



Fourth Quarter 2011
Macroeconomic Perspectives
January 1, 2012

presented by:

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President

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Fixed Income Trader

Our Investment Strategies

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Macroeconomic Discussion and Outlook

Macroeconomic Perspectives Summary

Review of the Fourth Quarter 2011

We stated in our last quarterly summary that the markets were pricing-in a lot of negative news to start out the final quarter of the year.¹ Not only were the markets legitimately concerned about a possible disorderly default in Europe, but also the markets were pricing-in another U.S. recession. Despite these real potential negative shocks that are still with us today, global central banks and fiscal authorities have demonstrated time and again that they will do everything possible to postpone defaults by insolvent institutions even if it may do more harm than good in the long run. The leaders in the advanced economies have neither the political support nor the wallet for another taxpayer-led bailout of another major financial institution. Instead, their approach has been to increase financial regulations, force structural reforms, and deleveraging to avoid another financial crisis. This has left the major central banks to do the heavy lifting of stimulating economic growth. Central banks can create money, and provide liquidity, but those tools can only buy time in situations of insolvency. Unfortunately, with short term interest rates already near 0%, the economic situation is already beyond what central banks in the U.S. and Europe can do to stimulate economic activity and grow out of the debt problems. All the central banks can do is buy more time by keeping risk assets propped-up while the political leaders make the necessary structural reforms, and get their fiscal houses in order. At least up to this point, if the central banks created money, then risk assets moved higher. With short term equity market technicals very depressed, we increased the risk in our balanced portfolios towards the end of the third quarter while expecting some policy action to once again turn stocks higher in the fourth quarter.

Given how pessimistic the investor sentiment was towards the end of the third quarter, we saw numerous potential catalysts that could have positively surprised the stock market. We didn't think it would take much to improve the market's short term outlook. After seeing early indications that Europe's sovereign debt crisis was having a negative impact on real growth in the emerging markets, we thought the first set of policy surprises would be announced out of Asia. The emerging Asian nations had previously been raising short term interest rates to fight rising inflationary trends; so, there was plenty of room to cut rates. Also, their fiscal positions provided the capacity to cut taxes or increase government spending to stimulate economic growth if need be. Lower commodity prices led inflation trends lower during the quarter, and we saw several developing countries start to ease monetary policy.^{8,15}

Macroeconomic Discussion and Outlook

We were also not surprised that the financial markets turned up after European Union (EU) member countries agreed to provide even more leverage to the debt-laden peripheral countries in return for more austerity.^{17,18} While very little has been done to reaccelerate economic growth trends in Europe, the financial markets were temporarily relieved that a major default was not immediately imminent.^{17,18} With the election season upon us, Washington's Super-Committee failed to agree to any grand plan that would put our country on a sustainable debt path, but the significant positive surprise out of the U.S. was the unanticipated strength in fourth quarter consumer spending.³² The global central bank interest rate cuts, EU summit agreements, and signs that the U.S. economy was not contracting like the rest of the global economy all contributed to the stock market rally during the fourth quarter. After stumbling out of the blocks early in the fourth quarter, the S&P traded down to make a new low for the year near 1,075 in early October, then turned and rallied nearly 20% higher in the span of three weeks!²⁹ By then, it was time to take gains, and get defensive once again.

Volatility, Financial Repression, and the Core Issue

This extreme volatility in the financial markets has been a constant during this new era of deleveraging, while central banks continuously find new ways to support financial asset prices. The short term volatility in the markets has given us opportunities to profitably trade the markets without keeping capital at risk for long periods of time. Holding more cash than normal has been an effective risk mitigation tactic for our clients that give us the flexibility to trade the extreme volatility around classic technical ranges. While it is critical that we get the timing right, a hurdle rate based on the risk-free rate, inflation, or even the last 12 month's return for the broad equity indices isn't very high for our short term tactical trades to add value. The volatility has helped us make money for clients while taking less absolute risk by being out of the markets for short periods of time with a portion of their portfolios.

One of the more difficult investment challenges for us has been dealing with the central banks' distortion of financial asset prices. The prices of stocks, bonds and currencies are being artificially supported by the major global central banks. In fact, the Federal Reserve (Fed), Bank of Japan (BoJ), Bank of England (BoE), European Central Bank (ECB), and Swiss National Bank (SNB) have all expanded their balance sheets by purchasing trillions of dollars in financial assets.^{2,4,9} This massive amount of buying by the central banks has created a condition called financial repression. Financial repression is commonly described as a condition of negative real interest rates created by central banks, but fiscal policymakers have their hand in it too.²⁴ Financial repression is intended to control the speed of the debt deleveraging process by keeping financial assets propped-up above their fundamental value. While it's affecting all markets, financial repression is most obvious in the U.S. bond market where the Fed funnels trillions of dollars to keep interest rates low.

Macroeconomic Discussion and Outlook

As the Fed owns one third of the U.S. Treasury market,¹ the artificial demand is being created on a massive scale. U.S. government bond prices are being propped-up to the point that current yields don't provide any real return even if current inflation rates trend back down towards the Fed's 2% target. Yields on high grade fixed income instruments are not sufficient to endure even modest stress scenarios.

Investors would be fooling themselves if they think they can avoid the financial repression by investing in passive equity strategies. As Fed Chairman Bernanke described in a Washington Post article, the purpose of QE2 was to get risky assets up.³⁶ He later pointed to the rise in the S&P as an indication that quantitative easing was working.³⁷ With "promises" to keep short term interest rates lower longer, central banks entice investors to take more risks, and seek out higher real returns in all markets. Financial repression gives financial institutions more time to shrink their balance sheets, and allow over-indebted households and sovereigns opportunities to refinance or sustain debt levels at lower financing costs.²⁴ The intended goals behind the unprecedented amounts of monetary stimulus are all very good. But, what it means for investors is that stock and bond prices are not being allowed to clear at their intrinsic value. Earning potentially higher returns with new cash investments into the stock and bond markets is being repressed by the central banks that don't want financial assets to fall to levels that reflect the real risks in the global economy.

More recently, we have seen the ECB purchase Italian and Spanish government bonds to reduce the sovereigns' interest expense.⁹ Not to be out done, the BoJ has not only intervened in the currency market much like the SNB, but also has been expanding its balance sheet by purchasing commercial paper, corporate bonds, REITs, and equity exchange-traded funds (ETFs).³⁸ To support short term financial stability, the major global central banks have expanded their balance sheets in order to support financial asset prices and avoid a deflationary asset price spiral. Other recent forms of financial repression include extending the ban on short selling EU banks, re-writing bank regulation that favors investments in government debt, forcing private investors that hedged against a Greek default in the credit default swap market to "voluntarily" agree to a principle reduction, and criticizing Moody's and S&P for downgrading a sovereign's credit ratings.¹² The global bond and equity markets aren't experiencing liquidity problems. These markets are trading lower in price based on poor fundamentals, but the central banks and fiscal agents are doing everything in their power to not let them drop. The core issue is too much debt, and there are really only three options to reduce debt: (1) restructuring (2) inflation and (3) growth. Financial repression may buy time for the debtors at the expense of the savers who earn lower returns on their investments. Policymakers need to be careful with delaying the inevitable, and doubling down on losing strategies that don't address the core issue.

Macroeconomic Discussion and Outlook

Kevin Warsh, a former Federal Reserve governor, explained the situation as a Financial Repression Trap in a recent Wall Street Journal editorial:

“Efforts to manage and manipulate prices are not new. But history provides little comfort that these practices work. Interfering with market prices occasionally buys time, but rarely do policy makers seize the window of opportunity to enact structural reform. Financial repression embeds the wrong incentives-obfuscation begets delay, and a robust recovery becomes unattainable.”¹²

Again, if it weren't for these unconventional methods that buy time in dealing with the excessive debt, risk assets would be trading at much lower levels. This is why our core neutral position is to be defensive.

Central Bank Credibility and Financial Market Stability

The key to maintaining this ability to continuously support the financial markets and manage a long drawn out period of debt deleveraging in a slow economy is to keep inflation and inflation expectations contained.¹³ While the markets and major central banks seem to be very complacent about the outlook for inflation or at least confident that inflation will trend lower, it is still a major risk for the markets. The risks revolve around the Fed losing credibility with achieving its dual mandate, and the massive fiscal deficits. With short term rates already at their lower bound, the Fed has resorted to the use of unconventional tools to achieve its dual mandate of maximum employment and stable inflation. Besides financial repression, the Fed has also used the “power of communication” to help reach its goals.

The Fed uses its Federal Open Market Committee (FOMC) press releases, speeches, and short to long term economic forecasts to shape the financial market's outlook for inflation and growth. Starting in 2011, Fed Chairman Bernanke also began hosting press conferences on a quarterly basis after FOMC meetings to further explain the economic forecasts,¹³ and the unprecedented amount of monetary accommodation. We expect the Fed to continue to expand its communication tools in 2012 in an effort to anchor the market's inflation expectations. If the Fed can convince the market that it will most likely keep short term interest rates lower longer and that inflation will remain low, then long term interest will most likely fall. Using the “power of communication” can potentially break down for the Fed if it doesn't build in the possibility for errors in its long term economic forecasts, and doesn't align monetary policy with the evolution of economic trends. While the Federal Reserve probably has more talented economists on staff and access to more information than anyone in the market, it has and will continue to make errors with its economic growth and inflation forecasts.⁵

Macroeconomic Discussion and Outlook

Simply, the accuracy of our own economic forecasts along with the Fed's and others in the private sector are imperfect over the short term, and very limited past a couple of years.¹⁰ Despite the potential for errors in its inflation forecast, the FOMC has stated that it will most likely keep short term rates pegged near 0% until mid-2013.¹¹

The Fed risks losing its credibility with the market if inflation doesn't trend lower in the short term with this long term "promise" to keep short term rates near 0%. Inflation is already currently above the Fed's 2% objective, and the unemployment rate is below where it forecast it would be when it announced the second round of quantitative easing.^{5,32} In order to maintain its credibility, we would normally expect for the Fed to take back some monetary accommodation given that inflation was higher and unemployment lower than what the Fed forecast; however, the Fed has instead provided even more monetary stimulus with "Operation Twist," and the expanded central bank currency swap lines.^{31,32} In order to maintain its credibility and keep inflation expectations contained, the Fed has to adjust monetary policy with incoming economic data. If economic growth and inflation surprise to the upside then the Fed should reduce its accommodative stance, and vice versa. But that is not what is happening. The Fed and other central banks appear to be focused on financial stability at the expense of inflation stability,¹³ and this is the source for a potential breakdown in credibility.

