Executive Summary

Economic Outlook

- The world economic outlook is more uncertain today than at any time since the 2008 financial crisis.
- The global economy’s performance in 2012 likely will hinge on whether European policymakers can stave off banking crisis and/or disorderly sovereign defaults.
- If policymakers are successful, we expect that a muddle-through scenario will prevail:
  - The U.S. and Japan continue with positive but unimpressive growth;
  - Europe experiences a mild rather than crushing recession; and
  - Emerging economies slow but maintain healthy rates of growth.
- Much time and credibility was squandered last year, but European policymakers showed some progress as 2011 ended and may eventually grope toward a solution in 2012.
- A disorderly default of a Eurozone country would likely trigger another widespread financial crisis and plunge the global economy into recession. A collapse of the common currency would usher in an even worse economic catastrophe.
- While the muddle-through scenario is still the most likely one, we cannot dismiss a more ominous outcome. The probabilities of the downside risk scenarios are non-trivial and rising.

Market Outlook & Investment Strategy

- The performance of markets in 2012 likely will hinge on the binary economic outlook described above.
- Risk assets are attractively valued relative to safe assets, so if the economy can find a way to muddle through in 2012, we expect that stock markets may potentially deliver double-digit gains.
- However, the gravity of the downside scenarios and their rising probabilities make an aggressive overweight in equities and other risk assets inappropriate, in our view.
- It is a particularly critical time for investors to review their strategic guidelines and ensure they are consistent with their tolerance for risk and their time horizons.
- We are not straying far from policy benchmarks with respect to the broad asset classes: equities, bonds, commodities and real estate.
- We believe a diversified portfolio of high-quality stocks with attractive dividend yields may outperform the S&P 500 with considerably less risk. Despite strong performance this past year, high-quality stocks still look cheap to us.
- We are overweight U.S. and emerging market stocks at the expense of EAFE markets.
- Treasury yields are likely to be volatile but rangebound in 2012, but we expect upward pressure on a multi-year horizon.
- We still prefer high-yield bonds to Treasuries and believe high-yield is an attractive equity substitute on a risk-adjusted basis.
- Gold performed well in 2011 despite sharp downdrafts in September and December. We are sticking with our current positions in portfolios that hold gold.
Economic Outlook

The global economic outlook is more uncertain today than at any time since the 2008 financial crisis. The authors of the most recent economic outlook from the Organisation for Economic Co-operation and Development (OECD) noted that economic prospects for 2012 will depend on the outcome of events whose nature and timing are impossible to predict. We agree with these sentiments. Of course they are talking about Europe’s sovereign debt crisis and to a lesser extent developments on U.S. fiscal policy. What sort of economic growth environment will prevail in 2012? It’s impossible to say unless one makes certain assumptions about how these unpredictable events are likely to play out.

Consensus forecasts seem to rely on a muddle-through outcome. That is, they assume that disorderly sovereign defaults, systemic banking crises and excessive fiscal tightening will be avoided and that the Eurozone common currency will hold together. If those assumptions are true then the consensus forecasts will most likely be realized. That is, the U.S. and Japan will continue with positive but unimpressive growth, the Eurozone will experience a mild rather than crushing recession, and emerging economies will slow but maintain healthy rates of growth (see OECD baseline forecasts in Chart 1). Not a wonderful scenario, but hardly a tragedy.

European policymakers have shown some progress and may eventually grope toward a solution in 2012 (this would need to include more aggressive debt monetization by the European Central Bank [ECB] and greater moves toward fiscal union). But we cannot dismiss the possibility of a more ominous outcome. In a recent interview with Bloomberg, PIMCO chief executive Mohamed El-Erian said he sees a more than 1 in 3 chance that the Eurozone will break apart and trigger a financial crisis akin to the one that devastated the global economy in 2008. El-Erian’s probabilities may or may not be on the mark, but it’s clear to us that the chances of a catastrophe are non-trivial.

