PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

"Should we fail to aid Greece in this fateful hour, the effect will be far reaching to the West as well as to the East. We must take immediate and resolute action."

President Harry S. Truman, March 12, 1947

Past is prologue with a twist. The quote above gave birth to the Truman Doctrine and came from a speech delivered by President Truman before a joint session of Congress. The immediate cause for the speech was a recent announcement by the British government that it would no longer provide military and economic assistance to the Greek government in its civil war against the Greek Communist Party. The same quote could be delivered today, verbatim, to any number of bodies, including the European Union, European Central Bank, and International Monetary Fund, with an emphasis on dangers from an economic rather than geopolitical perspective. To date, the most immediate victims to the West have been Eurozone neighbors Italy and Spain, but we have learned all too well that the impact from contagion is felt worldwide.

From the outset the euro was as much a political as an economic construct. If it were purely based on homogenous economics, the core would be comprised of France, Italy, Spain, and the Netherlands. Since the inception of the euro these countries have followed a similar path as measured by metrics including unit labor costs, explosion of debt levels, and housing prices. Germany is the outperforming outlier and Greece is the underperforming outlier. While German political wrangling over their role as de facto lender of last resort has led to speculation that it would be in their best interest to unhinge the monetary union, the results of such efforts would be disastrous. Germany has been the big winner from the euro project, as the Deutschmark was diluted with much weaker currencies from the periphery. In the seven years prior to the euro's launch net exports made zero contribution to Germany's economic growth. In the seven years after the euro net exports accounted for all of Germany's 7% growth.[i]

Such motivation is responsible for the ongoing, yet patchwork, steps that are being taken. The latest came recently with the announcement that euro zone finance ministers agreed to lend Spain up to €100 billion to help their battered banks. At best the move should provide temporary stability to Spanish 10-year yields, although trading activity on the first day after the bailout saw the biggest one-day increase in yields since December. Spain was encouraged to take the aid ahead of the June 17 elections in Greece, as a "bank jog" from Greece and Spain could turn into a stampede if the anti-austerity, leftist party, Syriza is able to put together a winning coalition.

There are potentially more significant steps that policymakers could take, such as permitting the European Stability Mechanism Fund to lend directly to banks to break the negative feedback loop between weak banks and distressed sovereign bonds. If Spain is unable to rollover debt coming due later in the year, and the government needs to refinance €82.5 billion, with a big hump at the end of October, and regions in the country have a further €15.7 billion maturing in the second half of 2012[ii], we may see such drastic options employed. Between the U.S. elections and the Spanish debt climax, we expect October/November to be particularly volatile. If Spain falls Italy is next, and Italy is the killer domino. With €2 trillion in debt, more as a share of its economy than any developed nation other than Greece and Japan, and economic growth lagging Spain's, Italy represents a huge global threat. The current firewall authorities have created is arguably sufficient to cover Spain. It is unequivocally insufficient to support Italy.

As of April 30, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	**Large Cap Equities**	-0.6	11.9	4.8	1.0
Russell 2000	**Small Cap Equities**	-1.5	10.7	-4.3	1.5
Russell 3000 Growth	**US Growth Equities**	-0.3	14.3	6.3	4.0
Russell 3000 Value	**US Value Equities**	-1.1	10.0	0.6	-1.6

* 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**	-1.6	8.7	-12.5	-3.7
MSCI EAFE GR	**Developed ex US Equities**	-1.8	8.9	-12.4	-4.3
MSCI Europe GR	**European Equities**	-2.1	8.5	-15.8	-5.0
MSCI Japan GR	**Japanese Equities**	-3.2	7.8	-3.1	-5.3
MSCI EM GR	**Emerging Mrkts Equities**	-1.2	12.8	-12.3	3.8

As the crisis continues to traverse the continent, we must not lose sight of the investment opportunities that are created. A disciplined investment approach looks to exploit pervasive skepticism. We've written in past **Perspectives** about the looming opportunity in European distressed debt, which we believe will be comparable to what we saw in U.S. high yield in early-2009. We have been investigating a number of options to invest in this space, and have identified a manager with the fundamental rigor required to take advantage of dislocations. Another theme that we think gets more attractive in an environment in which equity markets, particularly European bourses, are buffeted by macroeconomic forces is that of global brands.

Brands embody a core promise of values and benefits that are constantly delivered. They provide clarity and guidance for choices made by companies, consumers and investors, and provide the signposts that help to navigate the consumer and business-to-business landscapes. Many of these businesses, based in Europe, have advantages in emerging markets by virtue of their colonial past and their longstanding brand presence in those markets. Like Cleopatra, top ranking brands are neither withered by age, or even austerity. In an obviously volatile time for equity markets, driven largely by global political uncertainty and inflationary fears, global brands are uniquely positioned. These companies have issued long-term debt at low borrowing rates, and their strong consumer loyalty gives them the ability to raise product prices to offset inflation in input costs, as brand preferences are largely price inelastic. When companies build a reputation for craftsmanship and quality, people are willing to pay more.

