PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

It was Abraham Lincoln who first said, "You can fool some of the people all the time, and all the people some of the time, but you cannot fool all of the people all of the time." An examination of the chart below would seem to indicate, for better or for worse, that the US consumer isn't being fooled by the steep rise in the nominal S&P 500. Instead, since Quantitative Easing (QE) was first implemented in early-2009, the gauge of consumers' willingness to do their part to power the country's economic engine has aligned itself far more closely with the gold-adjusted index, referred to by some as the real S&P 500. The result is a breakdown in the "Wealth Effect" theory that Chairman Bernanke and his fellow central bankers have been counting on as a byproduct of QE and other unconventional monetary machinations (UMM).

This tendency towards myopic behavior on the part of the Federal Reserve has been well telegraphed. Fed papers on the effectiveness of QE have focused almost exclusively on the short-term impact it has had on interest rates and risk premium in the financial markets, with very little analysis or reference to the resulting effect on the real economy. Perhaps for good reason. It would appear clear after three-plus years and various iterations that QE and UMM lack any material transmission mechanism from monetary interventions to the real economy. Perhaps the US consumer knows what the Fed does not – that economic activity has very weak elasticity with respect to financial market fluctuations. Historically a 1% change in the value of the stock market is associated with a change of just 0.03-0.05% in GDP[i]. It's scary to think that the Fed may be artificially (and temporarily) propping up risk assets while simultaneously driving the financial system further from equilibrium.

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The most eye-catching evidence of the inability to lift the economy out of its malaise was the early-July report that the ISM manufacturing index had slumped from 53.5 in May to just 49.7 in June. The regional surveys that came out later in the month were sobering as well. The Richmond Fed reported a deepening pullback in manufacturing with shipments and new orders declining further into negative territory, while backlogs, capacity utilization and delivery times continued to contract. The Philly Fed was particularly worrisome on the employment front, as various components showed labor market conditions deteriorated. The gauge of the number of employees dropped to its lowest level since September 2009, and the average work week contacted again. Indeed, recession signals are flashing red, as all three of the ECRI Weekly Leading Index, OECD US Lead Indicators, and OECD Total World Lead Indicators are below a standardized -0.5, traditionally a harbinger of recession.

Compounding monetary policy ineffectiveness and an already weak economy is a looming potential fiscal policy disaster. Fear of the fiscal cliff and uncertainty over taxation has caused spending, investment, and hiring plans to be put on ice. The tax hikes and spending cuts which would potentially take effect in January of 2013 would total in excess of $600 billion, or 4% of GDP. Tax hikes alone would amount to 3% of GDP, and the last time we saw hikes that large was in 1968, with a recession soon to follow in 1969[ii]. The biggest hit would be to disposable income, which is already suffering in many households. The fiscal cliff would raise taxes and reduce transfer payments such as extended unemployment benefits against a backdrop in which June was the third month in a row in which retail sales less food and autos declined on a monthly basis.

There is one important sector of the economy which may be ready to turn – housing. There, the Fed and its interventionist policies could be credited with providing support. Low mortgage rates have kept the market afloat while fundamentals repair, and QE, most specifically Fed MBS purchases which may be on the horizon again, has seemingly played a significant role. If we are on the cusp of a rebound in home prices it is likely to be drawn-out, and follow an 'L' shape. This is based on competing forces, which on the upside include slowing price declines, increased affordability, an uptick in loan demand and a reduction in supply. On the downside you have the effect of retiring baby boomers, the weak financial health of the US consumer, the difficulty of obtaining a mortgage and general uncertainty which is scaring off purchasers. People still wonder about whether it is time to buy.

The ongoing saga in Europe certainly doesn't engender confidence in the global economy either. While there have been sporadic bouts of optimism driven by the likes of a summit declaration that the EU bailout facilities would be available to directly capitalize banks, or a declaration by ECB president Mario Draghi that the bank is "ready to do whatever it takes", those feelings are short-lived. Recapitalization of banks has proven to be the most successful approach in most debt crises, and a single supervisory system for euro area banks which allows future banking crises to be dealt with swiftly and centrally would be good. But the EU crisis is primarily one of external imbalances between private sector economies in the core and the periphery. A credible plan for tighter fiscal union would be the best news to date, but if anything the politics appear to be getting more tense. While the problems in Spain and Italy are currently front and center, don't be surprised if France is next to face the firing squad. France's debt-to-GDP ratio is set to explode upward, with a trajectory that looks more like Greece's than Germany's. Facing a fiscal cliff and quickly becoming less business and wealth friendly, France seems poised to move into the spotlight as the next, and biggest, domino to topple.