In the event of a disorderly sovereign debt restructuring, for example Greece, what would be the implications? The OECD offers a stylized downside scenario in their most recent economic outlook. The results assume no country exits the euro, but that there is significant bond market contagion within the Eurozone, and that financial conditions more generally tighten in line with the experience observed in the 2008 crisis. The results (shown in Chart 2) are not pretty and include a two-year recession across the developed world. In the event that one or more countries opt to leave the Eurozone, and reestablish their own national currencies, a prospect they consider a low-probability worst-case scenario, the results would be “a deep depression in …[the] euro area countries as well as in the global economy.”

We find it hard to believe that China could maintain the growth rates embodied in the OECD’s downside scenario if the developed world falls into a two-year recession. China’s twelfth five-year plan makes a priority of rebalancing the country’s growth model toward domestic consumption and away from exports and fixed investment, but reality currently lags the official plans. Chart 3 highlights how consumption as share of GDP has continued to decline in recent years. China cushioned the blow of the great recession by boosting investment when exports weakened. But with investment spending now at eye-popping levels (50% of GDP by year-end 2011 estimates) it’s far from clear that can happen again, and the Chinese consumer may not be ready to take the baton in the short term.

So the outlook is somewhat binary and dependent on politics. We believe the most likely outcome remains that European policymakers act to stave off extreme events and a muddle-through scenario prevails. But the probability of the downside scenarios is significant and rising.

Chart 1: OECD Global Growth Baseline Forecast

*Source: OECD, OECD Economic Outlook , Volume 2011, Issue 2, November 2011. URL: http://www.oecd.org/document/18/0,3746,en_2649_34109_20347538_1_1_1_1,00.html*

Chart 2: OECD Stylized Downside Scenario

*Source: OECD, OECD Economic Outlook , Volume 2011, Issue 2, November 2011. URL: http://www.oecd.org/document/18/0,3746,en_2649_34109_20347538_1_1_1_1,00.html*

Chart 3: Chinese GDP Components

*Source: Thomson Reuters Datastream*
Market Outlook & Investment Strategy

In reviewing our outlook from a year ago, our views turned out to be too sanguine. Economic growth hung in there, but looks to have come in a bit slower than we were anticipating. The escalation of the Eurozone debt crisis derailed our expectation that risk assets would outperform bonds and cash (Chart 4). However, we did shift gears in May, pulling back to a neutral position in equities (from an overweight position) as we saw trouble on the horizon.

The performance of the markets in 2012 will hinge on the binary outlook we described in the previous section. Risk assets exhibit attractive valuations relative to safe assets and much pessimism is already reflected in asset prices. For example, the earnings yield on stocks exceeds the yield on 10-year Treasury bonds by about 5.5%—a level exceeded only during the 2008 crisis and the 1973-74 bear market in Chart 5.

If the global economy can find a way to muddle through in 2012, we expect that stock markets would likely deliver double-digit gains. But given the gravity of the downside risk scenarios and their rising probabilities, we don’t believe now is the time for an aggressive overweight in equities and other risk assets. We are not straying far from policy benchmarks in our portfolios with respect to the broad asset classes: equities, commodities, bonds and real estate.

We think it is particularly critical today for investors to ensure that their strategic portfolios are consistent with their tolerance for risk and time horizons. If some of the downside scenarios that we explored are realized there would be few places to hide as we saw during the 2008 crisis (see Chart 6). Markets are already pricing in a fair degree of pessimism, but further declines would be likely in a global recession scenario. In the event of another sharp market decline, long-term investors might be able to take some solace in the notion that they could continue accumulating equities (if dollar-cost averaging) at rock-bottom prices in what may turn out to be the later stages of a secular bear market. Investors closer to retirement or nearing financial goals, however, could take no such comfort.

Within equities we would reiterate some advice from last year: We expect that a diversified portfolio of high-quality companies with attractive dividend yields will outperform the S&P 500 Index with considerably less risk over the next decade. This segment of the market performed well in 2011. As a proxy for quality and yield, we note that the S&P High Yield Dividend Aristocrats Index was up 7.6% this year versus 2.1% for the S&P 500 index. Despite the outperformance this year, high-quality stocks still look cheap relative to low-quality stocks (Chart 7).

