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Investment
REVIEW & OUTLOOK

MARCH 31, 2012

Economic Backdrop

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- Global economic activity remains subdued and growth appears to have slowed recently after picking up somewhat toward the end of last year; economic data has trended more positively in the United States than elsewhere
- We have recently become somewhat more cautious in our outlook for the economy as we think several key risks have increased
- It is becoming more evident that government policies in Europe are constricting growth and this is making it increasingly difficult for overleveraged economies to reduce debt burdens
- Activity in China still appears soft but aggressive policy ease may not be forthcoming as authorities try to temper credit growth and transition away from investment-driven to consumption-led GDP
- Energy prices have recently increased but still appear manageable at current levels; however, the potential for geopolitical instability in the Middle East could rise further and energy prices could move sharply higher as a result
- In the United States, a number of major budget issues must be addressed before the end of the year in order to avoid a sharp tightening of fiscal policy; the political environment surrounding the November elections could create gridlock
- Overall, we continue to believe that the global economy will expand at a moderate pace this year, but think the potential range of outcomes has widened considerably

Financial Market Outlook

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- Consensus earnings estimates are easing as global economic growth moderates
- Ongoing global growth is expected to support further earnings improvement in 2012; however, it probably will be difficult to meet bottom-up expectations of near double-digit U.S. earnings growth this year
- Stock market valuations appear attractive based on several valuation metrics; however, in our view, it will be important for equity markets to sense some degree of economic stability in order to move higher

Portfolio Strategy

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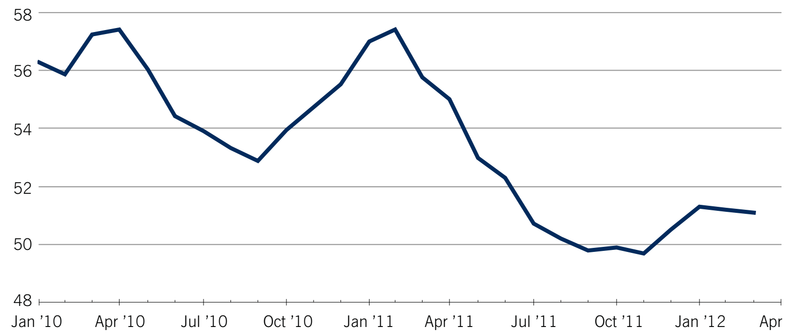
We believe the following themes are timely in an environment of below average economic growth:

- The “strong will get stronger” theme is maintained; the portfolio emphasizes companies with strong operational and financial characteristics; we believe these companies can gain share from weaker competitors and thus improve their earnings
- The theme of “earn and return cash” is maintained; stocks of companies that can both grow earnings and provide significant cash returns to shareholders should be attractive to many investors

Economic Activity Remains Sluggish as Risks Appear to Increase

Global economic conditions remain challenging. Real global gross domestic product (GDP) expanded by only 2.6% last year, and the annualized rate of growth in the fourth quarter was even weaker at 1.6%, according to estimates from JP Morgan. Based on the global manufacturing purchasing managers' index (PMI), which tends to be a good indicator of economic conditions, activity remains subdued, and after picking up some at the tail end of last year it began to decelerate again in February and March. (See Figure 1.)

FIGURE 1
Global manufacturing purchasing managers' index (PMI)

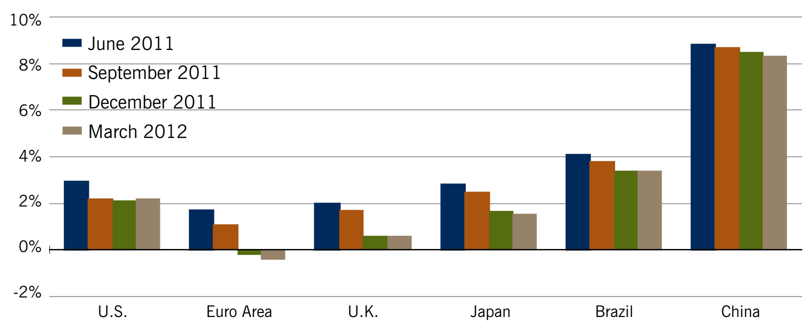


Source: Bloomberg, JP Morgan; data provided from 1/2010 through 3/2012

In the latter part of 2011 several factors made us more optimistic about economic conditions. First, consensus growth expectations had receded to levels that we felt were reasonable. Second, energy and commodity prices had eased along with inflation in general, and this helped put a floor under real personal and business income. Finally, we had started to see more monetary stimulus in the developed and emerging economies.

Since that time, consensus expectations for growth generally leveled off, and there were several positive economic developments. (See Figure 2.) In the United States, employment accelerated, housing showed signs of stabilizing, and auto sales and production improved considerably. In Europe, credit costs and financial stresses came down sharply from the very elevated levels reached last fall.

FIGURE 2
2012 consensus GDP forecasts - selected months



Source: Bloomberg

In spite of these positives, we have recently again become somewhat more concerned about the outlook as we think several key risks have increased. We classify these risks into three broad categories: deleveraging, energy prices, and politics.

Deleveraging, Energy Prices, and Politics All Pose Increased Risks to Global Economic Growth

Deleveraging and the need to reduce excessive levels of debt is not a new topic, and it has been our primary reason for believing that global growth would remain subdued. What has changed is that while we have seen some progress in deleveraging in the United States, debt in Europe has actually continued to build in relation to GDP. (See Figure 3.) Government policies in Europe are constricting growth, making it increasingly difficult for overleveraged economies to reduce debt burdens. Significant additional tightening is planned in Europe in 2012. This could continue to impair economic growth and actually impede progress on deleveraging.

We are also increasingly worried about the risks of deleveraging in emerging economies, especially China. The Chinese government encouraged a massive expansion in lending during the financial crisis in 2008, fueling an extraordinary increase in investment spending. Although this limited the impact of the global slowdown, it also created several new problems that Chinese officials are now attempting to resolve. The Chinese government is trying to slow loan growth in relation to GDP, address the potential impact of imprudently made loans, and steer the economy away from its heavy reliance on investment spending and toward a more balanced and consumer-driven model. Any misstep in trying to manage these issues presents a risk to global growth.

High energy prices and the potential for geopolitical conflict with Iran also pose a risk to the global economy. At current levels, energy prices are weighing on growth throughout the world, but still appear manageable. A conflict with Iran, however, could send prices to levels that would be much more detrimental to economic growth. Tensions are growing between the United States, Israel, and Iran, and the window to prevent armed conflict before Iran develops nuclear capabilities may be closing.

The probability of instability in the Middle East and the energy markets is very difficult to assess. However, it seems that such risks over the next six to twelve months are more significant than they have been in some time.

If a conflict between either the United States or Israel and Iran did arise, energy prices could rise sharply. If a war breaks out, the global economy could be significantly threatened. Iran could try to mine the Strait of Hormuz, which is a passageway to roughly 20% of the world's traded oil. Even if the United States military were able to reopen the strait in relatively short order, decreased Iranian oil exports could push energy prices higher. Iranian oil exports averaged around 2.5 million barrels per day between January and September of 2011. With OPEC spare capacity recently estimated at just 2.75 million barrels per day and Saudi Arabian spare capacity at 1.9 million barrels per day, it may be difficult for reduced Iranian output to be entirely replaced by increased OPEC production or the drawdown of national oil reserves.

It appears that the risk of a conflict with Iran already has pushed oil prices higher to some degree. To gauge this, we compare oil prices with the implied likelihood of a United States or Israeli airstrike in Iran in 2012, according to Intrade, a website that lets users make wagers on political, geopolitical, and other events. (See Figure 4.) Between January and March, the potential for conflict and the price of oil moved higher in lockstep. While the price of oil already seems to reflect some likelihood of a war with Iran, we think prices could move sharply higher if a conflict occurs.

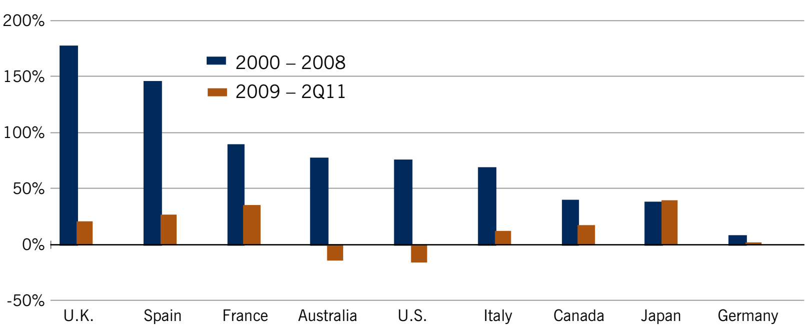
Lastly, we think politics pose an increasing risk to economic growth in a number of countries around the world. In the United States, several major budget issues must be addressed towards the end of the year. Significant tax increases and spending reductions are scheduled for January 2013. We worry that the political environment leading up to and subsequent to the election could create gridlock. Without action, fiscal policy in the United States will turn sharply towards contraction in 2013. Even the uncertainty in anticipation of such a scenario could slow economic activity.

Politics are also likely to have a major impact on the European crisis. First, Greek elections are scheduled for early May, and the new government may be less willing or less able to continue to institute the reforms required by the recent bailout package. France will also hold elections in late April (first round) and early May (second round), and the leading opposition candidate could try to renegotiate the recently agreed fiscal pact, which would likely disturb the fragile conditions in the Eurozone.

Overall, as a base case, we continue to look for moderate global growth in 2012. We think real global GDP will likely expand by between 2% and 2.5% and think growth in the United States will be similar to this. However, we see an increasingly wide range of possible outcomes, and we have become more cautious as a result.

