

FOURTH QUADRANT ASSET MANAGEMENT

Preparation Makes Opportunity

2012 Investment Strategy Guide



2012 Investment Strategy Guide

2012 — The Bull Should Take Control

Executive Summary

As we open the first month of 2012 many issues plaguing capital markets in 2011 remain at the forefront of mainstream newswire providers. European debt issues, a slowing US economy and fears of a Chinese “hard landing” permeate the air of opinion and are keeping investor sentiment in the doldrums. We find it difficult to locate a preponderance of equity bulls and many advice providers continue to promote heavily defensive portfolios laden with government fixed income, defensive equities and cash. Studies in behavioral finance demonstrate this type of behavior should be expected after a decade of booming bond returns, substandard equity returns and unorthodox levels of volatility. However, we feel this type of defensive positioning will be a mistake in 2012, as our research points toward lower volatility and a decent 2012 for those willing to hold more equities.

While we are optimistic 2012 should play out well, we do not want to come across “Pollyannaish” as we view this as a bullish short term trend within a longer period of structural change in the markets. The period between 1982—2000 marked a lengthy bull market that had major tail winds and was supercharged thru increased leverage by governments, corporations and individuals. From 2001 thru 2008 policy makers tried to fend off the inevitable by throwing the kitchen sink at the problem and pulling fiscal and monetary levers. Unfortunately this only culminated in the disaster of 2008 and with it the end of the great moderation. We are now within a period of transformation to the next version of capitalism and we should expect markets to perform similarly to like periods of structural change, which were marked by lower real growth, choppier economic cycles and lower equity returns. Some have called this type of market “the new normal”, suggestive of a permanent change. However, as we look back in history it is likely to be more akin to a temporary adjustment as capitalism adapts and another sustainable bull market eventually emerges. *(cont page 3)*

Contents	Page
Executive Summary	2
2012 Investment Themes	4
Investment Strategy	14
Closing Remarks	15



2012 Investment Strategy Guide

2012 — The Bull Should Take Control

With that being said, shorter term cycles within longer periods of structural change contain positive years for equity markets and we believe 2012 will be one of those years. Our base case outlook for 2012 expects total equity returns in the arena of +5% - +12% while commodities and fixed income lag and cash continues to earn approximately 0%. This estimate is driven by our themes, which are outlined on the following pages, and has led us to the following calculus.

=	<u>Total Equity Returns:</u>	+5% - +12%
	Corporate Profit Growth	+3% - +10%
+	Dividend Yield ~	+2%
+	P/E Multiple Expansion	+0%

Corporate profit growth will likely remain in positive territory this year, albeit at a slower pace than 2011, and dividends should add a couple of percentage points to total return. As for price-to-earnings multiples, it is unlikely we experience expansion as animal spirits remain muted due to worries about future corporate profits and margins, increased taxes and future cuts to government spending.



2012 Investment Strategy Guide

2012 — The Bull Should Take Control

2012 Investment Themes

Our investment outlook is based on our researched themes which are important in driving the different variables contributing to our forecast. Below is a list of the themes we feel will be impactful for 2012:

- [The United States will continue to outperform](#)
- [Corporate profit growth will decelerate but remain relatively strong](#)
- [Europe will likely sidestep crisis in 2012](#)
- [China will not have a hard landing in 2012](#)
- [Inflation will be moderate in 2012](#)
- [Global Monetary policy aligned towards easing but distribution mechanism remains plugged](#)
- [Valuations are attractive but P/E multiples are unlikely to expand](#)
- [Sentiment is a positive backdrop towards equities](#)

2012 Investment Strategy Guide

2012 — The Bull Should Take Control

The United States will outperform—

Walter Wiston, the late banker and former CEO of Citicorp, was famous and correct when stating “*capital will go where it is wanted, stay where it is well treated.*” As we view the three major investible regions today (US, Foreign Developed and Emerging Markets), the United States is the best on the block at meeting that criteria. This is not because we believe the US will experience a period of above average growth in 2012 but rather a combination of attributes. Included on the list of attributes is: the US is likely to remain a destination for risk averse investors, it will provide an environment of corporate profit growth that is more attractive than alternatives and it is a market with more transparency.

