PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

PERMIT CAPITAL ADVISORS, LLC

"The world economy has stepped back from the brink and we have causes to be a little bit more optimistic. But optimism should not give us a sense of comfort and certainly should not lull us into a false sense of security."

IMF Managing Director Christine Lagarde, March 17, 2012

We agree with the quote above and think it serves as a useful reminder for investors. Not only for the meaning that it carries, but for the relevance of the messenger as well. The force that moved the economy off the proverbial ledge may not have been ethereal, but it was anything but natural. Recognizing the role that central banks, international economic organizations, politicians and other policymakers (groups for which Ms. Lagarde serves as an appropriate proxy) have played in the global recovery is a critical factor in decisions about how to position portfolios going forward. Renowned professor of economics at Stanford, John Taylor, recently wrote an Op-Ed in the Wall Street Journal in which he stated that, "The Fed has effectively replaced the entire interbank money market and large segments of other markets with itself—i.e., the Fed determines the interest rate by declaring what it will pay on bank deposits at the Fed without regard for the supply and demand for money. By replacing large decentralized markets with centralized control by a few government officials, the Fed is distorting incentives and interfering with price discovery with unintended consequences throughout the economy."

As of February 29, 2012

INDEX	ASSET CLASS	1 Month	1 Year	3 Years (ann)	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	**Large Cap Equities**	4.3	5.1	25.6	1.6
Russell 2000	**Small Cap Equities**	2.4	-0.2	29.5	1.8
Russell 3000 Growth	**US Growth Equities**	4.7	7.2	27.8	4.5
Russell 3000 Value	**US Value Equities**	3.8	1.8	25.2	-1.0

* 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 ex US	**Global ex US Equities**	5.2	-10.6	17.0	-5.0
MSCI EAFE GR	**Developed ex US Equities**	5.8	-7.0	20.3	-2.5
MSCI Europe GR	**European Equities**	6.4	-7.2	21.2	-2.6
MSCI Japan GR	**Japanese Equities**	5.0	-10.0	12.4	-5.6
MSCI EM GR	**Emerging Mrkts Equities**	6.0	0.2	32.6	6.5

It would only tell a part of the story to describe the manufactured nature of the recent global growth profile as unsustainable. What would be left out is the real possibility that it could be actively unwound by the same parties credited with its creation. Potential missteps could be politically motivated or they could be the result of the fact that there is no playbook for the unprecedented course we've taken to arrive at our current status. The $8.6 trillion expansion of the collective central bank balance sheets of the U.S., U.K., ECB, Japan, China, and Switzerland, that has almost tripled their size since June of 2006, does not fully capture the limb that the global economy has stepped out on. The fiscal thrust and monetary policies adopted aren't necessarily as easily quantifiable as the size of a bank balance sheet. Poorly timed or reasoned unwinding of policies or implementation of austerity measures, could have a disastrous effect.

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For now, everything is in a state of equilibrium as the large public deficit is offset by private sector savings, particularly in the U.S. Since 2007 we've seen an 8% gain in the private sector gross savings rate and a 7% increase in the size of the federal budget balance. This informs us that public sector austerity must be coordinated with private sector growth. On the monetary front there is no immediate reason for the Fed to shift from its dovish stance, as unemployment remains high, the economy has just started to pick up momentum and inflation is not yet a problem. Just how much momentum the economy has picked up is still up for debate.

There has been an unusually large discrepancy between the improvement in jobs numbers and the improvement in economic growth figures. The latter is generally associated with GDP (Gross Domestic Product) growth, though some economists believe that GDI (Gross Domestic Income) may be a more reliable measure. While GDP measures the sum of money spent in the economy, GDI measures the total income in the economy. While there shouldn't be much of a discrepancy between the two over time, there are interim fluctuations created by timing issues. In the fourth quarter of 2011 GDP stayed flat at 3%, while GDI growth was recently revised up to 4.4%.[i] If typical convergence takes place we could soon be talking about a growth trajectory that is greater than originally thought.