FIGURE 3

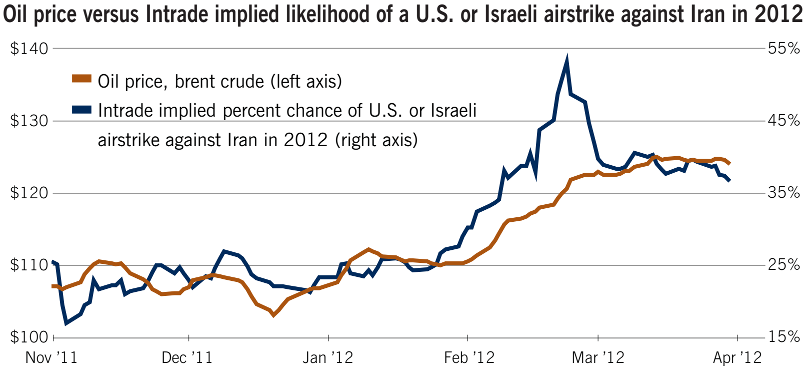
Change in total household, corporate, financial, and government debt as a percent of GDP



Source: McKinsey Global Institute

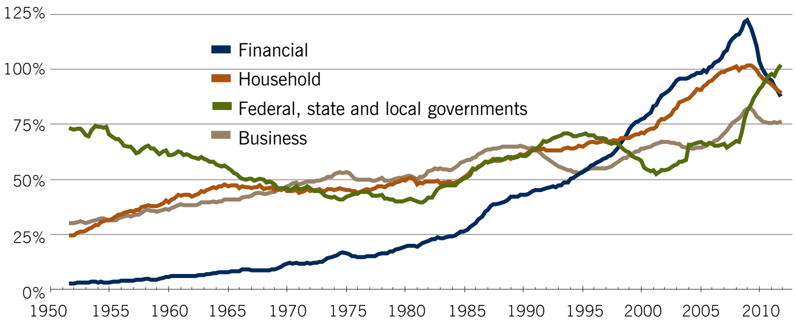
FIGURE 4

Oil price versus Intrade implied likelihood of a U.S. or Israeli airstrike against Iran in 2012



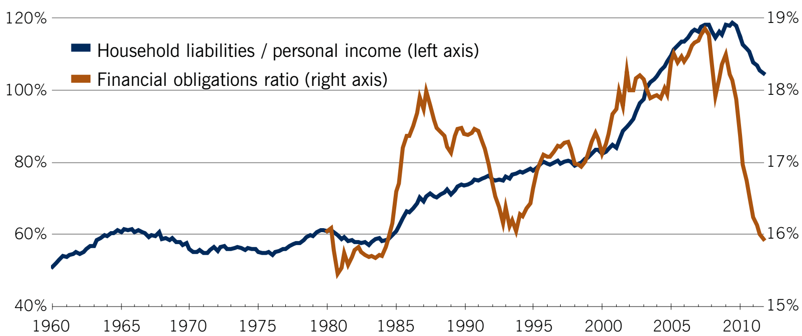
Source: Bloomberg, Intrade; data provided from 11/2011 through 3/2012

FIGURE 5
Ratio of U.S. debt to GDP by sector



Source: FactSet, Federal Reserve; data provided from 3/1950 through 12/2011

FIGURE 6
Ratio of U.S. household liabilities to personal income versus financial obligations ratio



Source: Federal Reserve, FactSet; data provided from 3/1960 through 12/2011

United States:

Deleveraging Likely to Continue to Limit Growth

After an enormous buildup prior to the crisis, U.S. total debt has receded in relation to GDP since 2008. This improvement, however, masks a very uneven performance. While corporate, household, and financial debt has shrunk in relation to GDP, government debt has risen sharply. (See Figure 5.) Thus, even though overall debt has fallen, some of the burden of deleveraging in the household, corporate, and financial sectors has shifted to the government sector. Eventually, the government too will need to pare its debt. Thus, while continued deleveraging in non-government sectors is likely to continue to moderate the pace of economic growth, economic activity may come under even greater pressure when the government sector begins deleveraging.

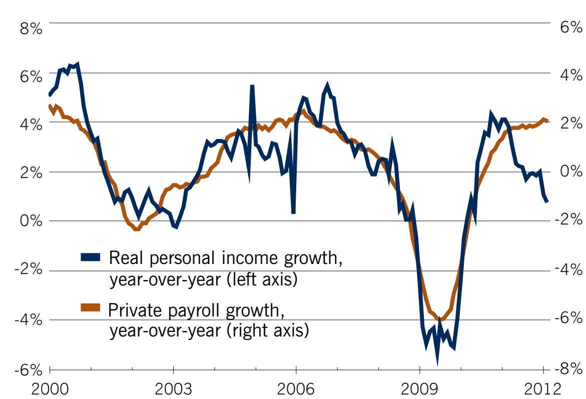
United States households have been reducing debt since the crisis and have brought the overall ratio of household debt to income closer into line with the historical average. Nonetheless, household deleveraging seems far from complete, and households are likely to continue reducing debt in relation to income and assets over the coming years. One improvement, however, is that household borrowing has begun to stabilize recently and households are no longer actively reducing debt via repayment or default. This means that future household deleveraging may result more from households keeping their debt levels relatively flat while their incomes and assets grow. This may reduce some of the negative economic impact of household deleveraging by slowing the pace of deleveraging and limiting the negative repercussions defaults can have on other sectors of the economy.

Another positive development is that the declines in interest rates, in combination with lower levels of debt in relation to income, have reduced annual debt servicing costs. As a result, the Federal Reserve's Financial Obligations Ratio has fallen sharply. This measure estimates the share of household income devoted to interest payments on mortgages, consumer debt, auto leases, rental expenses, homeowners' insurance, and property tax payments. (See Figure 6.) This should lessen the ongoing annual burden of debt while households gradually work to reduce high outstanding debt levels.

Employment Picking Up, But Other Factors Causing Income Growth to Lag

One of the most favorable developments for the U.S. economy over the past few months is that employment growth is finally picking up. Unfortunately, other components of income growth, such as hourly wages, the number of hours worked per week, and government transfer payments have slowed. The result is that real personal income growth is slowing in spite of the improvement in employment. (See Figure 7.) We expect these trends in other categories of income growth to generally continue in the coming quarters. Thus, real personal income growth may remain somewhat subdued even if employment growth stays relatively solid.

FIGURE 7
U.S. real personal income growth versus private payroll growth



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, FactSet; data provided from 1/2000 through 2/2012

Rise in Energy Prices Manageable But Geopolitical Conflict Could Push Prices to More Harmful Levels

At current levels, the rise in energy prices appears manageable for the U.S. economy. First, while oil prices are very high in absolute terms, the rise off of the lows set last summer is nowhere near as large as other increases that have disrupted growth. For example, Brent crude oil prices are up about 15% from their effective lows last year. This compares with a rise of over 60% between the middle of 2010 and the first part of 2011. Second, the rise in oil prices has been somewhat offset by much lower natural gas prices. As a result, the share of GDP devoted to expenditures on oil and natural gas has increased only modestly in 2012 based on our model, which uses futures prices to estimate total energy costs for the economy. (See Figure 8.) That said, a conflict in Iran could cause a sharp increase in oil prices, and then energy expenditures would rise much more sharply in relation to GDP.

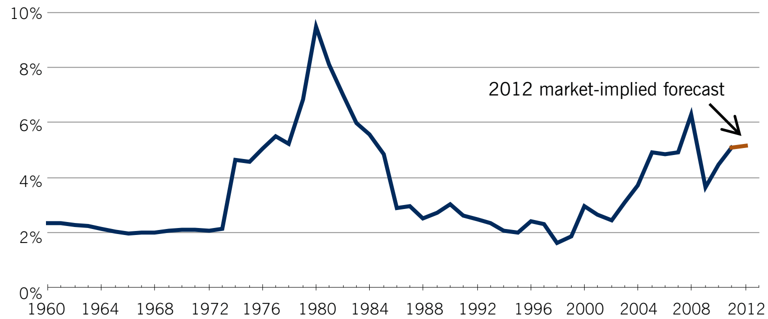
Although higher energy prices may be manageable for the economy overall barring a conflict with Iran, they may hurt consumers nonetheless. Gasoline prices have increased more sharply than oil prices and are now close to $4 per gallon, which could raise the share of personal income devoted to gasoline and crowd out other spending. (See Figure 9.) In addition, while businesses that produce energy-intensive products like chemicals are likely to benefit from low natural gas prices, this is less likely to be an offsetting factor for consumers who generally rely more on oil than natural gas as a source of energy.

Politics a Key Risk to Economic Growth in the United States

Politics are likely to have a major influence on the U.S. economy in 2012 and 2013. The presidential election could result in two very divergent paths for public policy that would likely have very different financial implications for businesses and individuals. In addition, the November elections will leave a lame-duck Congress and, possibly, lame-duck president to deal with a number of very significant decisions about important policies that are set to expire. First, the Bush tax cuts are set to expire at the beginning of 2013 and represent a potential $210 billion annual tax increase if they are not extended. Second, the 2% payroll tax cut is set to expire at the end of the year and would cause taxes to rise by roughly $110 billion per annum if not extended. Third, extended unemployment benefits are set to expire before 2013 as well, and this would mean a roughly $35 billion annual reduction in government support for unemployed workers. Fourth, the Alternative Minimum Tax will impact a much broader group of citizens and increase taxes by around $130 billion per annum if it is not adjusted. Fifth, the failure of the so-called "super committee" to reach an agreement on deficit reduction will trigger automatic spending cuts of around $120 billion per year starting in 2013 if Congress does not make any changes to current policy. In total, the potential contraction in fiscal policy represents almost 4% of GDP. In addition, other scheduled tax increases and spending cuts, like the 3.8% tax increase on investment income and 0.9% income tax on high wage earners, will take place in 2013. On top of this, the lame-duck Congress will likely have to begin negotiating another increase in the debt ceiling before the end of the year. Finally, the Supreme Court is likely to rule on the legality of the individual mandate in the Obama health care bill.

