Equity Market Recap First Quarter 2012

Market Environment

Global equity investors enjoyed strong, broad-based gains during the first quarter of 2012. The Standard & Poor's (S&P) 500 rose 12.6%, its best first-quarter rally since 1998. International markets, represented by the MSCI EAFE and MSCI Emerging Markets indices, posted 11.0% and 14.1% advances in U.S. dollar terms, respectively. For MSCI Emerging Markets, it was the strongest first-quarter gain since 1992. In aggregate, global equity market capitalization expanded by more than US$3 trillion during the period.

The early stages of the quarter reflected a somewhat stereotypical "January effect," wherein many of the worst-performing market segments of 2011 reversed course to lead the broader market advance. Strong gains by U.S. banks and homebuilding shares typified the "risk-on" environment. As the quarter progressed, investors seemed to demonstrate more scrutiny and selectivity toward areas with the strongest relative fundamentals. A persistent theme throughout the quarter was a strong downward trend in market volatility. The closely watched Chicago Board Options Exchange Market Volatility Index (VIX) declined by more than a third to close at its lowest levels since 2007. Correlations among individual stocks also trended significantly lower, a welcome development for active investors. Mutual fund flows also improved globally, but were dominated by flows to emerging markets, and heavily skewed to exchange-traded funds. U.S. equity funds saw continued net outflows since many retail investors remained disinterested.

Positive economic surprise, low valuations, and continuing monetary accommodation supported the market advance. In the U.S., consumer spending and manufacturing activity exceeded expectations. Employment steadily improved, capping the best six months of job growth since 2006. The four-week moving average for initial unemployment claims dropped to pre-crisis levels. In Japan, industrial production exceeded downbeat expectations, particularly in autos and technology. Japanese market sentiment improved significantly as the Bank of Japan expanded its quantitative easing and currency-intervention efforts. In mid-February, the Bank of Japan expanded its asset purchase program by 18% to ¥65 trillion.

The gloom surrounding the European sovereign debt crisis abated materially when Greece's private creditors approved its debt restructuring. This paved the way for a fresh round of new funding from the European Central Bank, which increased its Long Term Refinancing Operation (LTRO) by €529 billion. This brings the total size of the LTRO program to over €1 trillion, greatly easing liquidity strains on

European banks and avoiding the broad credit market contagion that many observers had feared. Italian bonds reversed their upward climb to finish the quarter near 5%. Conversely, fresh strains appeared in the Spanish market as the quarter drew to a close, serving as a reminder that longer-term structural challenges persist for the European Union.

Among the larger developed markets, the best relative results were seen in Japan, Germany and the United States. Relative laggards included Canada, the United Kingdom, and Portugal. Spanish equities declined nearly 6%*. Emerging markets had outperformed their developed-market counterparts by nearly 8% in the first two months of the quarter, but retraced almost 5% of those relative gains in the final month*. The primary culprit behind the reversal was China, where retail sales and production lagged expectations and much-anticipated monetary easing did not materialize. Chinese authorities also guided real gross domestic product (GDP) growth targets lower to 7.5% per annum.

Globally, returns by sector and style generally reflected a pro-cyclical environment. Growth-oriented benchmarks outpaced their value brethren. Sector leadership was seen in technology, financials, consumer discretionary, and industrials. Defensive areas such as consumer staples, health care, telecommunications, and utilities lagged. Energy and materials stocks came under pressure late in the quarter, partly because of the disappointing news emanating from China. In another reversal of 2011 results, dividend-oriented stocks generally lagged non-dividend payers.

Commodity markets saw significant dispersion for the period. Copper prices rose 11%, while steel declined 7%*. In agricultural markets, soybean prices rose nearly 12%, while corn and wheat each slid about 8%*. The biggest headlines were of course in the energy markets. U.S. crude prices (West Texas Intermediate (WTI)) rose a modest 4%, but crossed the psychologically important $100 per barrel threshold, and retail gasoline prices rose 8% to an average of $3.90 per gallon. Even more concerning, the Brent Crude global oil price benchmark rose more than 15% to close above $120 per barrel, reflecting heightened sensitivity to Iranian geopolitical risk. The economic ramifications of rising oil prices would no doubt have been more detrimental were it not for steep declines in the prices of natural gas, coupled with unseasonably warm weather. For the quarter, natural gas prices slid more than 30% to decade lows.

