

## Global Asset Allocation Notes

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### 'Don't fear what everyone else fears'; we're cautiously optimistic

Our year-end asset allocation gathering surfaced numerous fears, all front end loaded through spring. After 2011, which stood out for the sheer number of negative exogenous shocks (tsunami induced global supply chain shortfall, Arab Spring spike to energy prices, blundering leadership both in Europe and the US), the gathering's fears were prone to looking for downside risks. These included: the increasing political jousting with Iran over their nuclear program, Russia's unsettled political situation, and the ability of either of these to create another Arab Spring spike in energy prices. Not surprisingly, the greatest fear centered on the ability of Europe to roll over its sovereign debt through the spring. As widely understood, European sovereign refinancing needs are front end loaded. The inability of European Union ("EU") summiteers to formalize and lay out details of a new 'fiscal compact' prior to France's elections in the spring, along with the European Central Bank's (ECB's) presumed unwillingness to alleviate sovereign illiquidity prior to a formalized solvency solution, is at the heart of these fears. In contrast to most years where markets start on a strong note setting up a 'sell in May' dynamic, we enter this year with market participants quite cautious towards the early part of 2012. Market sentiment can best now be described as 'pray for May'.

Since the second quarter of 2011, investment flows have continued to flock towards safety and liquidity. As we gathered, a 10-year US Treasury auction experienced a record ratio of bids relative to debt offered (bid to cover), highlighting the degree to which a flight to safety has been in place. Valuations suggest that market participants have already positioned themselves for an imminent and extreme confluence of negative conditions. An example of this would be the US corporate investment grade space where, despite very healthy fundamentals and cash flows, the coupon rate relative to total yield is now near a record level indicating that the market is already braced for extremely negative events in the near term. (See Figure 1).

Typically, this ratio only hits such levels in the middle of a recession, after cash flows have already deteriorated quite significantly versus today's situation where such prospective deterioration is merely feared. Bank loans now price in a 10% default rate, seen only once in modern times during the Great Recession (extreme given that today's current run rate in loan defaults is near 1%). While

a failed European sovereign auction that freezes markets and drags us back into a double dip cannot be ruled out (and odds and implications of this need to be thought through), unless it occurs, existing risk averse positioning by the markets suggest the pendulum will swing back in the other direction causing risk assets to move higher.

Despite all these extremes, in at least one sense 2011 was a very typical year. After strong fundamental improvements in 2009 and 2010, the emerging markets ("EM") countries leading the global recovery hit their monetary brakes. This is typical for leading economies during the early stages of a recovery. Most such periods see global risk assets experience a mid-cycle pause, despite improving fundamentals which only belatedly pause, as monetary restraint neutralizes fundamental improvements. This pause often refreshes, allowing early cycle inflationary pressures to settle down, central banks to relax again (which we are now beginning to see in the emerging economies), and growth to resume with markets beginning an extended second upward leg (yet to be seen).

FIGURE 1 Option Adjusted Spread (OAS)/Yield To Worst (YTW)



Source: Barclay's Capital, as of 11 December 2011.

Meanwhile, today's high debt loads and hard to shake memories of 2008 keep the prospect of how bad things could get if we do not pull out of this economic pause, and instead get dragged by Europe into a double dip, at the forefront. We live in a world where markets continue to focus on such 'fat tail' events, however today's fundamentals are starkly different than those that facilitated 2008. That financial crisis was preceded by an era of extreme risk taking, nurtured by a global savings glut, and "too big to fail" policies. In that setting, market participants put their guard down and connected financially to practically everyone else. That created a contagious backdrop which amplified the financial transmission of both positive and negative events. This all ended the moment Lehman was allowed to fail. In contrast, today's anxious market participants have little confidence and have been distancing themselves from counterparties and anything other than the safest and most liquid investments. Financial contagion appears to require both a high degree of financial connectivity as well as an element of surprise. Today's lack of trust has brought about less connectivity and likely a less contagious setting.