Competing against the US is the Euro Zone which remains muddled in debt issues and is connected by an evolving currency union that resembles a quagmire. Additionally, it is pushing painful austerity measures and even promoting a Tobin Tax! This is not to suggest a crashing Europe, as we feel they have accomplished enough to avert that this year, but rather there is enough nagging uncertainty (and likely recession) to create an unsettled environment.

The Emerging Markets, on the other hand, starts with China. It is the 800lb guerrilla in the room and has a direct economic impact on many other countries by virtue of trade dependence. For example, China is now Brazil’s largest trading partner gobbling up approximately 40% of its iron ore exports and over 15% of total exports. Because of this increasing level of inter-connectivity fears of a Chinese hard landing will have a ripple effect on investment. In conjunction to the economic uncertainty, many Emerging Market countries still exhibit a habit of imposing draconian capital controls, suffer from opaqueness in economic data and have a suspect rule of law. While these countries may be able to get a way with this in times of greater animal spirits, it becomes much more challenging to attract and retain capital in times of uncertainty.

Other Foreign Developed countries like Canada and Australia are fine investment landscapes by many metrics, but the level of dependency towards Chinese demand for their bountiful natural resources creates similar uncertainties as with the Emerging Markets.

2012 Investment Strategy Guide

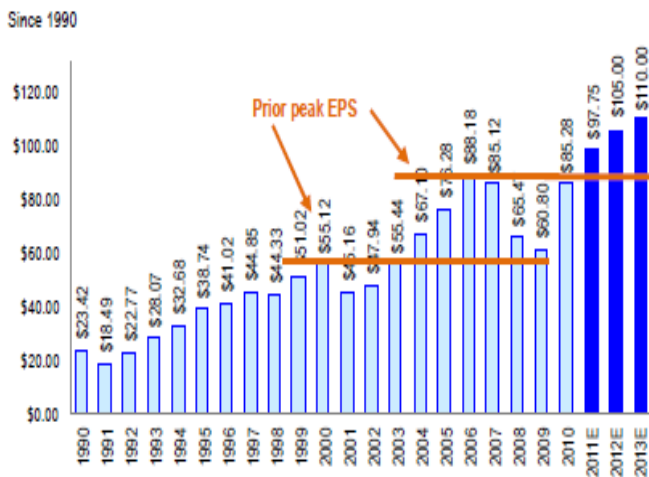
2012 — The Bull Should Take Control

Corporate profit growth will decelerate but remain relatively strong—

Major wirehouse prognosticators are, for the most part, aligned in opinion that corporate profit growth will decline in 2012 due to slower top line growth and unsustainably high profit margins (figure 22). Additionally, analysts have recently cut 2012 S&P earnings growth estimates from +17% y/y growth to approximately +8.5% y/y growth (figure 21). For the most part we agree, but if we had any argument it is that estimates may end up being too low. The reasoning is that while revenues may indeed slow input prices including labor costs, energy costs and interest rates remain benign or are in actual decline. Natural gas alone, which is used as a major source of energy for manufacturing and chemical companies, fell by 42.3% in 2011. Interest rates are likely to remain low due to FED suppression activities which will allow companies to continue to finance cheaply and keep margins from deteriorating too quickly.

Figure 21: S&P 500 Earnings

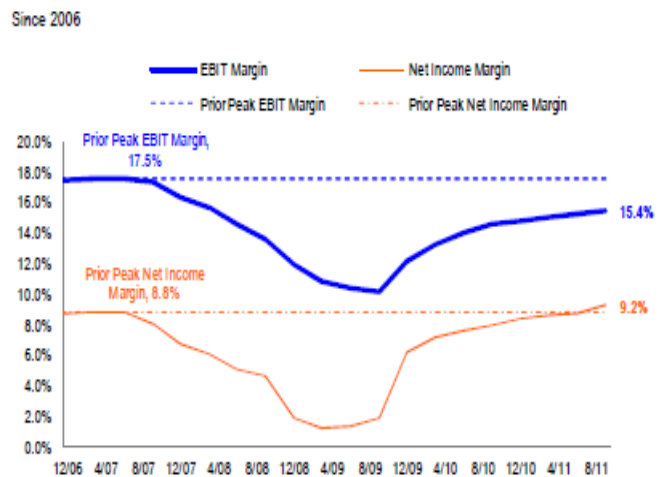
Figure 21: S&P 500 Annual EPS



Source: J.P. Morgan and FactSet.

