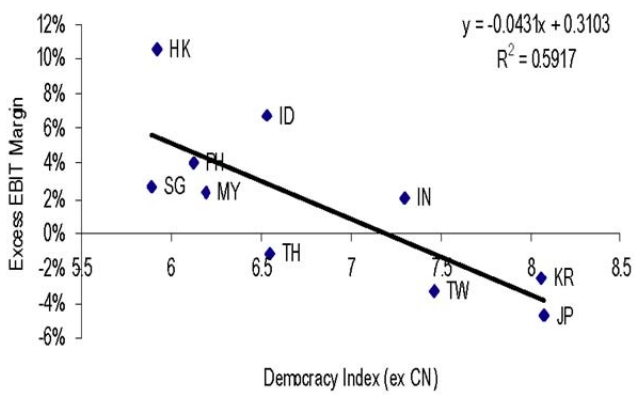
PCA PERSPECTIVES

Permit Capital Advisors' Monthly Thoughts on the Investing Landscape

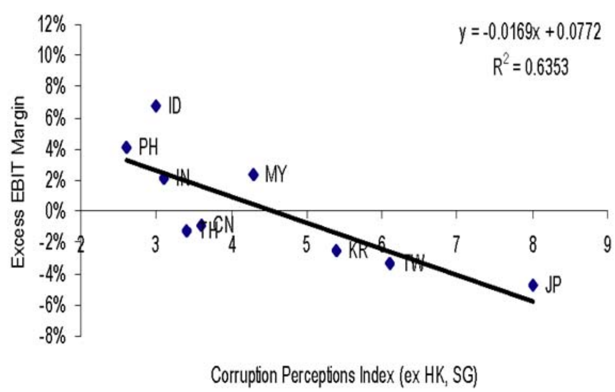
There is an axiom in investing, specific to the two largest emerging economies, that "businesses in China succeed because of the government, businesses in India succeed despite of it". Clearly we're in the midst of a period in which recognizing the likely impact of government intervention is critical to understanding the risks that are littering the investment landscape. Identifying where and when a government will step in is one part of the equation, the other is identifying the outcome it is trying to influence. The answer is not always obvious, and the impact on an investment outcome isn't always consistent with the impact on societal conditions. Take the graphs below, for example – they illustrate the relationship between excess profit margins in countries that are deemed to be corrupt versus those that are deemed to be democratic.

Excess Margin vs. Democracy



Sources: Economist Intelligence Unit, Citi Research.

Excess Margin vs. Corruption



Sources: Transparency International, Citi Research.

As indicated by the relative r-squared figures, the correlation between excess margins and perceived corruption (a score of 0 is considered highly corrupt) is stronger than the correlation between excess margins and perceived democratic principles. While considerations such as these are an aspect of determining the appropriate allocation to emerging markets in a portfolio, developed markets are certainly not immune to the influence of sovereign considerations on their long-term fate. Recently however, in a world that has simplistically been thought of as "risk-on/risk-off" since measures were put in place to stave off the deflationary impact of balance sheet damage caused by the Great Recession, fundamentals and valuations are beginning to feel more relevant.

Those valuations happen to be relatively attractive for emerging market equities, and within that universe, particularly so for emerging Asia. To a greater extent than many other regions, equities within emerging Asia already discount a significant amount of risks and potential bad news. In a number of markets within the region, including China, valuations have fallen to their lowest level since 1996. Times are challenging but the outlook for corporate earnings does not appear worse than it was in late-2008, as current stock valuations imply. The underperformance relative to developed market equities, even beleaguered

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European markets, over the recent twenty month period has been significant. From the beginning of 2011 through the end of August 2012, MSCI indices (in local currencies) showed US markets had advanced by 12.0%, the developed world as a whole had advanced 0.4%, markets within the European Monetary Union were off 11.8%, and emerging Asian equities were down 11.9%. Nearly a 24 percentage point underperformance relative to US equities in less than two years should trigger an analysis of portfolio exposures going forward.