Should European sovereign auctions run into trouble in the first quarter, it will not be a surprise. Many, if not most, investors have already positioned for this. In doing so, this lack of trust has destroyed liquidity which progressively held back markets in 2011. As we enter the new year, a key consideration to our cautiously optimistic positioning is the new European "compact" for long-term fiscal restraint. True, such austerity will prove negative for Europe's economies throughout 2012, however, whether this hurts markets is an entirely different matter. When executed with force and determination, monetary policy can offset fiscal drag, as well as economic weakness, leaving markets flat to up. In this respect, the EU Summit was underrated. We are very encouraged by the newly cooperative tone within the ECB, which appears the result of both commitment from the EU Summit to soon develop the longer term solvency

plans as well as the new leadership and communication skills being demonstrated by Mario Draghi, President of the ECB. Together these seem to have produced a new ECB, which has begun shifting gears from their former reluctant stance to one today that looks highly engaged and determined to play a more active role.

While the ECB's recent efforts to rebuild liquidity have not taken the form the market expected - the hoped for expanded purchases of sovereign debt through their Securities Market Program ("SMP") - an alternative ECB plan has surfaced which appears very significant nonetheless. This plan includes the extension of three year loans to European banks at 1% plus the broadening of collateral that the ECB will accept (soon to include loans as well as today's highly rated securities). Combined with the European summit's admitting that requiring private participation (read: banks) in sovereign debt write-downs was a mistake, these changes appear to have stopped the European banks from dumping their sovereign debt. After re-liquefying the banks with the first issuance of these 36-month tenders, this new plan appears to have the potential to alleviate the sovereign refinancing with its next tranche of tenders in February, should banks by then become more comfortable holding greater quantities of sovereign debt. Also, the European Financial Stability Facility ("EFSF") will soon finally start operations with the ECB implementing on their behalf. This too could be used to purchase sovereign debt. Together these new tools appear to have the ability to bridge over the much feared, front end loaded sovereign refinancing issues. As such, they shrink the likelihood of a fat tail. Of course, a bit better global backdrop would also be of great help.

Unlike Europe and EM, the United States did not pull back on policy which was a major differentiator (for the markets and economies) in favor of the US in 2011. Instead of exiting 2011 in a double dip, the world's largest economy exited with a surprisingly healthy glow. Bank loans are growing again, breathing life back into small business which, in turn, is nurturing job growth. While

the Federal Reserve remains in the middle of their operation twist (OT), this will soon be supplemented with a new communication policy that presumably will forecast the federal funds rate at its near zero level well through 2014. Like OT, this is designed to get investors more comfortable moving back into risk assets. With delay, the thinking is that this will pull along the markets first, and the economy next.

The absence of a US housing recovery has been the primary "new norm" holding down US trend growth and rendering this economy less sensitive to today's low interest rates. After six years of housing starts running below household formation, and housing formation itself being held back by a jobless recovery, the housing overhang should be largely behind us after 2012. By then, companies should be reassured of a new fiscal path, with less uncertainty leading to greater willingness to invest their underleveraged balance sheets once again. We could exit 2012 with the US offering a visible growth offset to the rest of the sluggish developed economies. Even in Europe, should early year refinancing issues be sidestepped, the real remaining question determining the depth of their problems is likely to be whether Germany can stay out of recession and continue to grow; their recent economic signals have surprisingly strengthened. European neighbors would have a life-line if, despite their own austerity driven declines, the Germans remained in growth mode and learned to spend. Such tentative signs are beginning to sprout; German travel and leisure spending in countries like Spain is increasing. Germany will also be the only European country not introducing austerity in 2012. Instead, they will actually be cutting taxes to spur consumption.

Meanwhile, a truly global central bank easing cycle is unfolding. This may or may not help Europe's early year illiquidity situation, yet it certainly should benefit global risk assets at some point in 2012. As a result, we see global markets slowly decoupling from European headlines (and economies) as we go through 2012. We are torn between extremely attractive

valuations (Capital Market Line, Chart 2) and the presence of dangerous fat tails. As a result, our asset allocation portfolios reflect cautious, or tempered, optimism.

US corporate investment grade offers opportunity earlier in the year as liquidity tentatively begins moving out of treasuries before spreading more confidently into high yield and bank loans later in the year. While the outlook for overall listed equities should slowly improve, US equities materially outperformed as the safe haven in 2011 and is unlikely to repeat this in relative terms if a better overall equity environment unfolds, as we expect. To curb inflation, emerging markets engineered a self inflicted slowdown in 2011. While secular inflation is still problematic, EM's cyclical inflation has clearly peaked. Their priorities are now rapidly shifting towards stimulating growth to offset Europe's drag on their economies. Meanwhile hard landing fears have spread and become baked into valuations.