While it doesn't appear to be on the market's radar screen, history has shown that higher rates of inflation have occurred even with excess capacity in the labor markets. For example, take a look at the double digit rates of inflation in the U.S. during the late 70's-early 80's. During this period, the U.S. was in a double-dip recession with an unemployment rate above 10%, but this still wasn't sufficient to keep inflation contained.³² We aren't expecting inflation rates to turn substantially higher in the short term. In fact, we think it will probably be the opposite for 2012. The risk of a turn higher in inflation would appear if the pain of the present course of deflation, deleveraging, austerity, and recession in Europe gets to be too great,¹⁹ or U.S. politicians fail to do anything significant with our deficit problems after the elections. We only say that it is a real underappreciated risk for the markets.

If the markets start to perceive that our massive fiscal deficits won't eventually be offset with future surpluses, then the U.S. dollar would be vulnerable, inflation would rise, and stock and bond markets would decline.³ Continuously running unsustainable fiscal deficits alongside a central bank that continuously buys U.S. government debt leaves the Federal Reserve in a very awkward position in maintaining its credibility and avoiding perceptions that it is monetizing politicians' reckless spending.³ Until the excessive debt levels are solved, the financial markets will be vulnerable to sharp sell-offs towards levels that reflect the repercussions of decades of living beyond what our national income can support.²⁹

Macroeconomic Discussion and Outlook

2012 Investment Considerations:

Portfolio Management

So, what can investors do in this era of financial repression, debt deleveraging, and slow economic growth? There are some options besides just hunkering down in short term government securities with negative real yields, or buying beta while hoping the Fed will do another round of quantitative easing (QE). As we stated before, investors can embrace the volatility and trade the markets around technical levels with a tactical allocation to cash. Opportunistic short term market timing can be cumbersome for many, but traditional long term strategic asset allocators can still get a similar effect by rebalancing portfolios more frequently around tighter ranges. If financial repression is artificially propping up financial asset prices, then having the ability to hedge through either taking short positions, or even using higher concentrations of U.S. Treasury securities as an uncorrelated asset class can help offset risk.

Domestic Equity

When thinking about which equity styles are likely to outperform in this financially repressed market, investors need to ask themselves whether 2012 will be another year of high volatility. Periods of deleveraging have historically been associated with shorter economic cycles as incurring more debt isn't available to bring demand forward and extend expansions.¹ Up to this point, the high financial market volatility appears to be inextricably linked to debt deleveraging and shorter economic cycles. High market volatility is usually a signal for a turn in the economic cycle. As the economy turns from expansion to recession and back again more frequently, periods of high market volatility are also likely going to be more persistent. For periods of high volatility, investors should consider balancing out their active fundamentally-based equity allocations with quantitatively managed equity styles. During periods of high volatility, stock correlations normally rise making it very difficult for traditional stock-pickers to outperform by differentiating across company fundamentals. The correlation between stocks in the Standard and Poor's 500 and the index itself rose as high as .86 in October 2011,³⁹ making for a very difficult market to outperform. Unlike 2009 and 2010, 2011 was one of the worst underperformance years for fundamental equity managers while it was one of the best for quants.²⁸ The difference in 2011 arose from the ability of quantitative managers to harvest alpha from various, diversifying factor exposures (e.g. value, momentum, and profitability) even in the midst of this highly correlated market. Further, by rebalancing more frequently, quant investment processes that can incorporate information from coincident and leading economic indicators into their factor model weightings have an edge in capturing cyclical trends. This adaptive behavior and less concentration in individual stocks can provide outperformance and stability in a more volatile, macro-driven market with shorter economic cycles.

Macroeconomic Discussion and Outlook

While both fundamental and quant equity styles have their advantages and disadvantages, investors should consider diversifying their long term strategic equity allocations with approaches that have demonstrated success during periods of high volatility, high correlations, and shorter economic cycles.

In addition to being faced with periods of high volatility and shorter economic cycles, equity investors must also deal with the deflation that is normally associated with periods of debt deleveraging. During periods of deflation, investments that generate current income normally trade at a premium. For long term domestic equity investment portfolios, we have been favoring higher dividend paying equities. The extra current yield from dividend income strategies does offer some downside protection, but we would caution against concentrating in financials, utilities, master limited partnerships (MLPs), and REITs that typically pay out higher dividends. The slow growth utility sector can be a drag on overall performance, and the other sectors are either highly dependent on the capital markets to issue new shares, or sit right at the epicenter of the debt crisis. We have found good value in certain faster growing technology companies that have strong balance sheets, and pay a higher than average dividend. We have also found unique special situations with companies based in Europe in the consumer staple, energy, and consumer discretionary sectors that generate the majority of their revenues in the U.S. or emerging markets. In addition to being more diversified across sectors, investors should consider taking advantage of higher dividend paying companies with stable business models that trade in the inefficient small to microcap markets. Higher dividend paying stocks are positively correlated with the overall stock market, but the tactics described above are ways to stay more balanced without giving up relative return, or overpaying in this financially repressed market.

International Equity

For strategic international equity allocations, we currently have more ideas on what to underweight especially with overleveraged sovereigns in the market's crosshairs. But, we still believe in the long term secular emerging market growth trend. For 2011, diversifying investment portfolios into the faster growing emerging economies did not offer investors much of a safe haven despite their much better debt profile.

Overall, the emerging equity markets were one of the worst places to be last year with a negative 20.2% return.²⁹ China's Shanghai equity composite index has now traded all the way back to where it was at the beginning of 2009.²⁹ The significant underperformance in the emerging equity markets last year can be attributed to tighter monetary policy, and the various degrees of exposure to the European debt crisis. The central and eastern European emerging economies have the closest financial and economic ties to the EU's debt troubles, and were some of the hardest hit.²⁹

Macroeconomic Discussion and Outlook

Many of the Asian emerging economies were negatively impacted by a slowdown in trade to Europe, but also their central banks had raised interest rates to reign in inflation. While the Chinese yuan traded up against the U.S. dollar last year,³² many un-hedged U.S. investors took a double performance hit from emerging market stocks trading down plus realizing significant depreciation in the foreign currency.^{29,32} A sharply weaker currency exacerbates the higher inflation that many of the Asian emerging nations are currently trying to curtail. Certain eastern European countries had to raise interest rates to support their currencies despite weaker banks and economic growth.²⁹ We think the cyclical economic slowdown brought on by monetary policy restraint will ultimately extend the expansion in several of the Asian emerging economies. While the severe sell off in their stock markets looks interesting to us, we are waiting for more significant accommodation in central bank policies or signs of stabilization in economic growth trends before increasing our investments there. Certain emerging Asian equity and currency markets have the potential for significant gains in 2012.

Cash and Fixed Income

On the fixed income side, we continue to stay up in quality with our tax exempt investments. We have been willing to sell volatility by accepting call risk in long term high grade municipals. This strategy has allowed us to keep our overall income levels relatively high without sacrificing credit quality. On the short end, our taxable fixed income strategies have even taken advantage of less liquid escrowed-to-maturity tax exempts that offer higher absolute yields than U.S. government securities or corporate bonds of similar quality. With our cash strategies there is unfortunately not a whole lot we can do from an investment standpoint to get out from under the financial repression. The first option for investors to consider is to keep management expenses as low as possible. While the current yields on highly rated unsecured short term EU bank debt looks enticing, we spent much of 2011 “de-banking” our taxable cash strategies.

Probably one of the best opportunities in the taxable fixed income markets is in fixed rate nonagency mortgage back securities. It is one of the few markets we are aware of that can withstand significant stress scenarios and still produce attractive absolute returns. In many ways the nonagency mortgage backed securities (MBS) market is orphaned. While the overall market is over \$1.2 trillion in size, it has lost its investment bank sponsorship with miniscule amounts of new issuance. Changes in bank regulatory capital and liquidity standards make investments in nonagency MBS less attractive for financial institutions.

Macroeconomic Discussion and Outlook

Much of the nonagency MBS market has been downgraded below investment grade as the rating agencies have retooled their rating methodology after being criticized for assigning AAA-ratings to mortgage back securities that took severe losses. While the ongoing deterioration in the U.S. housing market has more time to play out, certain nonagency MBS securities are able to withstand considerably higher default rates, loss severities and slower prepayment rates, and still provide a nice buffer above inflation. While higher home prices are unlikely to rise nationally in the very short term, the performance of the nonagency MBS securities would most likely improve with a general rise in inflation and real estate values. If an unforeseen significant improvement in economic growth leads to higher rates of job growth, then the rate of growth in mortgage defaults would also likely decline. There are certainly significant risks with nonagency MBS securities as demonstrated by their severe negative returns in 2008 and early 2009. But, at today's prices, it remains one of the few markets we know about that can withstand the known risks, and still produce some return in this financially repressed market.

Conclusion

Finally, as we start a new year, I would like to personally thank all of our wonderful clients. You can be assured we will keep your best interests front and center as we continue to pursue your investment objectives. This is a challenging market, but we believe our focus on managing the downside risks is the right strategy for the times.

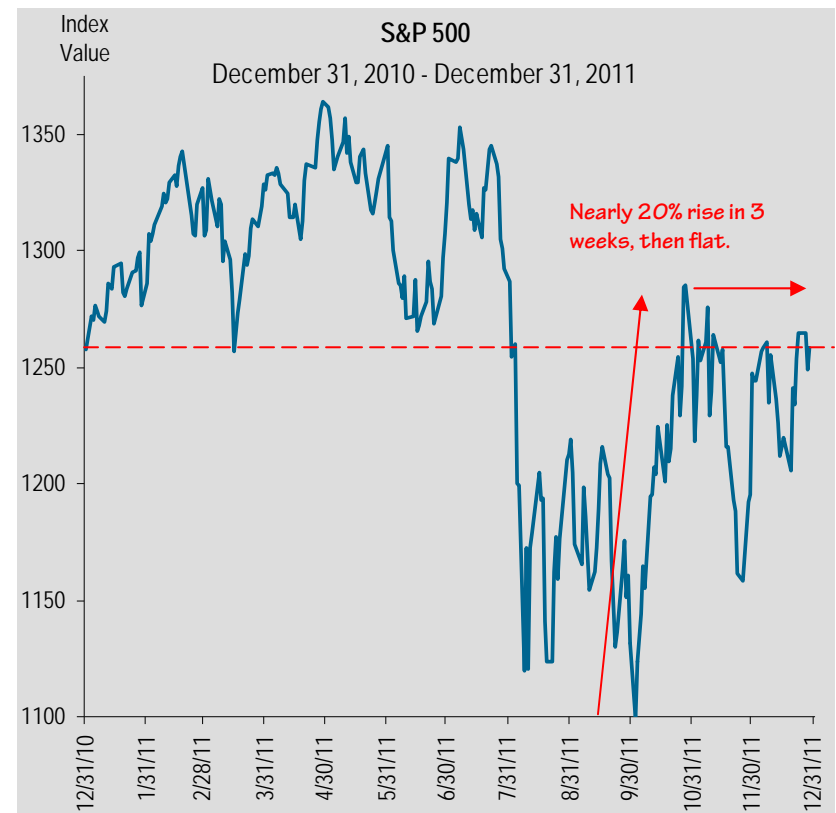
I would also like to thank the entire Cavanal Hill team for all their hard work this past year. It really paid off as 2011 was one of our best overall years ever. Thank you again and here's to a prosperous New Year!