As of August 31, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	**Large Cap Equities**	2.3	13.5	18.0	1.3
Russell 2000	**Small Cap Equities**	3.3	10.6	13.4	1.9
Russell 3000 Growth	**US Growth Equities**	2.8	14.3	17.0	3.6
Russell 3000 Value	**US Value Equities**	2.2	12.1	17.1	-0.7

* 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**	2.9	7.1	-0.2	-3.9
MSCI EAFE GR	**Developed ex US Equities**	2.7	7.4	0.5	-4.3
MSCI Europe GR	**European Equities**	4.4	8.8	2.2	-4.7
MSCI Japan GR	**Japanese Equities**	-0.7	0.0	-5.3	-6.4
MSCI EM GR	**Emerging Mrkts Equities**	-0.3	5.9	-5.5	-0.1

The growth and dynamism story is well known by now, and while the economic ties of the region to the developed world are strong and growing, the ripple effect of China is a more significant influence. If the developed world slips into recession (still a possibility) these economies won't be immune, but they won't be powerless either. The Chinese economy accounts for roughly half of emerging Asia's total GDP, and the spill-over economic benefits enjoyed by its neighbors are increasingly important in the face of developed market headwinds. China's growth model is an inward-facing one, and it depends upon a systematic transfer of wealth from the household sector to support growth. The problem, as with any investment-driven economy, is that the marginal return to capital slows and it becomes increasingly difficult to identify economically viable projects. Balance must be maintained by bringing down the savings rate and increasing the consumption-to-GDP ratio. Policymakers tend to overshoot in both directions. This led to a faster and more dramatic recovery from the global downturn than other large economies were able to engineer, but by 2011 it led to an uncomfortable rise in the levels of inflation, forcing policymakers to reverse course.

Today, unlike in the US and Europe, policymakers in China still have tools left in their arsenal to stimulate growth – 30-day interest rates in China are 3.6%, not 0.2% as in the US, and central government debt is only 17% of GDP, not close to 100% as in the Eurozone as a whole.[i] While the markets in emerging Asia are still inherently volatile, making it particularly important to size an allocation properly within the context of risk and duration tolerances, we appear to be at a point in time in which investors can add exposure to a strategically important investment at a very attractive level.

We would be remiss to discuss qualitative risks looming over the emerging world without acknowledging that we have our share in the developed world. In Europe, we lay witness to the efforts of ECB president

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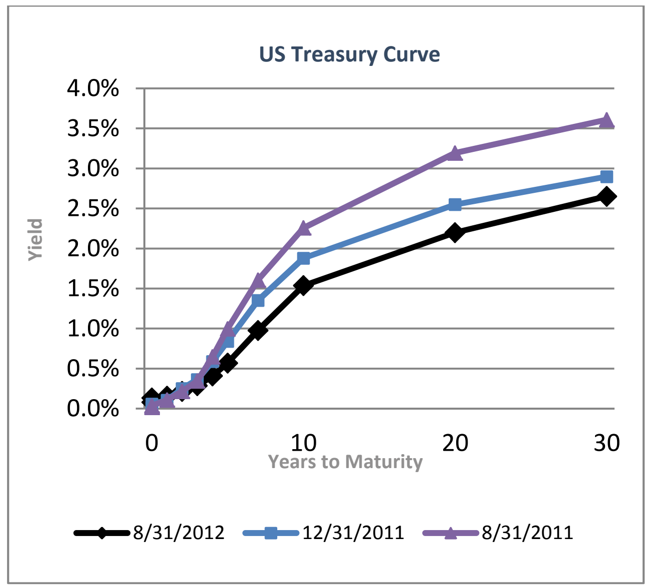
Mario Draghi as he goes into the lions' den and tries to explain to German industrialists about the essential nature of potentially 'unlimited' (which along with 'indefinitely' seems to be the preferred vernacular in central banking circles at this stage in crisis management) bond-buying in the secondary market by the ECB. In the US we have the dysfunction of our political system, and the fiscal cliff fears that has borne. By some measures we appear to be regressing. One such metric is the Economic Freedom Index, calculated by the British Columbia-based Frasier Institute. The index is an equal weighting of five components: size of government, legal system and security of property rights, sound money, freedom to trade internationally, and the level of regulation of credit, labor and business. This is not a partisan issue, as we were ranked number 2 in the world in 1995, saw our absolute peak score in 2000, and have steadily slid from that point to number 19.[ii] It is, however, an issue we would be well served to rectify, as academic studies (and recent empirical observations in the US) have shown the relationship between a country's increase in economic freedom and its rate of growth.