FIGURE 8

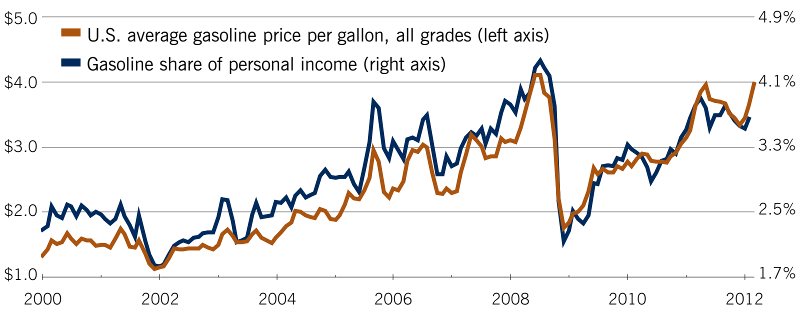
U.S. expenditures on crude oil and natural gas as a share of GDP



Source: Bloomberg, Energy Information Agency (EIA), Haver, ICAP; data provided from 12/1960 forecasted through 12/2012

FIGURE 9

Gasoline share of personal consumption versus gas price

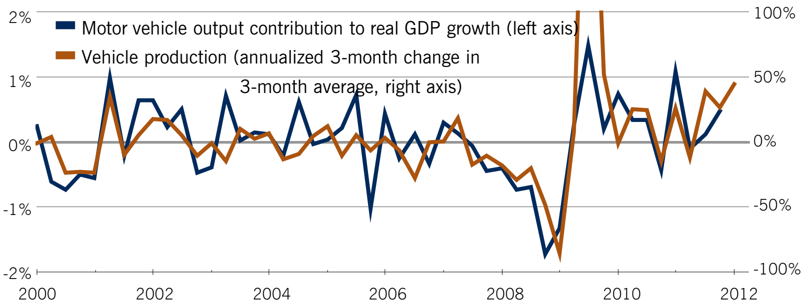


Source: FactSet, Bureau of Economic Analysis, U.S. Department of Energy, AAA; data provided from 1/2000 through 3/2012

Unfortunately, in spite of the significance of these issues, we are worried that the political environment may create gridlock. Given the magnitude of the policies that must be decided, any uncertainty about their resolution could slow economic activity if businesses and individuals defer key spending. In addition, given the magnitude of the contraction already scheduled, some fiscal consolidation seems likely in 2013 regardless of political outcomes.

FIGURE 10

U.S. auto production and contribution to GDP

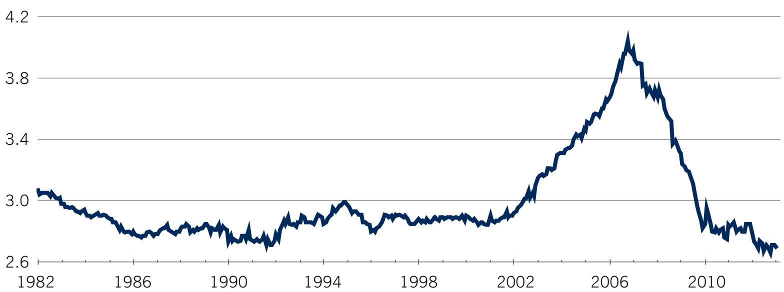


Source: FactSet, Bureau of Economic Analysis; data provided from 1/2000 through 3/2012

FIGURE 11

U.S. house price to income ratio

Ratio of seasonally adjusted median existing home price to household income



Source: National Association of Realtors, FactSet; data provided from 1/1981 through 1/2012

Accommodative Monetary Policy and Improving Auto and Housing Sectors Should Help Support U.S. Economy

Although the U.S. economy faces several headwinds, monetary policy and improving conditions in the auto and housing sectors should help support growth.

Recent signals from the Federal Reserve suggest that the Fed is ready to further ease policy at any sign of a slowdown. In addition, the Fed recently commented that any additional easing would likely take a slightly new form that would involve sterilizing asset purchases in order to prevent an outright expansion of the money supply. This would be somewhat similar to "operation twist" in that the government would sell shorter dated debt to buy longer dated debt. By offsetting or "sterilizing" asset purchases in this manner, the Fed hopes to quell concerns about the potential long-term inflationary impact of purchases.

Auto sales and production in the United States have improved substantially over the past several quarters. Monthly auto sales in the United States have risen from an annualized rate of below 10 million at the height of the crisis to roughly 15 million at present. While abnormally warm weather in winter months is likely to have affected seasonally adjusted annualized sales figures, the recovery has been solid even if sales are somewhat overstated. Auto production has also improved significantly and is likely to contribute solidly to GDP growth in the coming quarters. The three-month annualized growth rate in vehicle assemblies tracks the motor vehicle output contribution to real GDP growth fairly well, and it currently suggests that the recent rise in production is likely to have had a meaningful impact on GDP growth in the first quarter of the year. (See Figure 10.)

Even more encouraging is that auto sales and thus production may continue to rise. There are two main reasons for this view. First, auto sales have risen sharply recently in spite of credit remaining tight. Auto loan to value ratios are close to a historic low at nearly 80% on a three-month average basis, compared to an average of around 92% over the past twenty years. This suggests that as credit eventually eases, sales could rise even further. Second, sales of 15 million units on a seasonally adjusted rate are still below the 16 million to 18 million range that prevailed before the crisis and are even further from historic rates of sales on a per capita basis. This also suggests that sales could rise further. We therefore think the recent strength in the auto sector is likely to be sustained over the coming quarters, which should support growth.

The housing sector has also showed some signs of improvement recently. Unlike the auto sector that did not experience a bubble in sales or prices, the housing sector is still working off some of the excesses that made it the focal point of the economic crisis. In particular, the supply of housing units still appears fairly elevated in relation to the number of households. As a result, we do not expect housing starts to rebound sharply from current levels and do not think the housing sector will likely have a large direct impact on GDP growth in the near term. With starts at very depressed levels, however, we do not think home construction will be a drag on growth. Also, low levels of starts should allow household formation to absorb excess supply more rapidly, though this will still likely take several more years.

Another positive is that house prices are showing signs of stabilizing and may have a favorable indirect impact on economic activity. The ratio of the median existing house price to the median family income has now fallen back well below the average ratio. (See Figure 11.) In addition, house price indices that exclude distressed home sales, which tend to be done at steep discounts and thus distort measures of overall pricing, are flattening out. Any price stability would improve confidence and increase transaction activity, which would generate additional economic benefits because of increased spending on remodeling and other items.

Europe:

Deleveraging Far From Over and Likely to Remain a Headwind to Growth; Crisis to Persist

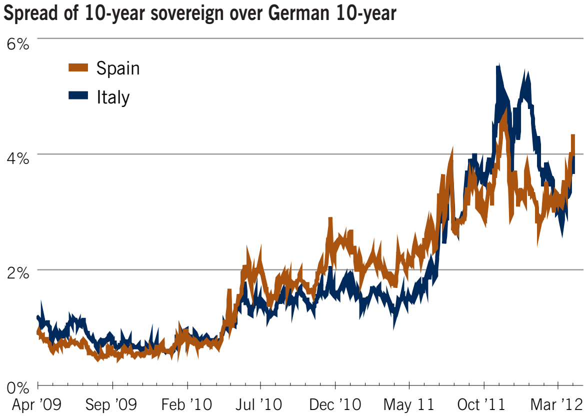
We continue to think the European crisis poses a critical risk to the global economy and are concerned about the slowdown in economic activity and the continued failure to reduce high levels of debt. The crisis in Europe is directly related to the accumulation of excessive amounts of debt in the household, corporate, financial, and government sectors and will likely require a considerable amount of deleveraging to resolve.

Crisis Beginning to Re-intensify as Weakening Economic Backdrop Making Deleveraging Increasingly Difficult

Amid weakening economic conditions, funding pressures appear to be re-intensifying in several European countries. The 10-year sovereign bond yield in Portugal remains very elevated, and Italian and Spanish 10-year sovereign yields have started to rise recently relative to German 10-year yields. (See Figure 12.)

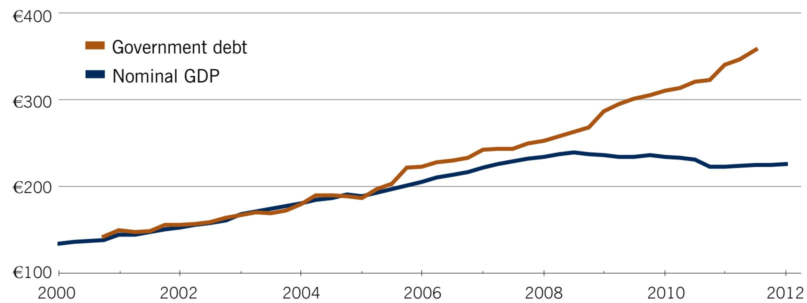
Economic conditions are particularly difficult in Portugal where real GDP fell around 5% on an annualized basis in the fourth quarter of 2011. Activity has remained weak since then. Portugal is currently expected to return to private markets for funding in 2013, but this is highly unlikely in our view given current Portuguese bond yields. The 10-year Portuguese sovereign currently yields 12%, and the two-year yields 14%. It is therefore probable that Portugal will need to renegotiate a funding agreement at some point this year and could even eventually be forced into default as Greece was if conditions do not improve.

FIGURE 12
European bond yields
Spread of 10-year sovereign over German 10-year



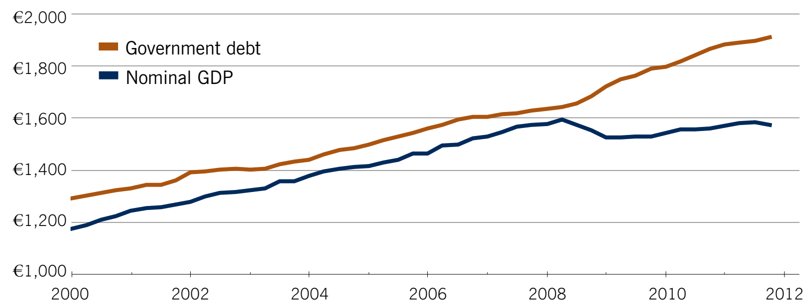
Source: FactSet; data provided from 4/2009 through 4/2012

FIGURE 13
Greece: nominal GDP versus total government debt
Billions of euros



Source: FactSet, EuroStat; data provided from 3/2000 through 3/2012

FIGURE 14
Italy: nominal GDP versus total government debt
Billions of euros



Source: FactSet, EuroStat; data provided from 3/2000 through 3/2012

News from Italy and Spain has also been disappointing. Both economies declined in the fourth quarter, and data for the first part of 2012 remained quite weak. Italy appears to be making some progress in enacting positive structural reforms, but it is uncertain how much these reforms will boost growth and when this might occur. Spain has been under even more pressure recently after significantly missing its government budget target for 2011 and shifting its 2012 deficit-to-GDP target from the previously agreed 4.4% to 5.3%.