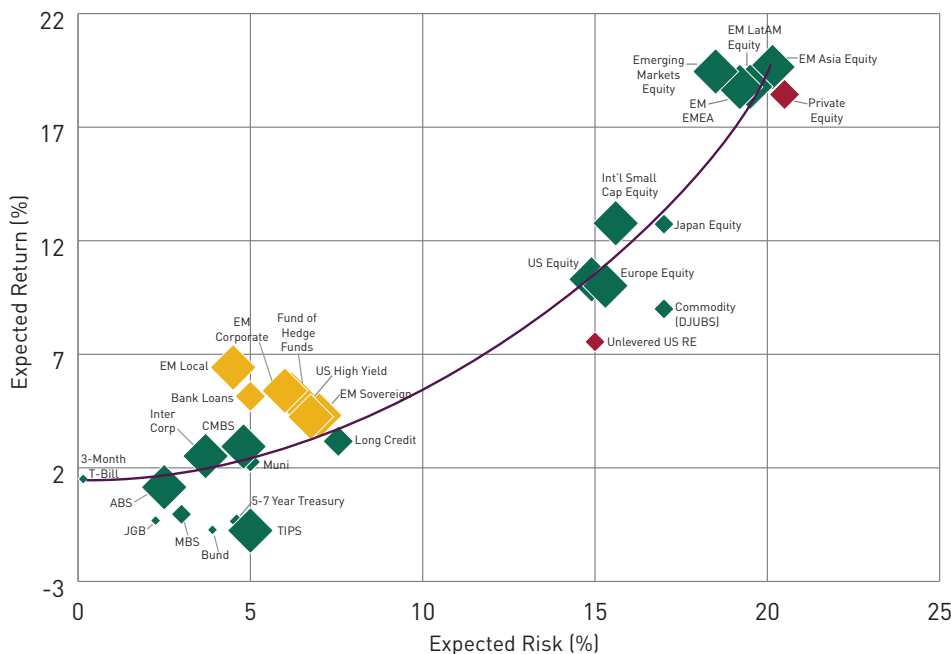
In our view, this will be the year for EM to dispel these hard landing fears and, in doing so, regain market leadership. Early on we prefer emerging market equities over emerging market debt. The former materially underperformed other equity markets during 2011 whereas EM debt only recently has fallen out of favor; both, however, are highly attractive if given a medium term perspective. Most EM equity markets are now priced with single digit P/E's yet still retain double digit long term growth rates.

In alternatives, we see renewed opportunity this year in private equity secondaries. During the financial crisis, many investors saw what was perceived to be a one-time opportunity to buy private equity investments at depressed valuations in the secondary market, as some endowments and foundations faced liquidity situations. Today, we see a second coming of secondary sales, this time from financial institutions. New liquidity requirements, higher capital requirements, more rigid regulatory

regimes, such as the Volcker rule, along with the European debt crisis are all congregating and swaying financial institutions to seek early exits for their private equity investments. Hedge funds registered a disappointing 2011. With residual beta in most products, the space typically does not do well when risk premiums rise. Looking ahead, 2012 should be a better year if we are correct that risk premiums will outperform fundamentals, owing to a new leg of liquidity being injected by central banks. One thing to watch will be the performance of long/short equity managers. With correlations so high between stocks, most had a difficult time identifying winners from the losers. This is the largest segment within the hedge fund universe and, while risk premiums should have a better year, correlations may not return to normal for some time to come. ■

FIGURE 2

Capital Markets Line (CML)  
Local Currency, as of 31 December 2011



This framework is based on a 5-year, forward-looking time horizon and is used by our allocation team to compare risk/return across major asset classes.

Asset classes that fall below the line are considered overvalued, while those that fall above the line are considered attractive.

Dot Size: Depicts the degree of correlation of the asset class to most others. Large dots are more correlated with most others.

Color: Shows liquidity of the asset class. Green is the most liquid, yellow may be less liquid in times of market stress, and red represents the least liquid.