Many consumer brands are family-controlled companies that are patient, focused on the long-term, and able to take advantage of this capacity to invest for the future at the expense of current earnings. This has allowed companies such as Richemont, Brown-Forman, Diageo and Pernod Ricard to get ahead of the curve in expanding from developed into developing markets. They offer currency diversification which serves as a useful hedge in portfolio construction, as the positive contribution to return from currencies has been the largest in those years when the U.S. equity market has declined. It appears that typically, foreign investors pull money from the U.S. during periods of U.S. stock market under-performance, leading to increases in the value of their home currencies as they sell dollars when they sell their U.S. investments, and repatriate their capital back home.

A difficult economic environment offers proof that not all brands are equal, as a strong brand is a great insulator against financial and recessionary pressures. Recently, Millward Brown Optimor – the WPP subsidiary – performed their annual BrandZ Top 100 survey. It showed that the world's favorite labels are becoming more highly influential, as the top-20 names grew hugely over the last several years. According to the survey of two million consumers in 31 countries, last year just under 60% of goods were bought on the strength of the brand, up from 43% a decade ago.[iii] Apple topped the list for the second straight year. One interesting development was that sustainability and corporate responsibility were big themes in the list of valuable brands.

Manufacturers and transport companies are hoping to woo consumers with sustainability credentials. This means less packaging, and developing systems that promise farmers, particularly in developing markets, a fairer price for raw materials they require. Brands have gone further by linking themselves more directly to social and emotional causes, such as disease or famine relief in poorer countries through profit-sharing arrangements and other donations. Procter & Gamble is benefitting from a campaign with UNICEF . For each pack of Pampers sold, P&G donates one tetanus vaccine to protect women and babies in less industrialized countries.

The number of consumers influenced by brand is significantly higher in emerging markets. This is attributed to aspirational desire, along with the confidence that is engendered by a strong brand, which is crucial in places like China where food safety issues ranging from the melamine in milk scandal of 2008 to the toxic cabbage problem of this year continue to plague the nation. These are also regions where tools like the internet are less available to perform research, and the perceived security that accompanies a strong brand is a real asset. Broadly speaking, Asia is a hotbed for brand development. Sales in Asia ex-Japan accounted for 27% of total sales in 2011 for Moet Hennessy Louis Vuitton, up from 17% in 2001. In Japan itself, a startling 85% of women now own a Louis Vuitton product.[iv] It takes a rare talent to be ubiquitous and retain an air of exclusivity.

Unfortunately, not all investments are built to be quite so durable. While we believe in structural portfolio exposure to commodities we think investors must be particularly careful right now when diagnosing recent patterns. The recent relapse in commodity prices may represent a major downturn of significant duration rather than a typical correction. China's capital spending and construction is decelerating markedly, weighing on commodities and related assets. Overvaluation in the property markets of China and certain other emerging market countries leads to a drop in real estate prices, pressuring construction activity and the corresponding demand for raw materials. U.S. equity sectors leveraged to commodities and capital spending in emerging markets such as materials, energy and machinery are overextended, posing a risk to investing in cyclical industries.

As of April 30, 2012

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ALTERNATIVES					
HFRI Fund Wtd. Composite Index	Broad Hedge Funds	-0.5	4.2	-4.3	2.2
MLM Index	Managed Futures	0.5	-0.7	2.6	4.1
DJ UBS Commodity	Commodities	-0.4	0.5	-19.4	-3.1
Wilshire US REIT	REITs	2.9	14.0	10.3	-0.1

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

	As of 4.30.12	Prior Yr End (12.31.11)	One Year Ago (4.30.11)	Five Years Ago (4.30.07)
CURRENCIES				
US Dollar Index Value	78.78	80.18	72.93	81.45
USD vs. Yen	79.82	76.91	81.19	119.53
Euro vs. USD	1.32	1.30	1.48	1.36
GBP vs. USD	1.62	1.55	1.67	2.00
COMMODITIES				
Gold ($ / ounce)	1664.75	1563.70	1563.70	678.45
Crude Oil ($ / barrel)	104.87	98.83	113.93	65.71
Copper ($ / ton)	8534.50	7590.00	9296.00	7821.00
Corn - Generic (Usd/bu)	660.25	646.50	754.00	358.00

Disappointing data on the U.S. economic front has added to recent market jitters. Unemployment numbers for May were poor. Economists were expecting a payroll figure of 150,000 but had to settle for 69,000. March and April numbers were revised down by 50,000 – a development which may be even more disconcerting since the direction of revisions is a reliable leading indicator. The unemployment rate rose to 8.2% on the heels of the first back-to-back sub-100,000 new jobs months since last summer, along with a very strong labor force gain of 642,000.[v] The rise in the labor force, due to the growing number of people now looking for jobs, will likely continue as those on extended unemployment benefits are beginning to come to the end of their two-year benefits period in large numbers each month.