Fourth Quarter 2011 Market Returns

Period Ending December 31, 2011

Leading U.S. Indices	4Q '11	Last 12 Months
Barclays Municipal Fixed Income	2.12%	10.70%
Barclays Aggregate Fixed Income	1.12%	7.84%
Dow Jones Industrial	13.19%	8.78%
Russell 1000 Growth	11.05%	3.06%
S&P 500	12.24%	2.50%
Russell 1000	12.30%	1.91%
Russell 1000 Value	13.53%	.77%
Russell 800 MidCap	12.82%	-1.10%
NASDAQ	8.21%	-1.48%
Russell 2000	16.59%	-3.25%
MSCI EAFE	1.96%	-15.56%
MSCI Emerging Market	4.32%	-20.23%

Munis were one of the best performing assets last year!



Source: MSCI, Barclays, S&P, Thomson One, Russell Investments, Bloomberg

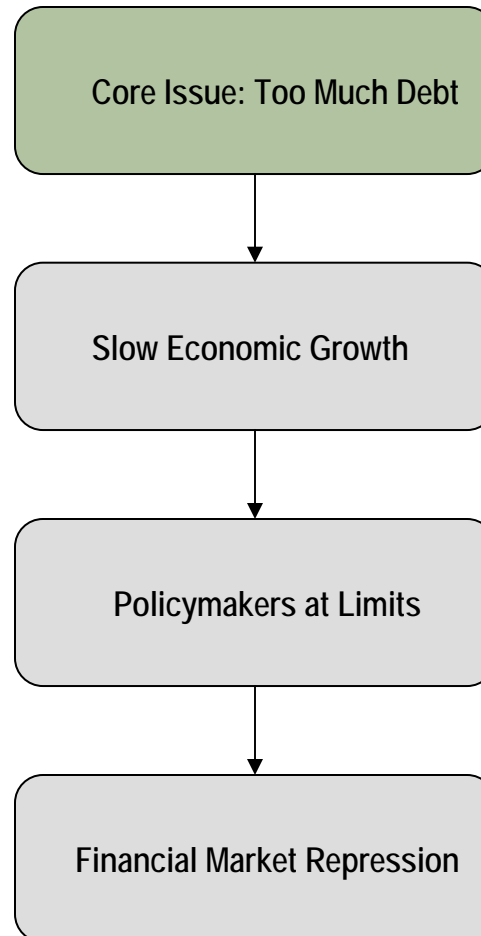
Dow Jones Credit Suisse Hedge Fund Index

Performance Through November 30, 2011

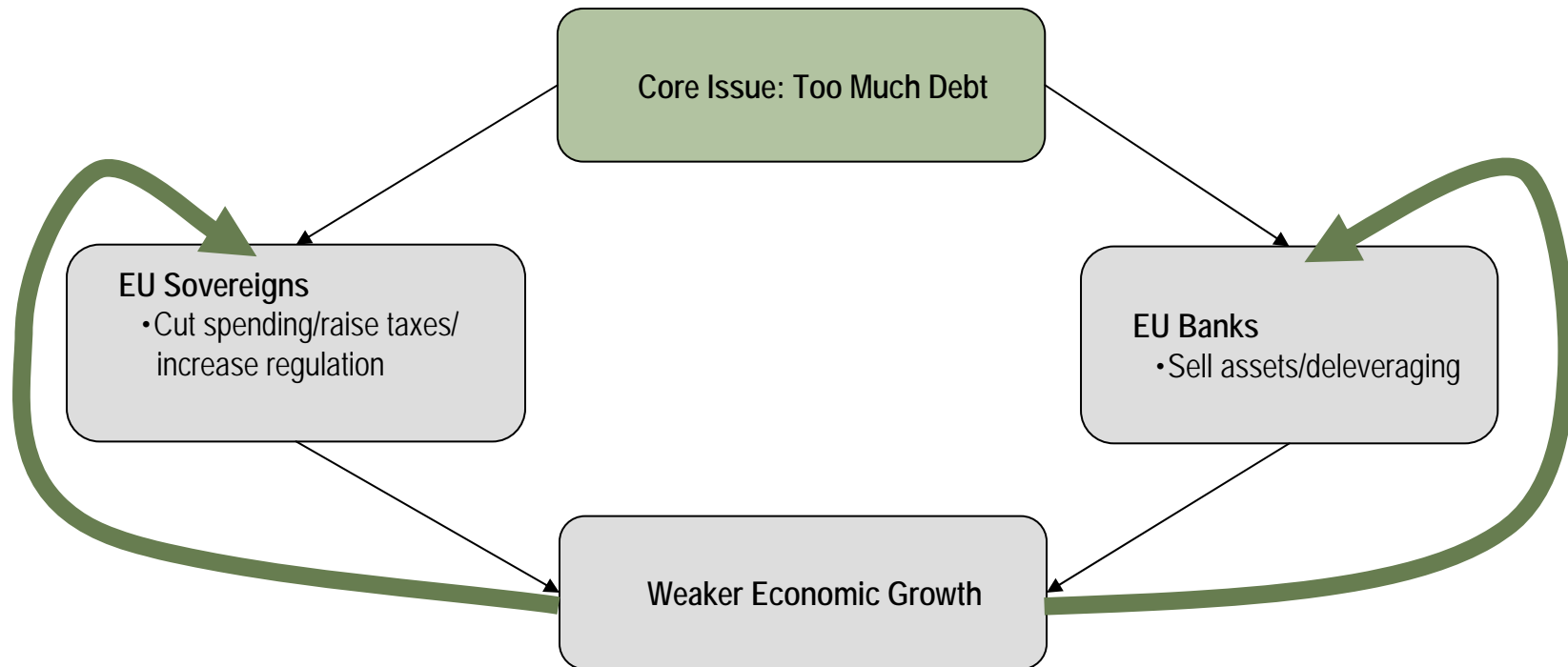
	Returns	
	Nov '11	YTD
Dow Jones Credit Suisse Hedge Fund Index	-0.79%	-2.31%
Convertible Arbitrage	-0.60%	0.50%
Dedicated Short Bias	-0.17%	2.17%
Emerging Markets	-2.69%	-6.03%
Equity Market Neutral	0.09%	5.00%
Event Driven	-1.05%	-8.35%
Fixed Income Arbitrage	-1.20%	-4.19%
Global Macro	-0.97%	-10.85%
Long/Short Equity	-0.27%	1.19%
Managed Futures	0.50%	4.29%
Multi-Strategy	-0.03%	5.98%

Source: Credit Suisse Hedge Index LLC

Core Issue in U.S.: Too Much Debt

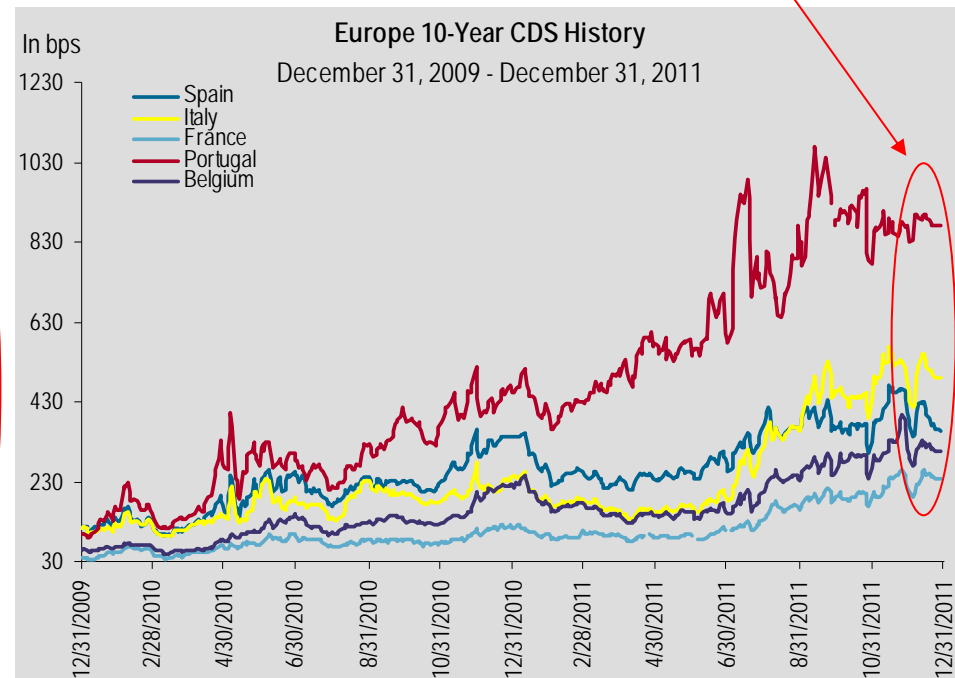


Core Issue in Europe: Too Much Debt



Eurozone Debt by Sector

	Debt % Nominal GDP		Latest	
	Household	Corporate	Gov't	Total
Spain	87%	193%	64%	344%
France	64%	150%	105%	319%
Italy	53%	121%	121%	295%
Eurozone	71%	99%	89%	259%
U.S.	89%	73%	82%	243%
Germany	61%	70%	84%	215%



It's not just about Greece anymore. Credit risk has spread to the core EU sovereigns.

It is not a liquidity problem that central banks can solve.

Negative Feedback Loop from Fiscal Austerity

2012 EU GDP Estimates		
Real GDP Y/Y%		
	Weight	2012: 3Q est.
Italy	17%	-2.0%
Spain	11%	-1.5%
Ireland	2%	-2.0%
Portugal	2%	-4.0%
Greece	2%	-10.0%
Peripherals	34%	-2.5% (Wtd Avg)
Germany	27%	0.0%
France	21%	-0.5%
Other	18%	-0.5%
Non-Peripherals	66%	-0.3% (Wtd Avg)
Eurozone	100%	-1.0%

Fiscal tightening is not the normal prescription for a recession, but the bailed-out nations have been given no other choice: Borrowing rates are too high, and no control over their monetary policy or currency.



