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Economic Overview & Capital Markets Discussion

October 28, 2011

Economic Overview

Economic Outlook (3-5 Years)

Economy:	Base Case	Better	Worse
Real GDP Growth:			
U.S.	0.0% to 3.0%	3.0% +	< 0%
Non-U.S. Developed	0.0% to 2.0%	2.0% +	< 0%
Emerging Markets	6.0% +	6.0% +	< 0%
Unemployment:			
U.S.	8.0% to 9.0%	5.0% to 7.0%	10.0% +
Non-U.S. Developed	6.5% to 7.5%	5.0% to 6.5%	10.0% +
Emerging Markets	5.0% to 6.0%	5.0% to 6.0%	7.0% +
Corporate Profit Growth:			
U.S.	Stable	Growing	Dedining
Non-U.S. Developed	Stable	Growing	Dedining
Emerging Markets	Growing	Growing	Stable
Inflation:			
U.S. (PCE)	0.5% to 1.5%	2.5% to 5.0%	< 0% (deflation)
Non-U.S. Developed	1.0% to 1.8%	1.9% to 2.4%	< 0% (deflation)
Emerging Markets	6.0% to 9.0%	6.0% to 9.0%	2.0% to 4.0%
Monetary Policy/Yields/Currency:	Base Case	Better	Worse
Monetary Policy:			
U.S.	Stable	Tightening	Easing
Non-U.S. Developed	Stable	Tightening	Easing
Emerging Markets	Tightening	Tightening	Easing
Sovereign Debt Yields:			
U.S. - 10 Year Treasury	3.0% to 4.5%	4.5% +	2.0% to 3.0%
Non-U.S. Developed	2.0% to 3.0%	3.0% +	1.0% to 2.0%
Emerging Markets	4.0% to 16.0%	4.0% to 16.0%	3.0% to 10.0%
Currency:			
US Dollar (Trade-Weighted)	Stable	Higher	Lower
Non-U.S. Developed	Stable	Lower/Stable	Lower
Emerging Markets	Higher	Higher	Higher

Economic Outlook – Implications

Investment Implications	3-5 Year Scenarios		
	Base Case	Better	Worse
Asset Classes:			
Global Fixed Income	=	-	+
U.S.	=	-	+
Non-U.S. Developed	=	-	+
Emerging Markets	=	-	+
Global Equities	+	+	-
U.S.	+	+	-
Non-U.S. Developed	+	+	-
Emerging Markets	+	+	-
Hedged Equities	+	-	+
Commodities	+	+	-
Real Estate	+	+	-

- **Macro considerations** which will affect the above scenarios include global fiscal concerns, divergent growth expectations, credit dislocation/interest rate environment, and inflation/deflation
- **Potential risks** to the above scenarios include potential European debt contagion, fiscal/regulatory measures in the U.S., supply/demand shocks, terrorist events, and hard landing for Chinese economy

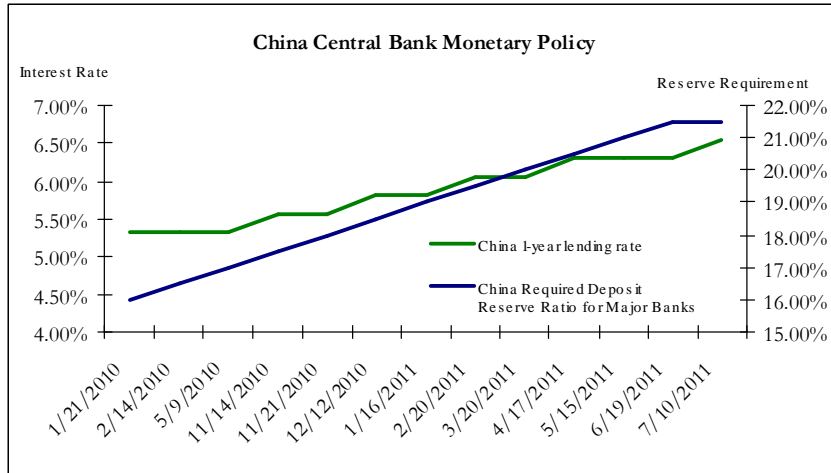
Investment Themes – Rationale & Implementation

Current Investing Themes

We believe that the themes below are most relevant today and will continue to play out over the next 2 to 5 years.

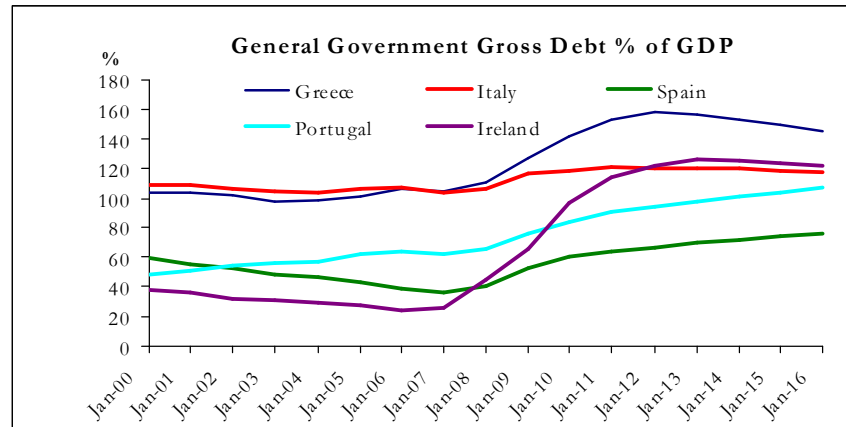
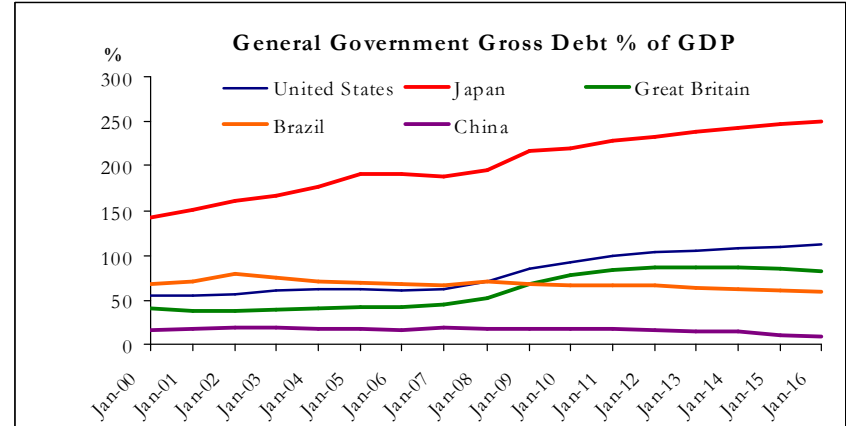
Theme	Rationale	Implementation Strategy
• Global Fiscal Concerns	Continued government intervention, global deficits and increasing sovereign debt burdens, impact on financial services industry and investment markets, Chinese economic policy, U.S. regulatory environment and policy responses, political uncertainty and election pressures	Maintain diversified exposure across global markets including hedging strategies to manage overall portfolio volatility. Ensure exposure to countries with stronger balance sheets and improving economic conditions
• Divergent Growth Expectations (Developed vs. Emerging)	GDP growth in developed markets is likely to remain below long term averages due to high U.S. unemployment, weak housing markets, and austerity measures around the globe	Maintain and/or enhance exposure to faster growing regions such as emerging markets. Consider allocations to specialist managers in emerging markets
• Credit Dislocation/ Rate Environment	Constrained credit environment and global deleveraging have contributed to pricing dislocations in fixed income markets	Maintain diversified global fixed income exposure with focus on real yields. Consider opportunistic strategies, distressed and direct lending strategies to complement liquid investments
• Inflationary Environment	Lagging effects of government stimulus plans (fiscal and monetary), tax policy, quantitative easing programs, volatile commodity prices	Not an immediate issue; ensure adequate inflation protection by allocating to real assets (commodities, real estate)

Investment Themes – Global Fiscal Concerns



Source: ACG Research, Bloomberg

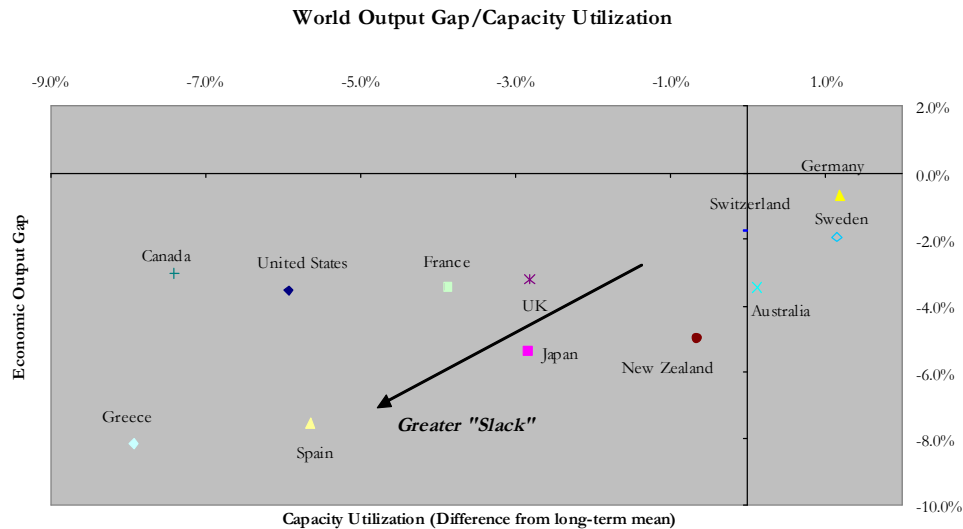
China’s central bank has implemented tightening measures in an effort to curb inflation caused by rising food and real estate prices. The Chinese 1-year lending rate jumped 125 basis points to 6.6% over the past 18 months. Additionally, banks must set aside a record 21.5% in cash reserves. Current government economic targets for 2011 include an inflation target of 4.0% (6.4% as of June) and a real GDP growth rate of 8.0% (9.5% as of 2nd Qtr.) The question remains **whether the world’s second largest economy can avoid a hard landing** during this monetary tightening cycle.



