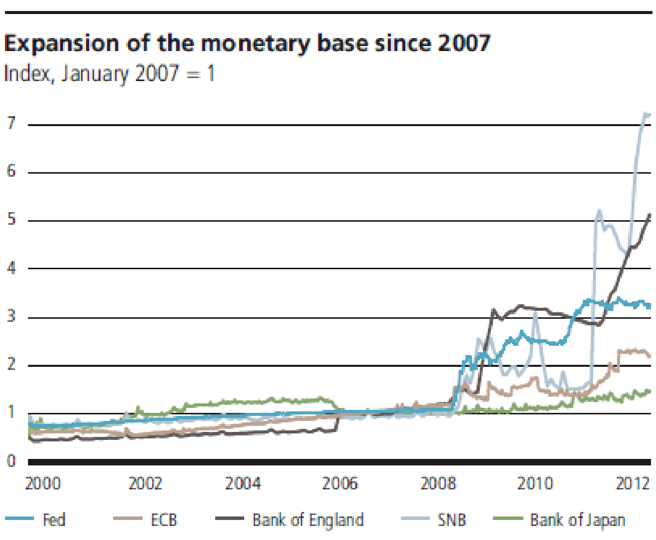
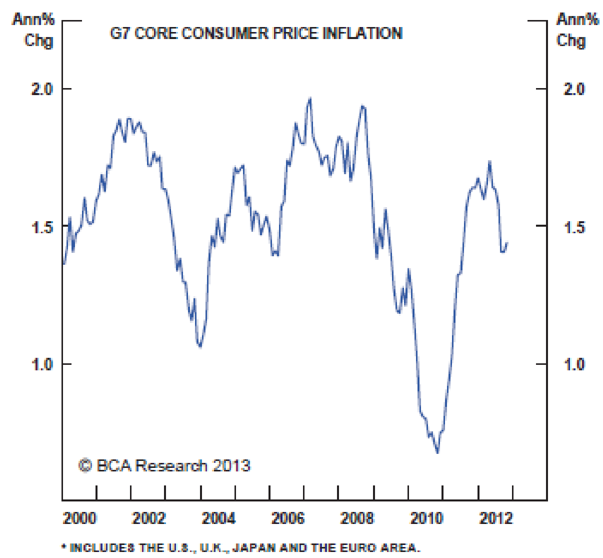
As we look back on 2012 and ahead to 2013, we must take note of the resiliency to this point that both the economy and markets have demonstrated in the face of ongoing, and increasing, political dysfunction. Today we are saddled with many of the same global issues and concerns that we had at this time last year, though some have moved in a more positive direction than anticipated (European debt crisis), some have continued to confound observers (US fiscal stance), and others have been on a natural glide path to resolution (soft landing in China).

One thing investors and consumers have demonstrated is that they, more so perhaps than their elected leaders, have the ability to recalibrate their practices and decision-making when provided with a degree of clarity about future conditions. In the US, there is not much fiscal clarity to speak of, and what happens at the year-end deadline may not provide the answers to the most relevant long-term questions. What we do have is an (over)abundance of transparency coming from the Federal Reserve. On fiscal matters, we are down to precious few hours and precious few options when it comes to a resolution regarding the fiscal cliff. Market expectation has been for some sort of an agreement that will avert the shocks associated with a plunge off the cliff, and the $700 billion package of federal tax increases and government spending cuts that would amount to a 3.5% hit to an economy growing at 2.0%. Consensus has vacillated between an eleventh hour resolution in 2012 and a bungee jump off the cliff that would bring resolution in early-2013.

Easy Money, but Stable Inflation



Source: UBS



Source: Bank Credit Analyst

Ultimately, it may not make much of a difference on which side of the calendar a resolution lies. If it does not produce a credible deficit reduction plan, then the series of downgrades and debt-ceiling related tumult it produces could be as punishing as the recessionary impact of sudden and dramatic fiscal contraction. In other words, getting it right is more important than beating a deadline. Impact on the economy to this point has been somewhat masked, as it appears that 2-3% growth has been pulled forward from the first half of 2013 into the second half of 2012, on the back of an increase in unsustainable government expenditures. These outlays leave government spending at roughly 24% of GDP, relative to an historical average of closer to 15%. At the same time tax revenue as a percentage of GDP sits at 18% relative to an historical average of closer to 20%.[i] Both of these figures must move back towards those averages if a resolution is to have any lasting substance.