Figure 22: S&P 500 Operating & Profit Margins

Figure 22: S&P 500 EBIT Margin and Net Income Margin



Source: J.P. Morgan and FactSet.

2012 Investment Strategy Guide

2012 — The Bull Should Take Control

Europe will likely sidestep crisis in 2012—

On December 29, 2011, we penned a piece titled [“European Crisis Averted, For Now”](#) where we suggested the European Central Bank (ECB) and politicians had produced both a plan and a message that were likely to lead to an aversion of crisis in the immediate future. Those opinions still hold and the market has so far demonstrated that opinion to be correct. To briefly recap, on December 8, 2011 the ECB announced a 3-year long term refinancing operation (LTRO) that would allow member institutions to borrow at approximately 1% in return for deposited collateral. At the same time German Chancellor Angela Merkel announced that private sector bondholders would not be subjected to arbitrary forced losses on future restructurings but instead oblige themselves of collective action clauses (CAC). The LTRO program and the Chancellor’s comments appear to be having the intended ‘market calming’ effect. With two LTRO programs now concluded ten year bond yields in key countries like France (chart 1) have receded and short term lending indicators (chart 2) have begun to roll over signaling some thawing in interbank lending. These are good signs for future equity prices, but we stress that policy makers must began devising concrete plans to reduce overall indebtedness, increase competitiveness and spur economic growth in order to keep momentum going.

Chart 1: French 10 Year Bond Yields (Source: Bloomberg)



Chart2: Libor-OIS Spread (Source: Bloomberg)



2012 Investment Strategy Guide

2012 — The Bull Should Take Control

China will not have a hard landing in 2012—

One of the central tenets of equity market bears is China will face a hard economic landing in 2012. The foundation for this thesis is an unsustainable property market boom and infrastructure development that was a product of a large state controlled stimulus in 2008 and shadow bank lending that continues today. While it is impossible to peg the numbers, some believe China's "legitimate" debt-to-GDP ratio had reached 150% by 2010. It is extremely difficult to tell truth from myth as China is very opaque when it comes to reporting economic statistics but worrying signs are abundant. In 2010, the state investment fund, Central Huijin, was buying stakes in China's four top banks in order to restore confidence and halt the slide in share prices even as reported non-performing loan coverage ratios were supposedly adequate. Additionally, China's finance ministry has quietly intervened to underwrite China's railway system as it had built up debts that approximated 5% of the country's entire GDP. Moving closer to this writing, it was announced in October of 2011 that Beijing was considering a \$15 billion bail out for the city of Wenzhou.

So what does all this tell us about the investment climate in China? In our opinion it is likely to be a repeat of history but one that will play out more profoundly in 2013 and possibly 2014. The reason we believe this is China has been through this type of misallocation of capital before and we are seeing signs of the same "clean up" playbook being used again. However, the wrinkle in this go-around is the transition of power to new leadership which occurs in late 2012. China is very keen on maintaining a smooth transition from the current Politburo members. A messy economic unwinding at a time of important leadership change would tarnish current leader's legacy and make it difficult for those coming into power. This leads us to conclude that clean up procedures and bailouts are likely to continue along with targeted monetary easing but it is still too early for renewed overweight investment into the region. While China will likely push-off problematic issues and valuations have come down significantly, the unknown extent of the property and infrastructure bubble and its impact will keep investors at bay for 2012.