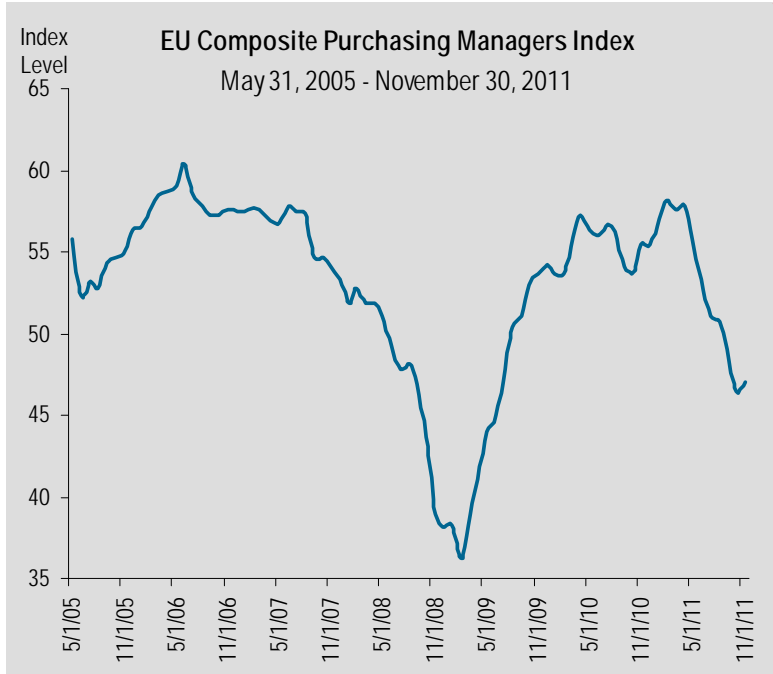
2012 Fiscal Austerity as a % of GDP	
2012 Fiscal Drag IMF Estimates	
Italy	-1.5%
France	-1.0%
Germany	-0.6%
Spain	-0.5%

A recession in Europe would most likely lead to more sovereign credit downgrades.

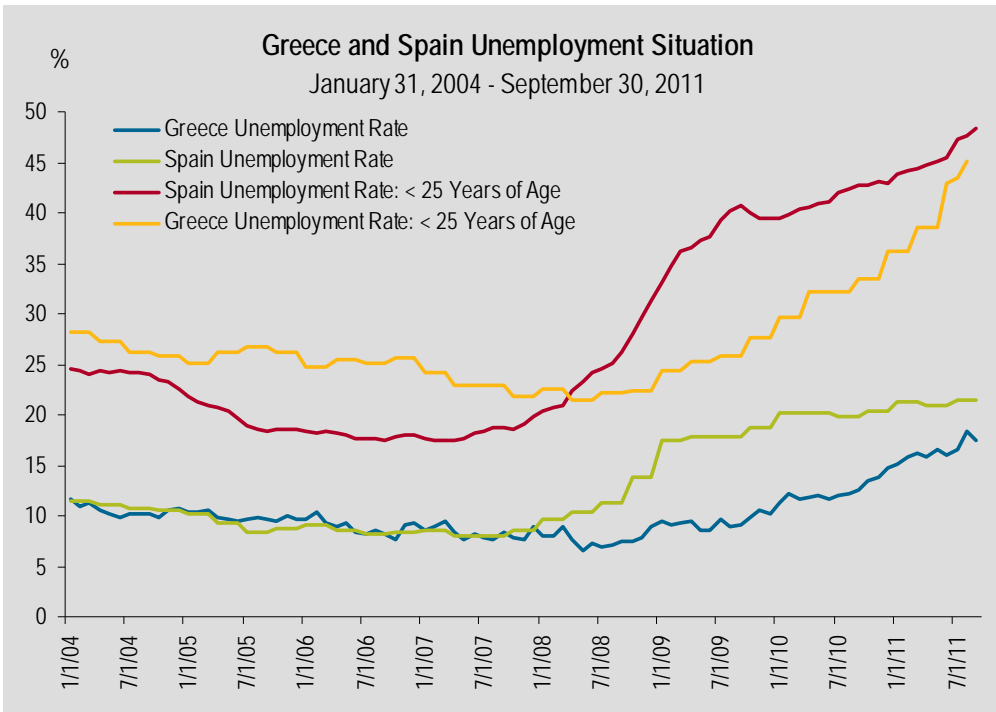


What About Growth in Europe?

Up to this point, the EU debt crisis has been primarily about undercapitalized banks and the debt-laden peripheral countries. The EU bailouts may buy time to rollover debts, but nothing to spur economic activity. A possible recession affecting the entire region would add a new dimension to the crisis in Europe.



What About Growth in Europe?



How long can the political leaders hold the EU together?

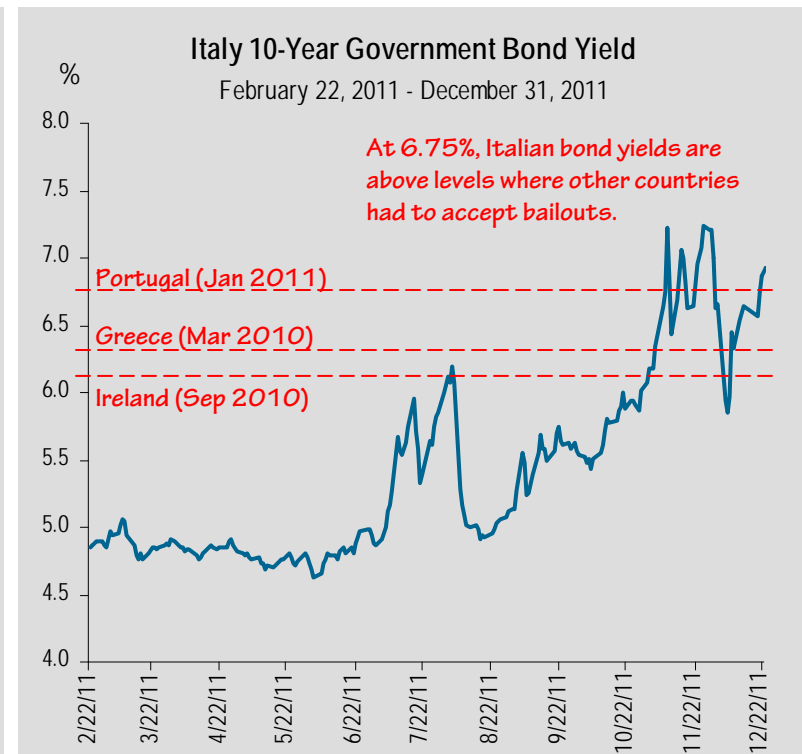
Perfect setup for deflation:

- Excess capacity in the labor market
- High interest rates
- Austerity: Higher taxes and lower spending
- Tight credit
- Recession

Unemployment Rate by Country	
Country	Rate
France	9.7%
Italy	8.5%
UK	8.3%
Germany	6.9%

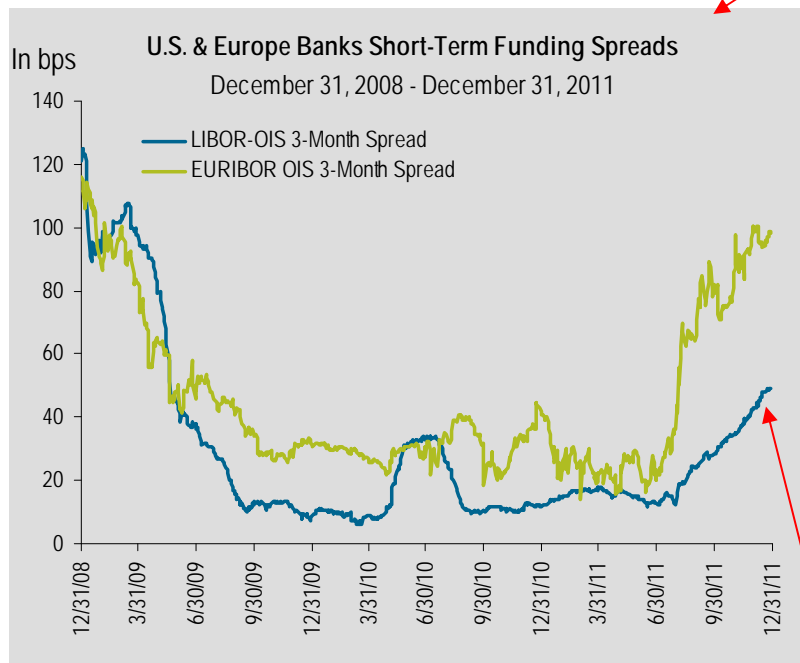
Heading for a recession with current unemployment at 7-10%.

What About Growth in Europe?



Negative Feedback Loop from EU Bank Deleveraging

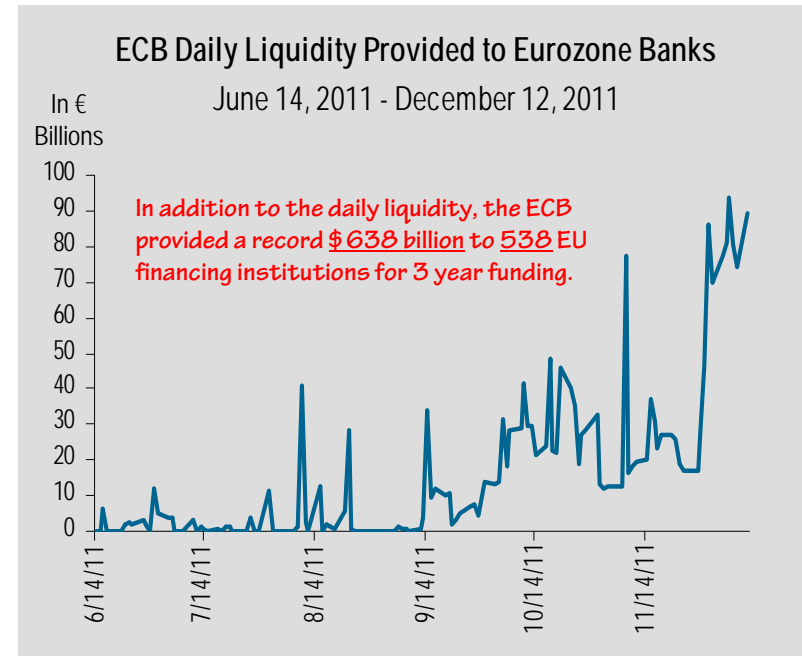
Short and long term funding costs for EU banks has been rising. No choice but to sell assets. Higher regulatory capital requirements adding pressure to delever.



While U.S. banks are relatively better capitalized, earnings are under pressure from slow economic growth, costly regulation, and possible Euro breakup.