Regarding equities, we are overweight the U.S. and emerging markets at the expense of EAFE markets. European stocks (which, excluding the U.K., make up more than 40% of the EAFE Index) look cheap, and while it may be tempting to bottom fish, we would put off buying for now as the risks appear too steep. Relative monetary conditions favor the United States (as measured by real short rates) and U.S. economic growth has so far been more resilient exhibiting some upside surprise as of late. A weaker euro and more aggressive ECB bond buying could cause us to shift to a more bullish position on the region in 2012.

Emerging markets stocks underperformed developed markets in 2011. Is this trend about to change in 2012? We think so. One key reason for
Market Outlook & Investment Strategy (Continued)

recent underperformance is that many emerging countries were tightening monetary policy to combat inflationary pressure. With growth and inflation easing, many countries are now starting to relax monetary policy and we think this trend has further to run.

In the past we’ve emphasized the positive structural story on emerging markets: We think this story is still intact. BCA Research has noted the following: “Many of these countries are still in the catch-up phase of their economic development and can expect to grow strongly for many years to come. Moreover, the rapid spread of new technologies is allowing the development process to progress at a faster pace than historically. As wealth increases, there should be a parallel growth in the domestic capital markets, creating more liquidity and investment opportunities for investors.”

This process is likely to occur against a backdrop of weak growth and deleveraging in the developed world. In terms of policy, EM countries have the means to stimulate if they choose to, while the developed world has already spent its fiscal and monetary ammunition. Valuations also look attractive to us in the current context (Chart 8). EM stocks may continue to underperform, however, in a downside scenario as they have tended behave as a leveraged play on global growth as of late.

Treasury bonds, TIPS in particular, were one of the best-performing asset classes in 2012 as investors sought safety. Treasury yields are now below 2% and TIPS offer negative yields on 5-year and 10-year maturities. Looking ahead, we believe that yields are likely to remain rangebound in 2012 but volatile as developments in Europe evolve. Looking further ahead, yields should move upward absent a Japanese-style stagnation in the United States. There could be another less benign source of rising yields. U.S Treasuries remain the “safe haven” asset class while bond market vigilantes are squarely focused on Europe. The U.S. has avoided their wrath for now. But if the U.S. does not get its fiscal house in order some time after the November 2012 elections it could face higher rates due to rising risk premiums.

While sovereign balance sheets have deteriorated, corporate-sector health has improved. Profit growth has been strong despite difficult economic conditions and company balance sheets look very solid. Spreads backed up in 2011 and are generally at attractive levels (e.g. Barclays Corporate High Yield OAS is at approximately 700 basis points). Thus we still prefer corporate bonds, including high yield, to Treasuries.

Last year we noted that high-yield bonds looked like an attractive equity market substitute on a risk-adjusted basis. This turned out to be the case in 2011 even on a total-return basis. Chart 9 shows that in each of past few years (this includes down, up, and flattish markets) high yields offered both better returns than equities and much lower volatility. A repeat performance could be in store for 2012.

We would hang on to positions in gold. Bullion performed reasonably well in 2011 despite sharp downdrafts in September and December. Our comments about gold last year still ring true: “Negative real interest rates, competitive currency devaluation, and mounting public debt burdens are all good reasons to maintain exposure to the ultimate hard currency.”

Chart 7:
High-Quality Stocks Still Look Cheap

Source: QMA, FactSet

Chart 8:
MSCI® Global Valuations and Profitability

Source: QMA, FactSet

Chart 9:
High-Yield Bonds – Good Risk/Reward Trade-off

Source: QMA, FactSet, Past Performance does not guarantee future results.
# Economic and Market Outlook

**January 2012**

### Performance Summary as of: 12/31/2011

<table>
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<tr>
<th>Equity</th>
<th>Quarter</th>
<th>YTD</th>
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<th>(A) 3 Year</th>
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<td>5.52%</td>
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*Formerly known as Lehman Brothers Aggregate Index

Please see page 6 for index definitions.

Source: FactSet Research Systems.

Source of sector classification: S&P/MSCI.

