

Capital Markets Flash Report

Overview

Happy New Year! Believe it or not, there are reasons to be optimistic as we look ahead to the capital markets of 2012. Despite a political mess in Washington DC, American consumers and corporations are showing signs of renewed health. Recent employment and housing data in the US indicate that the worst is likely over for job-seekers and homeowners. However, no one is expecting a return to full employment, nor booming home sales in 2012. The Euro weakened substantially in the 4th quarter and a recession may already be priced into European equities markets. European sovereign bond markets are definitely priced for a recession. In addition, the latest German business confidence survey was quite positive and recent sovereign debt auctions by peripheral European nations, like Spain, have gone well. Again, there are reasons for hope as well as concern.

US Equity

The S&P 500 edged higher this month by 1%, bringing its 2011 return to 2.1%. It's hard to believe that this small absolute return is the end result of a year marked by huge swings in investor and consumer confidence, political discord, and unusually high volatility. Small caps trailed large caps slightly this month. There were no major outliers in terms of sector return with a mix of cyclical and non-cyclical sectors showing strong performance. Still, for the year, investors clearly showed a preference for non-cyclical equities like healthcare, utilities, and consumer staples (up 12, 12.5, and 14.5%, respectively. No other sector returned more than a 6%.

International Equity

It was another poor month for the MSCI EAFE Index, which fell 1%, and ended this year down a dismal 12%. This month the Euro lost nearly 4%, adding to November's drop. As bad as European equity markets were in 2011, Japan was worse. Equities there dropped nearly 14% as the Yen strengthened by 5%. Emerging markets also struggled in December, ending the month down 1.2% and down 18% for 2011. We continue to see weakness in EM relative to the developed markets on signs of slowing economic growth, especially in China. However, the most recent manufacturing data from China and India has been encouraging. Also, valuations are looking more attractive now than this time last year as equity prices in India fell 37% in 2011 and the rest of the "BRIC" countries lost 20%.

Hedge Funds

Very volatile equity markets combined with rampant political uncertainty in the US and Eurozone throughout 2011, made it a difficult trading environment for many hedge strategies. Even former hedge fund heroes like John Paulson were not immune to the market mayhem. However, there were several winners amid the turbulent markets as many of the global macro managers that we follow were finally rewarded for their negative views on the Eurozone. These managers were able to use a mix of strategies and instruments including bets on gold, currencies, and interest rates to capitalize on the stress.

Fixed Income

Treasuries rallied in December even as US equities made gains. This is a very peculiar, albeit modest, change in the pattern of the risk on/risk off trade as US assets, not just Treasuries were acquired as safe haven investments. One can hope that investors are starting to view Europe's woes in isolation and recent GDP growth in the US as sustainable. High yield bonds posted a solid gain this year of 7%, capped by a 2.7% return in December. The high-yield default rate remained well below its long-term average. Despite this appreciation, yields are still attractive in this space (assuming that defaults don't spike dramatically in 2012).

Real Assets

Where have all of the gold bulls gone? After a sharp decline of 10.5% for December, the precious metal price has now fallen to \$1,563/oz. Just a few months ago, gold experts were only debating when gold would break \$2,000/oz. Today, it seems, there are less gold experts out there. Just as recent strength in the US dollar has rocked gold prices, it also seems to have stabilized WTI crude oil (right around \$100/bbl). The price has moderated even as Iran threatens to cutoff off vital shipping lanes in the Middle East and develops its nuclear capabilities further. An oil supply shock would definitely dampen prospects for continued economic recovery in the US as consumers seem to be responding favorably to lower gas prices as of late.

US Equity Markets

	<u>Dec-11</u>	<u>YTD</u>
Large Stocks:		
S&P 500	1.02%	2.11%
Russell 3000	0.82%	1.03%
Russell 1000	0.84%	1.53%
Russell 1000 Growth	-0.32%	2.64%
Russell 1000 Value	2.02%	0.39%
Small Stocks:		
Russell 2500	0.23%	-2.51%
Russell 2000	0.66%	-4.17%
Russell 2000 Growth	-0.23%	-2.91%
Russell 2000 Value	1.56%	-5.50%

International Equity Markets**

MSCI EAFE	-0.94%	-11.73%
MSCI EAFE Growth	-1.29%	-11.82%
MSCI EAFE Value	-0.57%	-11.65%
MSCI Europe	-1.53%	-10.50%
MSCI Japan	0.84%	-14.19%
MSCI Emerging Markets	-1.20%	-18.17%

Hedge Fund Markets***

HFRX Indexes:		
Convertible Arbitrage	0.07%	-3.31%
Distressed	-0.89%	-8.06%
Equity Hedge	-0.88%	-19.10%
Equity Market Neutral	0.12%	-2.98%
Event Driven	-0.63%	-4.96%
Macro	-0.50%	-5.09%
Relative Value Arbitrage	0.17%	-3.95%

US Fixed Income Markets

U.S. Treasury Bonds ⁽¹⁾	1.41%	13.01%
Treasury Inflation-Protected Securities ⁽²⁾	0.21%	13.39%
Tax-Exempt Bonds ⁽³⁾	1.94%	9.57%
Corporate Bonds ⁽⁴⁾	1.93%	7.45%
High-Yield Bonds ⁽⁵⁾	2.72%	7.04%

Real Asset Markets

DJ UBS Commodity Index Total Return	-3.75%	-13.32%
FTSE NAREIT Equity Index	4.80%	8.28%

(1) Fidelity Spartan Intermediate Treasury Bond Index is used as a proxy for intermediate US Treasury bond funds. (2) Vanguard Inflation-Protected Securities Fund is used as a proxy for US Treasury Inflation Protected Securities funds. (3) Vanguard Intermediate-Term Tax-Exempt Fund is used as a proxy for tax-exempt bond funds. (4) Vanguard Intermediate-Term Investment Grade Bond Fund (Admiral shares) is used as a proxy for intermediate corporate bond funds. (5) Vanguard High-Yield Corporate Fund is used as a proxy for high-yield corporate bond funds.

*Data Source: Bloomberg ** The MSCI returns are gross returns calculated in US Dollars. *** Hedge Fund Index returns are reported using Simple Price Appreciation and are only available on a one day lag. For complete Index Descriptions, please go to <http://www.greycourt.com/indices.html>