Source: ACG Research, Bloomberg, International Monetary Fund

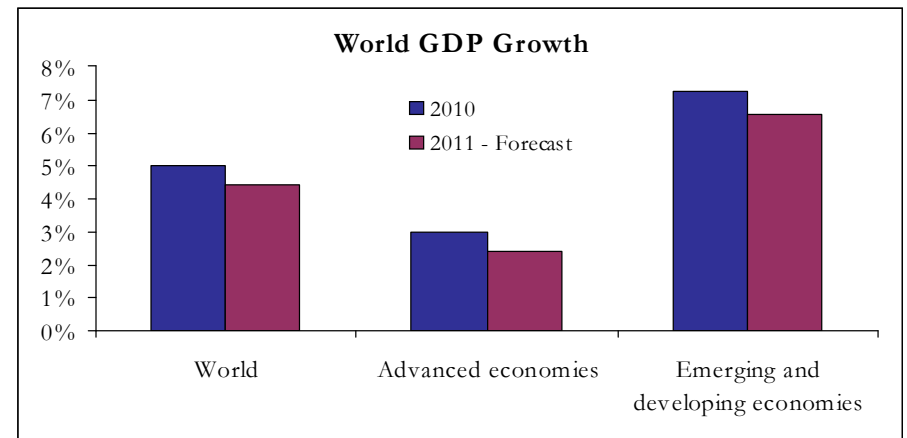
Fiscal deficits and public debt are quite high in many advanced economies resulting from the injection of public stimulus during the global financial crisis. The adjustment to more prudent debt levels will require significant changes and **could weigh on real GDP levels** for several years as governments at every level reduce spending.

Investment Themes – Divergent Growth Expectations



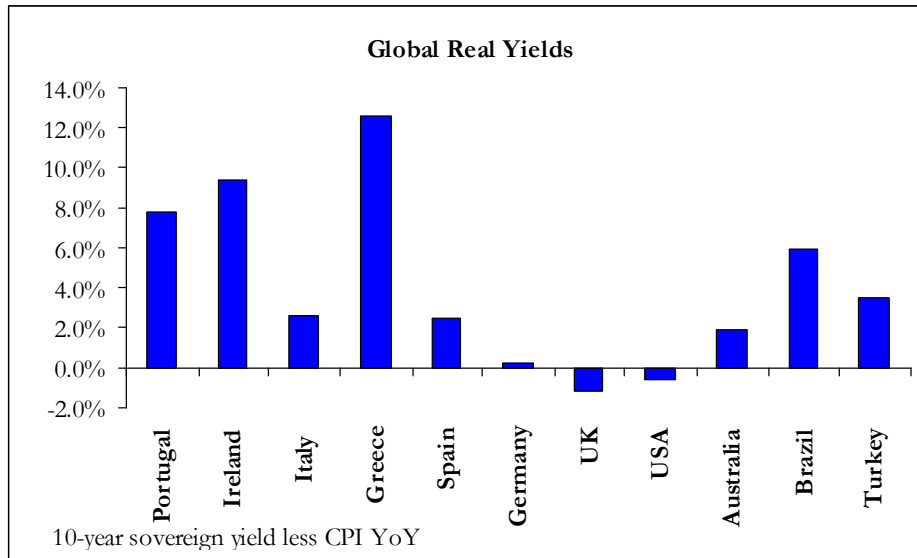
In many advanced economies, **output gaps are still large** and are **projected to close only gradually** over the medium term, and unemployment rates remain high. Unemployment rates are close to 9% and 10% in the U.S. and the euro area respectively, and output gaps for the first quarter of 2011 are estimated to be just under 4% of potential GDP for the U.S. and approximately 6% for the euro area.

World real GDP growth is forecast to be about 4.5% in 2011 and 2012, down modestly from 5.0% in 2010. Real GDP in advanced economies and emerging and developing economies is expected to expand by about 2.5% and 6.5%, respectively. The recovery, however, remains unbalanced. **In most advanced economies, output is still far below potential while emerging economies are benefiting from external demand and burgeoning local consumer demand.**



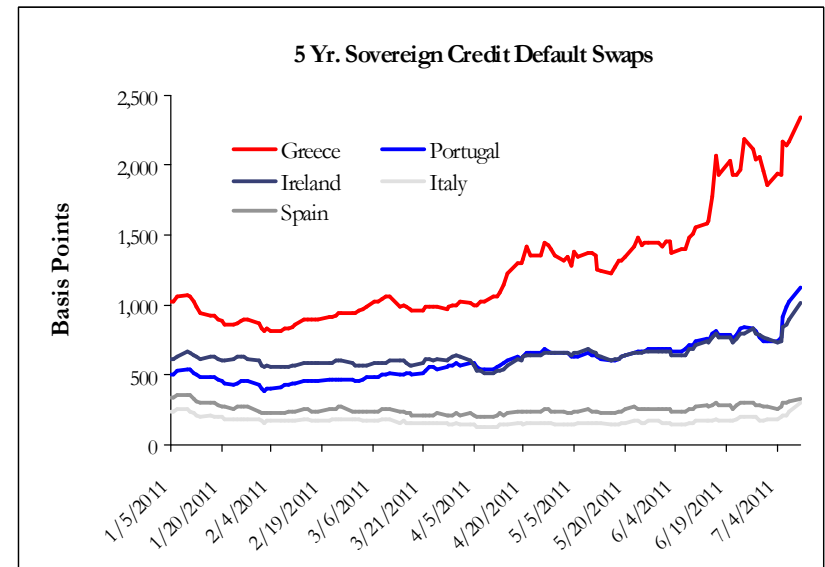
Source: ACG Research, Bloomberg, International Monetary Fund

Investment Themes – Credit Dislocation/Rate Environment



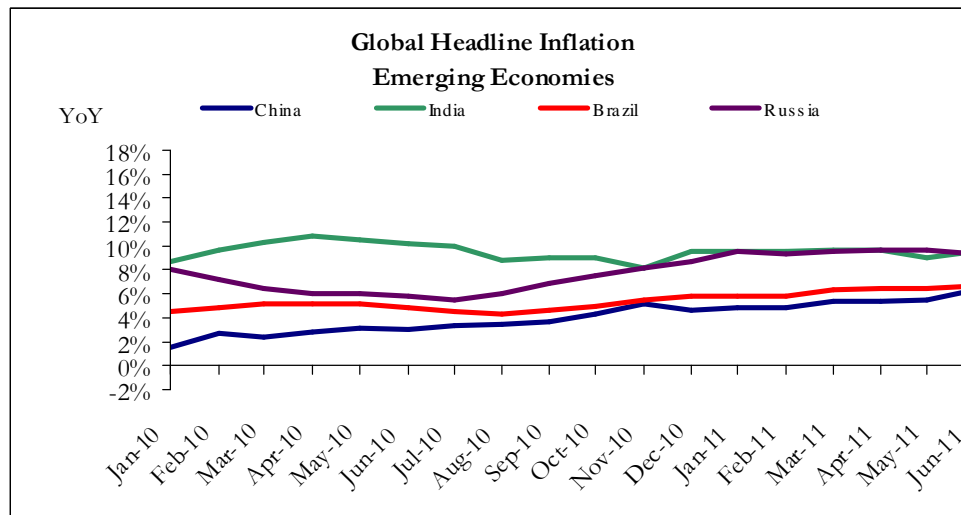
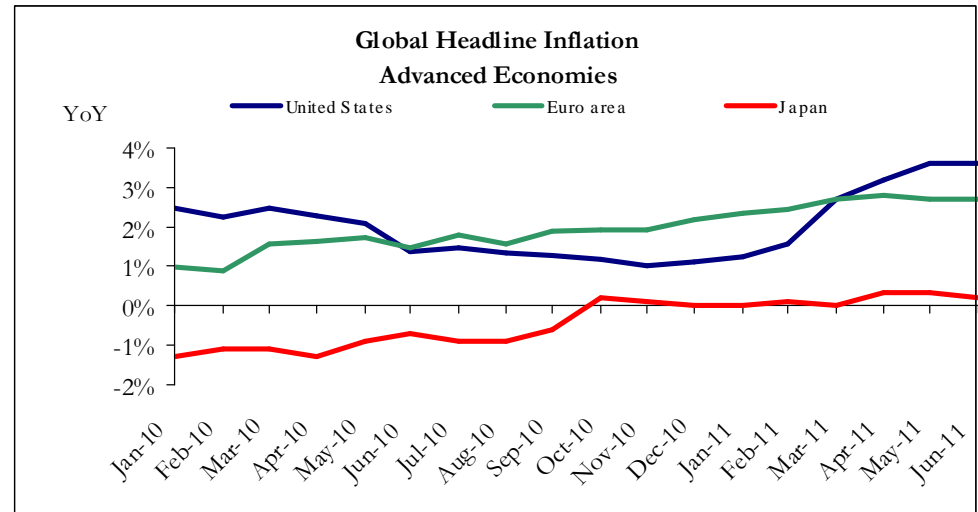
Real interest rates are appropriately low in many advanced economies and are **not expected to rise much** over the coming year.