The reality of just how difficult of a task that appears to be in the present political climate has caused CEO sentiment to plunge and capital expenditures to weaken. Business expending is extremely important because spending on plants and equipment tends to have a high multiplier effect on labor and the economy. On the other hand, the consumer has maintained a degree of resiliency, thanks largely to an uptick in housing and an accommodating Fed. The extent to which those two variables intertwine cannot be overstated. The Fed recently announced a continuation and expansion of quantitative easing, to the tune of purchases of an additional $45 billion a month of Treasury securities, on top of the ongoing commitment to buy $40 billion a month of mortgage-backed securities, for an annual addition of $1 trillion to the Fed balance sheet in 2013, making it $4 trillion overall. Perhaps more newsworthy was the announcement of official markers relating to employment and inflation that would be instrumental to policy decisions going forward.

Our two questions are: was this level of detail necessary given the clear signs that the Fed has provided to this point in their handling of monetary policy since the Great Recession? Could the level of transparency actually cause more confusion and distortions amongst those it is intended to assist? It has been clear for some time that presented with evidence of adverse financial and/or economic conditions, the Fed is willing to prop up the economy using any tools at its disposal. This clarity comes from both official and unofficial Fed rhetoric, as well as an understanding of inflationary conditions across the G7 (see chart on page 1). Fed efforts to prevent massive negative shocks to the economy have been guided by the belief that aggressive monetary easing is more likely to help prevent deflation than it is to unleash inflation. Of course, these attempts to utilize monetary policy to prevent a punishing recession only delay difficult fiscal actions until a later date, risking an even deeper recession down the road. Developed nations around the world are largely in their current straits because of a persistent tendency to delay dealing with financial imbalances.

The unemployment metric selected is a fairly straight-forward application of the Evans rule, named after Chicago Fed President Charles Evans, and involves a pledge to keep rates low until the unemployment rate drops below 6.5%, provided certain inflationary conditions. The inflation component of the guidance is murkier – as stated, the gauge for inflationary compliance for low rates to be maintained qualifies that the indicator must be below 2.5%. The metric selected is core PCE, which can be very different, and heading in different directions, than headline CPI. Further creating potential ambiguity is the caveat that as well, longer-run inflation expectations must remain “well anchored”. How “well anchored” is defined, and whose expectations are relevant is an unanswered source of potential market confusion. The Fed motivation for this strategy likely lies squarely on an effort to ensure continued repair to the badly damaged housing market.

It would appear that the Fed's explicit targets are designed to keep rates low for quite some time. This stems in part from Ben Bernanke's recognition that many homeowners who purchased 2/1 and 3/1 adjustable rate loans have still not been able to refinance them because they are among the 22% of US homeowners who are suffering from negative equity. Those homeowners have low payments right now, so they are spending. If rates rise too quickly, one of the primary backstops supporting the economy goes away. To quantify the situation, the housing price index is still 15.37% below the level it was at in September 2007, which is when the last adjustable rate loans of that nature were being written. Further, Fannie Mae has $19.23 billion of adjustable rate loans on its balance sheets, or 7.05% of their total single family loan portfolio.[ii] It will take a few more years of low rates for that total to decrease to a point where a spike in defaults and/or foreclosures would have a manageable effect on the housing market.

As of November 30, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	**Large Cap Equities**	0.6	15.0	16.1	1.3
Russell 2000	**Small Cap Equities**	0.5	12.4	13.1	2.8
Russell 3000 Growth	**US Growth Equities**	1.6	15.0	14.6	3.1
Russell 3000 Value	**US Value Equities**	0.0	15.0	17.3	0.2

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
INTERNATIONAL EQUITY					
MSCI World exUS GR	**Global ex US Equities**	2.1	13.6	12.4	-3.9
MSCI EAFE GR	**Developed ex US Equities**	2.4	14.2	13.2	-4.3
MSCI Europe GR	**European Equities**	2.6	16.6	14.8	-4.6
MSCI Japan GR	**Japanese Equities**	2.4	2.9	3.8	-5.9
MSCI EM GR	**Emerging Mrkts Equities**	1.3	13.1	11.7	-1.5

