Alhambra Investment Partners

A-BOOK

Analysis Beyond The Headlines

Monthly Edition – August 3, 2012

www.alhambrapartners.com

Miami – Coral Gables – West Palm Beach – Denver – Buffalo – Asheville, NC

A-BOOK TABLE OF CONTENTS

GDP ACCOUNTS

Q2 GDP +1.5%
-Down from 2.0% in Q1

PCE +1.5%
-Down from 2.4% in Q1

Non-Res. Fix Inv +5.3%
-Down from 7.5% in Q1

Real Final Sales +1.2%
-Down from 2.4% in Q1

Advance estimates for GDP growth in the second quarter confirmed the "unexpected" slowdown seen in a broad cross section of data. While growth rates declined in almost every segment, two areas of weakness stood out. First, the durable goods component of PCE fell 1% in Q2 from +13.9% and +11.5% in the preceding quarters; durable goods added .85 to GDP in Q1, but subtracted .08 in Q2. . It is also pretty clear that durable goods weakness itself can be mostly attributed to weak motor vehicle sales (and parts). Spending on nondurable goods was largely unchanged from the preceding quarter, while spending on personal services was slightly higher (most of the increase was seen in spending on "housing and utilities").

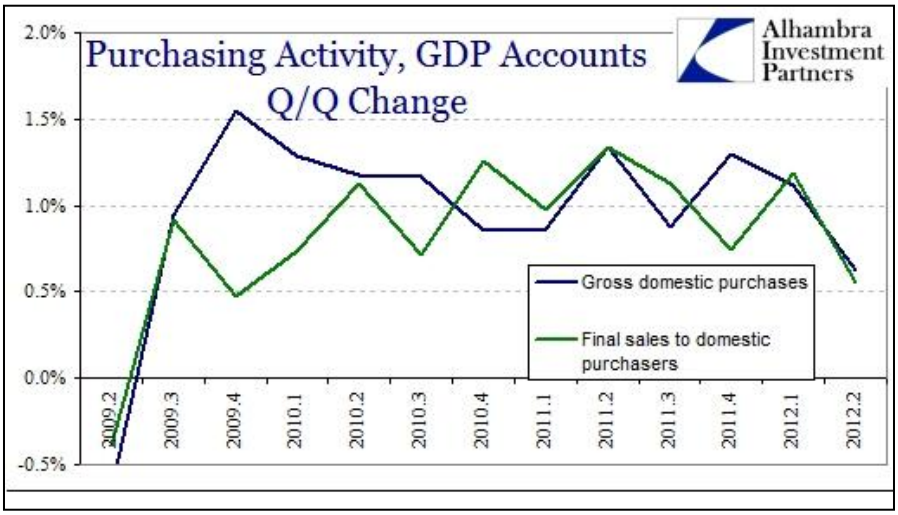
Within the durable goods segment itself, "sales of motor vehicles and parts" accounted for nearly all of the decline. That brought up a sharp contrast with motor vehicle "production":