This prospect sounds promising at first blush, and indeed we think there are investment opportunities created in such a scenario, but it also represents a risk to the fragility of today's landscape. Current monetary policy has been tailored to fight deflation and stem sustained economic weakness. As long as growth remains moderate, current policy is appropriate for the economy and will continue to be a tailwind for equities and other risk assets. If growth accelerates in a manner that is deemed to be too vigorous by policymakers working in unchartered territory it could disturb the previously described equilibrium as the market anticipates a shift in monetary and fiscal policies, and the all-important Fed rhetoric could turn hawkish. In effect, there is one positive track to follow and that is a continuation of steady growth. There are, however, two tracks which could lead to a derailment: an austerity-induced recession or above-trend growth.

The latter may not be as far-fetched as it would appear, and would principally be the result of an improving employment picture. The current pace of employment has been significant, with 2.5 million private sector jobs created since March of last year, and it has also been largely written off by economists for reasons attributed to a dwindling labor force participation rate. The underlying assumption is that the participation rate will eventually recover, but it has stayed depressed longer than anticipated, and if it remains at current levels and employment growth continues at its current pace the result will cause much consternation at the Fed. If that were to occur you could see unemployment fall to between 5 and 5.5% (the lower end of the Fed's projected "longer run" unemployment rate) before the end of 2014.[ii] This is the point that the Fed has used to describe the duration of their proclivity to keep short rates anchored.

If the Fed were to begin raising rates we do have a playbook with some relevance to refer to. As the U.S. economy struggled to return to health after a banking crisis and subsequent recession, the Federal Reserve significantly cut its target policy rate in an effort to engineer a recovery. No, we're not referring to 2009, but rather the early-1990s. By February of 1994 with the banking system on the mend the Fed began a series of interest rate hikes that took the federal funds target rate from 3% to 6% in twelve months. Intermediate and long-term government bond indices fell significantly, -5.1% and -7.8% respectively, even though they enjoyed a yield cushion of close to 8%.[iii] Large cap equities however enjoyed a slight gain of just over 1%, and high yield bond indices fell by only 1%. We believe both asset classes are attractive today, in part based on their relative favorability in a rising rate environment.

As of February 29, 2012

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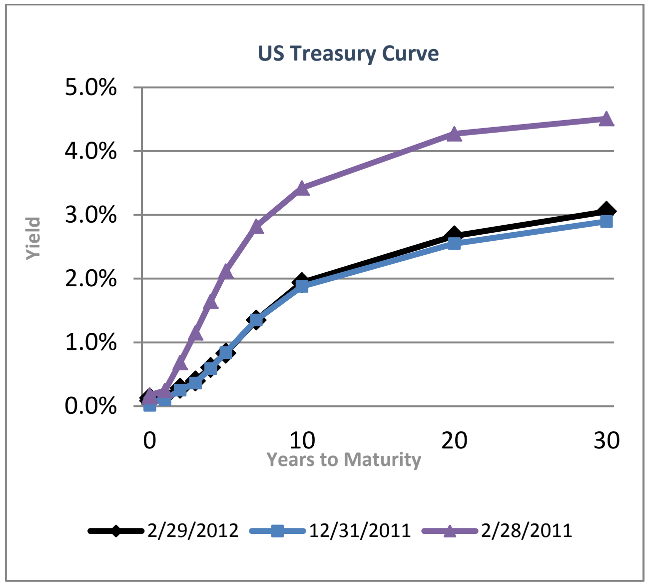
FIXED INCOME					
BofAML T-Bills 0-3 Mon	Cash	0.0	0.0	0.1	1.2
BarCap US Agg Bond	Broad US Investment Grade Bonds	0.0	8.4	7.5	6.4
BarCap Municipal	Municipal Bonds	0.1	12.4	7.9	5.5
BarCap Treasury	US Treasury Bonds	-0.7	9.6	5.0	6.4
Citi WGBI USD	Global Sovereigns	-0.9	6.5	7.5	7.0
BarCap US HY Interm	US High Yield Bonds	2.3	6.7	24.2	7.8
JPM EMBI Plus	Emerging Market Bonds	2.7	14.3	17.4	8.7

