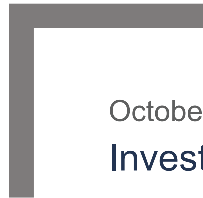

October 2012

Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"Near-Term Risk, Long-Term Reward?"

Barry Knapp et al., Barclays, October 12, 2012

The continuous threat of the fiscal cliff and public policy uncertainty has dampened U.S. economic activity. The election outcome will have a great impact on the pending fiscal hit and the future of the tax code. If the private sector believes pro-growth tax reform and entitlement restructuring are imminent, a boost in confidence could lead to a cyclical rally.

Uncertainty about the potential tax hikes and spending cuts that could take effect in January (i.e., the "fiscal cliff") is weighing on investor sentiment. Business confidence is also low, given structural issues such as government deficits and a failure to tackle entitlement spending. While the S&P 500 Index remains near its all-time nominal high, the poor performance of cyclical sectors relative to their defensive counterparts suggests fears of recession are pervasive.

The election results should mean that one party will suffer a setback regarding its economic vision for the country and therefore become more willing to compromise to get a deal done. Up for discussion are issues such as extending the 2010/2012 tax cuts, the debt ceiling, and rating agency and public tolerance for federal debt levels.

Depending on the election outcome, the impact of the fiscal cliff could vary significantly. In a GOP sweep, it is nearly certain that a lame duck session agrees to extend Bush-era tax cuts and reduce taxes on other income streams, limiting the impact to around $196 billion (1.2% of GDP). If the current coalition holds, there is only a 25% chance that a lame duck session will agree to a compromise that would involve just some tax cuts being extended; here, the economic impact would be much greater at $483 billion (3.0% of GDP). Finally, if Obama wins and the GOP takes both houses, there is only a 50% chance a lame duck deal is reached, and the fiscal hit would be $435 billion (2.7% of GDP). Based on these potential outcomes, Barclays' weighted probability of the fiscal hit is in excess of $300 billion (or 2.1% of GDP). These estimates are based on where polls stand today, and much could change in the weeks leading up to the election.

While prospects for Washington reaching a deal in the near-term on the fiscal cliff seem slight and a 2013 tax hike seems likely, there are debates on longer-term issues like tax and entitlement reform occurring that sound more encouraging. Lowering tax rates while broadening the base by reducing deductions has support on both sides of the aisle. There also seems to be widespread public support for pension reform, as evidenced by local developments such as referendums on the public sector pension in California and the mayor of Chicago's willingness to confront unions over these issues. Assuming that private sector spending has a larger multiplier than public sector spending, and that many high-tax payers are small businesses, tax reform could spur further growth. At a minimum, clarity on tax burdens could encourage small businesses to invest more and expand labor forces, making a cyclical recovery more probable.

Linking these policy concerns to earnings trends, recent trade data show that weakness in core capital goods orders has not been due to slowing global growth; rather it has been domestically driven. An election outcome that boosts business confidence and encourages investment would be positive for earnings. While it's too early to make this call, this would mark a welcome change from

relying on Federal Reserve announcements to spur positive equity returns.

"The Cliff, the Economy and Capital Markets"

Ethan Harris et al., BofA Merrill Lynch, October 17, 2012

Investors are becoming increasingly concerned about the impact of the fiscal cliff. Although some companies are bracing for the worst, it appears that some capital markets have yet to price in the potential outcomes. If politicians are able to reach a deal before the end of the year or soften the blow of the full impact, Treasury yields and economic growth could rise. Conversely, if Congress decides to retroactively address the fiscal cliff, Treasury yields could sink to an all-time low and sectors, such as consumer discretionary, could drag the United States into another recession.

The fiscal cliff creates two potential shocks to the economy: uncertainty over the type of austerity measures that will be agreed upon and the actual imposition of these measures after January 2013. There are a number of ways the cliff could be resolved or averted and each has different implications for investors. While the size of the shock is still unknown, it appears that some fixed income and equity markets could be underestimating the potential impact on the economy.