"Sales of MV", contributions to GDP past 5 quarters

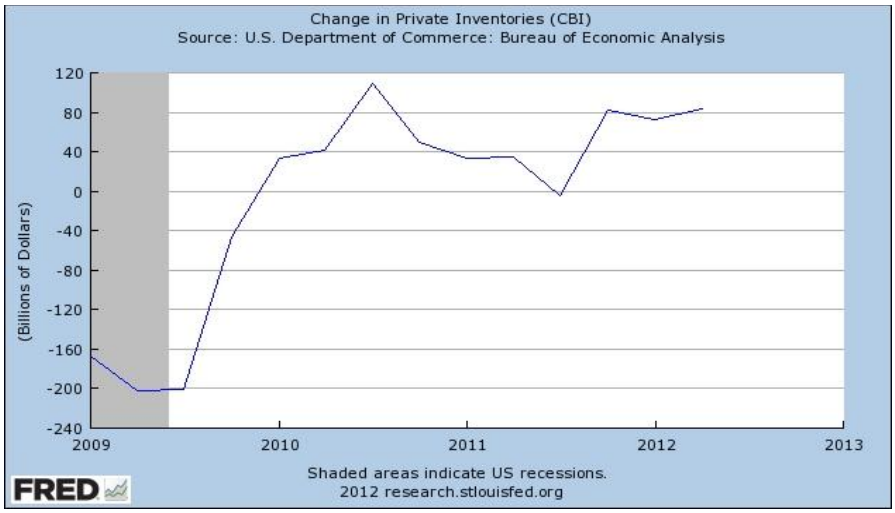
-0.53%	0.05%	0.63%	0.31%	-0.29%

"Output of MV", contributions to GDP past 5 quarters

0.05%	0.03%	0.55%	0.72%	0.13%



The difference between production and sales is inventory. Broadening our view of this dichotomy, the increase in Real Final Sales and Gross Domestic Purchases was far less robust than the previous trend.



On the production side, inventories have risen at a greater rate, leading to a growing disconnect. Whether or not the lack of follow-through sales leads to slowing production, or at least explains the current "soft-patch" remains to be seen. For the rest of 2012, this is likely to be the dominant macro theme – will purchasing and spending activity re-couple to production levels or will production levels, particularly inventory accumulation, re-align with a new trend in consumer and business spending?

Next GDP release (first revisions to Q2 estimate) scheduled for August 29, 2012.

PAYROLLS & UNEMPLOYMENT

JULY NFP Payrolls
+163,000 Total

June NFP revised lower to
+64k from +80k

May NFP revised upward to
+87k from +77k

Headline Non-Farm Payrolls for July 2012 surprised on the upside, coming in quite a bit stronger than the +100,000 expectations. There are some indications of seasonal factors playing a role with July production schedules at domestic automakers diverging from previous years, but it is clear that economic weakness has not translated into a declining payroll environment.

There are always some discrepancies between the household survey and the establishment survey, but within the household survey we remain concerned about the composition of the employment picture as it relates to potential income and therefore spending. Despite the headline improvement, the household survey showed a seasonally adjusted *decline* in full-time jobs of 228,000. Part-time employment increased by 31,000 on a seasonally adjusted basis.

Compared to July 2011, the level of full-time employment has risen by 2.4 million while part-time employment advanced 300,000, but those rates have not kept pace with the 3.7 million new estimated members of the civilian non-institutional population (potential labor force). As a result, the participation rate has fallen from 64% in July 2011 to 63.7% in July 2012.

Average hourly earnings, estimated in the establishment survey, rose a rather uninspiring 1.7% over July 2011 and only $0.02 from June 2012.

Without consistent payroll growth over and above population and labor force increases and a better mix of full-time employment with more robust wages, the economy can at best remain mired in malaise.

Next payroll report release scheduled for September 7, 2012.

INFLATION ACCOUNTS

JUNE CPI
0.0% SA
-0.1% NSA

JUNE PPI
+0.1% Finished Goods
-0.5% Intermediate Goods
-3.6% Crude Goods
-1.1% Ind'l Commodities
+1.9% Gasoline

Inflation on both the wholesale and retail levels continue to be in check as energy prices recede without further action from the US Federal Reserve. Emerging geo-political trends (Iran/Israel) as well as drought conditions in much of the agricultural regions of the United States and India are concerns for future readings. Corn and soybean production have already been strained and will likely contribute to some inflationary pressures across the broader spectrum of food prices.

The combination of rising geo-risk and food prices that are already bucking the established trend seen earlier in the year means that inflation pressures may act outside of monetary expectations. Weather is difficult to predict, but widespread crop yield weakness will no doubt add unwanted strain to consumer non-discretionary spending. If these trends deepen further, the timing of any potential impact will coincide with the second half of the year – breaking the trend of the past three years. That is not good news as the macro-economic trend of this post-recovery period has been overly reliant on the Christmas binge season.

Next CPI release scheduled for August 15, 2012.
Next PPI release scheduled for August 14, 2012.