2012 Investment Strategy Guide

2012 — The Bull Should Take Control

Inflation will be moderate in 2012-

There was a considerable amount of stress in 2011 emanating from increasing inflation in both Developing and Emerging Markets which led many policy makers to tighten monetary policy. Some even forget that beleaguered Europe tightened its policy rates twice before relenting. Rising costs in most countries were due primarily to higher oil prices, largely driven by Middle East upheaval, and weather related supply constraints impacting grains and meats. We expect this to change in 2012.

According to 2012 global agricultural estimates from the USDA, grain supplies are expected to be much improved this year and prices have already abated from their 2011 highs. If weather and crop yields continue as expected we estimate food inflation will moderate from 2011 levels and remain less volatile. Oil prices on the other hand remain elevated, especially compared to its cost of extraction, and appear to be pricing in risk of additional Middle East turmoil from the likes of Syria and/or possibly Iran. If there is even a modest hint of improvement from either area oil prices could face downward pressure and help ease inflation further (*Note: Nigeria remains a wildcard as it continues to experience violence and threats of oil production shutdowns*).

One area we think is an underappreciated positive is energy extraction technologies that have emerged more readily in the last few years. These technologies have led to an unrelenting trend of plummeting natural gas prices (-50% since Jan 2011) which positively impact over 50% of US households and many industrial customers. After such extreme price movements we would normally analyze where the cost of extraction levels are in order to estimate a floor in pricing, but this situation is somewhat unique. Natural gas can be a bi-product of oil production which continues to experience a very favorable cost/benefit relationship and as such natural gas production comes literally free. Since producers will continue to extract oil at current price levels we don't expect a material decline in supply and consumers and corporations will benefit.

The end result is we expect lower growth rates of inflation to boost consumer confidence, help corporations manage input costs and assist governments in promoting monetary policies that are favorable for equity prices.

2012 Investment Strategy Guide

2012 — The Bull Should Take Control

Monetary policy aligned but distribution mechanism remains plugged —

Divergent monetary policies was a common theme in 2011 as most Emerging Markets were trying to squash inflationary pressures with monetary tightening while most Developed Markets remained dovish. The one outlier was the ECB (European Central Bank) which apparently did not learn its lesson from 2008 and tightened policy twice as the Euro Zone economy was facing many headwinds. But this demonstrates the difficult nature of managing 17 different economies and their individual national central banks!

2012 marks a much different environment, one where most central banks have begun easing policy in unison in order to steady economic growth (Chart 3). Inflation has rolled over and expectations are for it to remain relatively stable allowing central banks more leeway. Easing cycles grease the wheels and typically fuel gains for equity markets down the road and this is a modest positive for equity bulls. However, it is our opinion this liquidity influx will result in limited impact as the transmission mechanism from central bank to the general economy remains impeded. Deleveraging in the developed world remains a primary theme and banks are hoarding capital at the reserve level in spite of miniscule returns. The Emerging Markets, for the most part, are just starting their easing cycle and China will have to be careful with how much they light the fuse as uncertainty remains over non-performing assets from its massive stimulus in 2008.