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



There continues to be much to like about equities. The last two recessions have rung excesses out of the private sector – 2001 corrected business over-investment and 2008 corrected household's over-consumption. A resumption of more normalized consumer credit conditions appears to be upon us, as the recent Fed Senior Loan Officer Survey reported that U.S. banks continued to relax credit conditions for both consumer credit and prime mortgages. It is worth noting that we have just experienced a market rally that was historically strong and persistent. In the 84 trading days between November 25th and March 26th the market was up 22%, with a standard deviation of returns below 1%.[iv] Not a single rally in the post-war era matches up based on a number of similar metrics. The last rally of this type occurred in April of 1943, after Germany was first defeated at Stalingrad. It is also worth noting that profit margins have never been wider, and that they have likely been propped up by government deficit spending that presumably can't go on forever.

The bottom line is that we think U.S. equities are poised to do well over the long-term but the short and intermediate-terms are far less sanguine, making it important to focus to a meaningful extent on entry point and an active management profile with good down market capture. We also continue to believe that emerging market equities offer an attractive opportunity for investors based on significant expectations for growth and well managed balance sheets, particularly relative to developed Europe. As an illustration of this last point, the original criteria for joining the European Monetary Union stated that a country was supposed to have a deficit of 3 percent or less and, if not below 60 percent of GDP, debt that was clearly heading in that direction. Applied today, of the 17 members of the EMU only Finland and Slovakia would qualify. By contrast, of the eight Growth Markets, defined by Goldman Sachs as the BRICs (Brazil, Russia, India, and China), Indonesia, Mexico, Korea, and Turkey, only India would fail to qualify.[v] Having missed a chance to introduce more aggressive reforms with its latest budget, India has concerning issues to address.

Within the equity sector we think master limited partnerships (MLPs) offer an interesting opportunity. MLPs are partnerships that trade publicly on a securities exchange and are limited to enterprises that engage in certain businesses, mostly pertaining to natural resources. The vast majority of MLPs are pipeline businesses which earn very stable income and the opportunity for principal appreciation from the transport of oil, gasoline and natural gas. The market cap growth of the space has been significant, going from $7.5 billion in 1995 to $273.9 billion in 2011[vi], which has greatly improved liquidity. We feel that the current fundamental backdrop is strong, as technology has lowered costs and opened vast new drilling areas by virtue of enhanced methods including horizontal drilling and multi-stage fracturing, commonly referred to as fracking. As a result, production is growing in energy sectors across the board and new supply areas require a full array of infrastructure. Distribution growth is projected to accelerate, spreads to Treasuries are about 20% higher than their historical average and the correlation to Treasuries has been negative over the last ten years. Yields in the 6% range for investment grade securities offer a unique tax characteristic, as a portion (often approaching 90%) of payouts are tax-deferred and shielded from ordinary income taxes until the position is sold. This portion must be subtracted from the original cost basis, making a buy-and-hold strategy most efficient.

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ALTERNATIVES					
HFRI Fund Wtd. Composite Index	Broad Hedge Funds	2.2	-2.1	10.1	2.9
MLM Index	Managed Futures	-0.8	3.4	0.8	4.0
DJ UBS Commodity	Commodities	2.7	-10.9	11.9	-1.8
Wilshire US REIT	REITs	-1.1	6.2	43.8	-2.2