As of August 31, 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	0.1	0.7
BarCap US Agg Bond	Broad US Investment Grade Bonds	0.1	3.9	5.8	6.7
BarCap Municipal	Municipal Bonds	0.1	5.4	8.8	6.2
BarCap Treasury	US Treasury Bonds	-0.1	2.4	5.1	6.4
Citi WGBI USD	Global Sovereigns	0.8	2.1	0.0	6.7
BarCap US HY Interm	US High Yield Bonds	1.1	10.2	13.6	9.2
JPM EMBI Plus	Emerging Market Bonds	1.0	12.7	13.8	10.5

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



While most informed observers believe the ultimate fiscal cliff will be avoided, the impact that both the arbitration process and its result will have on the country going forward is less apparent. The potential scope of the fiscal cliff (otherwise known as consequences of the Budget Control Act of 2011) is enormous. The budget deficit would be forcibly cut from roughly 7.6% of GDP this fiscal year to 3.8% of GDP next year. Getting there would involve rolling back Bush-era tax cuts and making deep cuts in the defense budget as well as more than 1,000 other government programs, including Medicare. Plans we've seen to bring the budget deficit down by a magnitude of 1% of GDP per year for several years seem like a more responsible way to spread the pain while providing a path towards responsibility. Unfortunately, such plans depend upon an element of legislative compromise, which is essentially an oxymoron.

Cuts in the defense budget appear at times to be overlooked in the national dialogue with respect to their potential impact. Beyond national defense considerations there is another cost that has not gotten much

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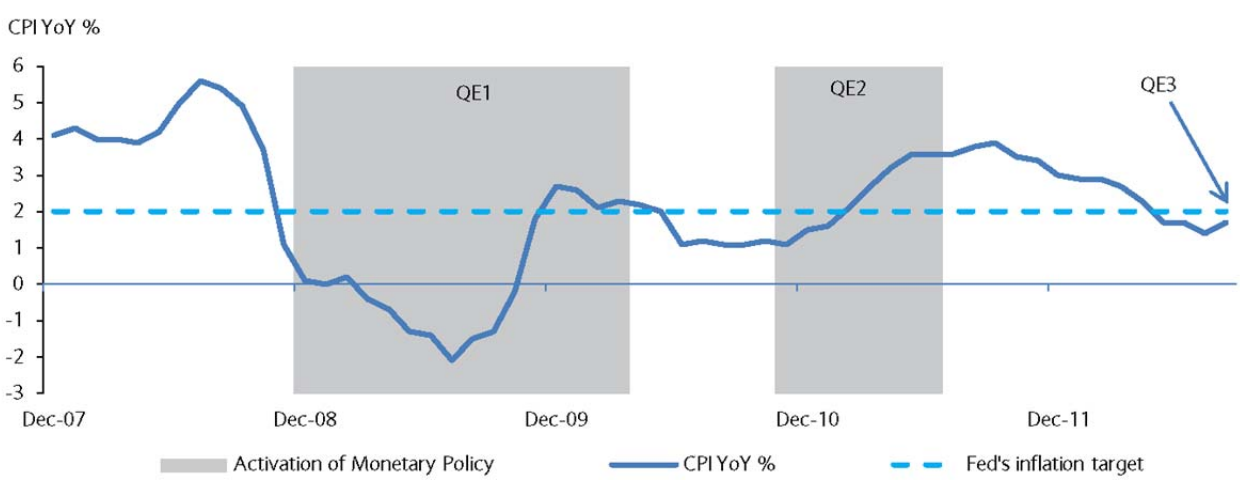
recognition. A number of critical centers of entrepreneurship in our country grew from innovation to meet defense needs in electronics, radar, and high-performance computing. Often times, corporate investment has followed where military money led, spawning a rich diversity of technologies and a culture of entrepreneurship that we need today more than ever, as a tool to help pull us out of the employment growth malaise we've been mired in. The internet, medical lasers, semiconductors, high resolution satellites, and global-positioning devices are among the technologies that arose from defense contracts. More directly with respect to jobs, and the types of jobs we need to promote in this country, the Defense Department employs approximately 80,000 engineers and scientists. Additional jobs of this nature come from defense contractors and the small and medium-sized enterprises that develop specialized technologies. All of whom could be significantly impaired if currently scheduled cuts are enacted.