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

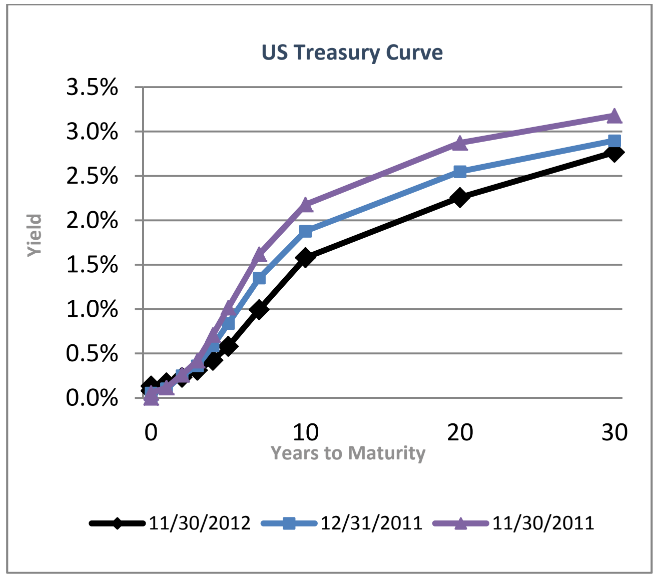
Our challenge as advisors and investors is to consolidate both bits of clarity (we know the Fed is going to keep the printing presses running for a considerable period of time in an effort to keep a lid on interest rates) as well as areas of uncertainty (the eventual outcome of the fiscal cliff and debt ceiling wrangling on Capitol Hill) into a durable investment strategy. We believe that financial assets have a fair value, and that over a typical business cycle asset prices tend to revert towards this fundamental value. In the shorter term, however, prices are much more volatile and harder to predict, and can move quickly and significantly away from this value based on a range of variables, including investor sentiment. This provides an opportunity for the disciplined investor to complement a strategic plan with tactical decisions. This is accomplished by tweaking the portfolio allocation at points in time when opportunities present themselves, by overweighting markets that offer a measure of value with respect to prices paid to own assets, while underweighting those that appear overvalued or vulnerable. Today there are a number of asset classes and markets that offer fundamental value as well as longer-term growth prospects, and a shift into these investments accomplishes both strategic and tactical objectives.

One such area is in a space that we have been underweight for some time but feel may be interesting in 2013, and that is US small cap stocks. Growth in both top and bottom lines is outpacing that in large cap stocks, and unlike their larger counterparts, profit margins for smaller companies are well below peak levels, providing greater potential for margin expansion. They may also benefit from increased acquisition activity, as large companies with cash-laden balance sheets and minimal profit growth may seek to generate higher returns for their shareholders by acquiring earnings. The potential for improving cyclical dynamics should disproportionately benefit small caps, which tend to have greater exposure to economically sensitive sectors. As a broad group, cyclical stocks appear attractive relative to defensive names. Cyclical sectors are trading near two-decade valuation lows relative to defensive sectors on a price-to-earnings basis.[iii] This reflects both an excessively pessimistic earnings outlook for sectors most tied to the business cycle as well as an extremely high valuation premium for safe-haven areas within equity markets. If an investor can accept volatility created by macro headlines, both small cap and cyclical areas of the market offer long-term value.

As of November 30, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
FIXED INCOME					
BofAML T-Bills 0-3 Mon	Cash	0.0	0.1	0.1	0.5
BarCap US Agg Bond	Broad US Investment Grade Bonds	0.2	4.4	5.5	6.0
BarCap Municipal	Municipal Bonds	1.7	8.1	10.2	6.2
BarCap Treasury	US Treasury Bonds	0.5	2.4	3.4	5.5
Citi WGBI USD	Global Sovereigns	-0.2	2.6	3.5	5.4
BarCap US HY Interm	US High Yield Bonds	0.8	13.5	16.5	9.6
JPM EMBI Plus	Emerging Market Bonds	1.7	17.0	18.5	10.3

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



MLPs are an investment opportunity that we've written about before, that fall under a small cap designation, as almost 90% of the group consists of small- to mid-cap companies. The average dividend yield for MLPs is 6.0%, and they are coming off of a year in 2012 that saw performance lag both small caps and other yield-oriented investments. Part of this underperformance may have come from concerns that tax-related negotiations would result in a change to the favorable tax treatment that MLPs enjoy. We believe that for a number of reasons these fears are unfounded, in part based on the recognition that MLPs are a primary financing vehicle for this country's burgeoning energy infrastructure.

North America is on track to achieve energy independence by the end of this decade. US energy production is rising, in part thanks to the previously untapped potential of shale oil and gas reserves. Over the past six years, America's energy production has climbed to the equivalent of 20 million barrels of oil a day from roughly 15 million, while imports have shrunk to 8 million from 14 million.[iv] This is a key positive for our country, from both a geopolitical and economic perspective. As costs come down, lower energy costs will cut trade deficits and ease inflation pressures. In particular, inexpensive natural gas should create a competitive advantage for the US. Natural gas will replace coal as the primary fuel used in power generation and may become more prevalent as a transportation fuel. Natural gas abundance could help lead a renaissance, making our manufacturers more competitive and creating expansion within energyintensive industrial operations, and if this is to be the case than MLPs will have to play a significant role in the process.