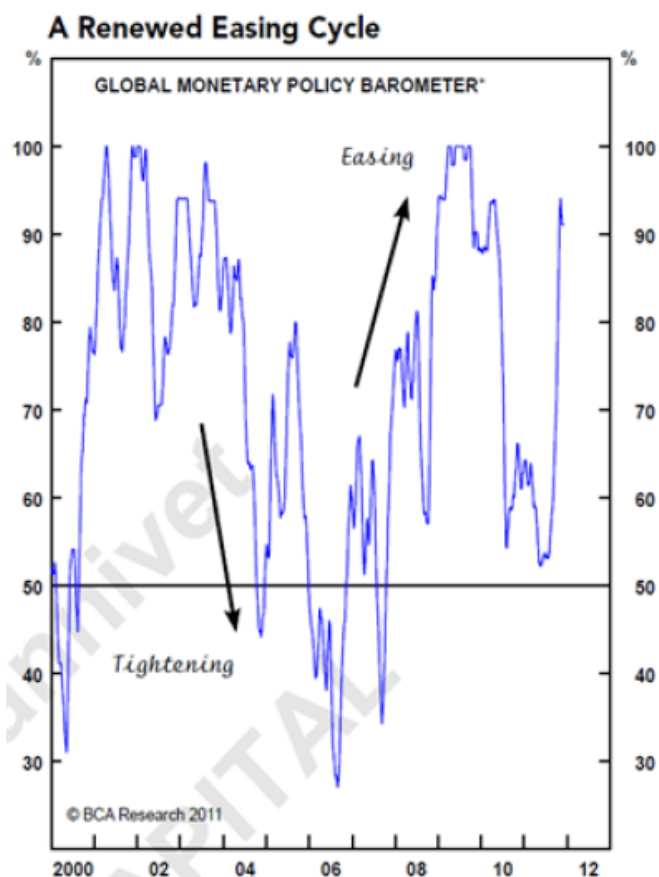


Chart 3: BCA Global Monetary Policy Barometer

2012 Investment Strategy Guide

2012 — The Bull Should Take Control

Valuations are attractive but P/E multiples are unlikely to expand —

Table 1 below demonstrates very clearly that a majority of global equity markets are historically inexpensive to their ten year average. In addition, if you examine relative earnings yields on stocks versus corporate fixed income yields you will find stocks to be extremely cheap on a relative basis. This is fine and we do advocate an overweight to equities versus bonds as history suggests these relationships will revert. However, we do not believe equities will experience expansion of price-to-earnings multiples in 2012.

Table 1: Country P/E ratios, relative and historic

	Forward P/E	10-Year Average	Difference	Discount / Premium to S&P 500	10-Year Average	Difference (Sorted)
MSCI Mexico	15.7	12.7	23.4%	1.26	0.85	47.6%
MSCI Indonesia	12.8	10.8	18.8%	1.02	0.73	39.7%
MSCI Philippines	13.9	13.6	1.6%	1.11	0.91	22.3%
MSCI Brazil	8.5	8.3	2.4%	0.68	0.57	20.6%
MSCI Belgium	11.0	11.2	-1.9%	0.88	0.74	18.7%
MSCI Denmark	14.2	14.7	-2.8%	1.14	0.97	17.2%
MSCI Thailand	10.0	10.4	-3.0%	0.81	0.69	17.0%
MSCI South Africa	10.1	10.3	-2.2%	0.81	0.69	16.9%
MSCI New Zealand	13.0	14.0	-6.8%	1.05	0.93	12.5%
MSCI Korea	8.9	9.5	-6.3%	0.71	0.64	11.5%
MSCI Taiwan	13.1	14.2	-8.1%	1.05	0.95	10.0%
MSCI Switzerland	11.8	13.9	-15.0%	0.95	0.91	3.7%
MSCI Norway	9.3	11.1	-16.7%	0.74	0.73	1.5%
MSCI Hong Kong	13.2	15.8	-16.5%	1.06	1.05	0.7%
S&P 500	12.5	15.3	-18.2%			
MSCI Singapore	11.7	14.4	-18.6%	0.94	0.95	-1.0%
MSCI Finland	11.5	14.4	-20.5%	0.92	0.94	-2.4%
MSCI Canada	11.3	14.1	-19.7%	0.91	0.93	-2.5%
MSCI Sweden	11.4	14.4	-20.9%	0.91	0.94	-3.1%
MSCI Netherlands	9.4	11.9	-21.2%	0.75	0.78	-3.5%
MSCI Portugal	10.5	13.5	-22.0%	0.84	0.89	-5.1%
MSCI India	11.5	14.6	-21.1%	0.92	0.98	-5.9%
MSCI Spain	8.8	11.8	-25.8%	0.70	0.77	-8.7%
MSCI Australia	10.2	13.8	-25.7%	0.82	0.91	-9.6%
MSCI France	9.0	12.6	-28.3%	0.72	0.82	-11.6%
MSCI Germany	8.9	12.6	-29.2%	0.72	0.82	-13.0%
MSCI Poland	8.7	12.2	-28.7%	0.70	0.80	-13.1%
MSCI UK	9.4	13.6	-30.7%	0.75	0.87	-13.6%
MSCI Greece	7.7	11.5	-33.2%	0.61	0.74	-17.4%
MSCI China	8.4	12.4	-32.5%	0.67	0.83	-18.8%
MSCI Austria	7.3	11.2	-34.7%	0.59	0.73	-19.6%
MSCI Japan	11.6	17.8	-34.7%	0.93	1.17	-20.3%
MSCI Italy	7.9	12.5	-37.3%	0.63	0.81	-22.2%