As of June 30, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	4.1	9.5	5.5	0.2
Russell 2000	Small Cap Equities	5.0	8.5	-2.1	0.5
Russell 3000 Growth	US Growth Equities	2.9	10.0	5.1	2.8
Russell 3000 Value	US Value Equities	5.0	8.6	2.6	-2.1

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

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INTERNATIONAL EQUITY					
MSCI World exUS GR	Global ex US Equities	6.6	2.8	-13.7	-5.2
MSCI EAFE GR	Developed ex US Equities	7.1	3.4	-13.4	-5.6
MSCI Europe GR	European Equities	8.0	3.0	-15.9	-6.4
MSCI Japan GR	Japanese Equities	5.2	3.2	-7.1	-6.4
MSCI EM GR	Emerging Mrkts Equities	3.9	4.1	-15.7	0.2

Today, there are four relevant principles that will give clients the discipline needed to take advantage of current conditions. 1) Defend and Counterattack- construct a portfolio with a tactically defensive posture that emphasizes yield and allows you to take advantage of risk-on/risk-off swings to build positions in risk assets. 2) Build a Portfolio Barbell- focus on opportunities that are presented in the short-term and those themes and investments expected to play out over five years. The intermediate term is too unpredictable because of the huge impact of various policy regimes. 3) Think Globally Act Locally- recognizing that we're in a world experiencing highly correlated swings driven by the macro environment, emphasize idiosyncratic and concentrated opportunities. 4) Inflate and Deflate- identify asset-based strategies in emerging markets where loose monetary policy may lead to inflation and yield opportunities in developed markets where deflation is likely to be of greater concern[iii].

Rebalancing can also prove valuable, if difficult, during periods of heightened uncertainty. It allows an investor to both benefit from trading against behavioral mistakes of those less disciplined, and to benefit from the additional risk premium that comes from bearing discomfort associated with taking on more risk when one is least inclined to do so. Currently this dynamic has many portfolios tilted towards an overweight in US large cap equities. Outperformance of the S&P 500 relative to other equity indices over the last 12 months, through Friday, has been dramatic – over 21 percentage points relative to non- US developed market equities (+8.61% versus MSCI EAFE which was -12.64%) and over 24 percentage points relative to emerging market equities (MSCI Emerging Markets was -15.47% for the period). There are three primary reasons for this divergence: the strength of the US corporate sector, the flight to perceived safety within equity markets, and the strength of the dollar.

The US has its challenges, but the resiliency and strength of the corporate sector has not been among them. It still boasts a high degree of technological innovation and a productive workforce with enhanced mobility relative to many developed market peers. Evidence of this strength is seen in aggregate corporate return-on-equity statistics by region which stands near 17% in the US versus 12% in Europe and 6% in Japan[iv]. That said, reported earnings are trending down and profit margins appear unsustainably high. Profit margins are nearly 70% above their historical norms, and are reflective of high deficit spending and weak savings rates. Unless deficit spending becomes an indefinite phenomenon, either revenues will revert closer to the level of labor compensation, or less likely, labor compensation will rise toward the level of revenues. Either way, the gap seems poised to narrow.

Taking a step back from recent market and macroeconomic developments, it is worthwhile to consider that much of the success of long-term investors comes from their willingness to adopt a countercyclical approach. Given the risk-off undertones that prevail at the moment, shifting assets into emerging markets would qualify as such an approach. Following the 24 percentage point underperformance relative to the S&P 500 that is referenced above, emerging market equities now trade at a 20% discount relative to developed markets. Historically a spread of that magnitude has been the launching pad for significant outperformance. As we have discussed in previous Perspectives, the long-term growth trends are supportive of this as well. The Growth Market economies (defined by Goldman Sachs as the BRICs plus the next four largest emerging market countries- Mexico, Korea, Turkey, and Indonesia) now account for 25% of global GDP. Before the Great Recession and subsequent market upheaval in 2008, their share of global market cap was fairly close to their global GDP share. Since then their market cap share has declined relative to their GDP share, and today sits at 15%[v]. If they move back close to historical parity, and if Growth Markets share of GDP climbs close to the 35% that Goldman Sachs predicts by 2020, emerging market equities will have an impressive run for the remainder of the decade.