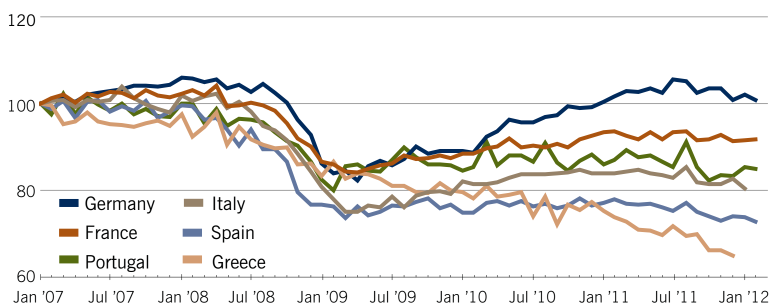
Growth is a key element in the current crisis in Europe, and we think it will garner increased attention if economic conditions remain weak. In the effort to deleverage and reduce the ratio of debt to GDP, the pace of GDP growth is critical. As growth slows, government spending usually rises due to increased costs for unemployment and other social benefit programs at the same time that government revenues typically weaken. In combination, weaker GDP growth thus not only reduces the denominator in the ratio of debt to GDP, but can also make it very difficult to slow the growth in the numerator. This interaction was particularly problematic in Greece where the ratio of debt to GDP rose sharply due to both a fall in GDP and an inability to slow the rise in debt. (See Figure 13.) Somewhat worryingly, the pattern of nominal GDP and government debt in Italy is not too different. (See Figure 14.) We worry that without growth, Portugal, Spain, or Italy could become trapped in a dynamic in which growth slows but debt continues to build. We therefore think that a return to economic growth will be critical to successful deleveraging and to resolving the present crisis.

Unfortunately, at the same time that we view growth as a key issue in the European crisis, economic activity remains quite weak. Industrial production is below its level at the beginning of 2007 in every major Eurozone country except for Germany and has recently begun to stagnate in France and fall further in Italy, Spain, Portugal and Greece. (See Figure 15.) In addition, most Eurozone countries are planning significant fiscal tightening this year, which will further slow growth. (See Figure 16.) In many of the larger countries like Italy and Spain, the tightening that is planned this year will be substantially more than was instituted last year.

Greece Still a Risk Even After Debt Writedown

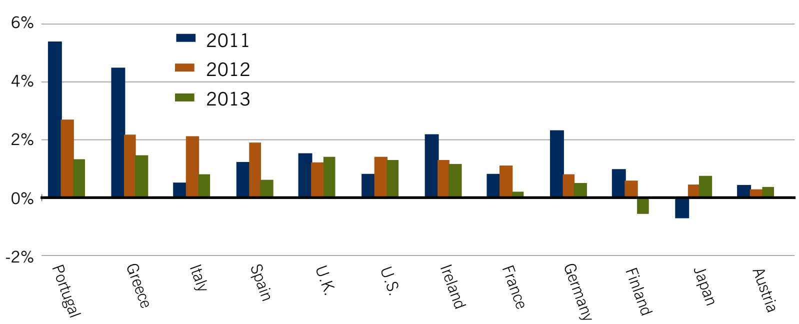
In addition to the risk that Portugal will need another bailout and the negative impact of slower GDP growth in Italy and Spain, we continue to be worried about Greece. Even after the roughly 70% writedown on privately held Greek sovereign debt, the IMF does not predict that Greece will be able to reduce its ratio of debt to GDP to below 120% until 2020. Moreover, this forecast is predicated on the belief that economic growth in Greece will soon pick up. In each of its previous four forecasts, the IMF has predicted just such a pickup and has been wrong. (See Figure 17.) A recently leaked IMF report acknowledged the risk of being wrong again and looked at an alternative scenario in which growth was slower and structural reforms were delayed. In this alternative scenario, Greece's debt was projected to be 145% of GDP in 2020. This same report also noted that "the prospects for Greece to be able to return to the market at the end of the program are uncertain." Given these concerns and the potential that Greece will miss its most recent budget targets and may not be able to fund itself privately, we think that Greece will probably require an additional bailout. With the willingness of fellow Eurozone countries to keep funding Greece seemingly waning, we think there is a risk that Greece could default on some of its remaining debt or could leave the Eurozone entirely. Such a situation could have substantial negative reverberations throughout the Eurozone.

FIGURE 15
Europe manufacturing industrial production
Indexed to 100 in 2007



Source: FactSet, EuroStat; data provided from 1/2007 through 2/2012

FIGURE 16
Incremental fiscal tightening* by year



*Measured as the change in the cyclically adjusted structural budget balance as a percent of potential GDP
Source: IMF World Economic Outlook September '11, IMF Fiscal Monitor Update January '12

LTRO Program Removes a Risk But Does Not Resolve the Crisis; "Firewall" Still Too Small

One of the biggest recent changes in the European crisis was the European Central Bank's (ECB) introduction of the Long Term Refinancing Operations (LTRO) last December. Through this facility, Eurozone banks borrowed a net amount of around €500 billion to €550 billion from the ECB for a three-year period at very low rates. This was a very positive development in that it helped alleviate bank funding stress and dramatically reduced the likelihood of a bank default or more severe credit crunch. Nevertheless, although the LTRO should give European leaders more time to find a solution to the crisis, the LTRO itself will do little to resolve it. In addition, while the LTRO may prevent a funding crisis for the banks, credit will likely still remain tight and thus weigh on economic activity. Euro area banks are estimated to need around €700 billion in long-term financing in 2012, so the LTRO only covers a portion of this amount. In addition, banks still need to significantly improve their capital ratios. Given each of these issues, we think banks will limit credit growth, and this will probably hurt economic activity.

European leaders also recently increased the size of the "firewall" to support stressed sovereigns from €500 billion to €700 billion. This increase is only temporary, however, in that it is achieved by combining the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) for the period that they overlap before the EFSF expires in late June 2013. Moreover, even the €700 billion is small compared to the estimated roughly €1.3 trillion that the stressed sovereigns of Greece, Ireland, Portugal, Italy, Spain, and Belgium will need to issue in 2012 and 2013. If conditions deteriorated and these sovereigns had to rely on funding from EFSF and ESM rather than private markets, these facilities might not be able to provide the necessary funding.

Energy Prices Not a Substantial Threat to European Economy at Present but Could Rise to Levels That Would Be If Conflict Broke Out With Iran

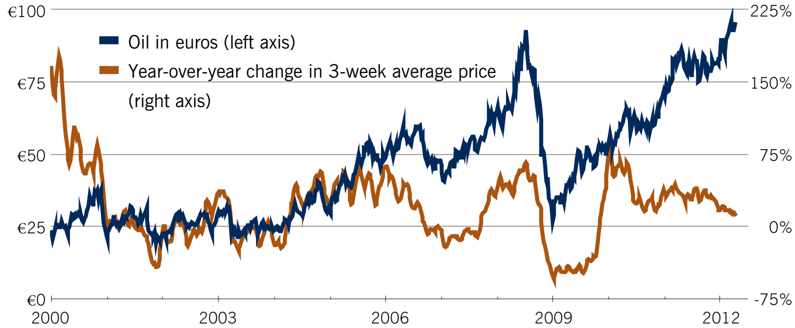
Unlike the United States, which has benefitted from lower natural gas prices and a stronger currency, energy prices are a bigger concern in Europe. Gas prices are generally linked to the price of oil in Europe and are therefore not providing much relief as in the United States. In addition, due to the depreciation of the euro, oil prices in euro terms are at new highs. While this is clearly negative for the European economy, fortunately the year-over-year increase in oil prices is not at extreme levels. (See Figure 18.) This is one reason that CPI inflation has remained below 3% in spite of oil prices being at new highs. (See Figure 19.) We therefore think that the rise in energy prices alone will not cause growth to slow sharply in Europe. If energy prices spike higher as a result of a conflict with Iran, however, European economic activity likely would suffer and the impact would probably be even greater than in the United States where there is the offset of lower natural gas prices and a stronger currency.

Politics a Significant Risk in Europe

Politics pose a significant risk to Europe. In Greece, elections will take place in early May. Politics in Greece are highly fragmented, represented by two main parties, the conservative New Democracy party and the more liberal PASOK socialist party. These parties recently polled around 22% and 15% of the total vote, respectively, according to a recent RealNews poll. This same poll showed that there are as many as 8 parties that could exceed the 3% threshold required for representation in the parliament. These parties range from the anti-euro Communist Party to the neo-Nazi Golden Dawn party. This high degree of fragmentation and enormous disparity in possible representatives may make it very difficult for the next parliament to institute the reforms required by the recent bailout. In addition, the election of a fragmented and contentious government could also further erode the willingness of other European countries to continue supporting Greece if an additional bailout is ultimately needed.

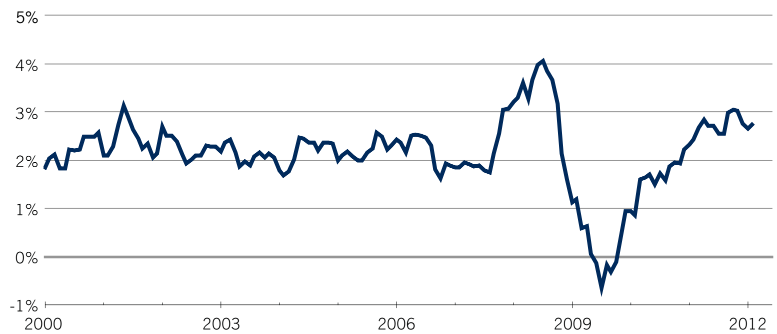
France will also soon hold key elections with votes for the next president scheduled to take place on April 22nd (round 1) and May 6th (round 2). Recent polls indicate that current President Nicolas Sarkozy and socialist candidate Francois Hollande are likely to win the first round, with Hollande leading Sarkozy in the second round by around 10 percentage points. Importantly, Hollande has pledged to renegotiate the recent fiscal treaty, and we worry that this renegotiation could disrupt Europe's already delicate situation. The treaty is also at risk of rejection in the Netherlands as well as from a referendum in Ireland. The European economy could be destabilized if either of these countries rejects the treaty.