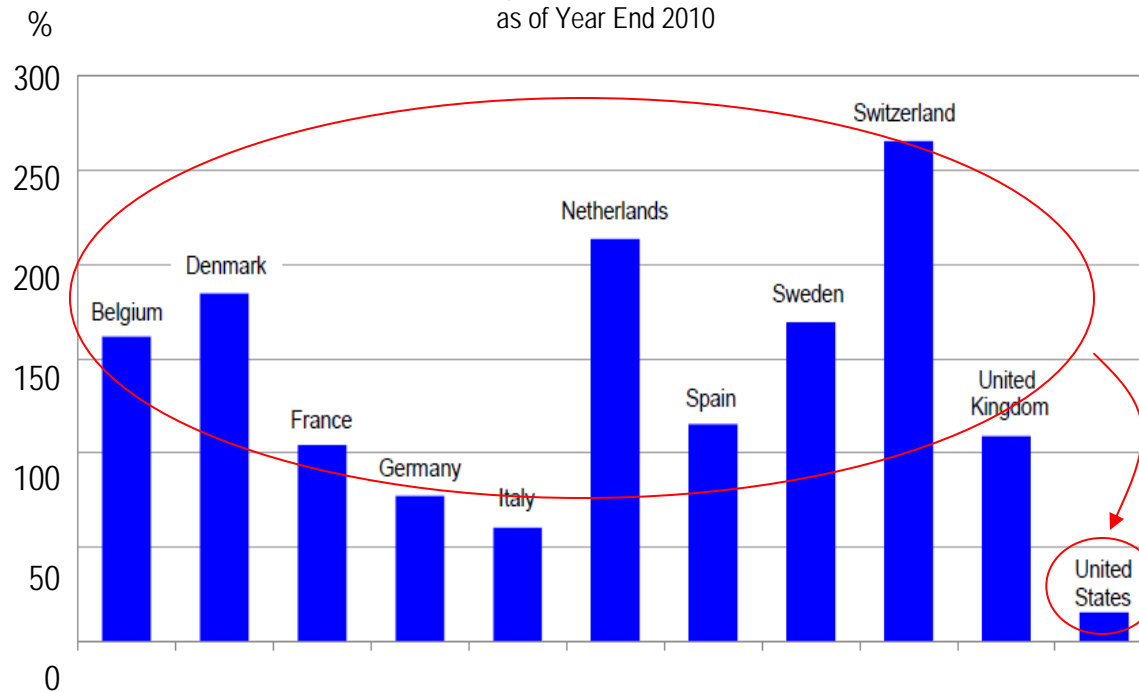
Negative Feedback Loop from EU Bank Deleveraging

Whether it likes it or not, the ECB is the defacto lender of last resort for the EU banks (and indirectly the overeiqns too).



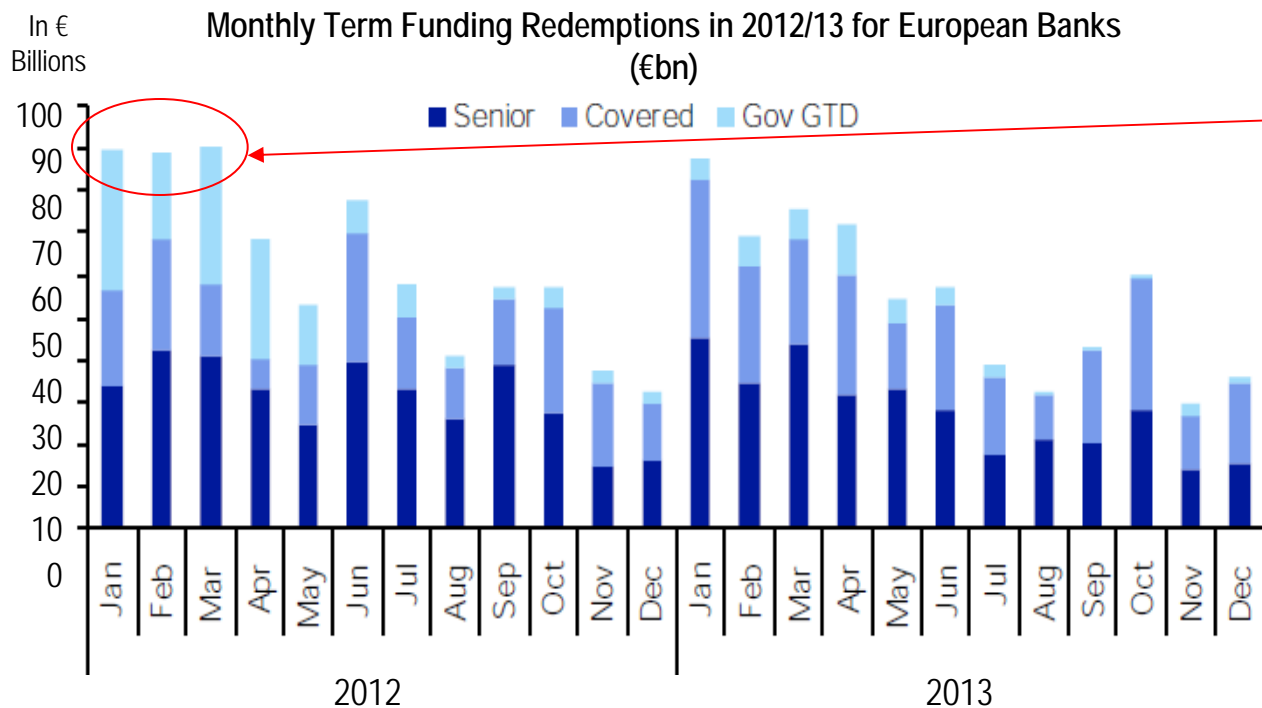
Negative Feedback Loop from EU Bank Deleveraging

**Bank Size Relative to Country Size:
Assets of Largest Bank as a Share of GDP**
as of Year End 2010



And we thought our banks were too big to fail. The European banks are enormous relative to the size of their country's economy.

Negative Feedback Loop from EU Bank Deleveraging



The first quarter is critical for EU sovereign debt auctions and bank debt issuance. Governments and banks in the Eurozone have about \$500 billion in debt they need to rollover in the first quarter.

Negative Feedback Loop from EU Bank Deleveraging

Meeting New Capital Standards by Shrinking Bank Assets				
In € Millions	EBA Capital Shortfall	Convert to Assets @ 40% Avg Risk Weighting @ 9% Tier I Capital	% GDP	
Cyprus	3,587	99,639	571%	
Greece	30,000	833,333	362%	
Portugal	7,804	216,778	126%	
Spain	26,161	726,694	68%	
Belgium	4,143	115,083	33%	
Austria	2,938	81,611	29%	
Italy	14,771	410,306	26%	
Slovenia	297	8,250	23%	
France	8,844	245,667	13%	
Norway	1,312	36,444	11%	
Sweden	1,359	37,750	10%	
Germany	5,184	144,000	6%	
Denmark	47	1,306	1%	
Total	106,447	2,956,861	33%	

EU banks must raise their Tier I capital ratios to 9% by June 2012. The European Banking Authority estimates the capital shortfall to be 106€ billion. If banks decide to reach the capital shortfall solely by selling assets, it would require nearly €3 trillion in asset sales (1/3 of EU GDP).

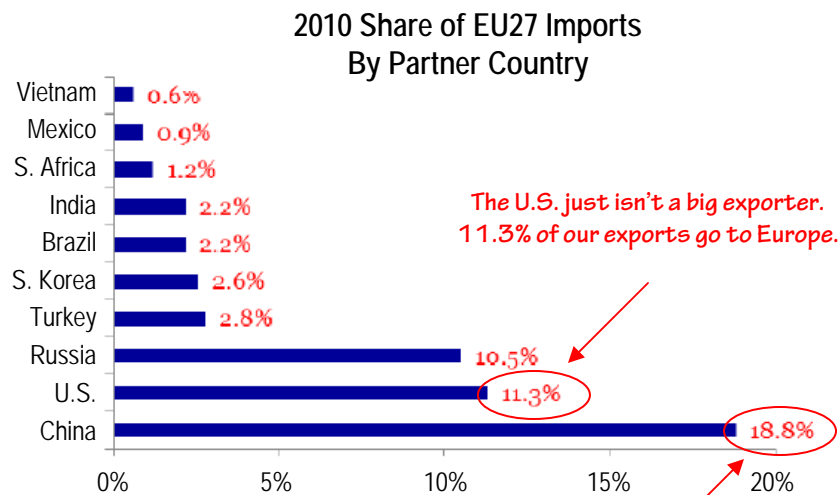
Transmitting Europe's Troubles Around the Globe

BIS Standard Exposures to Peripherals – Total (\$bn)

Exposure	France	Germany	UK	US	Other Europe	Europe	Other Non-Europe	Total
Greece	55.7	21.4	12.6	8.4	31.1	120.8	2.0	131.1
Ireland	32.0	110.5	140.9	53.6	96.7	380.1	33.4	467.1
Italy	416.4	161.8	73.7	46.9	185.6	837.5	54.7	939.0
Portugal	25.7	35.9	25.4	5.3	109.7	196.7	2.5	204.5
Spain	150.9	177.5	100.9	66.8	213.9	643.2	32.0	741.9
Total	680.7	507.0	353.5	180.9	637.0	2,178.2	124.5	2,483.6

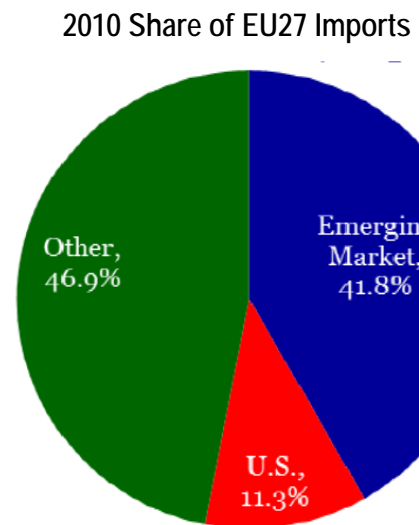
On-balance sheet U.S. bank exposure to Europe is comparatively low. Off-balance sheet CDS and Euro counterparty risk is a big unknown.

Transmitting Europe's Troubles Around the Globe



The U.S. just isn't a big exporter.
11.3% of our exports go to Europe.

China's economy is largely built on exports
and nearly 20% go towards Europe.