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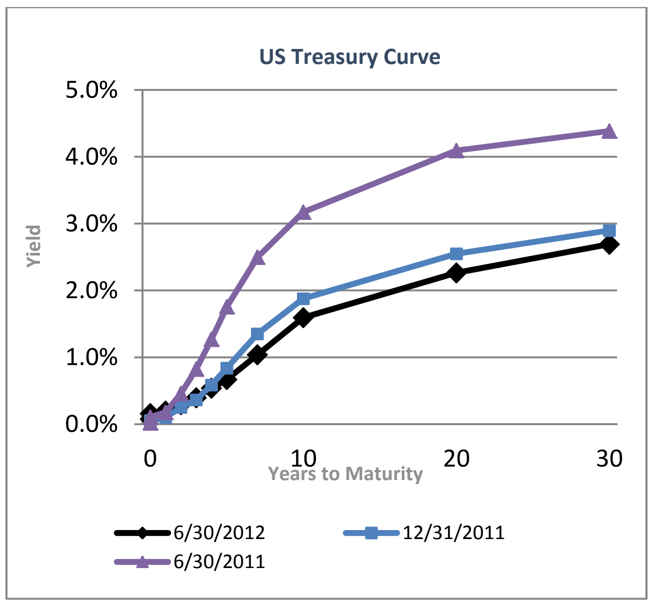
FIXED INCOME					
BofAML T-Bills 0-3 Mon	**Cash**	0.0	0.0	0.0	0.9
BarCap US Agg Bond	**Broad US Investment Grade Bonds**	0.0	2.4	7.5	6.8
BarCap Municipal	**Municipal Bonds**	-0.1	3.7	9.9	6.0
BarCap Treasury	**US Treasury Bonds**	-0.4	1.5	9.0	6.9
Citi WGBI USD	**Global Sovereigns**	0.1	0.4	2.7	7.3
BarCap US HY Interm	**US High Yield Bonds**	2.1	7.0	7.1	8.1
JPM EMBI Plus	**Emerging Market Bonds**	3.9	6.9	11.2	9.5

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



On the other side of the traditional risk spectrum, those assets thought of as less risky continue to be rife with potential pitfalls. We continue to believe that bottom-up, fundamental selection of municipal bonds can yield positive results, but there has been an uptick in the number of bankruptcies reported as well. Not approaching Meredith Whitney-like levels, but enough to warrant significant vigilance. One thing that is important to understand is the application of bankruptcy laws from state to state, particularly if you're going to reach for additional yield by holding bonds of stressed issuers. State law has been guided by federal law since the passage of the Bankruptcy Reform Act of 1994, which made it more difficult for a municipality to file for bankruptcy by requiring states to specifically authorize their municipalities to receive debt relief under Chapter 9. Certain states have since overridden the Act, and since 1994 78% of bankruptcy filings have occurred within those states even though they only account for 33% of municipal issuers[vi]. The states in question are Alabama, Arizona, California, Colorado, Minnesota, Missouri, Nebraska, Oklahoma, South Carolina, and Texas.

We continue to recommend an overweight in high yield as we have for much of the last several years. Over the last twelve months high yield has indeed been successful, as its return of over 7% has outpaced all major fixed income indices and most major equity indices as well, with large cap growth being the lone exception and that has had significantly more volatility than has high yield. Still, we believe both fundamentals and fund flows will continue to favor the asset class. Cash assets as a share of corporate GDP is at roughly 22%[vii] - that's not job creation friendly, and it's not necessarily stock price friendly, but it does provide a cushion for traditionally stressed issuers of credit. In addition, Congress is assisting certain corporations by passing recent legislation that allows them to alter the formula for determining the discount rates used in evaluating liabilities in complying with the Pension Protection Act of 2006. Instead of a two-year average the new law specifies a "corridor" of yields around a 25-year average, which should serve to increase the discount rates and reduce liability valuations. Factors surrounding credits are strengthening and the safety cushion high yield enjoys with respect to interest rate sensitivity relative to government bonds continues to increase. With a spread of roughly 625 basis points and a duration of 4.2 years, rates would have to rise 150 basis points to wipe out one-year of yield for non-investment grade credit. For 10-year US Treasuries they would only have to rise 16 basis points to wipe out that same one-year of yield.