FIGURE 18
Crude oil in euros



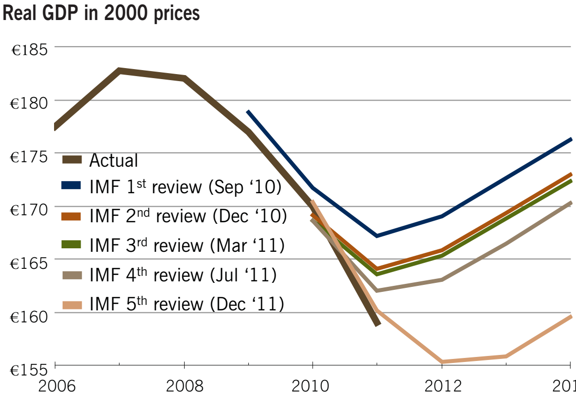
Source: FactSet; data provided from 1/2000 through 4/2012

FIGURE 19
Eurozone CPI inflation
Year-over-year change



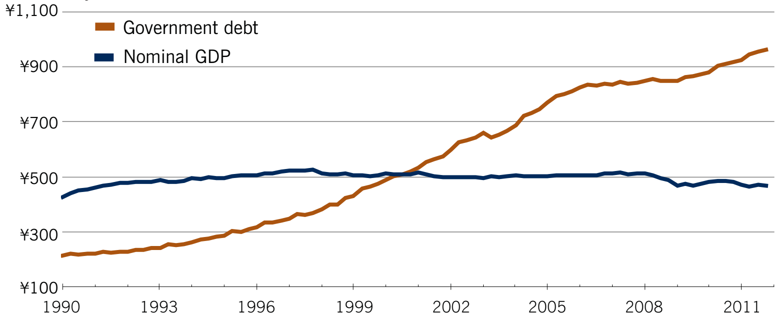
Source: FactSet; data provided from 1/2000 through 2/2012

FIGURE 17
Greece real GDP: actual versus various IMF forecasts
Real GDP in 2000 prices



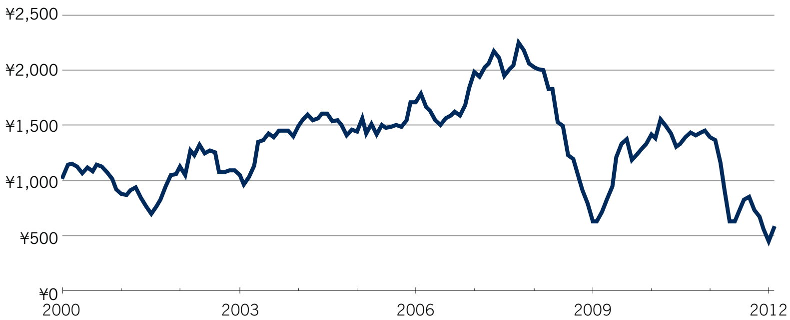
Source: IMF, Eurostat (with preliminary '11 estimate for Greek GDP); data provided from 2006 forecasted through 2014

FIGURE 20
Japan: nominal GDP versus total government debt
Trillions of yen



Source: Japan Ministry of Finance, FactSet; data provided from 3/1990 through 12/2011

FIGURE 21
Japan current account balance (3-month average)
Billions of yen



Source: Bank of Japan, FactSet; data provided from 1/2000 through 2/2012

Japan:

High Amount of Leverage Poses Long-Term Risk to Japanese Economy

Japanese government debt has been steadily rising over the past two decades while nominal GDP has mostly remained flat. (See Figure 20.) As a result, the ratio of government debt to GDP in Japan is now at around 200%, the highest of any major country in the world. Despite this large amount of debt, however, government bond yields and thus the interest expense on the debt have remained quite low. Only around 8% of Japanese government debt is held abroad, and domestic holders of the rest of the debt are willing to accept low nominal yields as long as inflation is expected to remain very low or negative.

Currently, the Japanese economy appears to need increased foreign ownership of its debt. First, due to the aging population, pension funds and other domestic holders of the debt may soon need to reduce their holdings in order to make obligated retirement benefit payments. As this happens, domestic sellers of debt may have to look abroad to find new buyers. Second, the current account surplus in Japan is falling. (See Figure 21.) If the current account continues to deteriorate, Japan will have to fund any deficit with inflows from abroad. These changes could push interest rates higher if foreign buyers demand higher returns than domestic investors. Given Japan's high level of debt, even a small rise in interest rates could cause overall interest payments to increase sharply.

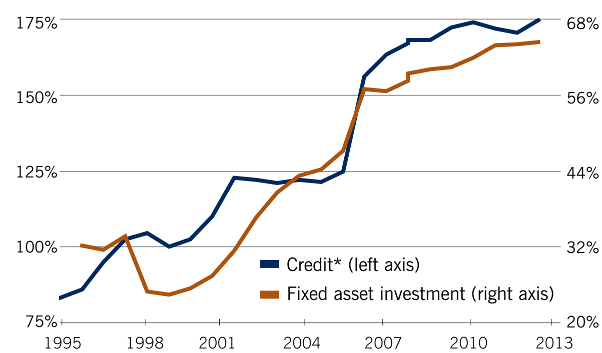
Energy Prices and Possibility of Conflict With Iran Pose Larger Challenge for Japan

Rising energy prices and the potential for even higher prices pose a big threat to the Japanese economy given its heavy dependence on imported energy. This is especially true after Japan's substantial reduction in the use of nuclear power generation in the wake of last year's Fukushima disaster. In Japan, 46% of energy consumption is from oil compared to 37% in the United States. Of that, 75% of Japan's oil comes through the Strait of Hormuz, which means that the Japanese economy is one of the most exposed to any potential closure of the Strait. Even if the Strait is not disrupted, Japan is still likely to suffer disproportionately from a conflict with Iran since a very large 9% of its oil imports come from Iran.

Bank of Japan Taking Action to Stimulate Growth

A key positive development for the Japanese economy in recent months is that the Bank of Japan (BOJ) has renewed its efforts to further stimulate the economy. The BOJ recently surprised markets by increasing its asset purchase program by ¥10 trillion. In addition, the BOJ has adopted a more explicit inflation target of 1% and said that temporary factors like food and energy prices will be excluded from the target. One favorable consequence of these actions is that the yen has eased from its recent highs, which should help support the economy and the stock market.

FIGURE 22
China: credit versus fixed asset investment in relation to GDP
Percent of GDP

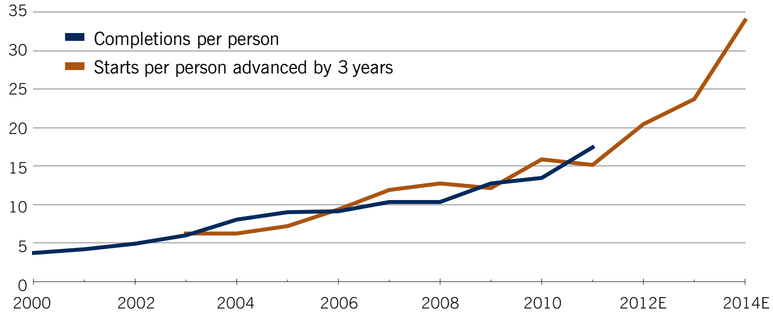


*Based on bank loans as a share of GDP through 2001 and the total social financing measure of lending thereafter
Source: China Economic Information Network, Bloomberg, CLSA, ICAP; data provided from 12/1995 through 12/2011

FIGURE 23

China total construction completed per person per year

Square feet



*Assumes urban population growth of 21 million in '11 through '14 versus avg. of 21 million from '05 to '10

Source: China National Bureau of Statistics, ICAP; data provided from 12/2000 forecasted through 12/2014

Emerging Economies:

Growing Risk of Slowdown from Deleveraging

Emerging economies and China in particular are also facing the need to deleverage. Unlike developed economies that accumulated large quantities of debt prior to the economic crisis, China added a substantial amount of debt during the crisis to cushion its impact. Although this succeeded, the economy must now confront the repercussions of having added so much debt in such a short time period. Authorities are trying to smoothly manage the necessary deleveraging, but we have recently become more concerned that this transition may be bumpy, especially given the size of the investment and construction sectors that are the focus of the government's efforts to cool the economy.

The main avenue through which the explosion in lending in China supported economic growth was through an increase in investment spending. This can be seen in the close relationship between lending and fixed asset investment, both of which surged in relation to overall GDP in 2008. (See Figure 22.) At present, however, the government is concerned about both the expansion in lending and investment and is taking steps to bring both back to more sustainable levels in relation to GDP. Authorities are trying to contain the risk of default on loans that may have been made imprudently during the massive credit expansion. A lot of the lending that took place involved off-balance sheet local government funding vehicles (LGFV). At the end of 2010, this debt was estimated at near RMB11 trillion or close to 30% of GDP. While we think the central government has the capacity to absorb losses on this lending and could thus prevent a banking crisis, we are worried that high default rates could slow future lending and thus future investment spending growth.

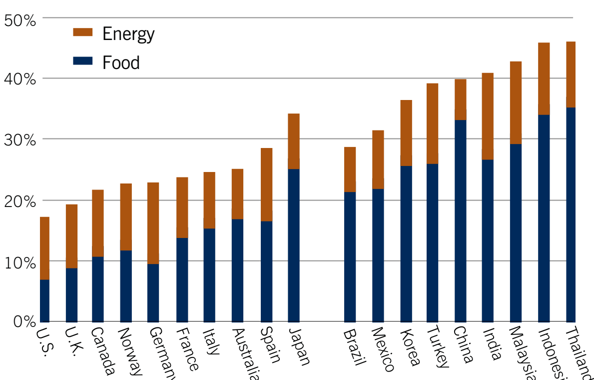
Within the category of fixed asset investment, the construction sector was a key beneficiary of the lending surge in China and is now the major focus of the government's efforts to reduce the economy's high dependence on investment spending. In our view, the construction sector is also a key risk for the Chinese economy as the full extent of the lending and construction surge that started in 2008 has yet to be felt. Construction starts tend to lag behind completions by around three years, which is logical since the majority of construction taking place is larger buildings that take roughly this amount of time to construct. This lag means that even though there are worries that the construction sector is already over-saturated in certain areas, completions are likely to double in the next several years. This could greatly exacerbate any issue of oversupply. On a per capita basis, China put in place roughly 17 square feet of residential, office, and other construction per person in 2011, but this number is likely to approach 35 square feet by 2014 based on the current level of starts. (See Figure 23.) The amount of construction started has recently begun to fall on a year-over-year basis, and this has a number of investors concerned. Yet, starts may have to slow substantially further in order to come into line with potential demand.

Overall, our major worry about China is the risk of a misstep in the government's effort to deleverage. Given the investment sector's large share of GDP, any overcorrection in the efforts to slow lending and investment runs the risk of causing a larger than planned slowdown in overall GDP growth. In the construction sector, we think activity may need to slow even more sharply than is expected given the enormous glut of supply that is set to come online. With fixed asset investment in real estate estimated to constitute approximately 15% of GDP, a more severe slowdown in this sector alone could cause overall growth to weaken more sharply than expected.