Credit markets have been adjusting for a **potential sovereign default** within the euro region.



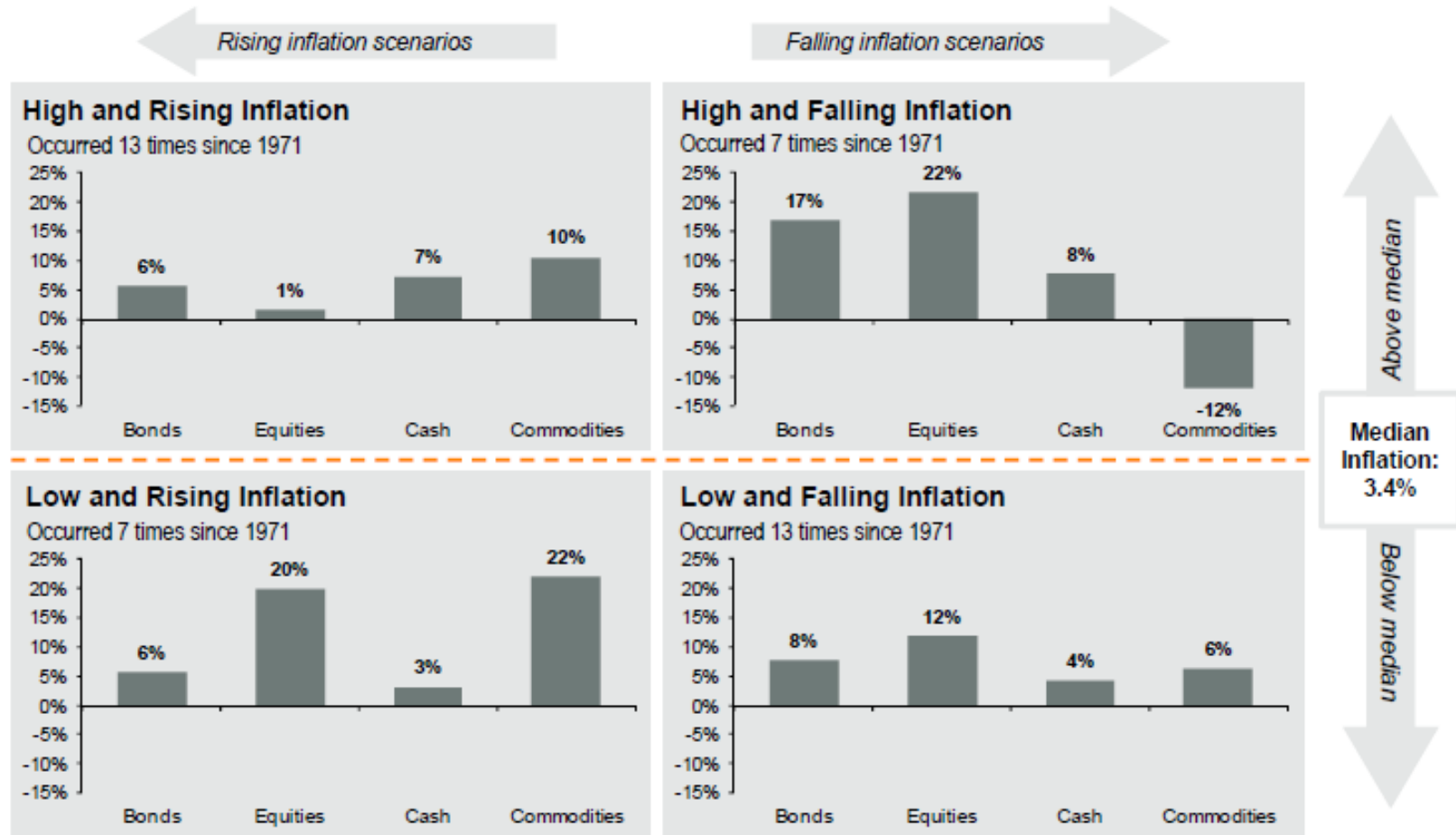
Investment Themes – Inflationary Environment

Advanced economies have seen a **slight uptick in inflation recently**



Emerging economies need to guard against overheating and have **initiated tightening monetary policies** in an effort to **curb inflationary pressures**

Investment Themes – Inflationary Environment



Source: BLS, Barclays Capital, Robert Shiller, Federal Reserve, Strategas/Ibbotson, Standard and Poor's, FactSet, J.P. Morgan Asset Management.

U.S. Economic Analysis

Economic Outlook

Despite recent slowing, the economic recovery is intact...

- While the economy has clearly lost some momentum and the risk of a recession has increased, ACG's base case scenario is that the **economy will continue to gradually recover.**
- While **consumer spending** has recently slowed, this is partially due to **delays in auto output** resulting from supply disruptions in Japan. However, **auto part shortages are abating** and there are emerging signs of a **rebound in vehicle production.**
- Additionally, while consumer sentiment has worsened, the **correlation between sentiment and actual spending is relatively weak.** Although consumer spending has slowed, it **remains positive and above pre-recession levels.**
- The U.S. trade deficit has improved as **exports have increased significantly** from pre-recession levels.
- Business conditions continue to improve, as **corporate profits are rising.** Non-financial companies have kept operations lean, **limiting the need for large-scale cuts** that typically precede a recession.
- Leading and coincident economic indicators **remain solidly positive.**
- The bond market, which has historically been an accurate predictor of recessions, is **not indicating a recession is imminent.** The **yield curve remains positive/upward sloping**, as evidenced by the spread between 10-year and 3-month Treasuries (currently over 200bps positive).

Where Will Growth Come From?

The prospects for the economy are for a prolonged recovery at a moderate pace...

- Analysts are forecasting that consumers will loosen their purse strings in coming quarters. The median forecast from Bloomberg's survey of 61 economists indicates **spending will average 2.5% over the next year**.
 - Since reaching a five-year low of \$49 trillion in the first quarter of 2009, **household net worth has improved by \$8.94 trillion**.
 - The dramatic improvement in household balance sheets, largely due to deleveraging and increased savings, has resulted in **deferred consumption that leaves little room for additional spending reductions** and is ultimately expected to **lead to renewed consumption** due to pent-up demand.

- The business outlook remains positive as the **manufacturing sector**, which led the economy out of the depths of the recession, is **still expanding** with industrial production rising 3.7% in July over the prior year.

- **Business investment in equipment and software has expanded** and current business surveys indicate **capital spending over the next six months will remain largely unchanged**. At the same time, companies have kept inventories and head-count lean, limiting the need for **large-scale cuts** that typically precede a recession.

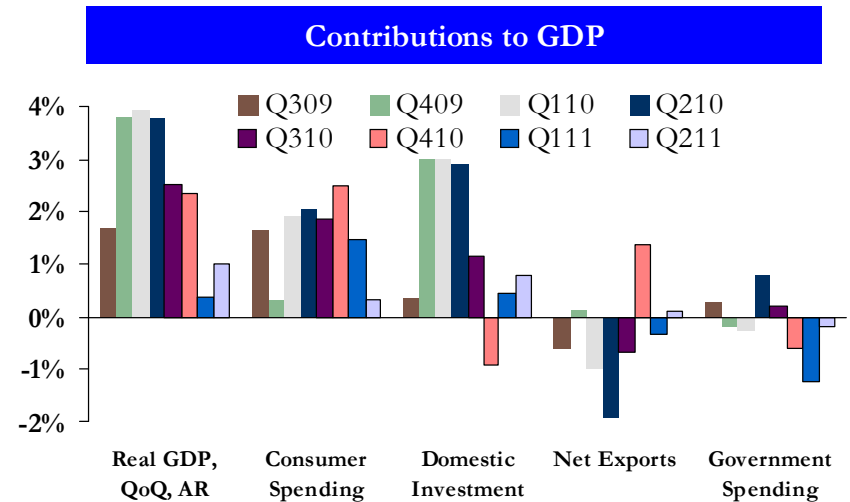
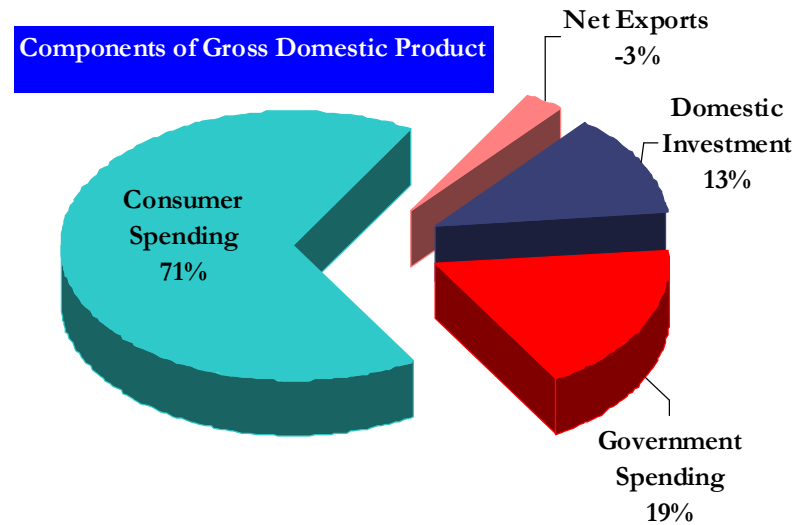
- U.S. **exports climbed to an all-time high** in the second quarter, reflecting the strong demand abroad for U.S. goods and services and a weak dollar. With the Federal Reserve committed to maintaining ultra-low interest rates through 2013, the **export environment for U.S. goods/services is likely to remain positive in the near term**.