While fiscal authorities fiddle, monetary policy burns – with the latest spark coming in the form of QE3. QE versions 1 and 2 have seemingly had little positive impact on generating global growth and bringing down the level of unemployment. The disappointing August employment report sealed the deal on that assessment. To wit, in the month of August there were more people who went on the food-stamp program (173,000) than those who found jobs (96,000). Beyond the appropriateness of specific policy steps taken, it is clear and proven that monetary policy becomes increasingly impotent when private sectors are deleveraging to repair balance sheet damage. What is also clear is that the goal of the quantitative easing strategy has not been focused primarily on either employment or growth, but rather on the inflation component of the Fed's mandate. Chairman Bernanke will not accept deflation without a fight, and the 2% inflation target appears to be squarely in the Fed's crosshairs. A quick glance at the chart below will crystallize the relationship, as each QE announcement occurred as CPI was trending below 2%. To this point, inflation has been subdued in large part because $1.4 trillion of the $2.5 trillion that the Fed has sent out into the financial system through asset purchases is being held by banks, on deposit with the central bank in the form of excess reserves. How long this period of latency will continue is the great unknown.

Inflation Below 2% Triggers Quantitative Easing



Source: Barclays.

All of this is not meant to imply that QE has been toothless, only that the impact might be seen as collateral (though not necessarily unintended), as opposed to direct. Where benefit has accrued from the liquidity that has made it out of the banks and into the system, it has come in the form of risk asset price appreciation, primarily within equities. Important to note with respect to the latest iteration of QE3 is the condition of equity markets in which it was launched. When the Fed unveiled QE1 in November 2008 and QE2 in August 2010, stocks were significantly oversold and testing their lows. The latest measure comes after a multi-year advance and a recent bounce off of this past June's low. If the question is, "will the Fed induce a surge on top of an overbought market?", the answer appears to be that it is a distinct possibility, as indicated by recent ETF flows.

As of August 31, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
ALTERNATIVES					
HFRI Fund Wtd. Composite Index	**Broad Hedge Funds**	0.8	3.5	0.3	1.8
MLM Index	**Managed Futures**	-1.0	-3.2	-3.7	3.7
DJ UBS Commodity	**Commodities**	1.3	3.9	-11.1	-1.9
Wilshire US REIT	**REITs**	-0.2	16.9	19.9	2.9

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

	As of 8.31.12	Prior Yr End (12.31.11)	One Year Ago (8.31.11)	Five Years Ago (8.31.07)
CURRENCIES				
US Dollar Index Value	81.21	80.18	74.12	80.79
USD vs. Yen	78.39	76.91	76.66	115.77
Euro vs. USD	1.26	1.30	1.44	1.36
GBP vs. USD	1.59	1.55	1.63	2.02
COMMODITIES				
Gold ($ / ounce)	1692.01	1563.70	1825.72	673.40
Crude Oil ($ / barrel)	96.47	98.83	88.81	74.04
Copper ($ / ton)	7606.25	7590.00	9257.50	7536.00
Corn - Generic (Usd/bu)	802.75	646.50	757.50	324.00

The danger signals take two forms: the US equity market is not as cheap as it once was, and the coming earnings season may disappoint. Shiller P/E, a favored ratio since it smoothes out extreme peaks and valleys in earnings and reduces fluctuations in the ratio caused by the variation in profit margins during business cycles, sits at 22.4. This is 36% higher than the historical mean of 16.5, and well above the 18 level that is generally seen as problematic from the standpoint of long-term returns. This would be easier to tolerate if market internals were trending more favorably, but that does not appear to be the case. Operating earnings for the S&P 500 were down approximately 1% in Q2, and Q3 is expected to be negative as well. On the revenue side there was 1% growth in Q2 and forecasts call for negative growth in Q3. That would be an ominous sign for economic growth, as approximately $11 trillion of our $16 trillion economy comes from the sales of S&P 500 companies.[iii] Indeed, FedEx, a bellwether of global economic activity, recently lowered its full-year earnings forecast and outlook for growth. They blamed economic weakness in Europe and the US for pinching global trade and company earnings. Not surprisingly in the face of these considerations, within corporate insiders sellers have outnumbered buyers by more than six to one recently. The next round of profit-takers could be those who invest on behalf of others, once the third quarter print is in the books.