Energy a Risk to Emerging Economies Given the High Share of Consumption Devoted to Food and Energy

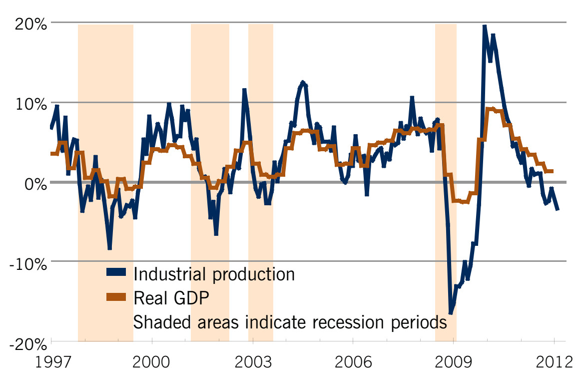
The risk of higher energy prices is a particularly large concern for emerging economies. Food and energy generally constitute a larger share of household spending and consumer price indexes in emerging economies than in developed economies. (See Figure 24.) Any increase in energy prices would therefore disproportionately affect emerging economies. Moreover, food prices could also move higher if energy prices rise. Food and energy prices tend to be somewhat correlated since energy is an input in crop production and some basic crops like corn and soybeans can be substitutes for oil through ethanol. This could make the impact of an energy price increase even worse for emerging economies.

FIGURE 24
Food and energy share of consumer price index



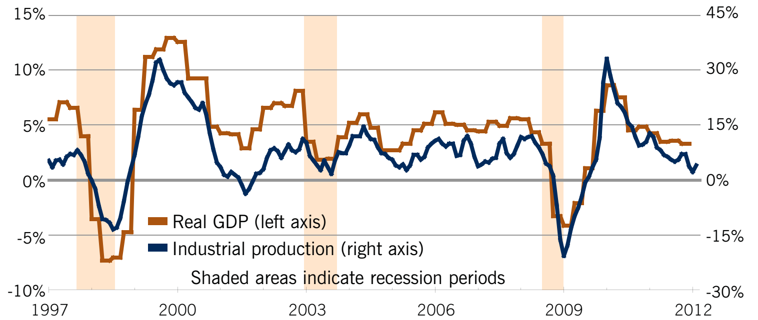
Source: Credit Suisse; data provided as of 9/2011

FIGURE 25
Brazil real GDP and industrial production
Year-over-year change



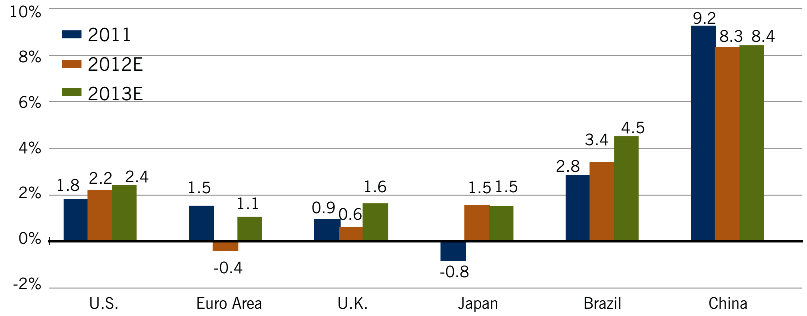
Source: FactSet, IBGE; data provided from 1/1997 through 2/2012

FIGURE 26
South Korea real GDP and industrial production
Year-over-year change



Source: Bank of Korea, Korean National Statistics Office, FactSet; data provided from 1/1997 through 2/2012

FIGURE 27
Consensus 2012 and 2013 real GDP forecasts by country



Source: Bloomberg

Other Key Emerging Economies Showing Signs of Slowing

In addition to the increased risk of a slowdown in China, other key emerging economies are already showing signs of slowing. In Brazil, industrial production has remained lackluster over the past several months, suggesting that real GDP growth may remain subdued. (See Figure 25.) Industrial production has also slowed in South Korea, which indicates that real GDP growth there may also remain under pressure. (See Figure 26.)

Overall, Global Growth Likely to Remain Subdued and Risks Have Risen

In summary, our base view that real global GDP will expand by a relatively modest 2% to 2.5% in 2012 has not changed. However, we have become somewhat more worried about risks to this forecast and think the range of potential outcomes is fairly wide at present.

Although consensus economic forecasts in key regions around the world generally call for growth to remain somewhat subdued this year, growth is expected to increase in 2013. (See Figure 27.) Given the risks facing the economy and depending on the trajectory of growth over the course of this year, we worry that the expectation for faster growth next year could prove optimistic. We will closely monitor the risks from deleveraging, energy prices, and politics for any indication that growth could either be weaker than expected this year or may fail to pick up next year.

Equity Rally Continues

In the first quarter of 2012, equity markets generally continued the rally that began in October of last year. Japan was one of the best performing markets in the world last quarter as the actions by the BOJ and the weakness in the yen helped boost equity performance. Spain and Portugal were among the worst performing markets as financial stresses remained high in Portugal and fears about Spain began to resurface. The performance of the S&P 500 Index was in the middle of the pack with a total return of 12.6% for the quarter.

Cyclical Sectors Outperformed in the First Quarter; Most Sectors Other than Financials Are Back to Pre-Crisis Levels

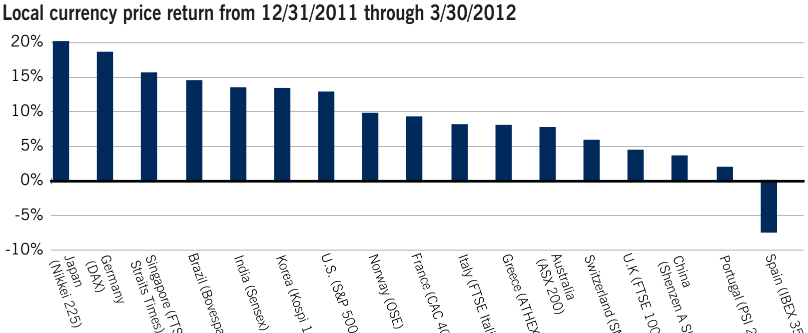
In the United States, on a sector basis, cyclical sectors generally performed better in the first quarter of the year. The financial and technology sectors offered the best total returns for the quarter at 22% and 21%, respectively. Conversely, the more traditionally defensive telecom and utility sectors had the worst performance with total returns of 2% and -2%, respectively.

After the recent rally, almost every sector in the S&P 500 index other than financials is back to pre-crisis levels on a total return basis. (See Figure 28.) The financial sector is still roughly 40% below its level at the beginning of 2008.

FIGURE 28

Returns for major equity indexes in select countries

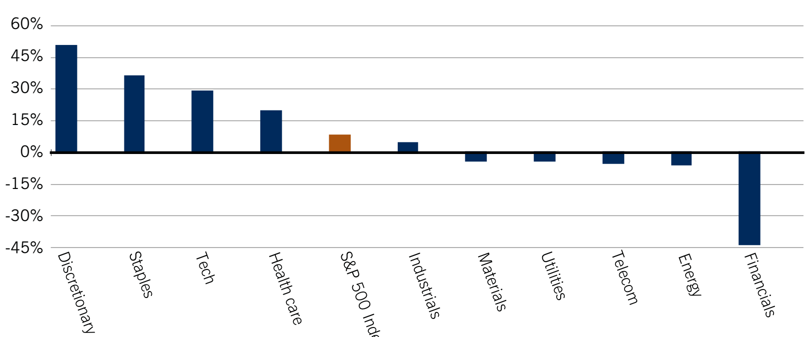
Local currency price return from 12/31/2011 through 3/30/2012



Source: FactSet

FIGURE 29

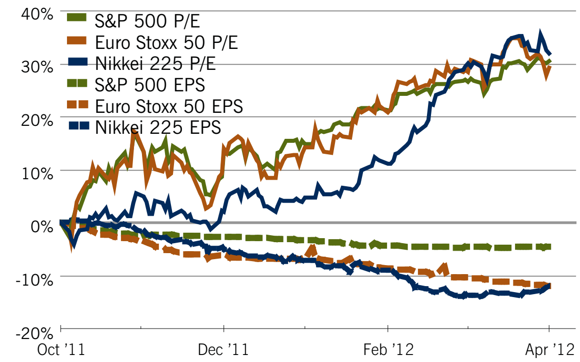
S&P 500 total return by sector since the end of 2007



Source: FactSet

FIGURE 30

Index return components ('12 EPS and P/E): U.S., Europe, Japan



Source: FactSet; data provided from 9/2011 through 3/2012

Multiple Expansion Drove Recent Rally as Earnings Estimates Are Generally Lower

Since the rally began in October of last year, major global equity markets are generally up by between 20% and 30%. The key driver behind this gain was an expansion in the price-to-earnings (P/E) multiple rather than increased earnings estimates. For key indexes in the United States, Japan, and Europe, earnings estimates for 2012 are between 5% and 15% lower than they were at the start of the rally, but P/E multiples on 2012 earnings estimates are between 25% and 35% higher. (See Figure 29.) We think this expansion in P/E multiples reflects investors' general view that economic risks from the crisis in Europe or a hard landing in China have eased since the fall of last year.

Earnings Estimates Receding But Still Appear Somewhat Optimistic

In the United States, 2012 consensus earnings estimates for the S&P 500 Index have come down from $113 in July of last year to around $105 at present. (See Figure 30.) Although estimates look much more reasonable to us now, they still call for an earnings-per-share increase of nearly 10%. Given the challenging macroeconomic environment, we think estimates could come down even further.

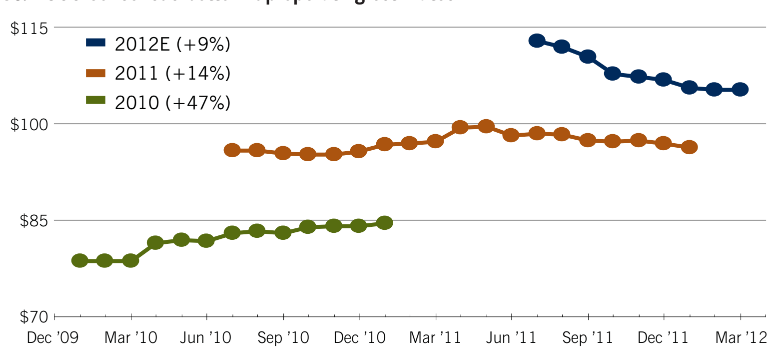
Margins Elevated, but Lack of Upward Pressure on Wages May Sustain Them in the Near Term

A key reason that corporate profits recovered more strongly than other parts of the economy in the past few years is because of significantly higher profit margins. Pretax margins for nonfinancial corporations are at 40-year highs, as reported in the Bureau of Economic Analysis' Net Income and Product Account (NIPA) data. This is somewhat surprising. Margins generally tend to track sales growth, but they have remained elevated in spite of decelerating sales. (See Figure 31.)