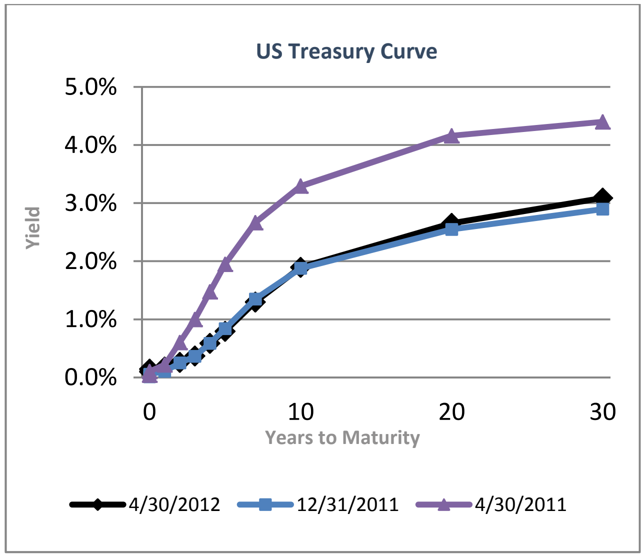
If there are structural headwinds to lowering the unemployment rate, we must examine structural means to create jobs. One traditional engine of growth on that front that has been lacking in recent years is entrepreneurship. The truly disruptive technologies that have advanced living standards the most over the long run have usually been commercialized by entrepreneurs rather than established companies. Most start-ups don't succeed but the number launched is the key determinant to how many will be successful. In the dozen years preceding the Great Recession somewhere between 500,000 and 600,000 new firms were launched annually[vi], seemingly impervious to the business cycle. Since then the numbers have dropped by over 30%. Comprehensive legislation beyond the JOBS (Jumpstart Our Business Startups) Act is needed to facilitate access to talent as well as regulatory and patent reform, but it is highly unlikely to be dealt with by a fractured Congress.

On the fixed income front, high yield is an asset class that we have been persistently bullish on for the last several years, based largely on our view that the fundamentals have been supported by a healthy corporate sector stuck in the economic and regulatory-inspired doldrums. We still believe that valuations are very cheap right now relative to default risk, although as the low hanging fruit is picked it becomes more important to focus on security structure and segments of the market. As the crisis in Europe has recently flared, spreads over Treasuries have widened 144 basis points to this year's high of 723 basis points. Below-investment grade rated companies have defaulted at a pace below 3 percent for 16 consecutive months, the longest such stretch since before the collapse of Lehman Brothers. Another measure of credit-worthiness, the Moody's Liquidity-Stress Index fell to a record low 3.3% in May, showing most borrowers can meet their obligations and covenants over the next year, from 4.2% in the same month of 2011. The index, which falls when measures such as borrowers' cash flow and access to capital improves, reached a peak of 20.9% in March 2009.

As of April 30, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
FIXED INCOME					
BofAML T-Bills 0-3 Mon	Cash	0.0	0.0	0.0	1.0
BarCap US Agg Bond	Broad US Investment Grade Bonds	1.1	1.4	7.5	6.4
BarCap Municipal	Municipal Bonds	1.2	2.9	11.4	5.6
BarCap Treasury	US Treasury Bonds	1.5	0.1	8.9	6.4
Citi WGBI USD	Global Sovereigns	1.5	1.0	3.3	6.9
BarCap US HY Interm	US High Yield Bonds	1.0	6.2	5.8	7.7
JPM EMBI Plus	Emerging Market Bonds	1.9	6.0	13.4	8.7

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



While high yield at an 8% yield is attractive, bank loans at a 6% yield are at a spread above LIBOR that is even more attractive relative to historical standards, and should be carefully analyzed for portfolio inclusion. Default recoveries have historically averaged about 40% for high yield bonds and 80% for loans[vii], as senior secured notes have fared markedly better than unsecured bonds and junior debt during the last two major default cycles. Bank loans are often considered desirable in a low-rate environment because they benefit from an increase in interest rates, but today they are attractive on a fundamental basis as well, as the systemic unwind of leverage has pushed many loan prices down below intrinsic value. Further support comes in the form of lower rates and nearly two years of strong cash flows which have boosted coverage ratios among leveraged issuers. Disruptions in the past from over-levered participants, particularly hedge funds, should be lessened as they make up a much smaller portion of the market than they did prior to 2008.

In our role as advisors we are constantly looking for an edge in our efforts to identify and manage risk. While sources of market stresses are manifold, they are also beginning to take shape in a way that allows for opportunities to be exploited. Macro variables, while a significant contributor to current volatility, are also important drivers of risk factors' returns. These are in turn the underlying components of asset class returns. The implementation of risk factors into the portfolio management process is not meant to be a substitute for a traditional valuation-based approach. Rather it is meant to establish an intuitive framework for scenario analysis and a benchmark for asset allocation decisions that must be augmented by judgment, experience, and a view on current events. 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] BCA Research, European Investment Strategy, Reports of the Euro's Death are Greatly Exaggerated- May 24, 2012
[ii] Bloomberg
[iii] Financial Times, Success stacks up for big names- May 22, 2012
[iv] The Economist, The empire of desire- June 2, 2012
[v] Millennium Wave Advisors, John Mauldin, First Deflation, Then Inflation. But the Timing….?- June 2, 201
[vi] Harvard Business Review, Think of Start-ups As Shots on Goal- June 2012
[vii] BlackRock Leveraged Finance Group: Appealing Income Opportunities in High Yield & Bank Loans- June 2012

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