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

	As of 2.29.12	Prior Yr End (12.31.11)	Three Years Ago (2.29.09)	Five Years Ago (2.29.07)
CURRENCIES				
US Dollar Index Value	78.74	80.18	88.01	83.57
USD vs. Yen	81.15	76.91	97.58	118.56
Euro vs. USD	1.33	1.30	1.27	1.32
GBP vs. USD	1.59	1.55	1.43	1.96
COMMODITIES				
Gold ($ / ounce)	1696.85	1563.70	942.35	669.35
Crude Oil ($ / barrel)	107.07	98.83	44.76	61.79
Copper ($ / ton)	8493.00	7590.00	3421.50	5976.00
Corn - Generic (Usd/bu)	656.50	646.50	350.75	452.25

We also think hard assets can play a role in managing portfolio risk in a world in which interest rates cannot be dramatically lowered and financial assets are likely to be less levered than they have been over the last 30 years. In a mildly reflating world where inflation remains above 2%, real growth as opposed to financial wizardry becomes paramount. This is also a world in which growth is stressed by excessive fiscal deficits and high debt/GDP levels. In such a world commodities and real assets become ascendant, particularly in relative terms. We have talked to analysts and looked at various fund structures, recognizing that there are idiosyncratic advantages within this universe to specific sectors. Further, investment options need to be evaluated based on their ownership of the assets, as negative roll yield within the futures space can significantly detract from fundamental value.

The evaluation and management of risks is far from a static endeavor, as changes to market fundamentals and the macroeconomic landscape are ongoing. Over much of 2011 our scrutiny of tail risk focused largely on the crisis in Europe. Beginning with the long-term refinancing operations (LTRO) enacted by the European Central Bank late in the year and continuing with agreement on a fiscal compact that should lead to stronger coordination of economic policies, we think the right steps are being taken to reduce the risk of a disorderly unraveling of affairs. While we don't think all is well on the European front, and believe that a recession there may be deeper and longer than anticipated, we think the systemic risk to global credit from a crisis has been reduced. This combination of economic weakness with some degree of re-established footing makes distressed debt investing in Europe particularly interesting to us. As a result of the financial and sovereign challenges, approximately €1.3 trillion in bank sales have been mandated by national regulators. As this deleveraging continues, a rigorous investment process focused on creditor-friendly jurisdictions may be significantly rewarded.

If the tail risk from Europe is waning, we think that the tail risk from increasing inflation and rising interest rates is likely fomenting beneath the surface. If, as referenced earlier, the employment and growth picture is reshaped then the Fed may determine that a zero percent interest rate policy becomes untenable for two additional years. Once this policy is abandoned we may see rates across the curve rise precipitously, as bond vigilantes and inflationary pressures from a more robust labor market take hold. This impacts our positioning of not only income-centric investments like high yield bonds and MLPs, but investment grade fixed income as well. Fixed income structures such as floating rate instruments tied to changes in LIBOR that give an investor the ability to go long credit/short duration are extremely appealing in this environment. Careful selection of individual issues can offer yields in the 6% range for securities tied to investment grade corporations. These can also be tax-efficient alternatives to municipal bonds, which still have a place in portfolios but should be appropriately sized, as they carry many of the risks that we are trying to avoid.

There are other risks on our radar including oil prices, which are not overly restrictive at current levels but the intensity of future gains must be monitored. Another potential issue could stem from an excessively strong dollar, which would be a problem for both the economy and the market. Over 40% of U.S. corporate profits come from overseas, and a strong dollar will constrain earnings growth. As we manage risk we also manage opportunities, and we continue to believe that there are proven managers and pockets of value across the asset class spectrum. We look forward to continuing our work with clients in a way that promotes confidence, transparency, and the enhanced probability of long-term investing success.

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] The Atlantic, Ignore GDP: This is the Obscure Stat that Explains the Hot Recovery- March 30, 2012
[ii] Barclays, In Focus- March 23, 2012
[iii] ibid
[iv] JP Morgan, Eye on the Market- March 29, 2012
[v] Goldman Sachs, Viewpoints from Chairman Jim O'Neill- March 26, 2012
[vi] Barclays Capital, MLPs Maturing as a Sector But Prospects Appear Bright as Ever- March 16, 2012