Potential uncertainty from the fiscal cliff has both micro and macro dimensions. At the micro level, the government is threatening to change many of its rules and policies regarding spending and taxation, and this creates uncertainty for businesses and consumers. At the macro level, if the cliff is not addressed, the impact could be as much as 6.6% of GDP, plunging the United States into recession. Companies and investors find planning extremely difficult given that they must factor in this potentially extreme outcome, even if its probability is somewhat low. There is currently a fair amount of uncertainty over which revenue increases and spending cuts will go through. However, reductions to both payroll tax cuts and unemployment benefits are likely outcomes when Congress ultimately reaches a compromise. This could negatively impact broad-based consumer spending, and in turn, overall economic growth.

There are three scenarios in which the fiscal cliff could be resolved. In a "fix before year end" scenario (which seems unlikely—15% probability), politicians will work out a compromise around all major components of the fiscal cliff except longer-term Medicare and tax reform. It is also possible that Congress opts to allow the full cliff to hit in hopes of retroactively addressing the core issues. This also seems unlikely (approximately 25% probability), but a change of power in Washington, underestimation of the impact on the economy, or attempts to leverage the cliff as a negotiating tool could lead politicians to delay any chance of resolution. A more likely scenario (roughly 60% probability) is that politicians address the cliff in a "multi-stage fix," compromising on key issues and allowing for modest initial austerity. The length of the decision process matters—the longer politicians take to agree to measures, the more damaging the longer-term impacts on planning and growth.

Treasury yields suggest that investors are expecting neither a recession nor solid growth, and instead have adopted a "wait and see" approach. If Washington is able to resolve the cliff before year end, higher growth expectations could push the yield on the ten-year

Treasury up to 2.25%. Conversely, if the United States goes over the cliff at the end of the year, investors could ironically flock to "safety" in U.S. debt. One reason is that the Federal Reserve might opt to continue quantitative easing measures in the face of slower growth prospects, reducing the supply of Treasuries and forcing yields lower. Treasury yields currently seem to be pricing in growth in early 2013 of around 1.5% and thus only about $40 billion to $80 billion of fiscal tightening. In the likely event that Congress adopts a "multi-stage fix," the fiscal hit would be higher; factoring in potential volatility could push ten-year rates back toward historical lows (around 1.4%) and flatten the yield curve.

Equity markets could also experience increased volatility in the months ahead. A disappointing earnings season, recession in Europe, decelerating growth trends in emerging markets, and the looming fiscal cliff present real downside risk for equities. The most obvious sectors that would be affected by austerity measures in the United States are defense and health care. About three quarters of government spending exposure in the S&P 500 Index (which equates to about 8% to 10% of overall S&P revenues) falls within these industries. It appears that the market has already priced in a negative outlook as the forward price-earnings (P/E) ratio of the defense industry has been contracting since last year and the relative P/E of the health care sector is trading at a discount to its historical average multiple. However, other sectors that could be affected by a reduction in consumer spending as a result of the cliff remain expensive. If all or most of the cliff occurs, GDP could drop as much as 4.5% and be detrimental to consumer spending. This is not reflected by a consumer discretionary sector that trades at a premium to its historical average relative P/E multiple.

In the most likely scenario of a multi-stage effort to address the cliff, growth and earnings are likely to disappoint, though multiples could modestly re-rate higher as uncertainty clears. An expected range for the S&P 500 in this scenario would be from 1,350 to 1,500. Should politicians surprise to the upside and reach an agreement before year end, it is likely growth and earnings expectations for 2013 would rise and the S&P could settle in the range of 1,400 to 1,600 this year. This could see all of 2013's expected gains pulled forward into the last weeks of 2012. Finally, in a scenario where the United States goes over the cliff and then various aspects are addressed in retrospect, the S&P 500 could experience a significant sell-off. Looking at previous instances of political gridlock weighing on markets, such as when Congress failed to approve TARP the first time, a sudden 10% drop cannot be ruled out. In the event that gridlock continued for many months and various aspects of the cliff were triggered, a recession could ensue and an even greater decline in the S&P 500 would occur, fueled by both earnings and multiple compression.