- Inflation spiked in the first half of 2011, but has **since decelerated** due to falling commodity prices and dissipating supply disruptions. **Inflation is expected to moderate** in the coming quarters while longer-term inflation expectations have **remained stable** according to market-based expectations.

Gross Domestic Product

Since the start of the economic recovery in July 2009, growth has been uneven...

- The economic recovery has been **slow by historical standards** as a rebound in business investment is being offset by reduced government spending and a leveling off of consumer spending.
- Economic growth slowed in the first half of 2011, weighed down by shocks from sharply higher oil prices and supply disruptions from Japan's natural disasters.
- Inflation-adjusted Q2 GDP **growth of 1.0% was revised to 1.3%** in late September as consumer spending was slightly higher than expected
- In general **economists expect economic activity will rebound in the second half of 2011** as Japan's supply chain disruption subsides and declining energy prices ease pressure on U.S. consumers.
- Economists are forecasting **1.5% growth** in the second half of 2011 and **2.2% growth** in 2012.

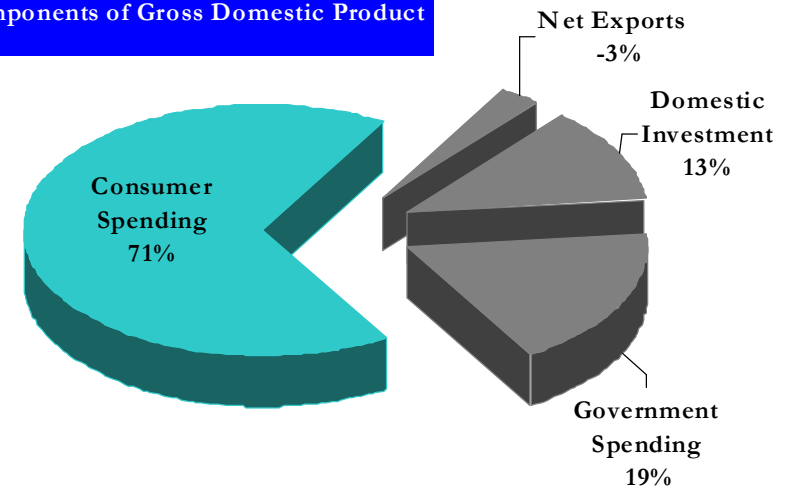


Gross Domestic Product – Consumer Spending

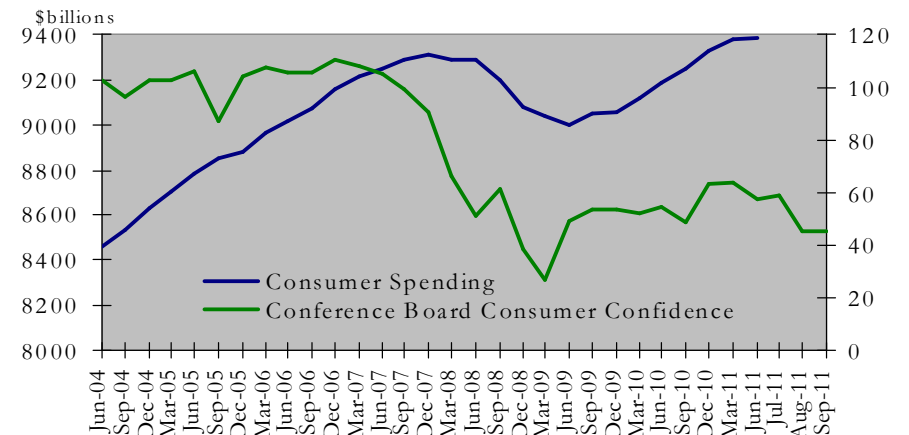
Consumer spending has surpassed pre-recessionary levels even while confidence wanes...

- Consumer spending, representing over 70% of economic activity, has been restrained by a lack of job growth and deleveraging.
- However, even with these headwinds, overall spending has surpassed pre-recession levels.
- Consumer spending, originally estimated to have grown at a 0.4% annual rate of growth in the second quarter, was revised upwards to 0.7% in late September. While this is down from 2.1% annualized growth in the first quarter, much of the decline was attributable to a **collapse in auto sales** resulting from supply constraints and reduced buyer incentives. **Excluding autos, spending rose 1%** from the first quarter.
- In August consumer confidence fell to the lowest level since March 2009, largely due to political intransigence over the U.S. budget deficit, the European debt crisis, and a volatile, “risk-off” stock market environment. However, the **correlation between confidence and actual spending is relatively weak**. Additionally, **low confidence readings can lead to positive forward U.S. equity returns**:

Components of Gross Domestic Product



Consumer Spending vs. Consumer Confidence



Consumer Confidence Level	Standard & Poor's 500 Index 12-Month Forward Returns (%)				Number of Instances	Positive Forward Returns (%)
	Average	Median	Highest	Lowest		
<60	22.0	24.1	61.0	-32.6	55	93
<70	18.9	20.8	61.0	-38.1	88	89
<80	15.8	15.2	61.0	-43.3	128	88
Average	18.8	19.9				90
>130	2.2	6.3	39.8	-26.6	63	56
>140	-7.8	-9.1	14.4	-26.6	11	18
Average	-2.8	-1.4				37

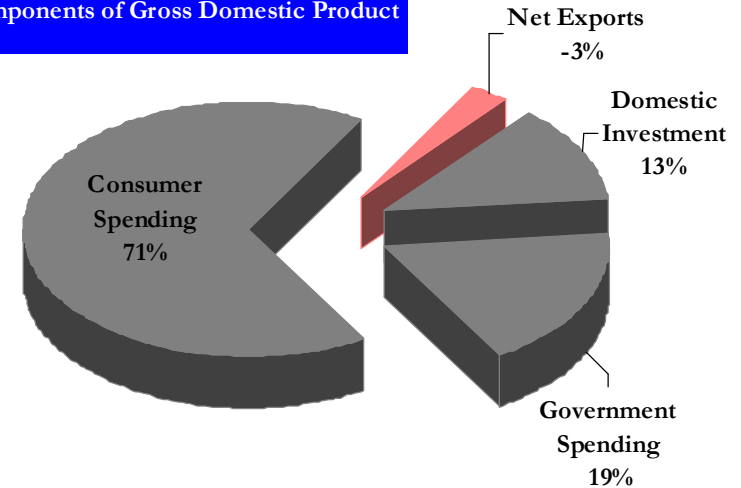
Based on data from February 1967 through July 2010
Source: FactSet, The Conference Board as of July 31, 2011

Gross Domestic Product – Net Exports

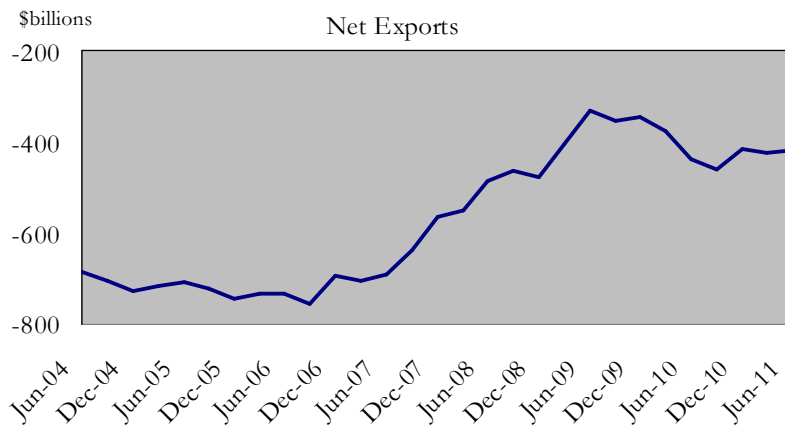
Exports of goods and services is contributing favorably to economic activity...

- U.S. exports are up 9% since December 2007 and reached an all-time record of \$1.8 trillion during the second quarter of 2011.
- However, the U.S. continues to run a trade deficit as imports outpace the increase in exports. **Oil imports are a large contributor** (rising 28% through July) due primarily to a spike in prices averaging \$101 a barrel over the first seven months versus \$84 over the same period in 2010.