As mentioned at the outset of this guide the world is moving from one level of capitalism to the next and based on our proprietary research periods of structural change have experienced lower growth rates of equity price returns and compression of p/e ratios (chart 5 on page 12). This effect is due to a lack of clarity on the investment horizon deriving from a decline in animal spirits, regulatory changes, fear of higher future taxation and/or deleveraging. As of this writing, global markets remain bogged down by all of these issues and it is unlikely investors are going to pay more for a dollar of earnings this year as it is unlikely the issues become completely resolved. (cont page 12)

Source: Strategas Research Partners 1/2012. www.strategasrp.com

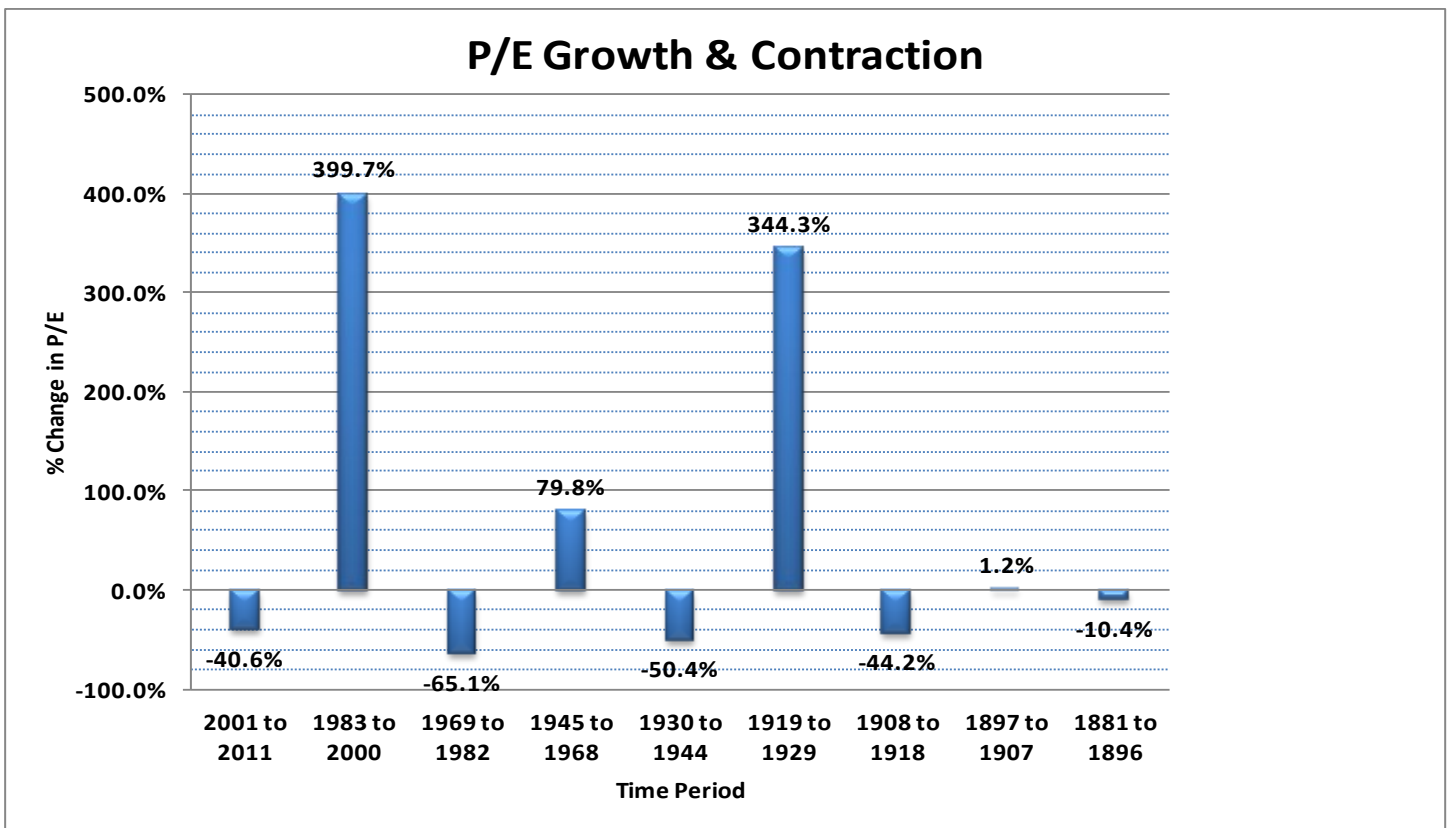
2012 Investment Strategy Guide

2012 — The Bull Should Take Control

Valuations are attractive but P/E multiples are unlikely to expand (cont)—