REGIONAL FED SURVEYS

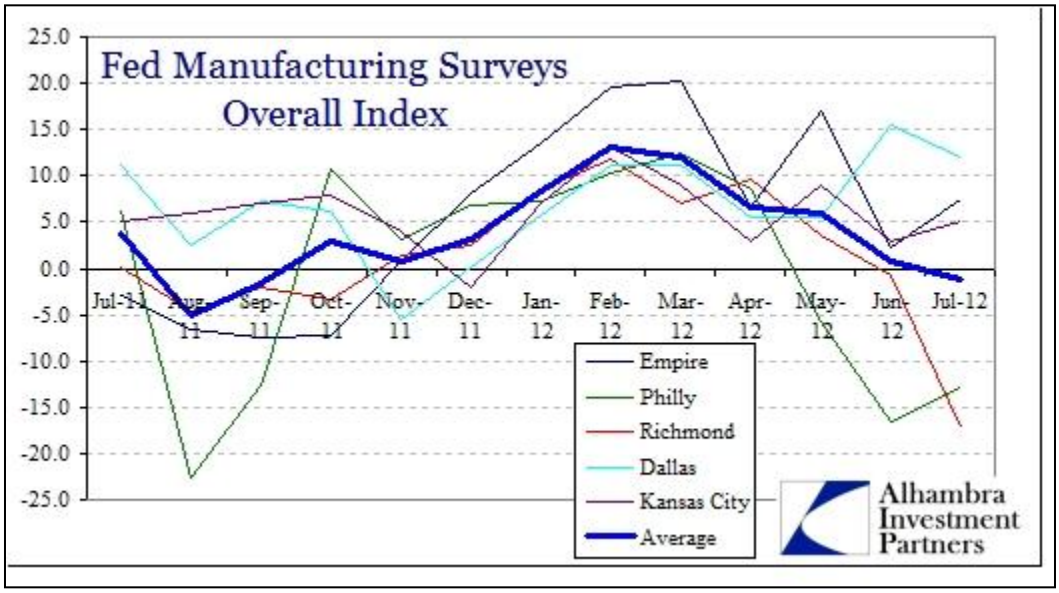
	Overall Index	M/M Change	New Orders	Employment	Unfilled Orders
Empire	7.4	Up 5.0	-2.7	18.5	-13.6
Philadelphia	-12.9	Up 3.7	-6.9	-8.4	-9.5
Richmond	-17	Down 16	-25	1	-27
Dallas	12.0	Down 3.5	1.4	11.8	-1.6
Kansas City	5	Up 2	-4	6	-10

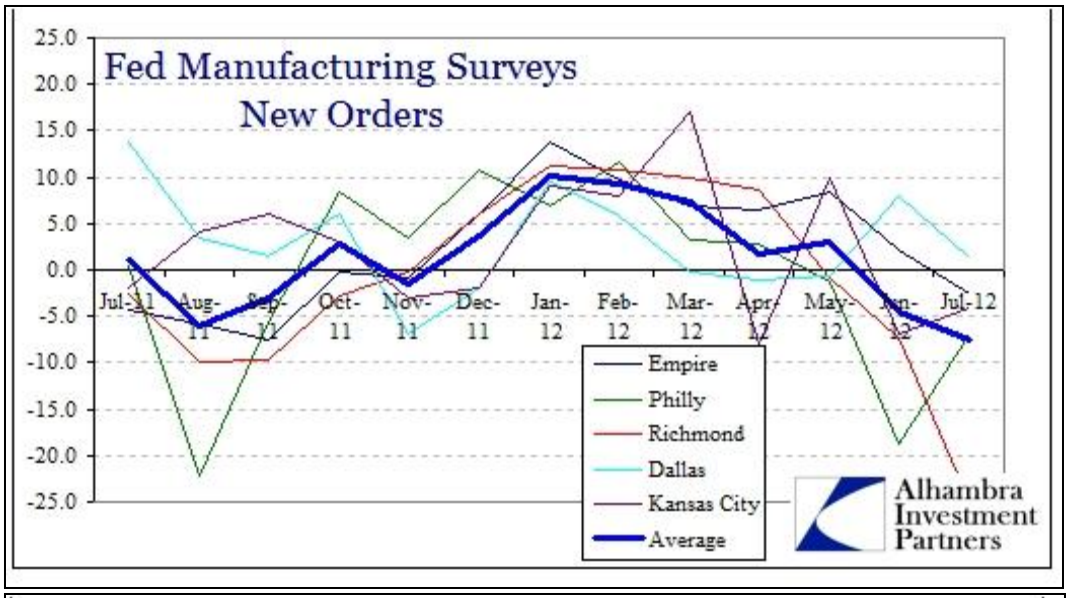
The deterioration in the Richmond and Philadelphia surveys were largely unexpected, both in terms of direction but especially the degree of contraction they indicated. In both cases the pace of the decline was particularly sharp – the Philly survey in June and the Richmond survey in July – with widespread weakness and contraction in most sub-indices.