To explain the divergence between margins and real corporate sales growth, we looked at the underlying components of margins using the same NIPA data. This data shows that while taxes and depreciation have generally stayed constant as a percentage of sales in recent years, interest expense and labor costs have fallen sharply. (See Figure 32.) The decline in interest expense is consistent with low interest rates and the reduction in corporate debt. The fall in labor expense is also not terribly surprising given the high unemployment rate and lack of upward pressure on wages. Over the long term, we think the labor share of corporate sales will likely rise and margins will tend to shrink. In the near term, however, given the high unemployment rate, we think that labor expenses are unlikely to rise sharply as a percentage of corporate sales. Margins could remain somewhat elevated, as a result. We do not, however, expect much in the way of margin improvement from here, since sales growth is slow and the unemployment rate is beginning to recede.

FIGURE 31

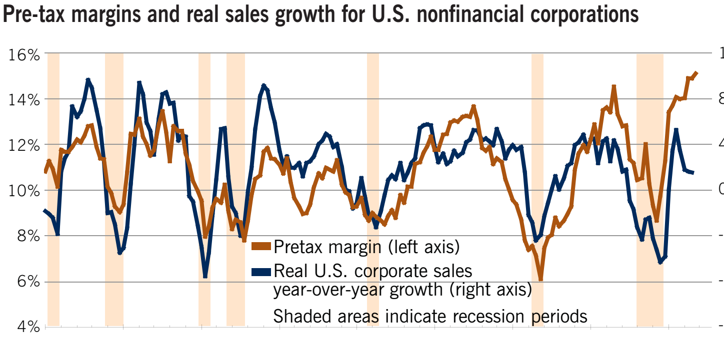
S&P 500 consensus bottom-up operating estimates



Source: FactSet; data provided from 12/2009 through 3/2012

FIGURE 32

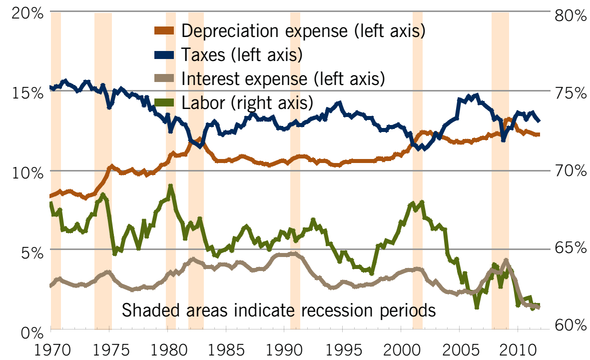
Pre-tax margins and real sales growth for U.S. nonfinancial corporations



Source: FactSet, Bureau of Economic Analysis, Bureau of Labor Statistics, ICAP; data provided from 3/1970 through 12/2011

FIGURE 33

Expenses for nonfinancial companies as a percent of sales



Source: Bureau of Economic Analysis, FactSet; data provided from 3/1970 through 12/2011

Equities Appear Reasonably Valued on Trend Earnings, but Very Attractive Against Fixed Income Alternatives

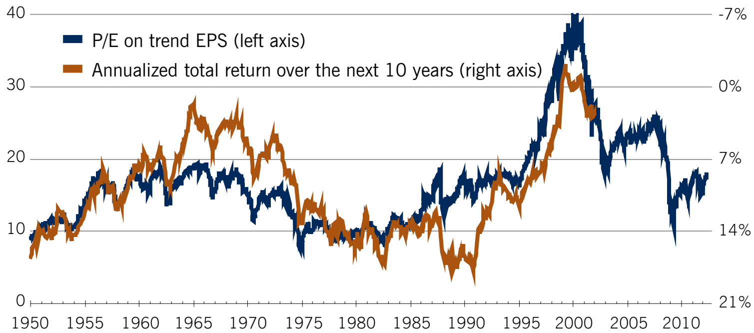
We prefer to value equities in relation to the long-term trend in earnings going back to 1950. This method avoids the issue of cyclicality in the economy as well as the impact of elevated or depressed margins. At present, equities are trading at a P/E multiple of nearly 18x trend earnings, which is above the long-term average P/E of 17x.

Over time, the P/E on trend earnings has tended to offer some indication regarding equity returns over the following decade. When we overlay the P/E on trend earnings with the annualized total return of the S&P 500 Index over the subsequent ten years, a relationship is apparent. (See Figure 33.) A scatter plot of the same data also highlights the relationship. (See Figure 34.) At the current P/E of 18x trend earnings, this simple association suggests that equities would return 7% to 8% per year in nominal terms over the next decade.

Although equities appear relatively reasonably valued in a historical context, they look much more attractive compared to fixed-income alternatives. While the equity P/E on trend earnings is roughly at its historic average, both the yield on 10-year Treasuries and the yield on the Moody's index of BAA-rated corporate bonds are close to historic lows. To directly measure Treasury yields to equities using our measure of trend earnings, we compared the 10-year treasury yield with the earnings yield on trend earnings, which is just the inverse of the P/E. This shows that although the 10-year Treasury yield and the equity yield on trend

FIGURE 34

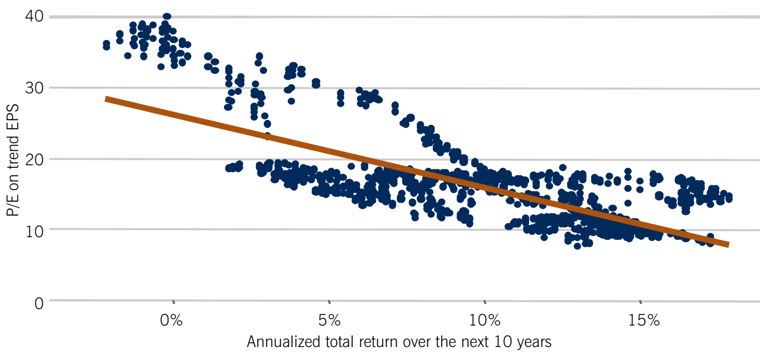
S&P 500 P/E on trend EPS versus annualized returns over the subsequent 10 years



Source: FactSet, ICAP; data provided from 12/1949 through 3/2012

FIGURE 35

S&P 500 P/E on trend EPS versus annualized returns over the subsequent 10 years
Weekly data since 1950



Source: FactSet, ICAP; data provided from 12/1950 through 3/2012

earnings have historically been somewhat close, the equity yield on trend earnings is now substantially higher than the Treasury yield. (See Figure 35.) This suggests that equities are much more attractive than Treasuries at current prices.

Continue to Focus on Stock-Specific Catalysts

Portfolio changes in the first quarter largely reflected company-specific developments and changes in valuation. We continue to maintain the theme that the "strong will get stronger" and believe that stocks with strong balance sheets and dominant market positions will weather difficult economic conditions and gain share over the longer term. We also continue to employ the portfolio theme called "earn and return cash." In an environment of very low interest rates and subdued economic growth, we think companies that can organically grow earnings and return significant amounts of cash to shareholders will attract investors.

As always, ICAP continues to use a bottom-up process to determine valuation and stock-specific catalysts. These catalysts reflect factors such as a management change, a new product, a financial restructuring, a problem-fixing situation, or a change in pricing dynamics. The following examples highlight the types of stocks and stock-specific catalysts at work in the portfolio.

U.S. Portfolio

Management:

Having taken the helm as CEO in 2011, Ian Read is taking aggressive action to restructure Pfizer and orient the company towards improving shareholder returns. Pfizer sells more than $60 billion of traditional pharmaceuticals, vaccines, infant formula, over-the-counter medicines, and animal health products annually. The 2009 purchase of Wyeth gave Pfizer the majority of its current non-pharmaceuticals businesses. Unlike pharmaceuticals, where value is tied to a patent with a finite life, these businesses rely more on brands, distribution, and manufacturing technology to drive sustainable sales. As the market seemingly was not applying an adequate valuation for these diversified businesses within Pfizer, management announced in 2011 it would pursue divestitures of its Nutritionals and Animal Health businesses. Together these units account for about seven percent of company profits but could fetch more than 15% to 20% of Pfizer's current market capitalization if divested.

In addition, Read has announced step-function changes in the level of cash the company will spend on research and development (R&D). This comes after a decade or more of seeing extremely low returns on this sort of investment. Prior to the merger with Wyeth, the companies together spent about $11 billion annually on R&D. While this spending had already fallen to around $9 billion through merger-related cost cutting, Read's team is targeting just $6.5 billion to $7 billion for this year. The magnitude of this cut is unprecedented in the industry, and we see it as a sign that Read is bringing an increased sense of discipline to capital allocation decisions. We do not think these decisions will impair Pfizer's future growth opportunities. In fact, and somewhat ironically in the context of the aforementioned spending cuts, the company's research pipeline is looking fuller than it has in over a decade. Anchoring this set of products is Eliquis, a blood thinner that has proven effective in preventing strokes in patients with irregular heartbeats. Eliquis is expected to launch this year. A new drug for rheumatoid arthritis and expanded usage of its Prevnar13 vaccine in adults offer Pfizer additional significant near-term growth opportunities.

We expect management to use the majority of the proceeds from any asset sales, as well as cash generated from improved ongoing operations, for share repurchases and higher dividends. Not including any proceeds from the Nutritionals and Animal Health sales, the company plans to purchase $5 billion of stock in 2012, in addition to roughly $6.5 billion of regular dividends. This combination equates to around seven percent of the company's current market capitalization. Management has also committed to raising its dividend payout ratio from around 32% in 2010 to around 40% by 2013. In the context of positive long-term earnings growth, we believe this cash return story will prove very attractive to investors.