As illustrated by the chart below, periods of uncertainty in the US showed contractions in p/e multiples only to expand again as animal spirits and uncertainty lifted. Duration and magnitude were also measured and suggested average expansions were longer (14.5 years vs. 13.6 years) and had more magnitude of change. While timing is difficult, it appears we should be in the final throws of the current period of p/e contraction and closer to the next long expansion (although there are many perma-bears who would suggest otherwise).

Chart 4: P/E Growth & Contraction of S&P 500 Index



(Source: Fourth Quadrant Asset Management. Data Source: Case/Shiller CAPE Ratio)

2012 Investment Strategy Guide

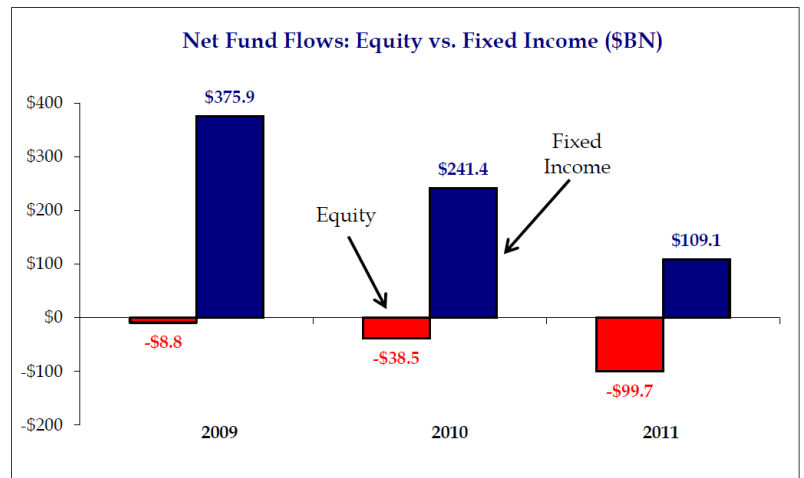
2012 — The Bull Should Take Control

Sentiment is a positive backdrop towards equities —

Bonds have been king for some time now and investors have certainly demonstrated no matter what the asset class they will always chase recent hot performance. As shown in chart 5 equity outflows and bond inflows continued last year even though ten year US treasuries yield negative real rates and earnings yields on stocks versus bond yields have rarely been this wide (chart 6).