Based on PineBridge's forward looking views for the next 5 years and prices as of 31 December 2011.

The relative valuations and investment expectations are for the indices listed above only and are subject to change at any time. They are shown for illustrative purposes only. These forecasts are not predictive of the future performance of the markets or any PineBridge Investments' account or portfolio. We are not recommending or soliciting any action based upon this material. There is no assurance that the asset classes shown will achieve the risk and/or returns stated.

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## Disclosure

**Equities Indices - USA:** MSCI USA. The MSCI USA Index is a free float adjusted market capitalization index that is designed to measure large and mid cap US equity market performance. **Europe:** MSCI Europe. The MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. **Japan:** MSCI Japan. The MSCI Japan Index is a free float adjusted market capitalization index that is designed to measure large and mid cap Japanese equity market performance. **ISC:** MSCI AC W ex-USA. The MSCI All Country World ex-USA Index is an index that is designed to measure small cap equity market performance in every country except USA. **EM Total:** MSCI EM. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. **EM Asia:** MSCI EM Asia. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand. **EM EMEA:** MSCI EMEA. The MSCI EM (Emerging Markets) Europe, Middle East and Africa Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of Europe, the Middle East & Africa. As of May 27, 2010 the MSCI EM EMEA Index consisted of the following 8 emerging market country indices: Czech Republic, Hungary, Poland, Russia, Turkey, Egypt, Morocco, and South Africa. **EM Latam:** MSCI Latam. The MSCI EM (Emerging Markets) Latin America Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America. As of June 2007 the MSCI EM Latin America Index consisted of the following 5 emerging market country indices: Brazil, Chile, Colombia, Mexico, and Peru.

**Fixed Income Indices - 5-7 year Treasuries:** Barcap US Government 5-7 Year. Contains the Securities that are public obligations of the US Treasury with maturities from 5 to 7 years. **US Core:** Barcap US Aggregate. The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage passthrough securities, and asset-backed securities. **Inter Corp:** Barcap Intermediate Corporate. Contains publicly issued US Corporate investment grade intermediate maturity securities. **High Yield:** Barcap US Corporate High Yield. Contains the universe of fixed rate, non-investment grade US corporate debt. **Long Credit:** Barcap US Long Credit. Contains publicly issued US Corporate investment grade long maturity securities. **Municipal Bond:** Barcap 8-12 Year Municipal Bond. Contains investment grade tax-exempt municipal bonds with maturities from 8 to 12 years. **Build America:** Barcap Build America Bonds. Contains the universe of Build America bonds. **TIPS:** Barcap US Treasury: US TIPS. Contains the universe of US Treasury Inflation Protected Securities. **JGB:** Barcap Asian-Pacific Japan Treasury. Contains the fixed rate obligations of the Japanese Treasury. **Bund:** Barcap Euro Aggregate Treasury Germany. Contains the fixed rate obligations of the German Treasury. **EM Corporate:** JPM CEMBI Broad Diversified. Contains liquid USD denominated Emerging Market corporate bonds. Countries include China, Hong Kong, India, Malaysia, Singapore, Taiwan, Kazakhstan, Ukraine, Brazil, Columbia, Jamaica, Mexico, Peru, Israel and Egypt. **EM Sovereign:** JPM EMBI+ Contains liquid, fixed rate government securities of Emerging Market countries, including Argentine, Brazil, Bulgaria, Columbia, Ecuador, Indonesia, Mexico, Panama, Peru, Philippines, Russia, South Africa, Turkey, Ukraine, and Venezuela.

**Alternative Investments - Fund of Hedge Funds:** HFRI FOF Index. Equal weighted index of Fund of Hedge Funds that report monthly returns net of fees to Hedge Fund Research. A fund of funds invests with multiple managers with the goal of lowering return volatility. This index includes funds that allocate to multiple managers with a single strategy or multiple strategies. **Private Equity:** Thompson Venture Economics. Pooled internal rate of return of all US Private Equity funds that report returns to Thompson Venture Economics. **Commodities:** DJUBS Index. Contains futures contracts on 19 physical commodities. Reflects the return on fully collateralized futures positions. **Real Estate:** NCREIF Index. Contains the total return of a broad range of property types and locations in the US. Produced by the National Council on Real Estate Investment Fiduciaries.

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