"U.S. Election & Equity Sectors: Policy and Fiscal Realities"

Salvatore Ruscitti, MRB Partners, October 16, 2012

The upcoming elections and potential ways the fiscal cliff will be addressed have significant impacts for equity markets in the months ahead. A Mitt Romney win would likely create at least a temporary boost for defense contractors, energy stocks, and financials, while creating serious headwinds for the health care industry. A Barack Obama victory

could weigh on high-dividend yielding sectors such as telecoms, tobacco, and utilities. Regardless of who wins, however, he will need to face the realities of an over-levered U.S. economy, and this will limit policy options going forward.

The upcoming elections and potential ways the fiscal cliff will be addressed could have significant implications for equity markets in the months ahead. If a political compromise is reached and the hit from the fiscal cliff can be limited to around 1% to 1.5% of GDP, growth in 2013 is likely to remain positive and the drag on corporate earnings would be reduced. Looking at possible election outcomes, Obama and Romney have sharply different visions on topics such as taxes, health care spending, and energy reform, and the performance of some equity sectors and styles could hinge on the budget policies that are adopted. Regardless of who wins, however, he will need to face the reality of an over-levered U.S. economy, and this will limit policy options going forward.

Taxes are a key area of contention where a deal will need to be reached. If Obama is re-elected and follows through with his plan to increase taxes on upper income individuals, consumer spending may be negatively impacted. Conversely, Romney would like to extend tax cuts and this could provide a near-term benefit to sectors such as consumer discretionary. However, Romney's plans seem at odds with balancing the budget, and it is unlikely that either party will see its income tax or dividend tax plans fully realized. A likely compromise would be a moderate tax increase that leaves the dividend tax rate well below the income tax rate. If that were to happen, overall risk appetite and the economic cycle could be bigger performance drivers than the corporate or income tax rate for sectors such as consumer discretionary and high dividend payers (such as telecoms, tobacco, and utilities).

The November election and looming fiscal cliff could have a much larger impact on the defense industry. Defense spending in 2011 reached 4.6% of GDP (a 60-year high), but this figure promises to change as the United States faces greater fiscal austerity. The threat of sequestration, which would result in almost $500 billion of mandatory defense cuts over the next decade, as well as the winding down of operations in Afghanistan and Iraq, present serious headwinds for the defense industry. Obama's plans are more modest than this, targeting around $145 billion of cuts over the next five years, while Romney would cap defense spending as a percentage of GDP. Regardless of who wins, barring a major military conflict, investors may want to consider underweighting companies in this sector.

In 2011, federal spending for Medicare and Medicaid programs exceeded 5.6% of GDP. Any serious plan to balance the budget will have to entail major cuts in these entitlement programs, which could bode ill for the health care sector. If Obama is re-elected, there will likely be little reaction from health care stocks as equity markets have already discounted the major provisions of his plan. Conversely, Romney has pledged to repeal "Obamacare," but without a super-majority in the Senate, a full reversal of Obama's policies seems unlikely. Republicans would probably use the budget reconciliation process to rescind or delay major provisions of this act. Consequently, reimbursement pressures across the entire health care industry would be unavoidable with adverse consequences for earnings.

Financials are the most legislation-sensitive sector and will be heavily influenced by the outcome of November's election. Dodd-Frank

represented a sweeping overhaul of financial regulation, with significant measures like the Volcker Rule, which limits proprietary trading at major banks, and the creation of a consumer financial protection bureau. The Obama administration has made it clear that it will continue to support stricter regulation in attempts to curb future shocks to the financial system. A Romney victory could mean a temporary boost for the sector as Republicans are likely to try to rescind some measures of the Dodd-Frank Act. However, less regulation is unlikely to materially boost the profitability of the sector, which is being challenged by higher capital requirements (under Basel III), household deleveraging, and low interest rates.

While each presidential candidate presents very different plans for addressing the future of the economy, policy options going forward will be limited by fiscal realities such as overlevered household and government sectors. This suggests that moderate, rather than radical, policy change is likely, aided by political compromise. The health of the overall U.S. economy will be the driving force behind equity rallies in many sectors, though public policy will play an important role in determining the speed of the recovery. ■