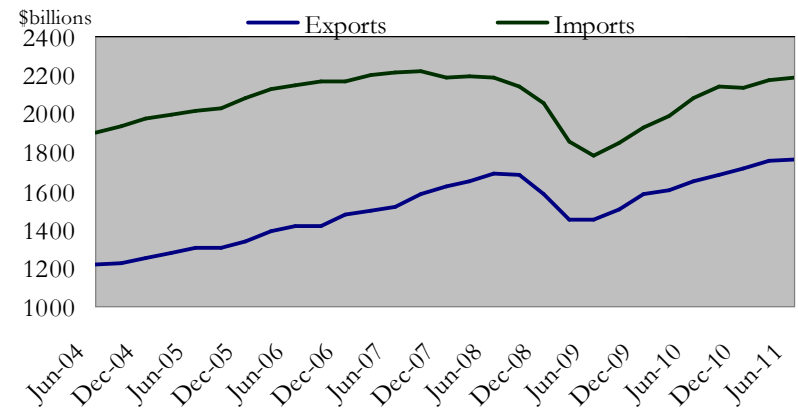
Components of Gross Domestic Product



Exports



Contributions to GDP

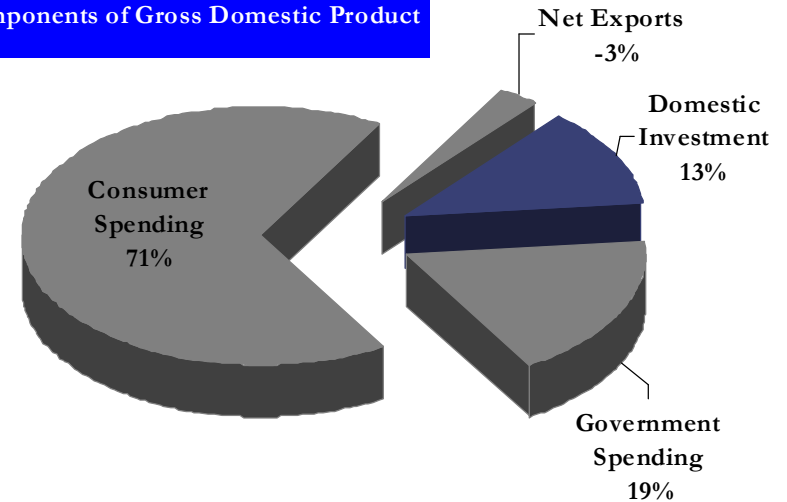


Gross Domestic Product – Domestic Investment

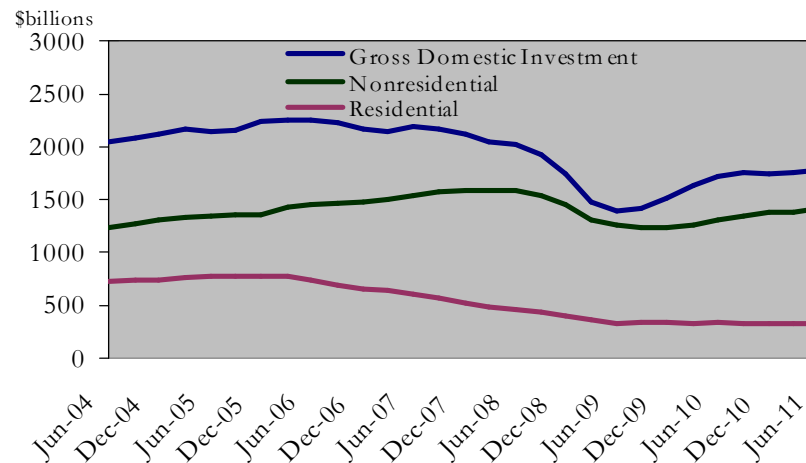
Business investment is showing signs of firming...

- Business investment in such items as machinery, equipment and technology has increased as companies look to improve operating efficiencies.
- In total, orders for durable goods (items meant to last three years or more) have increased 35% since the end of the recession in June 2009. Much of this was due to investment in equipment and software, which increased 27% over this time period.
- Additionally, companies have slowed inventory buildup in a sign they are keeping a tight rein on supply, suggesting the economy will not suffer from excess supply as the current expansion enters its later stages.

Components of Gross Domestic Product



Contributions to GDP

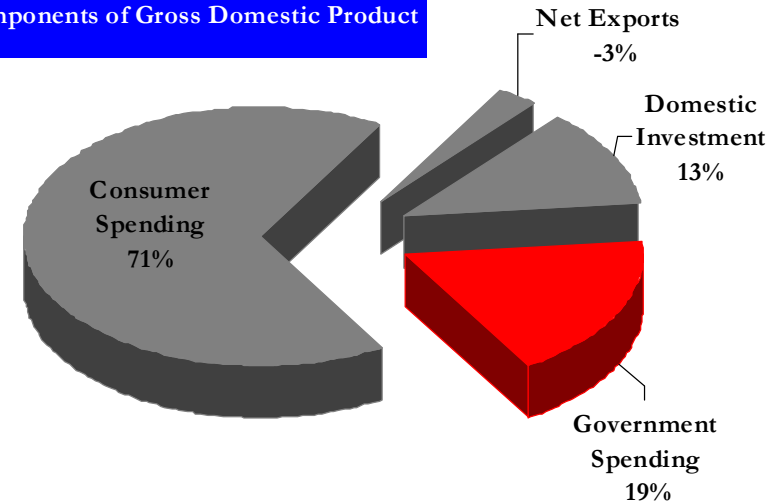


Gross Domestic Product – Government Spending

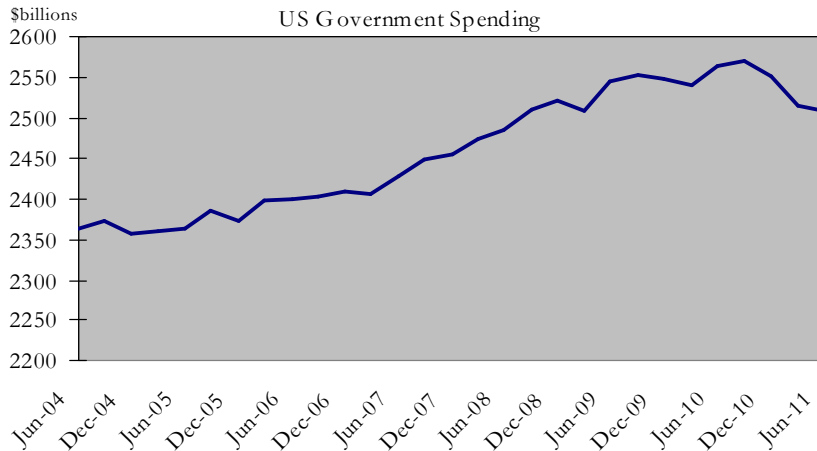
The U.S. Government is reducing spending to address budget deficits...

- Government expenditures are averaging zero to slightly negative growth during the recovery. Representing 20% of GDP, **reduced government spending has a contractionary effect** on GDP.
- Spending at the Federal level got an initial boost as **stimulus plans injected funds into the economy**, but continued stimulus is unlikely as politicians respond to pressures from constituents and credit rating agencies to reduce the federal deficit.
- State and local governments have **reduced spending by an even greater percentage** as both property taxes and federal support have decreased.

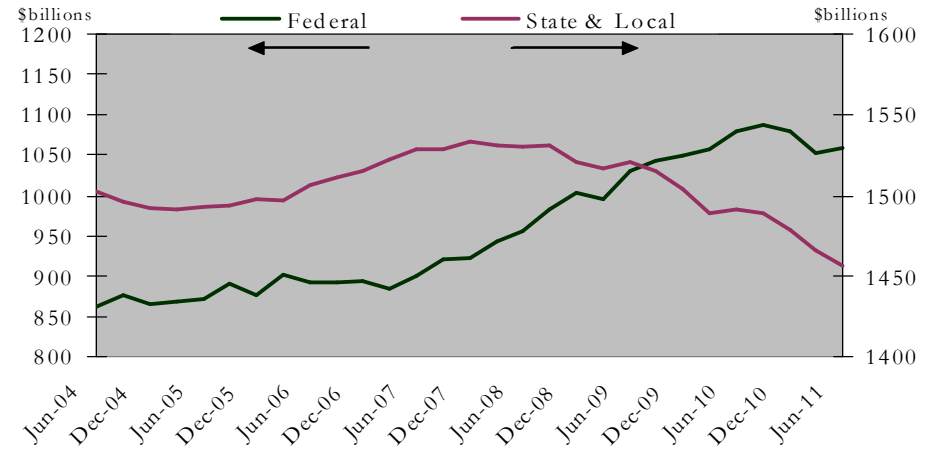
Components of Gross Domestic Product



Contributions to GDP



Contributions to GDP

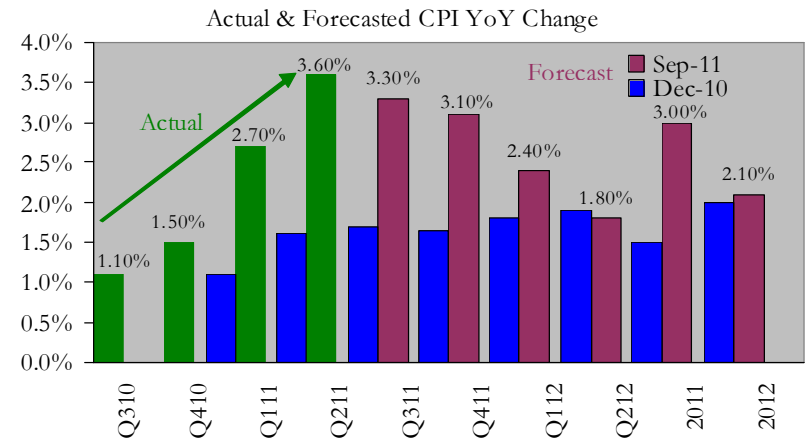


Inflation

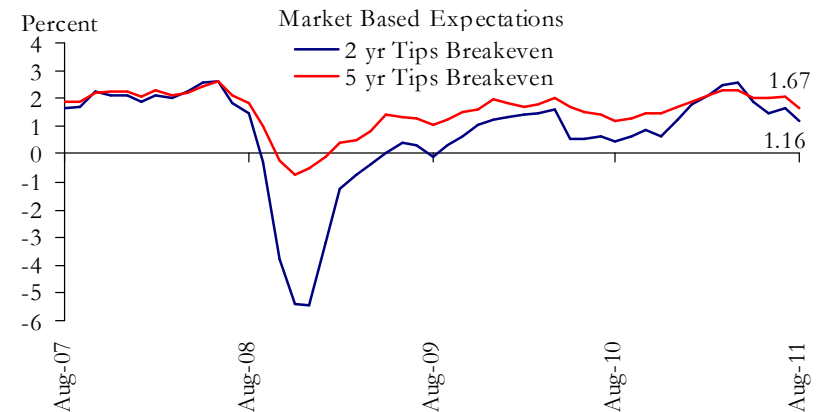
Prices of many commodities, which increased sharply earlier in 2011, are expected to moderate...