Corporate treasurers continued to express a preference for selling bonds and buying stock as capital-raising through debt issuance reached new heights. International bond underwriting reached nearly $1.4 trillion during the quarter, an annual rate of $5.4 trillion. This compares to averages of $3.4 trillion

*Sources: Equity performance statistics from MSCI; Commodity indices performance from Commodity Exchange, Inc. (CMX), London Metal Exchange (LME), and Chicago Board of Exchange (CBOE) in each of the prior two years. Globally, high yield issuance exceeded $110 billion, an annualized increase of more than 20% over the prior year. Despite favorable market conditions, equity IPO issuance was meager. Sovereign government bond yields edged up during the quarter for the larger “safe” markets, but remained near generational lows. Currency movements were relatively muted, save the nearly 7% decline in the yen relative to the dollar. The euro climbed nearly 3% to finish at €1.33 per dollar. Most emerging markets currencies posted single-digit gains.

The table below summarizes global equity results for the quarter and trailing 12 months by major region and sector in U.S. dollar terms.

		3 Mo.	12 Mo.
MSCI World Index		**11.7%**	**1.1%**
	North America	12.3%	6.4%
	Europe	10.8%	-6.9%
	Pacific	11.3%	-1.9%
MSCI Emerging Markets Index		**14.1%**	**-8.5%**
	Latin America	14.7%	-8.1%
	EEMEA	16.0%	-11.9%
	Asia	13.4%	-7.6%
MSCI All Country World Index		**12.0%**	**-0.2%**
	Consumer Discretionary	17.3%	9.5%
	Consumer Staples	7.4%	15.0%
	Energy	5.2%	-9.8%
	Materials	10.5%	-15.0%
	Industrials	12.5%	-4.5%
	Financials	17.7%	-8.3%
	Health Care	8.0%	12.9%
	Technology	20.2%	13.3%
	Telecommunications	2.6%	2.5%
	Utilities	3.1%	-2.1%

Looking Ahead

The resiliency of corporate earnings has been a bedrock underpinning attractive valuation in the equity markets and an interesting dichotomy has presented itself in recent months. While top-down economic expectations have been ratcheting up in the face of positive surprise, bottom-up earnings expectations have been trending down. A preponderance of companies has also been guiding expectations more cautiously. From our perspective, a watchful eye on earnings trends is a much more reliable means of identifying opportunities and challenges than macro indicators. Given the magnitude of the rally since

October and the downward earnings revisions, forward price multiples for most market segments are now in the territory of "merely cheap," compared to their prior status as "extremely cheap" by historical standards. Importantly, however, the downward trajectory in earnings revisions seems to have run its course in many developed markets, and could be poised for positive surprise. In emerging markets, the revision process probably has a bit further to go especially as it relates to China. This leaves us with a somewhat cautious stance in emerging markets, while being a bit more confidently pro-cyclical regarding the U.S. market.

Two of the more timely outcomes of our bottom-up approach in recent months have been increased exposure to financial services in the U.S. and decreased exposure to commodity-sensitive companies in emerging markets. With regard to U.S. financials, we are now modestly overweight for the first time since 2007. In emerging markets, our focus on earnings trends and the lack of more aggressive policy accommodation in China led us to reduce materials exposure, particularly in the steel value chain. That said, while earnings trends point to slower growth in China, they remain consistent with a soft-landing scenario.

Overall, an environment remains where investors must continue to balance the difficult choice of negative real yields on so called "safe" assets with the potential for renewed volatility and pull-backs among various "risk" assets. The road to recovery remains a bumpy one. Our focus on bottom-up earnings trends (i.e. fundamental change) is well suited to the current environment and is further aided by our proprietary Style Risk Monitor (valuation dispersion analysis framework.) Both are complementary means to identify pockets of opportunity and dislocations amid anxious investor sentiment. Our client portfolios are neither particularly defensive, nor pro-cyclical, but demonstrate several notable underlying themes in a well-diversified fashion.

In Europe, we see good reason to remain cautious around the epicenter of the crisis, particularly among financials. Conversely, we see compelling valuation opportunities among select industrial and cyclical companies levered for global growth and among the stronger core and Scandinavian markets. A bottom-up focus on credit conditions is our best defense.

We also have become a bit more constructive on select Japanese exporters, owing in part to the downward pressure on the yen, but more importantly because of their highly discounted valuations relative to global peers. Corporate governance and regulatory conditions also warrant continued scrutiny in the year ahead, given the TEPCO disaster and the Olympus accounting scandal.

Globally, the capital-spending cycle still bears some promise, particularly in the technology sector, and for select industrial companies. The resiliency of consumption trends among higher-end consumers, where rising gasoline prices pose less of a headwind. Two areas where our earnings focus has notably contrasted with consensus expectations have been in consumer finance and managed-care companies, reflecting intriguing distinctions relative to their broader sector peers.

These are just a few illustrations of our research-driven process in action, and do not necessarily reflect the current positioning of any particular portfolio. Regardless of the region, sector, or general market conditions, our bottom-up focus on sustainable earnings trends and valuations relative to expectations remains a constant across all portfolios, and helps our team rise above the fray of short-term “risk on/risk off” tendencies seen with many investors.

Disclosures

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