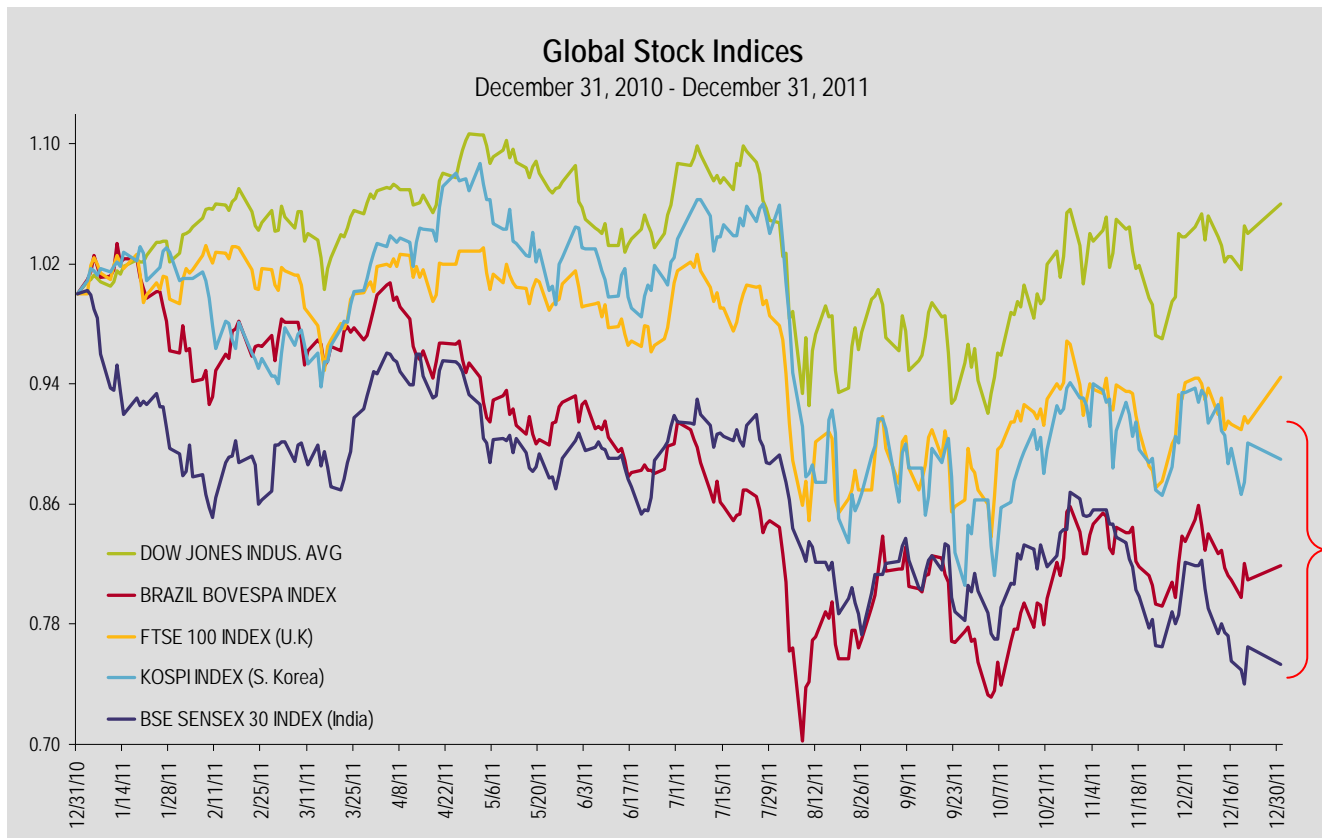


European economic slowdown has had a negative impact on the emerging countries. Nearly 42% of the EU's imports originate from emerging economies.

Transmitting Europe's Troubles Around the Globe



U.S. Immune to Europe's Troubles?



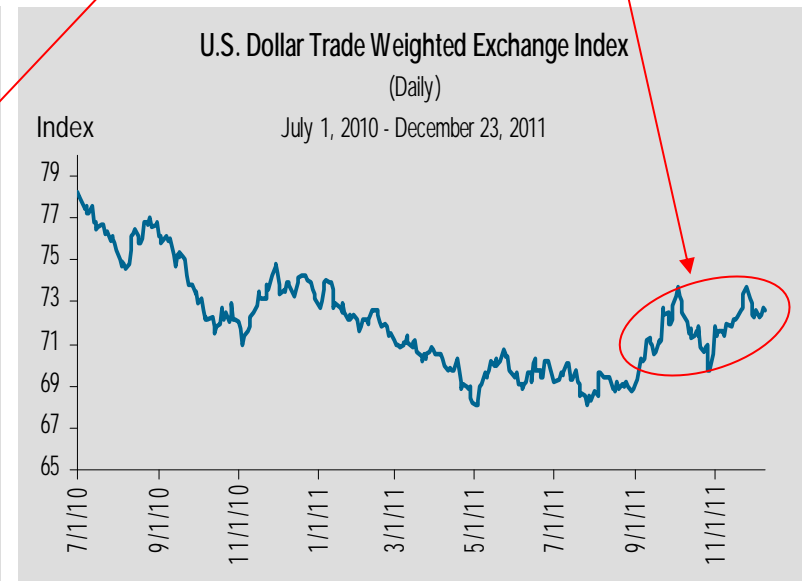
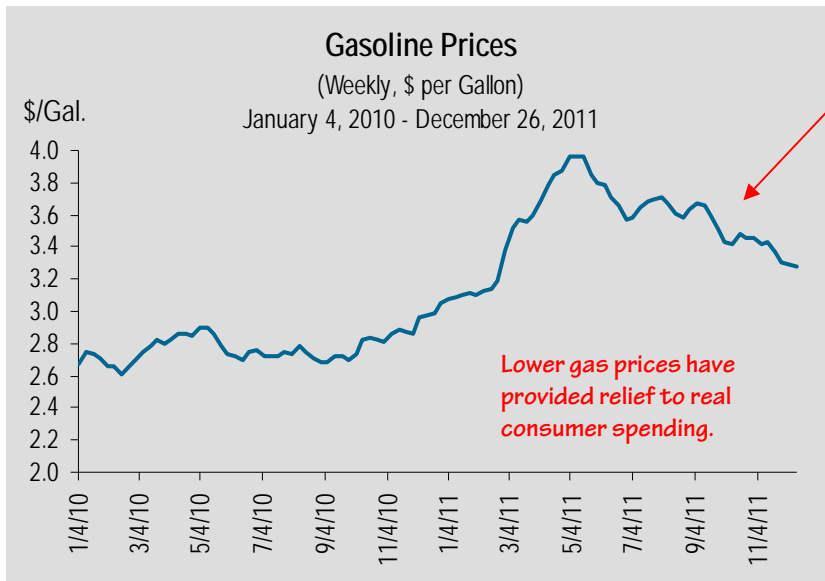
U.S. Immune to Europe's Troubles?

Estimated Effect of European Recession Scenarios on S&P 500 Earnings November 2011		
	Base Case	Bear Case
Euro Area Real Growth GDP	-1%	-5%
Euro Area Nominal GDP Growth (€)	0.5%	-5%
Change in the Euro	-10%	-20%
Change in Earned Profits in Euro Area (\$)	-9.5%	-25%
Change in S&P 500 Profits	-1.8%	-4.6%

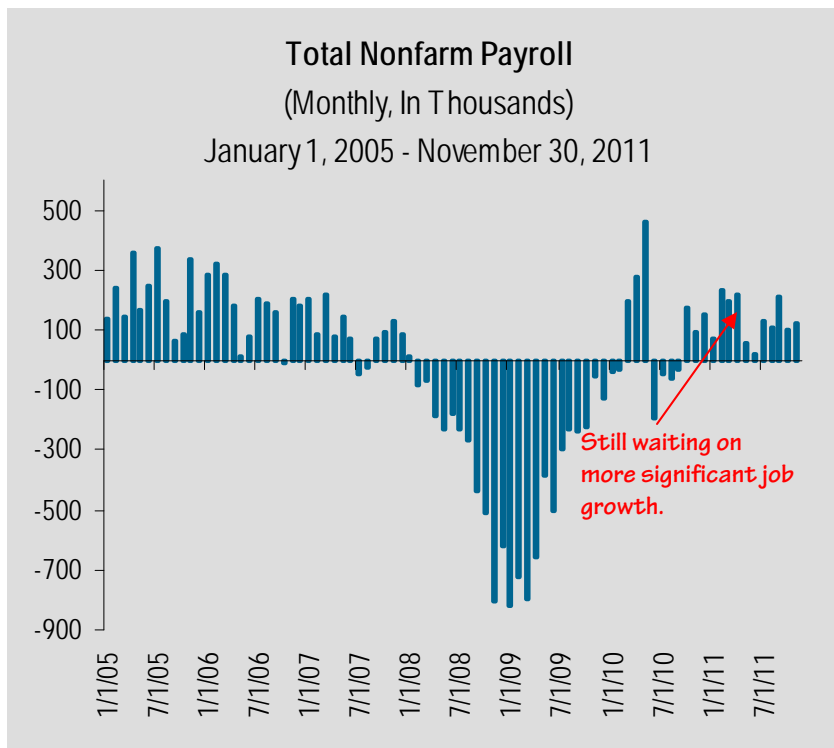
Markets not expecting much of a hit to earnings from a mild European recession.

U.S. Immune to Europe's Troubles?

The capital flight out of Europe and emerging countries has pushed up the value of the U.S. dollar and lowered commodity prices.

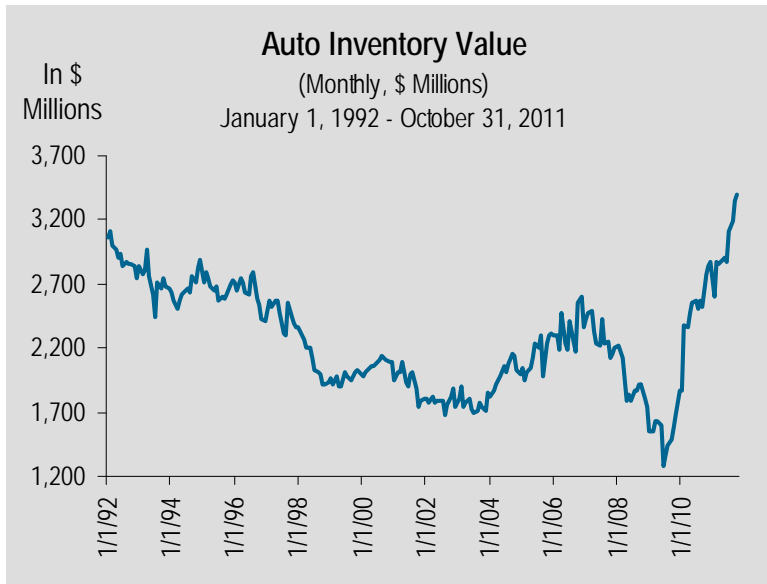


U.S. Immune to Europe's Troubles?