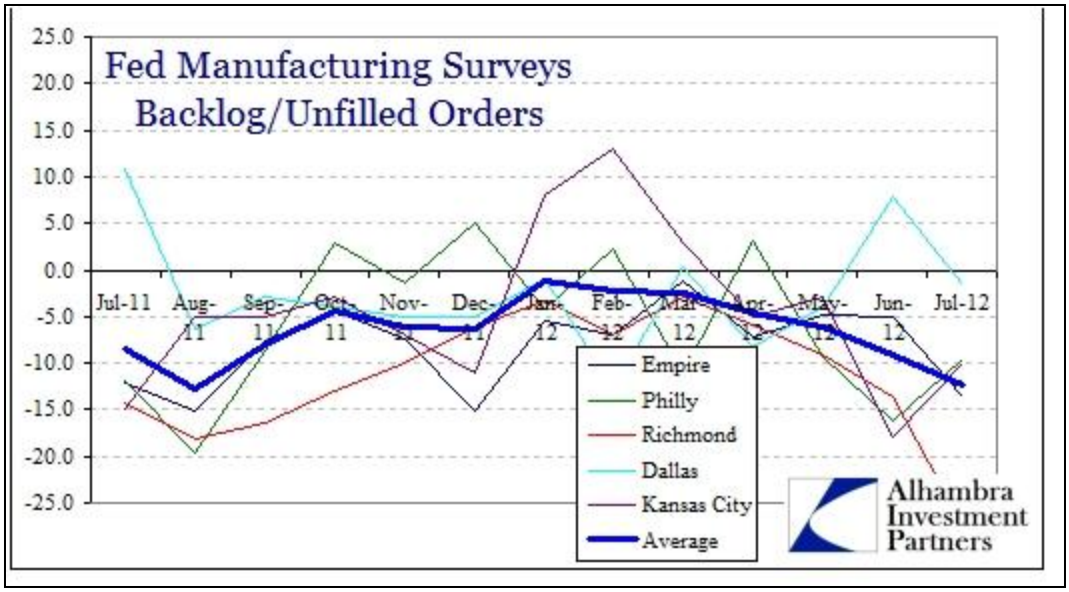
On average throughout the five surveys, new orders and the backlog of new orders have been trending lower throughout 2012. In the case of the Philly survey, new orders and the order backlog are back at the lows reached in 2011, while the Richmond survey results are well below 2011 lows. Overall, only the Dallas Fed new orders sub-index remains positive, but just barely above 0.

In addition to the largely uniform trend in 2012, it is clear across the surveys that conditions changed dramatically from May to June with July maintaining that downward drift. Again, this conforms to results seen elsewhere in prevailing economic accounts.

Next Empire Fed release scheduled for September 17, 2012.
Next Philly Fed release scheduled for September 20, 2012.
Next Dallas Fed release scheduled for September 24, 2012.
Next Richmond Fed release scheduled for September 25, 2012.
Next KC Fed release scheduled for September 27, 2012.







ISM SURVEYS

ISM Manufacturing
July 49.8 +0.1

ISM Manufacturing – Posted first contractionary indication in June 2012 since July 2009, confirmed by July sub 50 reading. Amongst the sub-indices indicating that slowing growth may be changing to negative growth, the new orders sub-index failed to improve much from its steep decline in June (new orders fell from 60.1 in May to contraction indication of 47.8 in June). The largest positive or "improvement" in the July survey was seen in the inventories sub-index, increasing 5.0 to 49.0.