- The cost of living in the U.S. climbed dramatically over the first seven months of 2011 as **higher gasoline and food prices** translated directly into increased inflation for consumers.
- The headline consumer price index, which includes food and energy, rose at an annual rate of 3.6% in July from the same period last year, compared with an average of 1.63% over the course of 2010. Crude oil prices, after peaking in April at \$114 a barrel, **averaged \$98** through July, **after averaging \$78** over the same period in 2010.
- **Longer-term inflation expectations have remained stable** according to break-even rates on Treasury Inflation Protected Securities (TIPS). The five-year breakeven rate has **fallen to 1.67% from a high this year of 2.31%** reached in April.
- Measured on a fourth-quarter over fourth-quarter basis, headline consumer **inflation is expected to average 3% in 2011 and 2.1% in 2012** (Federal Reserve of Philadelphia's third quarter survey of Professional Forecasters).

Headline Consumer Price Index



U.S. TIPS Breakeven Rates



Interest Rates

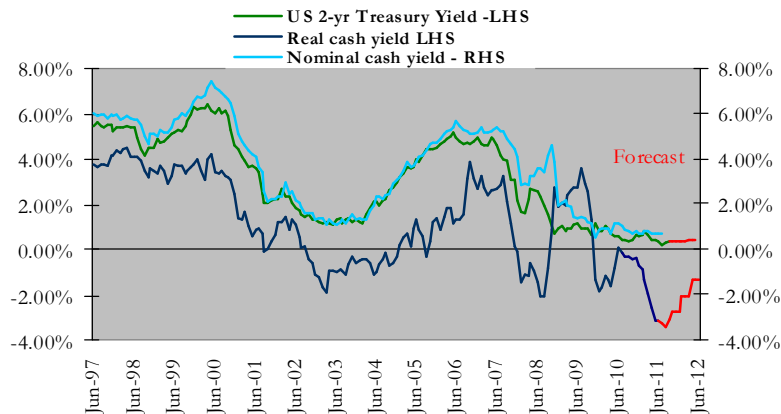
Slower than expected economic growth has lowered interest rate expectations...

- Based on the U.S. Treasury forward curve, **investors expect the treasury curve to shift upwards 30 basis points**, on average, one year from today.
- The Fed recently announced they would **hold their benchmark lending rate near zero** at least through mid-2013 to spur the economy.
- This could continue to keep **short-term real yields negative** over the next year.

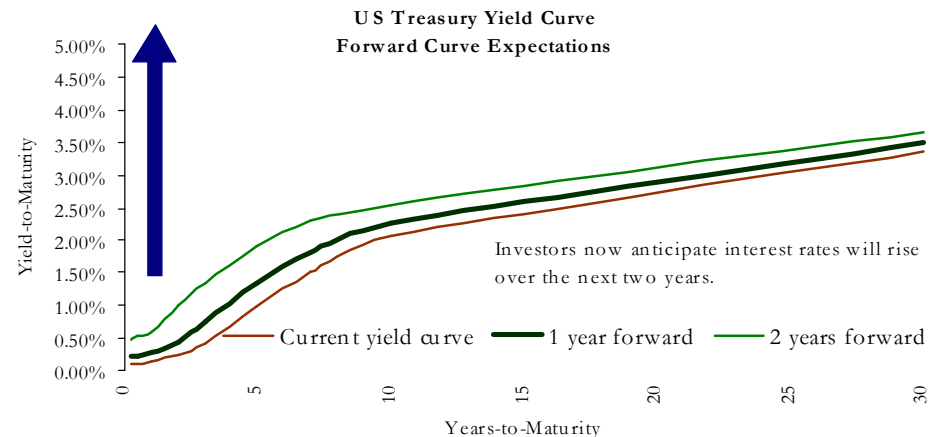
U.S. Treasury Forward Interest Rates

US Treasury Actives Forward Curve (as of 9/08/11)					
Tenor	3 Month	1 Year	2 Years	3 Years	4 Years
1 Month	0.0754%	0.1991%	0.4638%	1.1779%	1.7427%
3 Month	0.1041%	0.2142%	0.4855%	1.2240%	1.7893%
6 Month	0.1124%	0.2371%	0.5183%	1.2936%	1.8597%
1 Year	0.1502%	0.2833%	0.5873%	1.4339%	2.0023%
2 Year	0.2503%	0.4349%	1.0081%	1.7155%	2.2606%
3 Year	0.4228%	0.7647%	1.3341%	1.9794%	2.5324%
5 Year	0.9842%	1.3487%	1.9043%	2.4095%	2.8336%
7 Year	1.5019%	1.8205%	2.2819%	2.7696%	2.9894%
10 Year	2.0569%	2.2670%	2.5512%	2.8274%	3.0316%
30 Year	3.3555%	3.4831%	3.6551%	3.8228%	3.9549%

Short-term U.S. Interest Rates



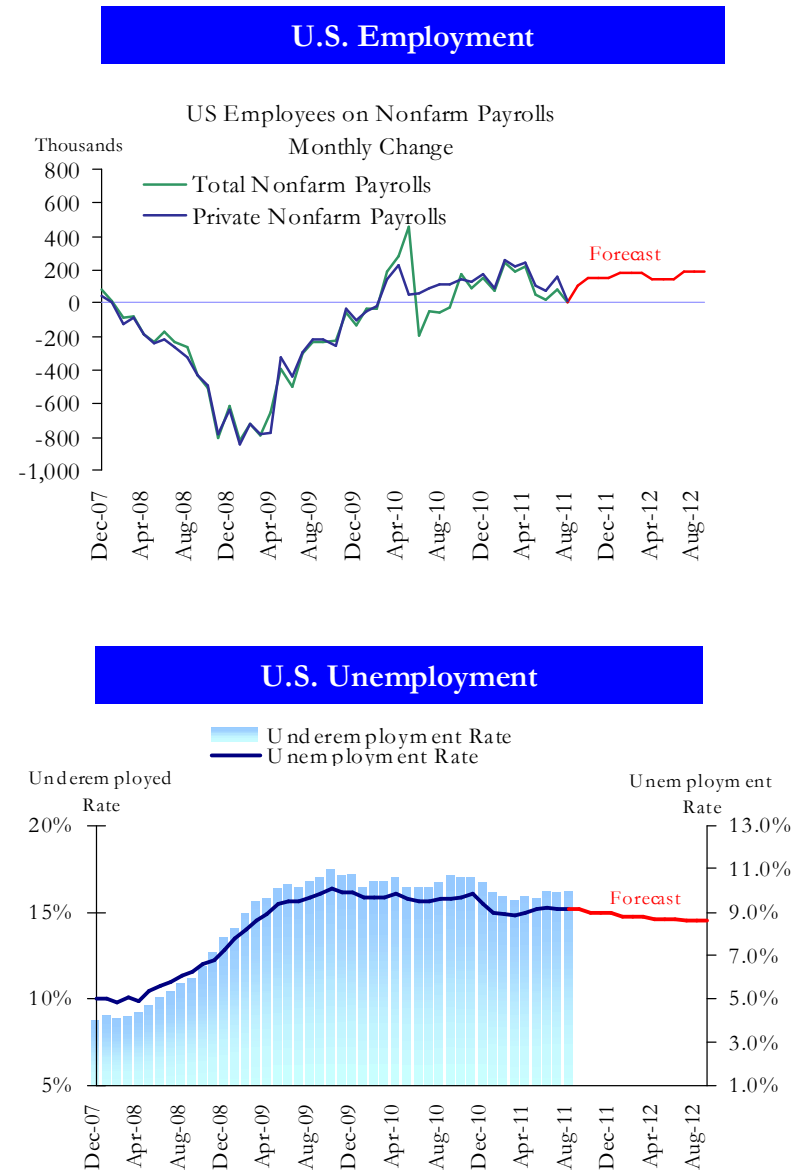
U.S. Treasury Yield Curve



Employment

Employment gains have been mild in 2011...

- The economic recovery has led to a rebound in corporate revenues and profits, but business confidence continues to lag which has kept **employment gains below expectations**.
- Since July 2009 U.S. employers **added 639,000 jobs**, with payrolls unchanged in August.
- **Private employers have added 1.2 million jobs** since the recovery commenced, an average of 47,000 a month, which remains well below the 200,000 forecasted by economists.
- Much of the **private sector hiring has been offset by declines in government payrolls**, which have fallen by 595,000 since the recovery began. However, the largest decline in government payrolls over this period was due to the ending of temporary employment for census takers in mid-2010.
- The lack of job growth has led to a fairly **stagnant unemployment rate**, which dropped below 9% in early 2011 from nearly 10% in 2010, only to inch back over 9% by August.
- The Federal Reserve of Philadelphia's third quarter survey of Professional Forecasters projects nonfarm payroll employment job gains at a monthly rate of **111,500 in 2011 and 150,100 in 2012**.
- Unemployment is projected to remain at an annual average rate of 9.0% in 2011 before falling slightly to 8.6% in 2012.

