



Investment Commentary
January 2012

In “Senseless”, Concord-based Stona Fitch’s harrowing 2001 novel, the lead character is taken hostage by a ring of terrorists, and over several weeks subjected to an inventive but extreme brand of brutality, all shared with a faithful internet audience: each of his senses is removed, one by one. Fitch wrote the book in the late 1990s, during the creation of Europe’s single currency and unified monetary system. Who was the hostage and why was he taken? He was an American economist and deal-maker who helped the European Monetary Union come to be, and his captors were, quite stridently, opposed: “What better way to weaken us than to join us together – like a marriage of cousins.”

One might wonder whether the book’s title carried more than one meaning, or does now. Certainly the euro’s architects, even a dozen years in the rear-view mirror, weren’t devoid of all senses, or even sense. The appeal of a single regional currency was well recognized at the time, not just by Eurail pass holders but by leading economists, corporate CFOs, and many others. And the benefits of systemic integration lived on for a time before they were revealed as actual frailties; smaller governments were able to finance development at low interest rates akin to those enjoyed in Germany and France, and a single central bank put all members on the same policy page.

As we sort through any prescience that may have resided in the minds of fictional terrorists, we’ve just experienced another quarter whose daily returns were driven by Euro-watching, and big mood swings tied to perceived prospects for either resolution or chaos. In the end, optimism narrowly prevailed and most indices closed the quarter in the black. U.S. equities led the way, supported by material improvement in economic performance and sharply reduced recession odds. Thanks mainly to fiscal concerns in Europe as well as the U.S., the full year was dominated by the summer “risk-off” trade, which put particular pressure on European and emerging market stocks. The S&P’s gain came entirely from dividends. The risk-off move also propped up municipal bonds and U.S. Treasuries. The 10-year Treasury yield moved below 2% for the first time ever in August, and ended the year at 1.89%. The 30-year Treasury, similarly, broke below 3% and closed 2011 at 2.89%

	Fourth Quarter	2011	Five Years (ann.)
S&P 500	11.8%	2.1%	-0.3%
EAFE	3.3	-11.7	-4.7
Emerging Markets	4.4	-18.4	2.4
Treasury Bonds	0.9	9.8	6.8
Municipal Bonds	2.1	11.2	5.3
U.S. Taxable Bonds	1.1	7.8	6.5
High Yield Bonds	6.2	4.4	7.4
Global Bonds	0.3	6.0	6.5
Commodities	0.4	-13.3	-2.1

Entering 2012, we remain wary of the bouts of dislocation and volatility that are sure to accompany the ongoing quest for equilibrium in fiscal policy, and a more manageable debt structure in many important countries. This means continued emphasis on tactically flexible managers with an ability to hedge against risk, across the asset spectrum. We are adding a modest amount to the small capitalization emerging market space, as we continue to like its rising middle class theme, and the stocks now come at a cheaper price after last year's declines. In the more bond-oriented portfolios we are trimming exposure to municipals following their very strong year, putting the proceeds with a flexible mandate bond manager.

The hedging ability seems particularly vital in the bond arena. As the historically low Treasury rates indicate, valuations are at precarious highs. There may be few signs of a jump in rates on the near horizon, but of course it never can be ruled out. From current levels, each 100 basis point rise would translate to 8.9% and 19.5% mark to market losses, respectively, for 10 and 30-year Treasury holders. At the same time, the better case scenarios are capped, with so little room left for rate declines. Long term holders are signing up for a return that about matches historical inflation rates. This presents an unfavorable, asymmetric risk profile for long-only bond managers.

Continuing equity exposure is justified by reasonable valuations – most stock markets sell at material discounts to longer term averages, and the discounts widened in 2011 on continuing earnings growth combined with returns that were flat to down – and promising fundamental trends. The global GDP growth picture remains muted, and the IMF may cut its 4% 2012 estimate shortly due to Europe's issues and possible recession, but many regions are showing fundamental improvement. U.S. GDP growth forecasts for the year are around 3%, up about a percent from three months ago. Healing on the private sector employment front continues, with December's 212,000 gain putting the net addition of jobs above 3 million over the last two years, offsetting about a 700,000 job reduction in the public sector. Auto sales ended 2011 on a strong note, and the U.S. became a net exporter of oil-based energy for the first time in 62 years.