As of June 30, 2012

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ALTERNATIVES					
HFRI Fund Wtd. Composite Index	**Broad Hedge Funds**	0.2	1.9	-4.2	1.1
MLM Index	**Managed Futures**	-2.0	-1.4	2.3	3.8
DJ UBS Commodity	**Commodities**	5.5	-3.7	-14.3	-3.7
Wilshire US REIT	**REITs**	5.6	14.9	13.2	2.1

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

	As of 6.30.12	Prior Yr End (12.31.11)	One Year Ago (6.30.11)	Five Years Ago (6.30.07)
CURRENCIES				
US Dollar Index Value	81.63	80.18	74.30	81.92
USD vs. Yen	79.79	76.91	80.56	123.17
Euro vs. USD	1.27	1.30	1.45	1.35
GBP vs. USD	1.57	1.55	1.61	2.01
COMMODITIES				
Gold ($ / ounce)	1597.40	1563.70	1500.35	649.65
Crude Oil ($ / barrel)	84.96	98.83	95.42	70.68
Copper ($ / ton)	7691.75	7590.00	9414.00	7678.00
Corn - Generic (Usd/bu)	672.50	646.50	629.00	329.50

We wrote about MLPs in a recent Perspectives - another asset class that we favor in part for the yield it produces is Real Estate Investment Trusts (REITs). Similar to our view of MLPs and high yield, REITs is an asset class that favors active fundamental management. There is a wide disparity of valuations within the broad asset class, and the volatility can be significant at times, which to us makes a bottom-up, selective approach attractive. We have a long-standing relationship with just such a manager. The wide spread between private market "cap rates", public market pricing and Treasury yields creates a favorable environment. The pure dividend yield is well above the normal spread relative to Treasuries, and yet REITs are underpaying dividends relative to typical payout ratios – adjusted funds from operations payout ratios are at 74% versus the long-term average of 82%. With weighted average dividend growth in the first quarter at a 6% annual rate compared to the previous quarter, quarterly REIT dividends are up $2.2 billion since the third quarter of 2009. The apartment sector appears fairly priced while suburban office and hotel assets appear undervalued due to low supply and better than expected occupancy and pricing. New commercial real estate supply across all property types is still at or barely above obsolescence levels, and even with sluggish economic growth, occupancy and cash flow are steadily rising. Finally, balance sheets are well fortified as REIT common equity issuance since the end of 2008 has totaled more than $80 billion, and debt issuance has been increasing as weighted average unsecured real estate debt interest rates have come down to roughly 4% from almost 10% in early 2009[viii].

Once again we find ourselves at a point in time in which dislocations and aberrational forces within both markets and the economy put an investor in a position to weigh an atypical variety of risks against an atypical subset of opportunities. Analyzing and attempting to scale the risks with the rewards is what makes investing an exercise of weighted average probabilities. It will be important to remember that prospective returns are likely to vary a great deal over the course of the next cycle, and varying risk exposure in proportion to expected return will be essential. Managing that risk exposure, and keeping portfolios diversified while recognizing that asset classes are really just bundles of risk factors is going to continue to be our focus. We look forward to continuing this practice in collaborative fashion with our clients.

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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[i] Hussman Funds, Extraordinary Strains- July 22, 2012
[ii] iShares Blog, Russ Koesterich, The Fiscal Cliff: 4 Reasons to be Concerned- July 20, 2012
[iii] BlackRock, Standing Still…But Still Standing- July 2012
[iv] BlackRock, Investing in a World of Role Reversals- June 2012
[v] Goldman Sachs, Viewpoint from Chairman Jim O'Neill- July 6, 2012
[vi] BMO Capital Markets, Bond Market Focus- July 30, 2012
[vii] Western Asset, The Market Effects of 2012 US Pension Changes- July 2012
[viii] Real Estate Management Services Group, LLC