**From:** US GIO <[redacted]
**To:** Undisclosed recipients:;
**Subject:** On today's financial market developments
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This is a little unorthodox, but here is the text of an internal note that I just sent to our integrated Private Bank client coverage teams a few moments ago. Mary thought it would be a good idea to share this with our clients given the events of the day.

"Here is what I plan to say at our Aspen Insights conference tomorrow about today's events. The last two weeks have been a severe setback for financial markets and the global recovery.

**[1] Today, Italian equity markets sold off sharply and were eventually shut down after the ECB (for now) rejected being the buyer of last resort for Italian government bonds, as the markets were hoping. The Bundesbank apparently has objections to the idea.** This is a problem: Italy has issued around as much public debt as Germany, but is a considerably smaller country with almost twice the debt load as a percentage of its GDP. Absent a decision by Germany to move to Federalism or a lot more debt monetization by the ECB, the European Monetary Union (as it is currently configured) could be facing its final stretch. Today's reported move by Italian regulators to seize documents at Moody's regarding declines in Italian bank stocks is an indication of the pressure the system is under, and the possible search for scapegoats. I don't think you will find a firm that has written more often and more direly about the structural inconsistencies of the EMU than we have (I have a 2-year bibliography of what we said and when, if anyone wants it). The "*Sick Men of Europe*" paper from February 2010 and "*Don Quixote Thanksgiving*" from November 2010 go into the greatest detail on why. Our concerns sky-rocketed upon Greece's financial disclosures in November 2009, after which we took portfolio decisions to back that up, purging exposures to the GIPSI countries from our credit, government bond and equity portfolios. Since early 2010, our underweight positions in Europe represent the largest regional underweights we have ever held.

**[2] Will there be another recession in the US? Our friend Marty Feldstein at Harvard puts the odds at 50-50.** Sell side and buy side economists missed last month's US economic rollover by a country mile, so I am not sure how much weight to put in their current forecasts. Most summarily dismissed our concerns that the recovery earlier this year had elements of a stimulus-driven mirage. Bridgewater Associates was the only firm we spoke to that consistently highlighted the broader process of household deleveraging; and cautioned that when stimulus faded, so would the US economy, given the weakness in household income. Their insights have been invaluable to us in terms of not stepping into this and taking too much risk prematurely during the three market swoons this year. Our central scenario for the US in 2012 is not another recession, but low growth in the 2.0% range, which is enough of a problem given the low job creation that entails. Note that the CBO assumes growth rates of 3.0% to 3.6% over the next few years in their analyses of future US federal debt levels.

**[3] Do not blame today's events on the debt ceiling debate, US politicians or European regulators. If we get to the point where economic and profit fundamentals in a given market or region are not sustainable on their own, then we should be underweight that region (as in Europe).** Owning an asset class under the assumption that there will always be a "*Lord of the Flies*" type rescue from Central Banks and Treasuries is very risky, and historically, fraught with failure. I remember similar logic in the summer of 1998, when the accepted mantra was that the US would bail out Russia and Boris Yeltsin, since President Clinton would not want to see a nuclear power like Russia slide back into Soviet rule, or anarchy (that view turned out to be wrong). Anyone market-weight European risk out of the expectation that "Trichet and Merkel will fix surely it" is taking a binary risk that impossible to handicap. Similarly, we should not start buying anything just because we think Qe3 is coming in the US (in the form of securities purchases, a permanently controlled long bond, etc).

[4] When we began this year, I made the following decision: **we would risk underperforming if there was a strong equity rally, out of concerns about the macroeconomic landscape (weakness in the West, inflation in the East).** As a result, we have held less equity exposure than usual for a period of high margins, low P/E multiples and strong earnings. Instead, we've held larger exposures to investment grade and high yield credit, and hedge funds. Over the last couple of years, our hedge funds (long-short funds with low net positions, macro hedge funds, distressed credit) have helped cushion

portfolio returns when markets declined. We won't know until the data comes in, but we expect the same to happen this time.

[5] The "Eye on the Market" has endlessly chronicled this year the fissures which are now affecting financial markets: European sovereign risk and inadequate bank capitalization; weak labor compensation as an Achilles heel of the US profits recovery, given its negative impact on spending; the political divide in Congress over how to deal with falling government revenue and rising entitlement spending; inflation risks in Asia and Latin America and the resulting need for more policy tightening; and the mixed track record of low interest rates to sustainability solve structural problems. The cover of the 2011 Outlook (a printing press, out of control) expressed our concern regarding a recovery built upon a stimulus machine. I would contrast this with the cover of a competitor's 2011 publication, which had a picture of George Washington crossing the Delaware, with the caption "America's structural resilience, fortitude and ingenuity will carry the economy and financial markets in 2011 – and beyond". **Our job is not to point to where we would like the financial markets to go, but rather to point to where they might end up**. It's like the scene in Oliver Stone's *Nixon*, when Nixon looks up at a portrait of JFK and says, "*When they look at you, they see what they want to be. When they look at me, they see what they are*." Our job is to see financial markets for what they are.

[6] All that said, we have lessons to learn here.

> Too many of our investment discussions this year focused on the negative real return characteristics of cash, and why to reduce it. In a world of deflation risk on financial assets (rather than of goods and services), cash retains substantial option value at times like these.
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> We could have connected the dots more aggressively on our views on weak growth and easy monetary policy, and owned more gold. While we have had rising price forecasts for gold and owned it in portfolios, we did not have large enough allocations.
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> Given the all-time high of US government transfers to households and negative real interest rates, we should not have interpreted positive economic data earlier this year as being highly representative of the true run-rate of the US economy. The same goes for the global economy, which has been the beneficiary of a lot of stimulus that is now fading, for a variety of economic and political reasons.
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> Great corporate profits are no guarantee against a problem in financial markets. Corporate profits and P/E multiples were fine in June 2007, but rested on top of a systemic problem in private sector credit markets and private sector balance sheets. This year, strong corporate profits and low P/E multiples sit on top of systemic problems in public sector finances.

[7] In the wreckage, as usual, there are opportunities, and we will be reviewing them with you in the days ahead. There is a benefit to having held back on our firepower this year. With risk to spend held in reserve, there are oversold assets with considering, particularly among multinationals with strong balance sheets, high dividends and which trade at very low multiples, something we reviewed earlier in the week."

Michael Cembalest
Chief Investment Officer