Emerging market equities are another asset class that we continue to like, based on attractive valuations for entry and growth potential that augurs well for the long run. The broad indices are trading with forward price-to-earnings and price-to-book ratios that are both at the low end of their historical range. Within the space, Asia is a broad region that captures the positive dynamics of both attractive valuations and well positioned growth prospects. China is in the midst of what appears to be a successful leadership transition and the economy appeared to trough in the third quarter, with both industrial production and retail sales recently surprising to the upside. Further, the most populous countries in the Association of Southeast Asia Nations – Indonesia, Thailand, Malaysia, and the Philippines – have benefited from buoyant domestic demand, favorable demographics, and improvement in the overall business environment. As these countries maintain growth momentum and the exporting Tigers of South Korea, Singapore, and Taiwan benefit from recovering global trade, the investment opportunities presented continue to look significant.

As of November 30, 2012

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
ALTERNATIVES					
HFRI Fund Wtd. Composite Index	Broad Hedge Funds	0.3	4.8	4.3	1.3
MLM Index	Managed Futures	-0.1	-5.4	-5.3	2.5
DJ UBS Commodity	Commodities	0.1	1.6	-2.2	-3.8
Wilshire US REIT	REITs	-0.4	13.3	18.6	3.3

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

	As of 11.30.12	Prior Yr End (12.31.11)	One Year Ago (11.30.11)	Five Years Ago (11.30.07)
CURRENCIES				
US Dollar Index Value	80.15	80.18	78.38	76.15
USD vs. Yen	82.48	76.91	77.62	111.24
Euro vs. USD	1.30	1.30	1.34	1.46
GBP vs. USD	1.60	1.55	1.57	2.06
COMMODITIES				
Gold ($ / ounce)	1714.80	1563.70	1746.38	783.75
Crude Oil ($ / barrel)	88.91	98.83	100.36	88.71
Copper ($ / ton)	7978.75	7590.00	7859.50	6960.50
Corn - Generic (Usd/bu)	748.00	646.50	601.25	384.50

We remain committed to strategies that contribute to both portfolio growth and yield, and we believe both bank loans and REITs continue to be compelling. Within credit, we continue to favor non-investment grade to investment grade securities, as the latter offers yields that are two standard deviations below historical averages. A number of factors support non-investment grade credit, including spreads that overcompensate for default risk, and very loose central bank policies that encourage investors to continue moving into higher yielding securities. Also, many companies took advantage of bond market conditions in 2012 to issue new bonds and pre-finance existing debt. Consequently, near-term maturities have dropped considerably along with the interest burden. Within non-investment grade we favor bank loans over high yield bonds. They are, on average, trading with prices below par as opposed to high yield bonds which are above par; they offer better default and recovery characteristics in the event that the business cycle turns more negative than anticipated; and, they pay coupons that are floating as opposed to fixed, providing a cheap option if and when interest rates begin their ascent.

While REITs have performed very well in the last couple of years, we believe they continue to be attractive, particularly preferred REITs which offer better yields and capital structure positioning. Yields are well supported by all-time low payout ratios. With the Fed promising low interest rates for at least a couple of more years, REITs should be able to continue to refinance their debt cheaply and extend durations. There has been a limited build-up in recent years of new rental properties, and the tight supply is supportive of both higher rental rates and underlying property values. If rates on qualified dividends increase, REIT income, which has historically been taxed at ordinary income rates, becomes comparatively more valuable.

While the fiscal cliff and debt ceiling debates and their eventual fallout may continue to dominate investor sentiment, it is important to take stock of other considerations and investment decisions that can often be most successful when made in periods when uncertainty reigns. In Europe, for example, although there has been a dramatic shift in governments' cyclically-adjusted primary balances, the improvement in market performance there has taken place in an environment still dominated by fears of financial implosion. In unpredictable times it is more important than ever for investors to have a sound, disciplined investment process to help them meet their financial goals. We believe in a core asset allocation that guides longer-term strategic decisions, overlaid with a tactical approach to navigating market opportunities and risks with a shorter-term horizon.

We look forward to continuing this exercise with our clients, and wish all of you a healthy and happy New Year. 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] Barclays- Compass- December 2012/January 2013

[ii] Seeking Alpha- Your Long-Term Risk Vs. Reward Investment For 2013- 12.27.12

[iii] UBS- Chief Investment Office and Wealth Management Research, Year Ahead – December 2012

[iv] Barron's- Half-Right or Half-Baked?- 12.17.12

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