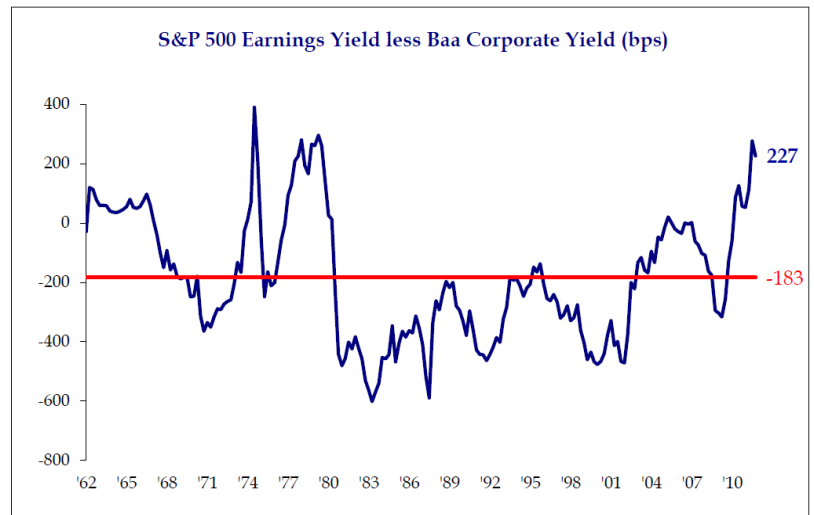
Negative sentiment typically does not lead to large downdrafts as those who would be selling have already done so and we believe this dynamic should be supportive of equity prices in 2012.

Chart 5: Net fund flows



Data through November 2011.

Chart 6: S&P 500 Earnings Yield Vs Corporate Yields



(Sources: Strategas Research Partners 1/2012.)

2012 Investment Strategy Guide

2012 — The Bull Should Take Control

Investment Strategy

Based on our research and investment themes client positioning for the beginning of 2012 is broadly outlined in the bullet points below (for a more detailed view regarding this strategy guide and our positions please feel free to contact us to discuss).

Country Weighting

- Overweight to US equities and Germany. Underweight Foreign Developed and Emerging Markets

Sector Weighting

- Overweight US technology, global industrials and global consumer discretionary. Underweight energy, consumer staples, materials, telecommunications. Neutral to utilities and health care

Market Capitalization

- Average market capitalization will be \$45 billion which is smaller in size than our benchmark the MSCI All Country World Index

Fixed Income

- Short duration, 3.6 versus benchmark at 7.4
- Overweight investible grade corporate, high yield growth and a small overweight to US TIPS

Hedging

61% of equities will be hedged to the downside in the following manner

1. Emerging Markets will be hedged from ~ -5% to -32% till January 18, 2013
2. US equities will be partially hedged from ~ -15% to -35% till December 2012
3. Foreign Developed equities (EFA holdings) will be hedged from ~ -5% to -20% till June 15, 2012

2012 Investment Strategy Guide

Closing Remarks

Our research into valuations, liquidity, economic activity, and sentiment are supportive to a modestly positive environment for equities. However, we are cognizant of the longer term picture which is global economies and markets remain in an adjustment period where the landscape is cloudier. This leads to a greater risk of surprise and larger equity risk premiums which require a careful hedging program and close scrutiny for optimal success.

Thank you for your interest in our strategy guide. We hope it will play an important part in shaping your investment strategy for 2012. We invite you to call or email us for further discussion on the information provided or to review your current portfolio.

Patrick Hejlik
CEO



This document constitutes the general views of Fourth Quadrant Asset Management and should not be regarded as personalized investment advice. No assurances are made we will continue to hold these views, which may change at any time based on new information, analysis, or reconsideration. In addition, no assurances are made regarding the accuracy of any forecast made herein. Past performance is no guarantee of future results. A risk of loss is involved with investments in stocks, bonds, options and futures markets.



FOURTH QUADRANT  ASSET MANAGEMENT

4115 Blackhawk Plaza Circle, Suite 14
Danville, CA 94506
T:925-648-2071
P.hejlik@fourthqam.com
www.FourthQuadrantAssetManagement.com

FOURTH QUADRANT ASSET MANAGEMENT
4115 BLACKHAWK PLAZA CIRCLE, SUITE 14
DANVILLE, CA 94506
T: 925.648.2071 FAX: 925.648.2072
EMAIL: P.HEJLIK@FOURTHQAM.COM
WWW.FOURTHQUADRANTASSETMANAGEMENT.COM