Another beneficiary of the quantitative easing-sponsored risk grab has been agency mortgage-backed securities (MBS). They were the target of QE1 and are now the target of QE3, with the ubiquitous 'indefinitely' tag applied to the plan to purchase $40 billion of these securities per month, to indicate the Fed's determination to own this market if need be. They already own 12% of all agency MBS, to go along with their cache of 16% of the Treasury market, and analyst projections have them headed to 20% with the advent of QE3.[iv] For better or for worse, the level of market manipulation marches on. Perhaps the die regarding the exact nature of QE3 was cast on August 17th, when the Treasury announced a set of modifications to the Preferred Stock Purchase Agreements that define the terms under which the Treasury provides capital support to Fannie Mae and Freddie Mac. Under the changes the GSEs will no longer be required to make a flat 10% dividend payment, but instead will sweep all future net income generated by the GSEs directly into the Treasury. This ends the circular practice of advancing funds to the GSEs simply to pay dividends back to the Treasury.[v] The modification improves the financial strength of the agencies as they are closer than ever to the government. In essence the GSEs have taken one big step towards nationalization, as Fannie and Freddie are basically off-balance sheet businesses of the government.

One thing we have learned during this period of historic interventionism is that every action has a reaction, and every reaction has a follow-on reaction. In this case the immediate spillover benefactor will likely become non-agency residential mortgage-backed securities (RMBS). With the Fed soaking up the majority of agency MBS, and banks likely to gather up the rest (particularly if the Fed lowers their capital risk weightings based on the modifications described above), other fixed income investors who want to capitalize on the positive trends in mortgages will be forced out to non-agency RMBS. Attractive opportunities in this space come from valuations and structure, as well as the impact that a housing recovery will have on collateral values. Supply of non-agency RMBS is dwindling based on diminished issuance (which has been shut down for over 3 years) as well as $15 billion of voluntary and involuntary prepayments per month. From a fundamental perspective, delinquencies and severities are both trending lower. While some of this is priced into the market, Fed control of the agency market, and to a significant extent a recovery in housing, is largely not yet reflected. While we're not yet out of the woods, it does appear clear that housing has turned the corner and is now a modest boost to GDP rather than the drag that it has been for most of the past five years. The two most prominent home price measures, Case-Shiller and FHFA, are both up at about a 7% annual rate over the past six months. The number of existing homes for sale is down to the same level as 2003-2004, while the US population has grown 8% and the home ownership rate is lower.[vi]

Other investments that look interesting include bank loans and gold. Bank loans, while often provided to below-investment grade companies, offer a level of security in that they get repaid first in a bankruptcy. They also offer floating rates that can act as a hedge against rising rates – maybe not valuable today but a good, cheap option to have in the future. There are other features that make them attractive relative to high-yield, which should also benefit from a continuing low default cycle. Recoveries in default proceedings are higher in bank loans, and at 96 cents on the dollar (relative to high yield indices trading at 104 cents on the dollar) there is still growth on the way to par. Gold as an investment is difficult to value in any fundamental convention, but what we do know is that it becomes a sought after option in the face of fiat currency debasement, and it tends to appreciate in value when real rates are negative. Real three-month rates in the US are negative today and seem poised to stay there for quite a while.

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We believe that a successful investment program thoughtfully positions a portfolio to achieve investor goals while also being constructed in a manner that will allow scenarios to play themselves out over a reasonable period of time. This requires a level of oversight to ensure that there is proper balance between different "buckets", or portfolio allocations with varying considerations as they pertain to risk, reward, and liquidity. In today's world we think an investor should consider a role for the following portfolio components: an allocation that in a significant pullback will either provide dry powder or profit (e.g. cash or managed futures), an allocation that will benefit from continued central bank risk prompting (emerging market equities), an allocation that represents a store of value in the event that fiat currencies continue their race to the bottom (gold or hard assets), and one that will benefit from the status quo of a low growth environment teetering on the edge of deflation (non-agency mortgage backed bonds or bank loans). This framework won't fit all mandates, but the approach behind it that seeks fundamental advantage combined with an awareness of the macro landscape, represents an exercise that all investors should be performing on an ongoing basis.

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

[i] Barclays- In Focus- 8.30.12
[ii] Barron's- Striving to Breathe Free- 9.24.12
[iii] Jim Bianco- Markets Will Benefit From Disastrous Fed Policy- 9.25.12
[iv] HousingWire- QE3 enriches subprime mortgage bonds- 9.24.12
[v] BMO- Bond Market Focus- 8.27.12
[vi] First Trust Advisors- Housing Recovery Still Young- 9.24.12