Ominously, only three of sixteen industries reported expansion in new orders. The backlog of new orders continued to decline, from 49.5 in April 2012 to 43.0 in July

2012. Of the fourteen industries reporting, only three indicated an increase in their new orders backlog. The eleven industries reporting declining backlogs were: Nonmetallic Mineral Products; Wood Products; Miscellaneous Manufacturing; Furniture & Related Products; *Transportation Equipment*; *Computer & Electronic Products*; Paper Products; Machinery; Fabricated Metal Products; Food, Beverage & Tobacco Products; and Apparel, Leather & Allied Products. GDP growth since 2009 has largely been related to, on the business side, business investment in computers and transportation equipment. The dramatic inflection in the pace of new orders and the backlog of new orders conforms to the pace of activity seen in a broadening cross section of data points and surveys. The ISM Manufacturing survey, together with the regional Fed manufacturing surveys, confirm that growth has slowed rather aggressively and that trend is not isolated to individual regions or industries.

Next ISM Manufacturing Survey release scheduled for September 3, 2012.

ISM Non-Manufacturing
52.6 +0.5

ISM Non-Manufacturing – June results for the services sector were largely better than the manufacturing sector, but not by much. Business activity is still relatively slower than the 53.7 reading in May and the 57.3 reading from February. The backlog of new orders fell further into contraction, down to 44.5 in July. Inventory sentiment is still being indicated as "too high".

The current activity/production sub-index, however, showed a quickening pace in July, up 5.5 from June to 57.2. The large increase in the sub-index was *incongruous relative to the underlying respondent results* – there was little change from respondents in July from June: only 1% indicated higher activity, but that was equally matched by a 1% increase in those indicating lower activity. Based on those numbers alone the level or pace of current production is not consistent with a large improvement.

Of note, comments from respondents were also less optimistic than the production index itself:

- "The general economy and unemployment are keeping our business flat." (Health Care & Social Assistance)
- "Beginning to see effects of slowing economy. New orders are down versus same time last year." (Information)
- "Business is slowing; input costs are weakening." (Agriculture, Forestry, Fishing & Hunting)
- "Seeing a slight uptick in sales revenue." (Public Administration)
- "Things have not changed too much this past month; however, we are seeing more aggressive marketing/sales efforts by suppliers hungry for business." (Transportation & Warehousing)
- "Overall, we are still seeing growth over last year, but the sequential growth has gone flat to negative." (Wholesale Trade)

Next ISM Non-Manufacturing Survey release scheduled for September 5, 2012.

INDUSTRIAL PRODUCTION & CAPACITY UTILIZATION

June Industrial Production +0.4%

June Capacity Utilization 78.9%

Overall industrial output rose in June after a contraction in May. In terms of overall trend, manufacturing output for the full second quarter advanced at a 1.4% annual rate compared to a much larger 9.8% rise in the first quarter. Motor vehicle production continues to make up much of the growth in overall industrial output (matching the GDP accounts). Excluding motor vehicles, second quarter manufacturing output would have been almost flat at 0.1%.

Industrial output for business equipment continues to expand at a robust rate, but at a markedly slowing pace from 2010 and even 2011 levels. Overall output for consumer goods has now nearly stalled for 2012, and is up only 2.1% from 2011.

Construction production has now seen declines in three of the past four months, though the overall level is almost 5% above 2011. Mining output has been similar to construction, and has displayed a contractionary tendency in 2012.

After registering hefty increases in April and May, utility output reversed again in June, now standing 2.3% below 2011.

Capacity utilization has disappointed so far in 2012. June's level of 78.9% is unchanged from February 2012, and up only 1.3% from June 2011. For crude stage goods, capacity utilization now registers 1.1% above its long-term average, while primary and unfinished goods remain well below average (-5%). Notably, capacity utilization for high-tech industries has been declining since the middle of 2010, falling from around 85% to 75%.

Next Industrial Production and Capacity Utilization release scheduled for August 15, 2012.