New Products:

Cisco Systems is the largest provider of networking-related products in the Local Area Network (LAN) and Wide Area Network (WAN) environments, and has leading shares in most switching and router segments. Having experienced market share losses and declining margins, Cisco announced a new three-year business strategy that targets leadership in the core (switching, routing, and services), and ramping up its new products in major technology and business architectural transitions, such as data center virtualization, mobility, security, and video collaboration. The company refreshed its switching portfolio, which has improved market share and gross margins. Cisco sees potential for additional incremental gains. It also has been investing more capital into the new product segment, driving nearly 50% of its growth in the first half of the current fiscal year. We expect the trend to continue as the company focuses on expanding its new product portfolio while integrating multi-disciplinary products into a complete solution. In addition, Cisco has also reduced its headcount to improve margins, and it has streamlined its corporate structure to allow its employees to react more quickly and use the firm's scale to its advantage. This balance of combining focused investing in faster growing categories with better operating expense control should allow Cisco's management team to continue to execute effectively.

Restructuring:

ConocoPhillips is an integrated, international energy company. Over the past couple of years ConocoPhillips has undergone a dramatic restructuring, creating what we believe to be significant shareholder value. This entailed about $20 billion of non-core asset sales, including $9.5 billion of Lukoil stock. The sales proceeds, along with excess free cash, were used to reduce debt by $6 billion and repurchase $15 billion of stock, which equated to 15% of outstanding shares. Management also walked away from large, low-return investment projects, like the Shah gas project in Abu Dhabi and the Yanbu refinery project in Saudi Arabia, which we believe clearly exhibits a commitment to improved returns rather than scale. Looking ahead, we see a host of additional steps that should add incremental value. First, an additional $10 billion of asset sales are anticipated this year, with all of the proceeds going towards share repurchases. Considering the high multiples we continue to see for energy assets and the low valuation of ConocoPhillips (~8x P/E) we believe the share buybacks will help enhance the stock price. Next, COP will split the company into two separately traded entities on May 1. The legacy company will consist of the exploration and production assets, and we think investors have underestimated the possibility of additional large asset sales or restructuring. More specifically, management could sell lower growth, mature assets (e.g. North Sea) or spin out higher-growth assets that would trade at a premium valuation (e.g. Asia Pacific or North America). A new company, Phillips 66 (PSX), will be spun to shareholders and will consist of the refining and marketing, chemical and midstream assets. We think investors will want to retain PSX given its attractive growth options in Chemicals, the restructuring potential in Midstream and significant free cash generation, which will be applied to debt reduction and eventually share repurchases.

Problem Fixing:

Applied Materials is the leading semiconductor equipment manufacturer in the world. It primarily operates in the front-end process of semiconductor manufacturing, but also in areas including flat panel display, solar energy, and customer support services. Although the semiconductor equipment industry is expected to sustain its strong growth driven by mobility, the company's display and solar businesses have remained an issue for the company due to the significant overcapacity in those industries in the past few years. Encouragingly, management has been cutting costs in the troubled areas and expects the solar and display business to breakeven in the next 12 to 18 months. With these problems being addressed and fixed, we think investors will be able to refocus on the semiconductor equipment business where investment is currently being led by customers who want to participate in new end markets, such as tablets, smartphones, and other form factors, which all require substantial capacity additions. The company actually expects to gain market share in the next few years due to its research and development advantage over competition. We expect Applied Materials to improve its earnings power in the next few years as a result of continuing growth in the semiconductor equipment industry, market share gains, and its improving cost structure.

Pricing Flexibility:

Time Warner's management is focused on wringing the most value out of its current stable of assets while being extremely disciplined with capital allocation. Cable networks (TNT, TBS, CNN, and HBO) are Time Warner's primary source of profit and, in our opinion, should produce strong and stable growth for several years. The cable networks have invested in original programming and sports content (e.g. MLB, NBA, NCAA), which has enabled them to command higher affiliate fees (fees from cable or satellite operators that are paid to content owners) and higher advertising prices. In addition to affiliate fee increases, Time Warner's "TV Everywhere" and "HBO Go" initiatives will enable consumers to watch programming from computers and tablets, which we expect may increase viewership (higher advertising rates) and improve subscriber retention (higher affiliate fees). On the content production side, Warner Brothers is the leading film and TV production studio in the world. Although investors are concerned with how digital media will affect profits, much of the innovation in this sector occurs in distributing the content, not creating it. Thus, more outlets are bidding for the TV shows and movies that Warner Brothers produces, which should result in higher prices for exclusive content or additional buyers of the same content. We believe that, as the largest producer of television and film content, Time Warner has an underappreciated opportunity to benefit from this environment in which digital rights can provide an additional revenue stream. Time Warner has also shown a commitment to shareholders by repurchasing a significant amount of stock in 2011. Purchases are expected to continue at a strong pace in 2012.

International Portfolio

Management:

Over the past decade, DBS Group has grown steadily, capitalizing on its position as one of the largest banks in Singapore. However, lack of execution led to below-peer return on equity (ROE) with DBS's historical ROE some 200 basis points below that of its two major peers. The hiring of current CEO Piyush Gupta in late 2009 heralded a new strategy that focused on expanding DBS's presence throughout Southeast Asia and cementing their market leadership in their home market of Singapore. The bank has invested in people and technology during the past two years, which resulted in improved revenue growth and deeper wallet penetration within their customer base. Market shares in Singapore have improved in the past year, and DBS is gaining banking share outside of Singapore, namely in trade finance and other growth markets where China, Taiwan, India, and Indonesia now account for 19% of group earnings. We believe the bulk of this investment spending is now behind DBS, providing the bank with scope to increase expense efficiency and generate improvements in their ROE as they continue to grow. In addition, we believe the turmoil in the European banking system has opened up opportunities for DBS to leverage its strong credit ratings and Asian presence, taking market share in areas such as corporate cash management and trade finance. Our view is that management is pragmatically generating sustainable growth at DBS without sacrificing the bank’s historically conservative credit culture. The new strategy is improving financial results and continuing to generate strong levels of capital under the new Basel 3 global regulatory framework. Ultimately, we have confidence in management’s ability to drive growth at DBS and take advantage of market share opportunities.

New Products:

Nissan is one of the leading auto makers in the world, selling more than 4 million cars per year globally. The United States and emerging markets (mainly China) contribute more than 70% of the company’s operating profit, making Nissan a direct beneficiary of the cyclical recovery of auto demand in the United States and the secular growth in China. U.S. auto sales for Nissan in the year-to-date period have increased more than 7% from the 2011 level. The U.S. is a strong market where Nissan is refreshing more than half of its sales volume by introducing new/redesigned models, the highest renewal rate in the auto industry. This makes Nissan better positioned than its peers to benefit from the continuing U.S. sales recovery. With its V-Platform strategy, Nissan has also led the industry in making cars suited to the emerging markets. Supported by new products tailored to local demand, the company has outgrown its peers in China, where annual auto demand has more than doubled in the past three years. To tackle its capacity bottleneck in China, Nissan aims to expand its production base to 900,000 vehicles a year by 2012. This is more extensive than the other Japanese majors and should drive faster top-line growth than the rest of the industry. Supported by its stronger new product cycle and solid end market position, Nissan is expected to continue to outgrow its peers in the coming years.

Restructuring:

Siemens AG is a German conglomerate with operating groups organized broadly around three core sectors: energy (power generation, renewables, transmission, and distribution), industrial (automation, transportation, and lighting), and healthcare. Even though Siemens maintains leading positions in what we believe are attractive markets, the company’s overall execution and profitability have lagged behind its peers, forcing a shake-up. In mid-2007, Peter Loescher became the first outsider ever to head Siemens. Since taking the helm, Loescher has executed a restructuring program that encompasses widespread change, including: 1) identifying cost-cutting and productivity opportunities; 2) increasing management’s accountability by revamping compliance processes and changing executive compensation metrics; 3) simplifying the company structure around the three key end markets, leading to the sale of non-core businesses; and 4) improving capital allocation decisions, including increasing the dividend to a payout target ratio at 30% to 50% of net income. Now, the company is focusing more on both capital efficiency and growth targets. Management has set a return on capital employed (ROCE) target of between 15% and 20%, to be achieved even while accelerating growth and expanding its market position within emerging markets and infrastructure solutions. We believe that these restructuring actions and the new focus on growth and capital efficiency targets should support share price gains.

Problem Fixing:

Danone is the leading maker of fresh dairy (primarily yogurt) products worldwide, which account for 58% of its sales. Danone is also a leading player in water (#3 globally, 17% of sales), baby nutrition (#2 globally, 19% of sales), and clinical nutrition (#3 globally, 6% of sales), and is exposed to high-growth categories (dairy, baby, medical) and high-growth geographies (50% of sales in emerging markets). There are two regions within the dairy segment that Danone is working to improve: Russia and the United States. In 2010, Danone acquired Unimilk, a dairy company in Russia. While this acquisition provided significant cost-cutting and incremental revenue opportunities, the initial integration was disappointing, and profitability was a major concern. However, Danone's recent efficiency initiatives have caused margins in the region to nearly double from 2.3% in 2010 to 4.5% in 2011. The Unimilk integration in Russia is now on track with lower than expected dilution to the group margin, and it has set a base to expand distribution and increase brand awareness. In the United States, Danone entered the Greek yogurt business late, and as a result lost overall yogurt share to its peers. However, with its successful rollout of the Oikos brand and new capacity additions, Danone grew its Greek yogurt sales by 88% in the second half of 2011 compared to the first half of 2011. Management expects that additional production capacity in June 2012 and the expansion of national distribution for Oikos will produce further gains in the U.S. Greek yogurt segment. With these two areas improving, investors should refocus on Danone's entire portfolio, which we believe should continue to grow 5-7% organically, the fastest growing and healthiest among large global staples companies.

Pricing Flexibility:

Pernod Ricard is the second largest global spirits player behind Diageo. Their brands include Chivas, Absolute, Ballantine's, Martell, and Jameson. Thanks to its focus on premium brands (74% of group sales) and emerging markets (38% of group sales) where the number of affluent households is expected to grow fast, Pernod enjoys strong pricing power and flexibility. Pernod's top 14 premium spirits brands (60% of group sales) grew organic revenues 14% in the first half of fiscal year 2012, with 5% coming from pricing despite the challenging macro environment. Pernod's scotch brands are very strong throughout Asia where premium spirits sales are exploding. Asian organic revenues grew 18% in the period, much better than the group's 11%. The strong sales of these higher priced brands have provided strong profit growth. Pernod is reinvesting these profits into marketing, distribution, brand extensions, and new packaging designed to ensure their premium positioning for years to come. Total advertising and promotion spending increased by double-digits with most of the increase targeted at emerging markets where consumers are expected to continue to trade up from lower-quality local spirits.

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