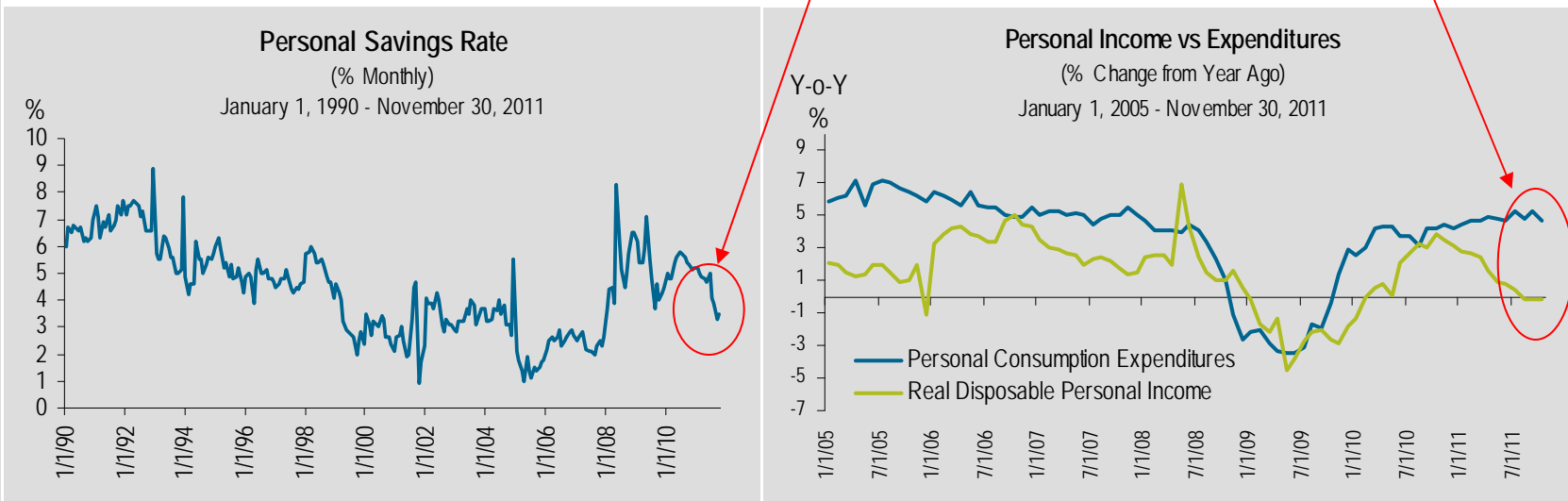
U.S. Immune to Europe's Troubles?

U.S. manufacturing activity has been surprisingly strong, but part of it has been an inventory build.



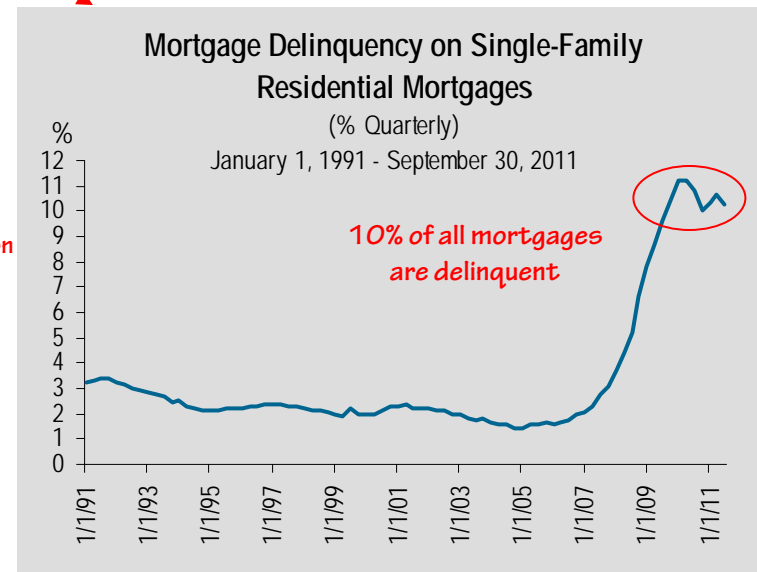
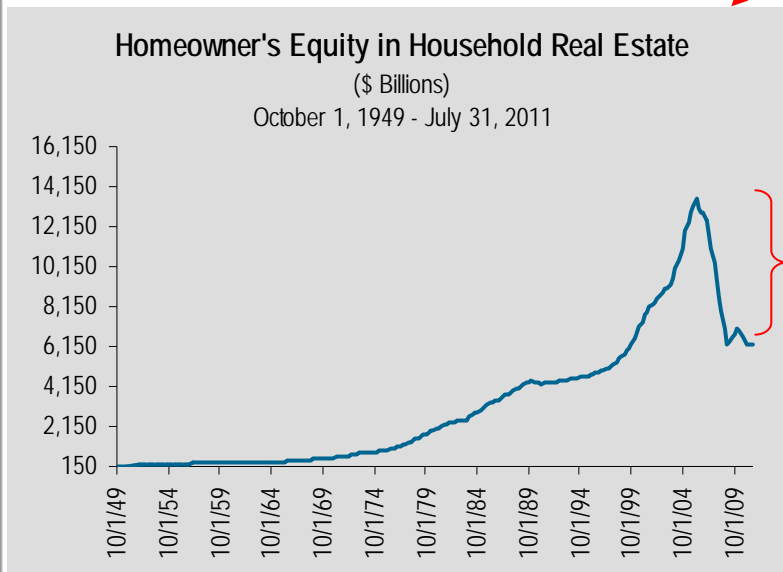
U.S. Immune to Europe's Troubles?

Surprisingly strong U.S. consumer spending is what has held up the U.S. economy. But, how long can spending outpace income growth now that savings have been tapped?



U.S. Immune to Europe's Troubles?

The overall credit profile for the U.S. household sector has weakened. The Fed's QE programs have helped rebuild the wealth lost in the stock market, but not in housing.

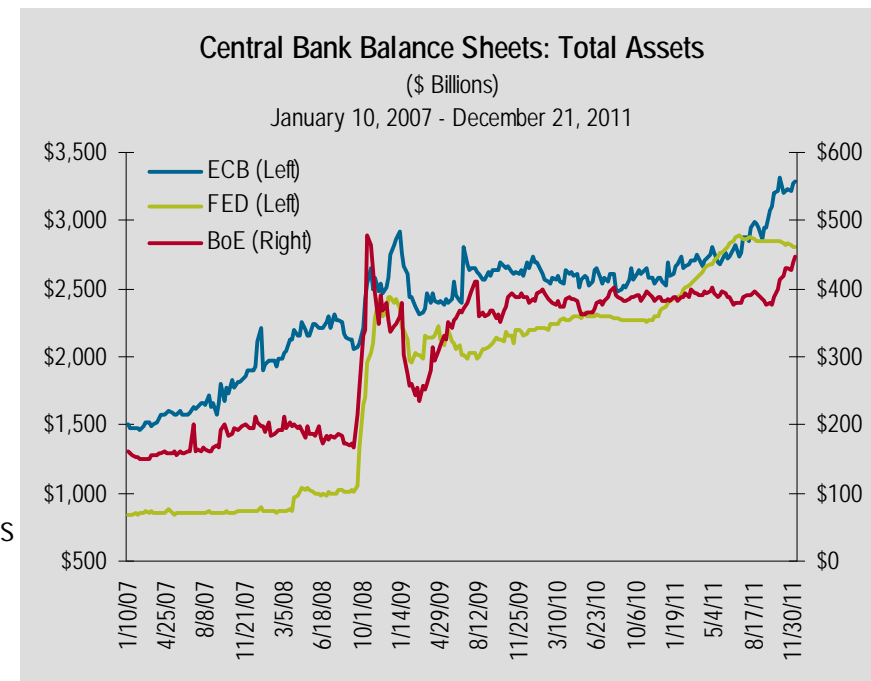


Central Bank Credibility/Financial Market Stability

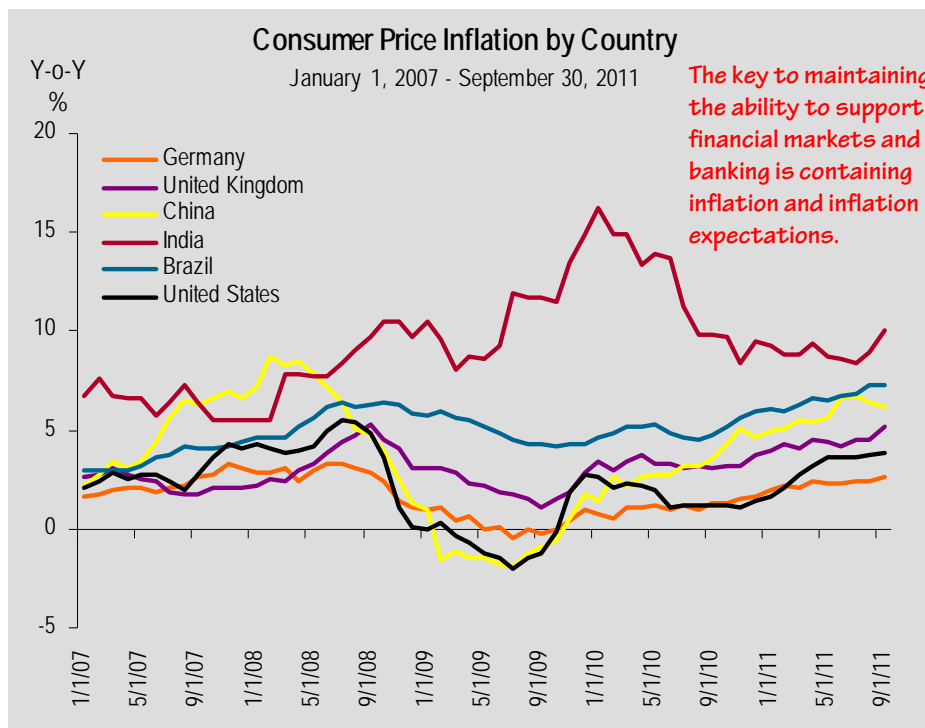
These central banks have been expanding their balance sheets and distorting financial asset prices.