RETAIL SALES

June Retail Sales -0.5%
ex-Autos -0.4% m/m

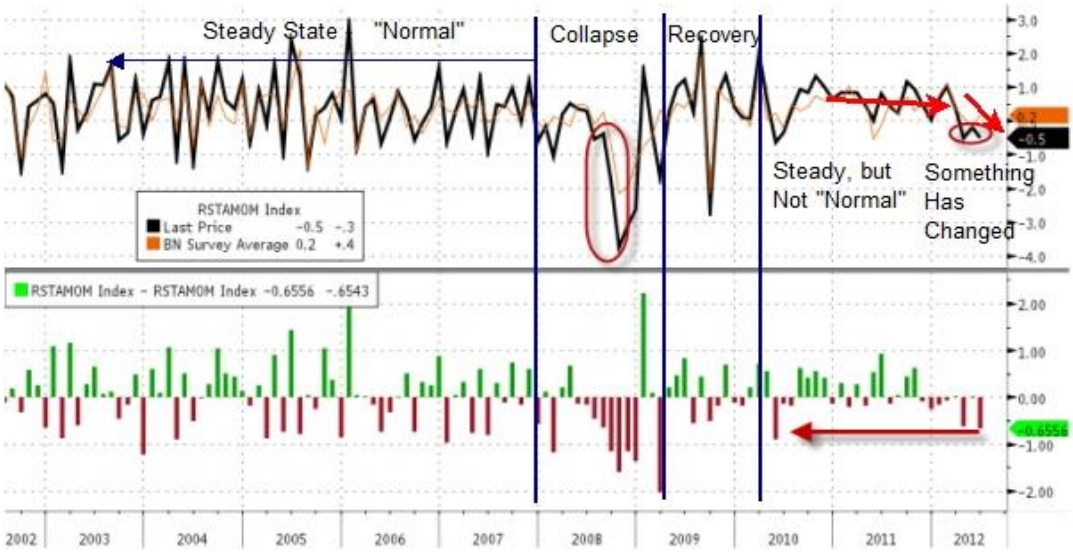
–0.2% 3-month change for 2nd Quarter over 1st Quarter

If you accept the premise that the recovery, such that it was, ended in the middle of 2010, you begin to see that, for the most part, various real economy variables have been treading water at best. This all adds up to an economy that is operating under severe constraints, an economy that does not look anything like the previous pre-crisis era.

Retail sales, for example, show rather clearly the different phases of the economy as it progressed through collapse and recovery. On the other side of recovery is this sputtering "steady state". While not showing the deceleration that other economic accounts have, such as business investment, the healthy "amplitude" has been replaced by what is being called a "muddle". Unfortunately, it very much appears as

if the muddle that has at least existed since mid-2010 has again changed. Retail sales appear to be joining business investment in the second derivative change downward.

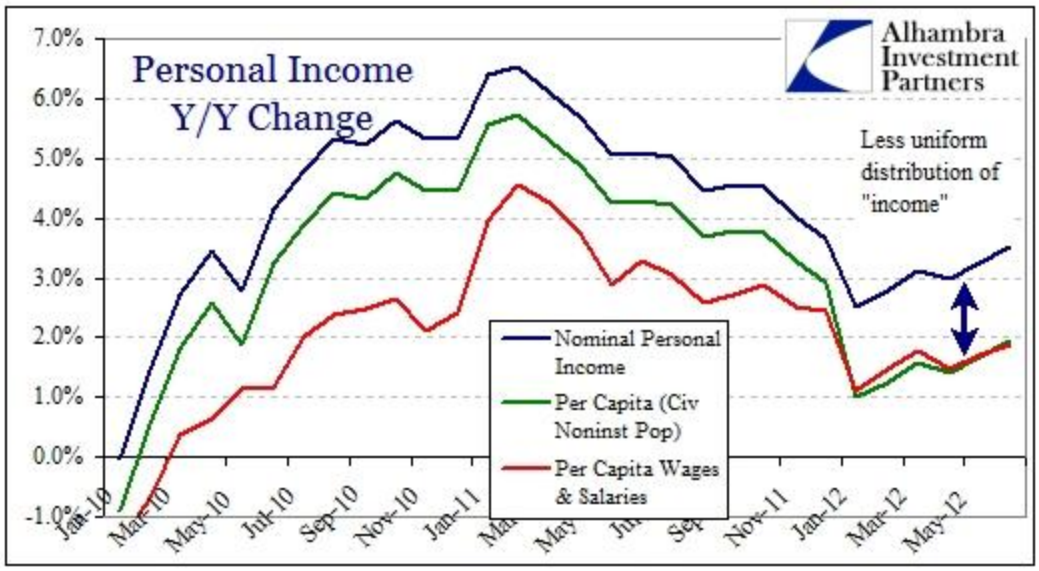
The explanation is quite simple: another economic account (Personal Income) has been signaling warning for more than a year. Real income growth has been trending lower since 2010 as well, but real income on a per capita basis had been shrinking for most of 2011 and early 2012. Even now, income growth is very non-uniform.