Emerging market economies also are showing signs of better health. Fears of a sharp pullback in China, tied to lending restrictions, have eased. Many emerging economies had been beset by higher inflation in 2010 and 2011, thanks to surging food costs combined with food's relative importance, accounting for 30% of emerging market CPI compared to only 13% of developed market CPI. In 2012, countries such as China, Brazil, and India stand to benefit from relief in inflationary pressure, thanks to a significant pullback in food and energy prices from twelve months ago. Central banks are responding by easing up on the brake pedal. This includes China, which late in 2011 relaxed bank reserve requirements for the first time following an aggressive three year tightening campaign.

Europe, its systemic flaws exposed, faces unique challenges. Surging bond interest rates and austerity pressure in the most debt-burdened countries have darkened prospects for overall economic growth. Last year included no fewer than eight "summit meetings" geared to resolving the debt issues and saving the euro, or at least finding a pathway. Most of the events initially were applauded by the financial markets, and then derided upon closer inspection. There was a growing sense that policy-makers, while committed to a solution, would get there only through a series of barely sufficient, incremental steps, rather than embracing a more ambitious, comprehensive plan. Initial implementation of reforms lies ahead in early 2012, including a Greek debt restructuring (and write-down of 50% or more) which needs to be resolved ahead of an \$18.7 billion bond repayment due in mid-March.

A more complete fix may require a Eurobond market and unified fiscal policy, better matching the single monetary policy and currency. This is a daunting prospect given the great divide between the healthy and unhealthy nations, but the incentive remains powerful. Germany has very good reasons to recoil from

greater integration with the likes of less-disciplined Greece, Portugal and Spain, but a move in the other direction, toward a dismantling of the euro, could hit harder still. Exports of goods account for 37% of Germany's GDP, far more than in any other major economy (China is next at 27%), and more than half of the exports go to other European countries. A return to the deutsche mark, and freely floating exchange rates, could saddle Germany with a steeply appreciated currency, perhaps on the order of 50-100% higher versus key trading partners, severely hindering export competitiveness.

Markets also will take cues from election politics this year, here and elsewhere – almost half of the world's GDP will be subject to presidential elections or other leadership transitions in 2012, headlined by the U.S., China, France and Russia but also including both Koreas, Mexico and Turkey. In the U.S., the window of opportunity for significant tax and outlay reform, along Bowles-Simpson lines, is not likely to reopen until after the election. The two-month 2% payroll tax cut extension obviously has to be revisited soon, the most likely outcome a further extension over at least the rest of 2012. Congressional job approval ratings are barely in double digits, and no politician can afford to be associated with an immediate reduction in net pay across a workforce of 150 million.

Notwithstanding its outcome, our election will be followed by a pressure-packed several weeks. Multiple trillions worth of spending and tax decisions need to be finalized by year-end. This includes the \$1.2 trillion in automatic spending cuts resulting from last year's August debt ceiling deal and later failure of the super-committee to draw up a customized cut list. More drama may come from the handling of the 2001 and 2003 Bush tax cuts, worth \$3.8 trillion over the next ten years. A lot will happen between now and year-end, but from today's standpoint one can envision either a departing (with nothing to lose) or victorious (with second term swagger) president pushing hard for expiration.

After a year that was dominated by major political stories, related macro-economic concerns, and emotionally charged financial markets, the relatively tranquil early days of 2012 only feel like intermission. Going forward, determining whether the euro's creation will in the end prove to have been "senseless", or a convenient smokescreen for Germany's practice of currency manipulation, or something else, is only one of several pressing topics. The heavy election calendar across both the developed and emerging markets comes as the latter become ever more established as the primary force for global economic growth. This implies a major redefinition of the competitive arena and all but permanent melding of economic and geopolitical issues in the years ahead. At the same time, there is much opportunity. On this landscape, RINET portfolio positioning continues to play to aspects of our program that we particularly value, most notably an ability to invest anywhere in the world and our access to talented, agile managers.

We hope 2012 is treating you well so far. As always, please contact me with any questions, comments or concerns.

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