Lots of recent easing moves:

- Brazil cut 100bps
- Russia cut 25bps
- Indonesia cut 25bps
- Israel cuts 25bps
- Bank of England announced more QE
- The Fed announced Operation Twist
- ECB cut rates 50bps
- Coordinated central bank intervention
- ECB expands acceptable collateral & term funding to 3 years
- China cut bank reserve requirements by 50bps



Central Bank Credibility/Financial Market Stability



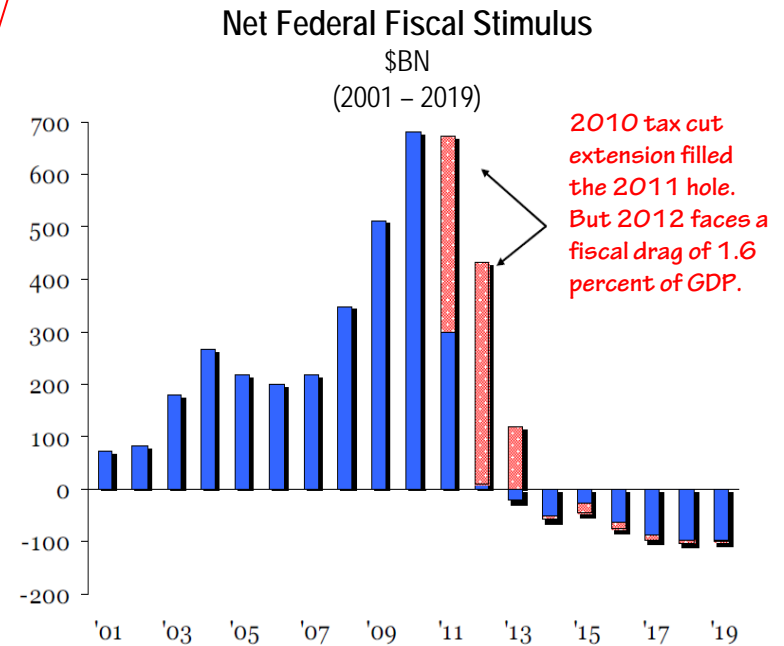
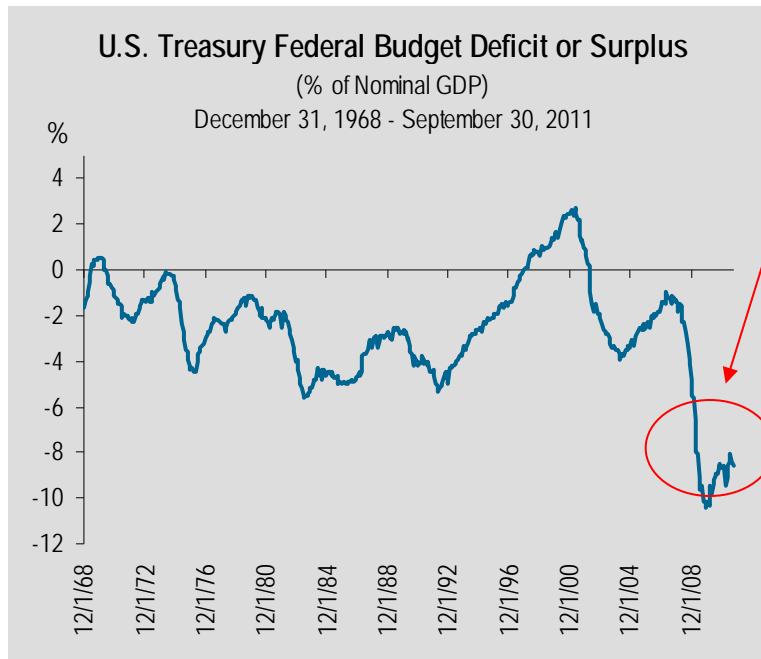
Evolution of the Fed's Dashboard

Date	Core CPI	Unemployment Rate
Nov 2010 (QE2)	0.7%	9.8%
Nov 2011	2.2%	8.6%

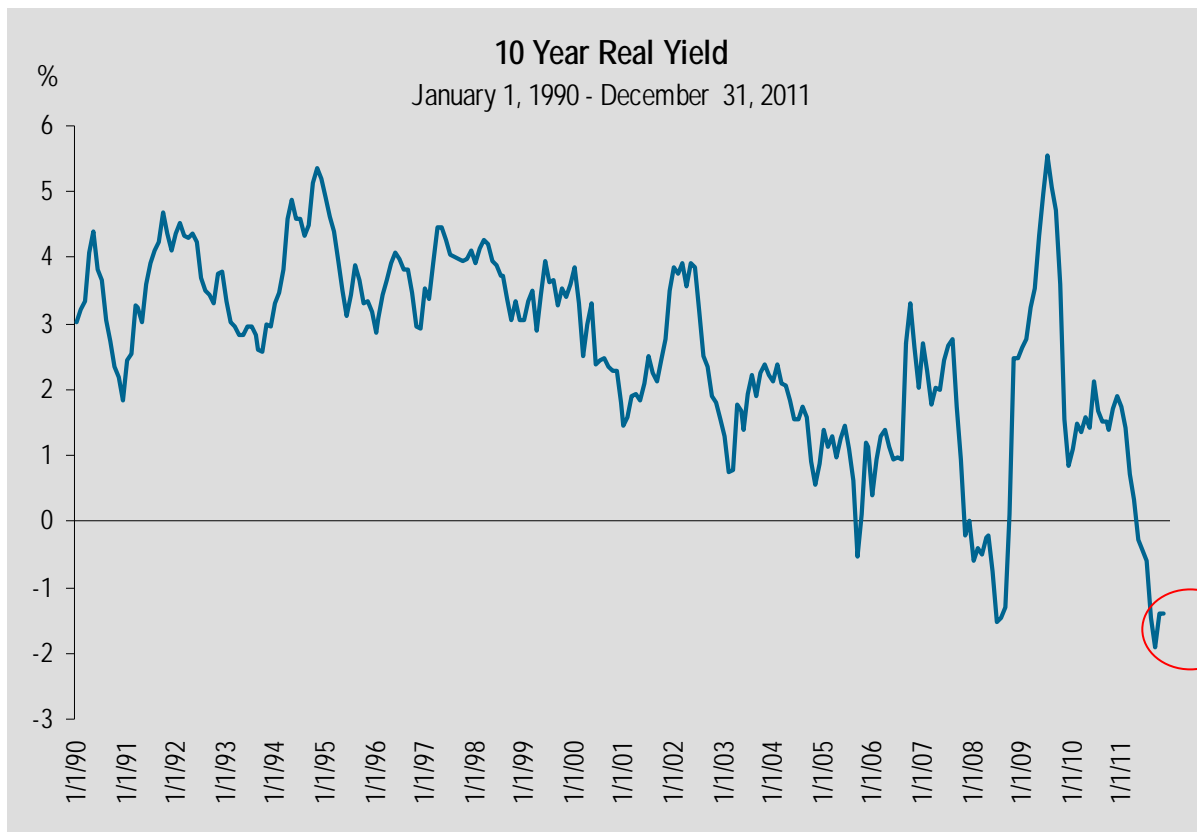
Inflation is higher, and unemployment is lower than the Fed forecasted when it did QE2. Still keeping its foot on the gas.

U.S. Fiscal Austerity

1.5% to 2.5% GDP growth isn't going to make a dent in our debt levels. U.S. credit rating remains vulnerable.

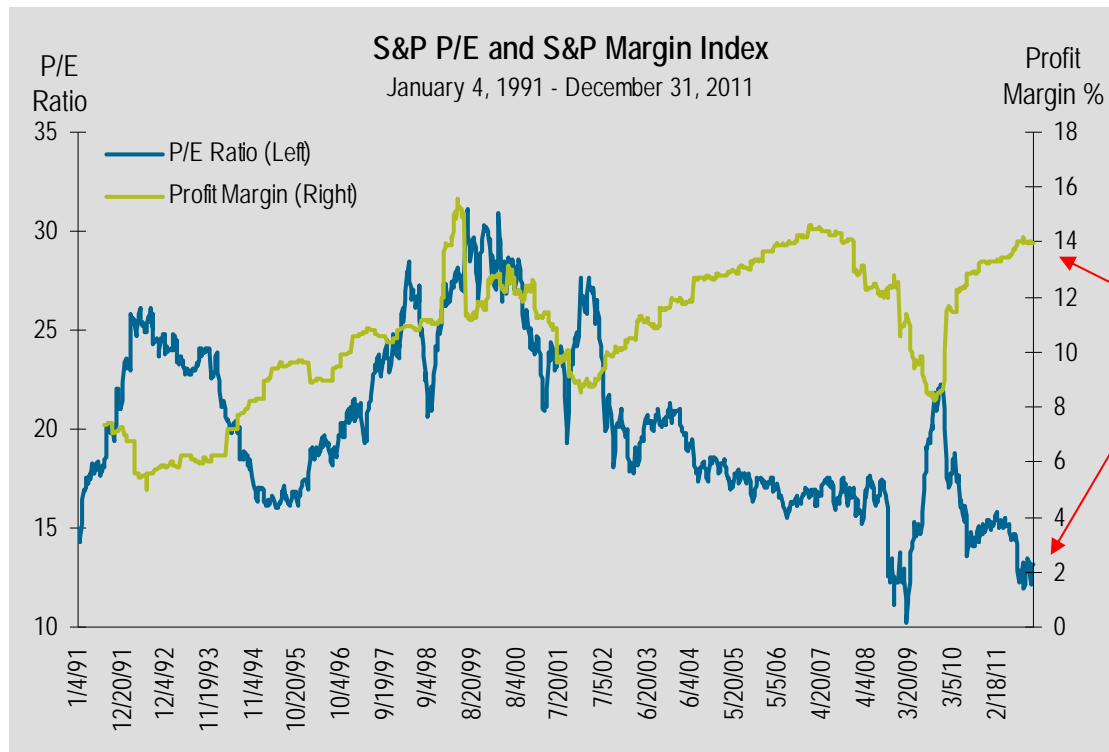


Financial Market Repression



Fed is distorting bond prices.
Current yields are below inflation.

Financial Market Repression



**Near record profit margins.
Low valuation.**

Financial Repression: 2012 Investment Considerations

Portfolio Management

- › Embrace volatility with short term trading and tactical cash position
- › More frequent portfolio rebalancing within tighter allocation ranges
- › Hedging with short positions, and U.S. Treasuries

Domestic Equity

- › Broadly diversified high turnover quant equity approaches
- › Higher dividend paying stocks

International Equity

- › Highly leveraged sovereigns in the crosshairs
- › Emerging markets with flexibility to lower rates and cut taxes

Fixed Income and Cash

- › Accept high quality, call risk
- › “De-banking”, and lowering expenses
- › Inefficient markets that can endure stress scenarios

A Market That Can Take Some Stress: Non-Agency MBS

Securitized Mortgage Balance Outstanding 2011			
Sector: Non-Agency MBS	Current Balance		Percent
PRIME	\$ 325,110,788,247.27		25.1%
ALT-A	517,963,232,772.57		40.0%
SUBPRIME	440,147,643,422.07		34.0%
OTHER	<u>11,933,359,072.65</u>		<u>0.9%</u>
Non-Agency	\$ 1,295,155,023,514.56	35.6%	100.0%
Sector: Agency MBS	Current Balance		Percent
AGENCY	\$ 2,338,694,526,248.03		99.8%
AGENCY ADMIN PRIVATE	<u>3,524,801,307.46</u>		<u>0.2%</u>
Agency	\$ 2,342,219,327,555.49	64.4%	100.0%
Total	\$ 3,637,374,351,070.05	100.0%	100.0%

This is where our focus is.

Orphaned market

- No new issuance
- Requires specialized tools and expertise to analyze
- Regulatory capital constraints keep banks out of the market
- Lack of liquidity: much of the market has been downgraded below investment grade

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