Next Retail Sales release scheduled for August 14, 2012.

PERSONAL INCOME & SPENDING

For much of the past fifteen months, personal income on a real per capita basis had been declining due to inflation pressures and non-uniform income distribution. Since the early part of 2012, inflation pressures have largely abated (as indicated in the inflation accounts) providing some relief for personal income. As a result, the trend in personal income has changed back toward rising income, but only slightly since only the inflation trend has changed. Unfortunately, the income distribution problem remains unresolved.

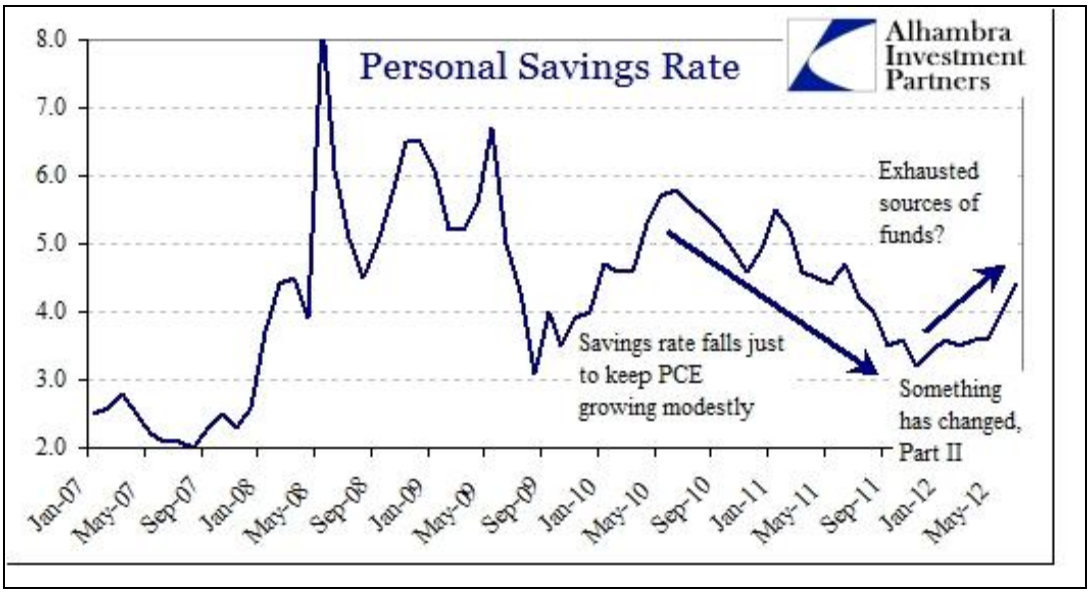


Inside the numbers, almost a third of the gain in personal income in June was from "Income on Assets". That's not a bad thing at all, but it is not a uniform method of getting income to all income segments since it's largely concentrated in the upper ends. From October of last year, more than 25% of the gain in personal income has been on asset income. Throw in the *imputation* of "Rental Income" and these two segments together account for almost 35% of the total gain over that period.