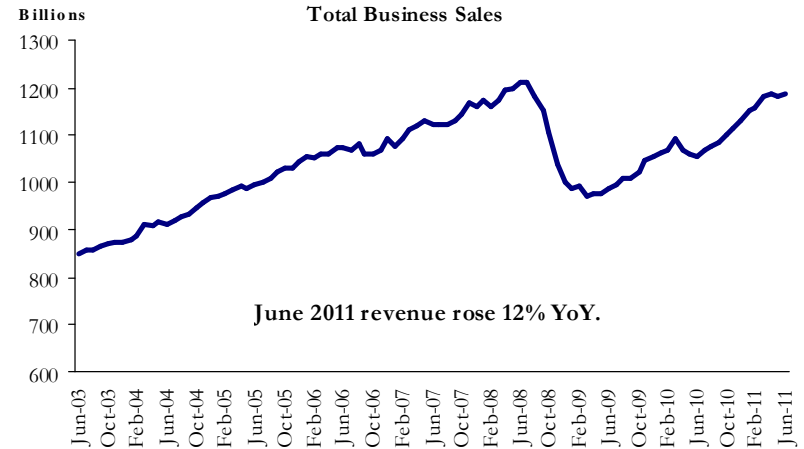


Business Conditions

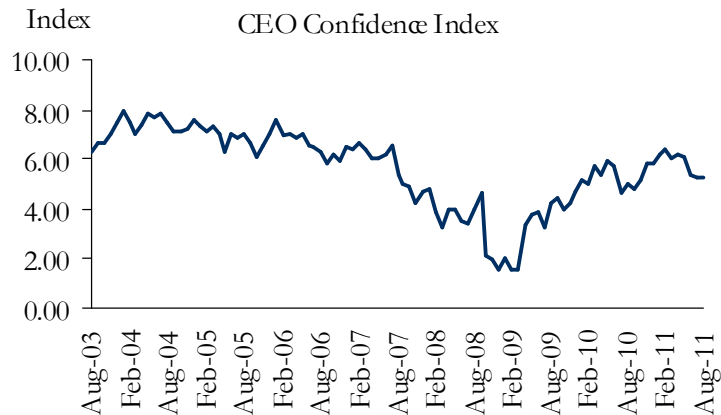
Revenues are higher, profits are rising, but confidence has cooled...

- US Census bureau indicate that total **business sales rose 12%** year-over-year (y-o-y) in June and have **increased 20%** since the start of the recovery. **Corporate profits rose 8%** in the second quarter y-o-y and **increased 63%** from June 2009.
- CEO confidence has cooled, with the consensus expectation that the economy will **continue to expand, but at a slow pace** of growth.
- However, corporate profit guidance continues to be positive. For 2011, the number of companies **raising** or **maintaining** profit guidance each month has averaged 2.5x those companies lowering guidance through August of 2011. The last time this ratio reached similar levels was April 2004, which was **bullish for equities (6.8% return on S&P 500 over forward 12 months)**.

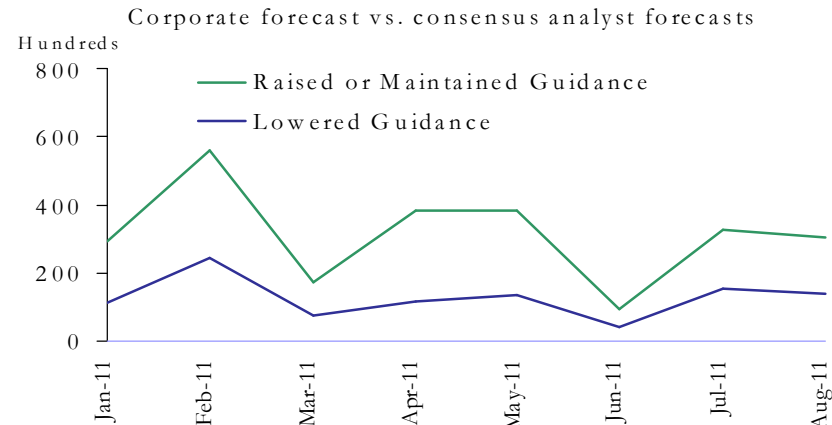
U.S. Business Sales



CEO Confidence in the Economy in 1 Year



U.S. Corporate Profit Guidance

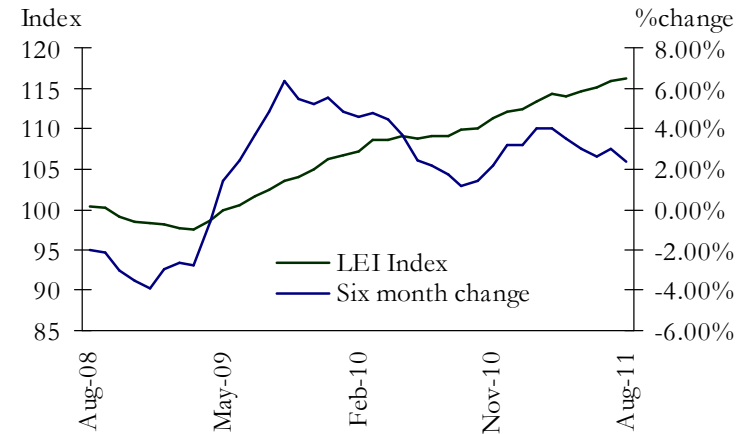


Leading Indicators

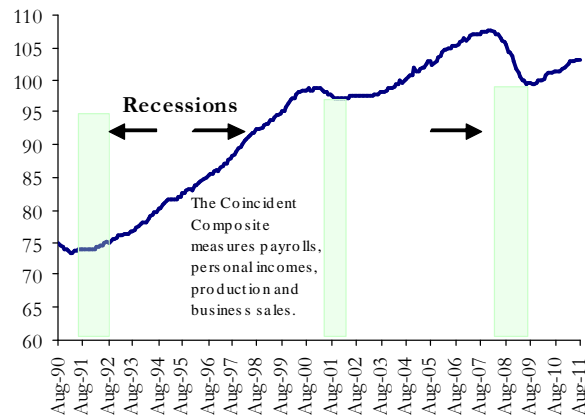
Traditional U.S. business cycle indicators that measure the economy's future direction are positive...

- The Conference Board's Leading Economic Index (LEI) typically leads inflection points within U.S. economic cycles by roughly six months. The LEI **rose in August for a fourth consecutive month and increased 2.4% over the past six months** – about a 5% annual rate.
- The Conference Board's Coincident Economic Index (CEI), which measures current levels of industrial production, employees on nonagricultural payrolls, personal income and manufacturing and trade sales, **expanded in August for the 21st consecutive month**. During the six month period through August, the CEI increased 0.8%.
- **The CEI is typically more responsive to immediate changes in the conditions of the U.S. economy.** In past economic cycles, the CEI has peaked prior to an onslaught of a recession but currently **does not show signs it is peaking**.

Leading Economic Index (LEI)



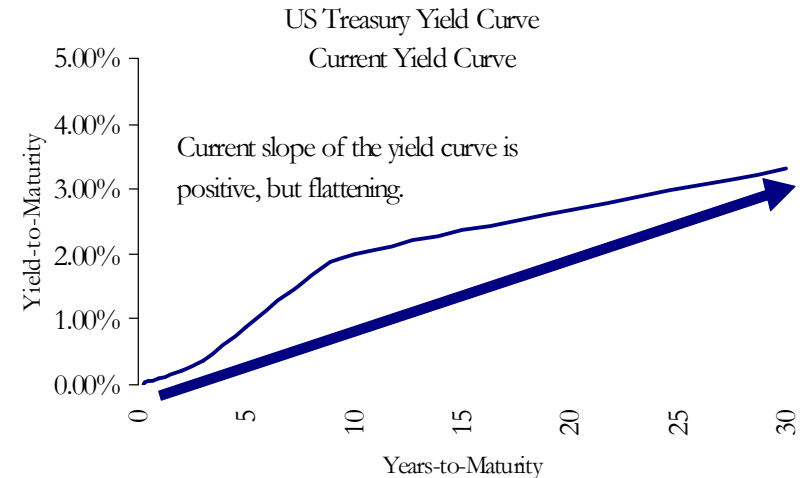
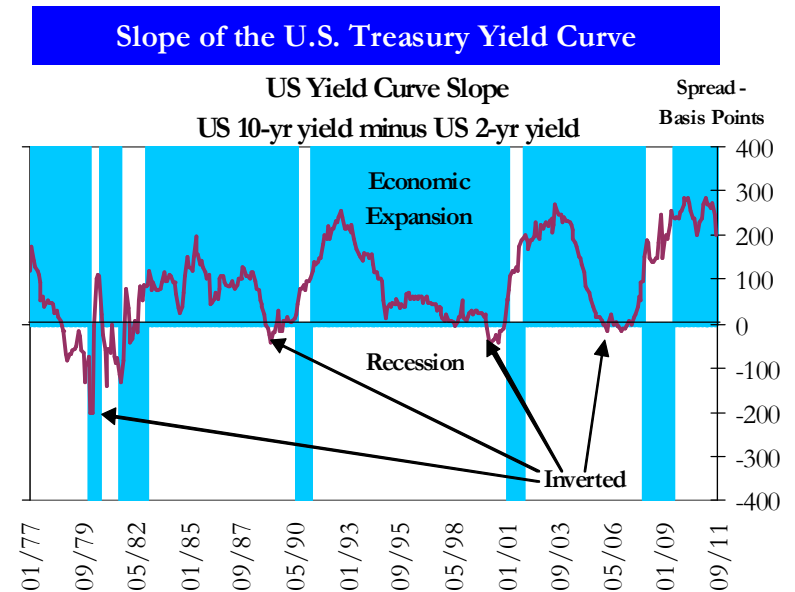
Coincident Economic Index (CEI)



Leading Indicators

Non-economic indicators point toward further economic expansion...