Past Performance does not guarantee future results. An investment cannot be made directly in an index.
Explanation of Indices

Citigroup (formerly Salomon Smith Barney) Non-U.S. World Government Bond Index—Unhedged. This Index is based on the Citigroup formerly Salomon Brothers) World Bond Index, and excludes issues denominated in U.S. dollars. The Index measures the total return of government securities in major sectors of the international bond market.

Citi Non-US Government Hedged is an international fixed-income fund.

Citi BIG T-Bill (3-month) is the 3-month Treasury bill subsector of the Broad Investment Grade (BIG) index.

Dow Jones - AIG Commodity Index is a diversified benchmark for the commodity futures market. It is composed of futures contracts on 19 physical commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Dow Jones Wilshire REIT Index. Measures U.S. publicly traded Real Estate Investment Trusts. The index is a subset of the Dow Jones Wilshire Real Estate Securities Index (WRESI). The indexes are weighted by both full market capitalization and float-adjusted market capitalization.


Barclays Capital Aggregate. Composed of U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities, and commercial mortgage-based securities. Barclays US Corporate High Yield Index. Covers the universe of high-yield corporate bonds. Barclays Capital US TIPS Index. An unmanaged index that represents securities that protect against adverse inflation and provide a minimum level of real return. To be included in this index, bonds must have cash flows linked to an inflation index, be sovereign issues denominated in U.S. currency, and have more than one year to maturity, and, as a portion of the index, total a minimum amount outstanding of $100 million U.S. dollars.


Morgan Stanley Capital International (MSCI®) Europe, Australasia, and Far East (EAFE) Equity Index. MSCI® EAFE acts as a benchmark for 24 developed-market stock portfolios. MSCI® Japan Equity Index is a subset of MSCI® EAFE.

Morgan Stanley Capital International (MSCI®) Emerging Markets Equity Index. MSCI® EM acts as a benchmark for 27 emerging-market stock portfolios. MSCI World Index. A free-floating weighted equity index that includes developed world markets but not emerging markets.

Russell 3000®, 2000®, & 1000®. The Russell 3000® is composed of 3,000 large U.S. companies representing approximately 98% of the U.S. equity market. The Russell 1000® represents the largest 1,000 companies in the Russell 3000®, and the Russell 2000® represents the 2,000 smallest companies. The Russell 1000® Growth includes those Russell 1000® companies with higher price-to-book ratios and higher forecast growth values. The Russell 1000® Value includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. The Russell 2000® Growth includes those Russell 2000® companies with higher price-to-book ratios and higher forecast growth values. The Russell 2000® Value includes those Russell 2000® companies with lower price-to-book ratios and lower forecast growth values. The indexes are value-weighted. The Russell indices are trademarks/service marks of the Russell Investments. Russell is a trademark of the Russell Investments.

Wilshire 5000 Total Market IndexSM represents the broadest index for the US equity market, measuring the performance of all US equity securities with readily available price data. A number of securities are over-the-counter and small companies. Wilshire®, the Wilshire IndexesSM and the Wilshire 5000 Total Market IndexSM are service marks of Wilshire Associates Incorporated (“Wilshire”) and have been licensed for use by QMA. All content of the Wilshire IndexesSM and Wilshire 5000 Total Market IndexSM is © 2010 Wilshire Associates Incorporated, all rights reserved.

S&P 500 Index. Covers 500 industrial, utility, transportation, and financial companies of the U.S. markets. The value-weighted index represents about 75% of the NYSE market capitalization and 30% of the NYSE issues. S&P High Yield Dividend Aristocrats Index is designed to measure the performance of the 60 highest dividend yielding S&P Composite 1500 constituents which have followed a managed dividends policy of consistently increasing dividends every year for at least 25 years.

Emerging market countries may have unstable governments and/or economies that are subject to sudden change. These changes may be magnified by the countries’ emergent financial markets, resulting in significant volatility to investments in these countries.

Gold returns represent the performance of the price of gold bullion per the spot price of one ounce of London fixing. The spot price is valued in USD.

These indices are all unmanaged. Investors cannot invest directly in an index.
IMPORTANT INFORMATION
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