.[iii] What concerns us about these outcomes, likely or not, is that we see no indication that the market is even pricing in their potential. For this reason we think it is critical that investors maintain a degree of portfolio insurance, which can take a variety of forms spanning traditional, alternative, and options-based investment strategies. At the same time we believe that long-term investors are well served by systematically putting money to work in asset classes where the entry point is compelling in "proportion to the evidence" and the fundamentals are durable. We continue to believe that high yield fixed income and emerging market equities represent two such opportunities.

High yield bonds present value on a number of levels. In terms of pricing, spreads are historically attractive at nearly 700 basis points over Treasuries. Regarding fundamentals, cash as a percentage of short-term debt for high yield issuers is at roughly 185% versus 105% in early '09, while the net leverage ratio of high yield issuers is at roughly 3.2x versus 4.2x in '09. Regarding income, the Barclays Capital High Yield Bond Index yields 8.3%, a 4.7 percentage point pickup compared to the Barclays Capital Investment Grade Index (relative to 4.5 percentage points over the last ten years) and a 7.3 percentage point pickup over the Barclays Capital Treasury Index (relative to 6.5 percentage points over the last ten years).[iv] That said, the market risks discussed above dictate that an indiscriminate use of the asset class could be particularly dangerous right now, and we choose to invest with managers that have historically avoided defaults by constructing portfolios with significantly more BB, and less CCC, exposure than that of the indices.

As of December 31, 2011

INDEX	ASSET CLASS	1 Year	3 Years (ann)	5 Years (ann)
FIXED INCOME				
BofAML T-Bills 0-3 Mon	Cash	0.1	0.1	1.4
BarCap US Agg Bond	Broad US Investment Grade Bonds	7.8	6.8	6.5
BarCap Municipal	Municipal Bonds	10.7	8.6	5.2
BarCap Treasury	US Treasury Bonds	9.8	3.9	6.8
Citi WGBI USD	Global Sovereigns	6.4	4.7	7.1
BarCap US HY Interm	US High Yield Bonds	4.8	23.2	7.3
JPM EMBI Plus	Emerging Market Bonds	9.2	15.4	8.1

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



Emerging market equities are another asset class that continues to look attractive on a number of levels, particularly for investors with a long horizon. The demographics are compelling. These growth markets, defined by Goldman Sachs as the BRICs plus other countries outside the developed world that today account for at least 1% of global GDP – Mexico, Korea, Indonesia, and Turkey, could add $16 trillion to global GDP this decade, a figure three times the potential combined contribution of the US and Euroland.[v] The nature of growth in these regions is also supportive, as structural entitlement reforms have lifted millions out of poverty and created a flourishing middle class, and along with it significant investment opportunities in consumer-related sectors. Further, the potential for market expansion is strong. Capital markets in these growth areas grew from half a trillion US$ in 2001 to over $3 trillion in 2011 and are likely to continue to expand, driven by strong economic growth. Their share of total global market cap could rise from 16% currently to 45% in 2030. Additionally, estimates suggest that pension funds, mutual funds and insurance companies domiciled in the developed world are holding on average only 6% exposure to growth and emerging markets, or half their current market capitalization weight in the MSCI All Country World Index. Finally, pricing is attractive in these areas. According to a December report, on a one-year forward PE basis growth market equities were trading 12% cheaper than their average during the past decade, and 15% cheaper than developed markets.[vi]

Risks present in emerging and growth market equities don't necessarily look like risks in other asset classes, and we believe a vigilant monitoring of how exposure is provided is required to mitigate their impact. In addition to economic and financial factors, the presence of emerging market-centric forces like state capitalism must be weighed. The share of state-controlled companies' capitalization in MSCI national stock market indices is staggering: up to 80% in China, 62% in Russia, and 38% in Brazil. It is a more common phenomenon in industries like energy (60-70%) and utilities (50-60%) but very rare in consumer-related sectors.[vii] State capitalism has produced obvious achievements in infrastructure, as China has seen record hydroelectric projects and a mobile-phone network that surpasses America's in both size and reliability, and even Russia has produced an admirable railway system despite difficult geological conditions. However, investing in a world where many companies are ultimately not responsible to their private shareholders but

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rather the government (which may not only own the majority of the shares but also control the regulatory and legal system) requires a specific skillset that not every manager possesses.

As of December 31, 2011

INDEX	ASSET CLASS	1 Year	3 Years (ann)	5 Years (ann)
ALTERNATIVES				
HFRI Fund Wtd. Composite Index	Broad Hedge Funds	-5.0	7.9	2.3
MLM Index	Managed Futures	4.5	1.7	4.2
DJ UBS Commodity	Commodities	-13.3	6.4	-2.1
Wilshire US REIT	REITs	9.2	21.8	-2.0

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

	As of 12.31.11	Prior Yr End (12.31.10)	Three Years Ago (12.31.08)	Five Years Ago (12.31.06)
CURRENCIES				
US Dollar Index Value	80.18	79.03	81.31	83.65
USD vs. Yen	76.91	81.12	90.64	119.06
Euro vs. USD	1.30	1.34	1.40	1.32
GBP vs. USD	1.55	1.56	1.46	1.96
COMMODITIES				
Gold ($ / ounce)	1563.70	1420.78	882.05	636.70
Crude Oil ($ / barrel)	98.83	91.38	44.60	61.05
Copper ($ / ton)	7590.00	9650.00	3041.75	6308.00
Corn - Generic (Usd/bu)	646.50	629.00	407.00	390.25

We are allocating capital to investments within these and other asset classes that allow us to stay meaningfully invested through periods of heightened and prolonged uncertainty. We recognize that principal impairment is a significant risk in volatile markets, but the flipside to that risk is the opportunities that are presented to methodical investors with access to high quality investment management options. We are confident that our clients have been well served by this access over many market cycles, and look forward to continuing to invest on behalf of those who have entrusted us.

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

The opinions contained in this document are intended to be an unconstrained review of issues and topics and are not intended to be applicable to any particular client or portfolio. Actual investment decisions for client portfolios are made with consideration to these views, but may differ based on changes in the economic environment and specific client portfolio mandates. There is no guarantee that historical risk, rates of return, or scenarios discussed will persist in the future. All investments are subject to risks. Investments in bonds and bond funds are subject to interest rate, credit and inflation risk.

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[i] BlackRock, Fixed Income Outlook 2012

[ii] The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten consensus.

[iii] BlackRock, <u>Don't Stare at the Accident in the Rearview Mirror…There's Traffic Ahead. And This Will Determine How 2012 Ends Up For Returns…</u> - January 12, 2012

[iv] Barclays Wealth, In Focus- January 20, 2012

[v] Goldman Sachs Asset Management, Strategy Series, From the Office of the Chairman, December 6, 2011

[vi] ibid

[vii] The Economist, <u>Special Report, State Capitalism</u>- January 21, 2012