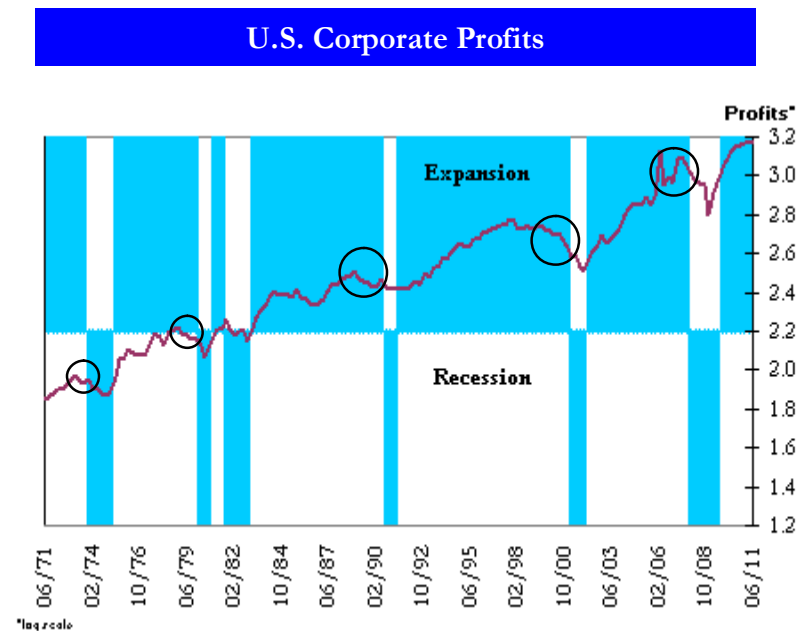
- The slope of the U.S. yield curve has proven to be an **excellent predictor of economic recessions**.
- Historically an inverted yield curve (short rates above long rates) indicates a recession about a year in advance, and yield curve **inversions have preceded each of the last seven recessions** (as defined by the National Business Economic Research).
- **The yield curve predicted the “Great Recession”** as the yield curve inverted in August 2006, slightly more than a year before the current recession started in December 2007.
- **Today the yield curve is positive**, although safe-haven buying has caused it to flatten somewhat.
- In general, a positive, but **flattening yield curve indicates a weak but positive** pace of economic growth in the medium term.



Leading Indicators

Leading indicators point toward further economic expansion...

- Corporate profits are a leading economic indicator of the future direction of the economy as historically **corporate profits typically weaken sharply before the onset of a recession.**
- In fact, this is what helps bring about a downturn as companies reduce payrolls in order to maintain profitability. Slowing job growth in turn weakens the rate of income creation, translating to lower domestic demand.
- Despite fading business confidence, **corporate profits remain robust**, climbing to an all time high in the second quarter but corporations still have not hired workers at a meaningful rate. As such, **corporations are not overstaffed and would not need to revert to massive layoffs.**
- The behavior of **corporate profits suggests a recession is not imminent.** Additionally, companies have demonstrated an **ability to generate profits despite a slow growth environment.**
- **Corporate after-tax earnings rose at an annual rate of 0.3%** in the second quarter; the government had previously estimated flat profits.

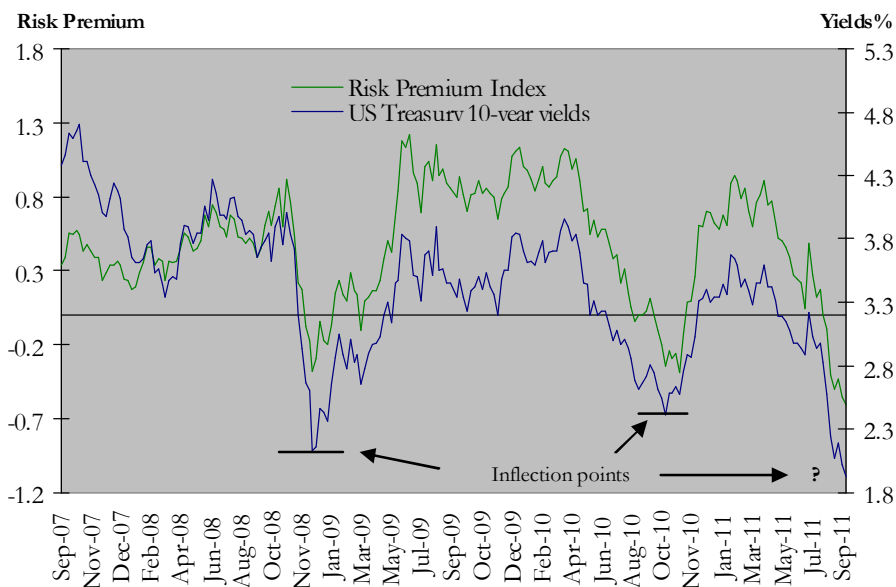


Financial Market Valuations

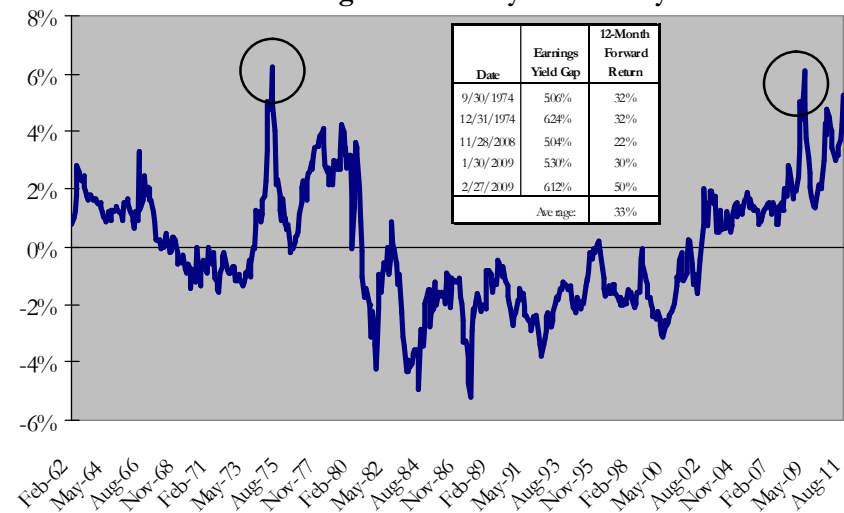
U.S. Treasury yields are near all time lows as risk aversion surges...

- Investors continue to seek the “safe-haven” of U.S. Treasuries in the wake of European debt concerns.
- Treasury 10-year yields have declined to **all-time lows** sending the term premium, which accounts for expectations for interest rates, growth and inflation, to -0.54% versus an average of +0.48% over the past five years, **indicating that Treasury bonds are expensive.**
- Conversely, the selloff in equity markets has moved **equity valuations to oversold conditions** that historically have led to positive returns over the next 12 months.
 - The earnings yield gap (which measures the difference between the S&P 500 earnings yield and the 10-yr Treasury yield) stood at 5.27% at the end of August. The previous high was reached in December 1974 at 6.24% and has averaged -.02% since 1962. **When the gap has reached 5% or more, the S&P 500 has returned 33% on average.**

Federal Reserve risk premium model



S&P 500 Earnings Yield less 10-yr US Treasury



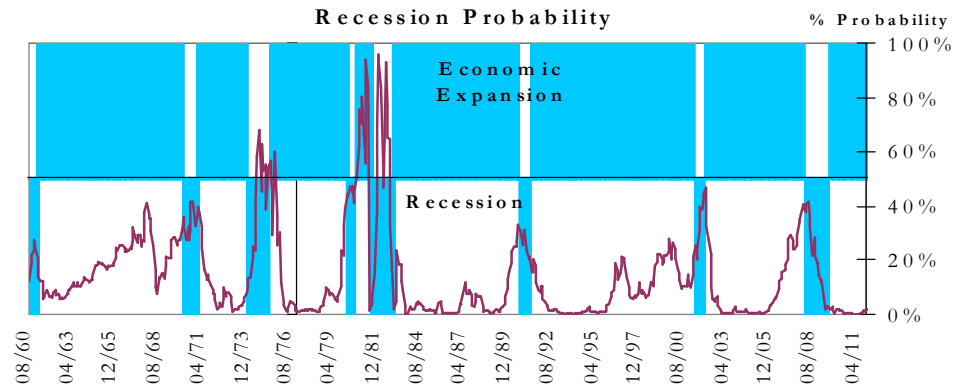
Leading Indicators Forecasts

Both economic and financial market based indicators suggest further economic expansion...

- The Conference Board **Leading Economic Index** for the U.S. **increased 0.5% in July**, following a 0.3% increase in June and a 0.7% increase in May. The recent gains in the LEI are modest, but despite growing uncertainties, the leading indicators still suggest **economic activity** should be **slowly expanding** through the end of the year.
- The Conference Board **Coincident Economic Index** for the U.S. **increased 0.3% in July**, following a 0.1% increase in June, and a 0.1% increase in May. Three of the four coincident indicators advanced over the past six months. The CEI is more responsive to immediate turning point patterns in economic data.
- U.S. corporate profits, which are also a leading indicator, remain robust.
- The Treasury **yield curve is positive and upward sloping**, suggesting the economy **is not** in imminent danger of **falling into a recession**.
- The Federal Reserve Bank of New York's model, which is based on the 10Yr/3Mth treasury spread, estimates the **probability of a recession at less than 2.0%**:

Recession Probability	Value of Spread (bps)
5%	121
10%	76
15%	46
20%	22
25%	2
30%	-17
40%	-50
50%	-82
60%	-113
70%	-146
80%	-185
90%	-240

The current spread between the ten-year yield and the 3-month T-bill is 207 bps. A spread of 121bps indicates a 5% chance of recession.



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