At the other end of the income scale, however, unemployment insurance and "other" government transfers have decreased (from an annual rate of about $546bln to $513bln). If you look at the distribution of "income" as estimated here it is clear DPI is being concentrated at different ends of the spectrum (chart above). Yes, the trend in 2012 is moving in the right direction at a very slight pace, but is it reaching the bottom levels where all the economic torpor is?

This offers a very good explanation as to why the savings rate is moving up despite the slight progress in income - it is decidedly non-uniform. Those at the bottom are doing worse despite some improvements elsewhere. Those without jobs altogether are now finding themselves with even fewer options for acquiring currency units.

This recovery period has been bifurcated from the outset, but that dichotomy has grown since the end of the real recovery in mid-2010. Those that are doing well are doing very well, while those that are doing poorly at least had a shot at doing well until 2010. Since then we have seen the growing effects of monetary repression for the bottom rungs. This economy needs jobs and wage income to even out the flow of money and the creation of real wealth. The inflection in the savings rate, having occurred almost entirely within CY2012, is an indication of what might be a predicate cause to the current "soft patch". The surge higher after May also coincides with the inflection seen in the manufacturing data above.



Next Personal Income & Spending release scheduled for August 30, 2012.

CONSUMER CONFIDENCE

Gallup Economic Conditions Survey -29

Conference Board Consumer Confidence Index July 2012 65.9

UM Index of Consumer Sentiment 72.0

Both the Gallup measure and the UM measure showed an inflection in consumer and economic sentiment in May (another series conforming to the larger trend). The UM survey, however, has been much more understated in its measurement of any growing pessimism, though the decline in June was significant (from 79.3 to 73.2). The index was expected to improve in July to 73.5, so the continued downward trend was "unexpected". The decline in the Gallup survey, while still showing levels far above last summer's swoon, has erased all of the improvement seen in 2012 – minus 29 brings confidence levels back to early January 2012.

The Conference Board's estimate of consumer sentiment rebounded in July after the large drop in June. Driving the two month volatility has been future expectations, diverging from the persistent downward trend in current conditions. Current conditions remain depressed (down to 46.2 from 46.6), but the expectations index climbed back to 79.1 in July after falling from 77.3 to 72.3 in June.

Overall, consumer confidence measured amongst all three surveys suggests that consumer sentiment has turned, largely following the pattern set in 2010 and 2011. The degree to which that sentiment is turning, however, is as yet unclear. But it is very clear that sentiment, as a lagging indicator, confirms weakness we have noted in the consumer segments of the macro-indications.

The Gallup survey is conducted weekly.
The next Conference Board survey release is scheduled for August 28, 2012.
The next Thomson Reuters/UM index release is scheduled for August 17, 2012.

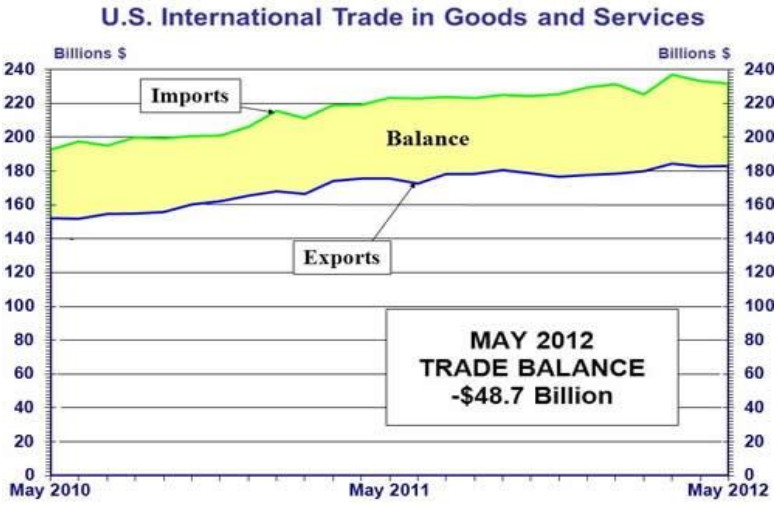
CURRENT ACCOUNT & FOREIGN TRADE

Change in US Exports of Goods
-$0.4 billion May 2012

Change in US Imports of Goods
-$1.6 billion May 2012

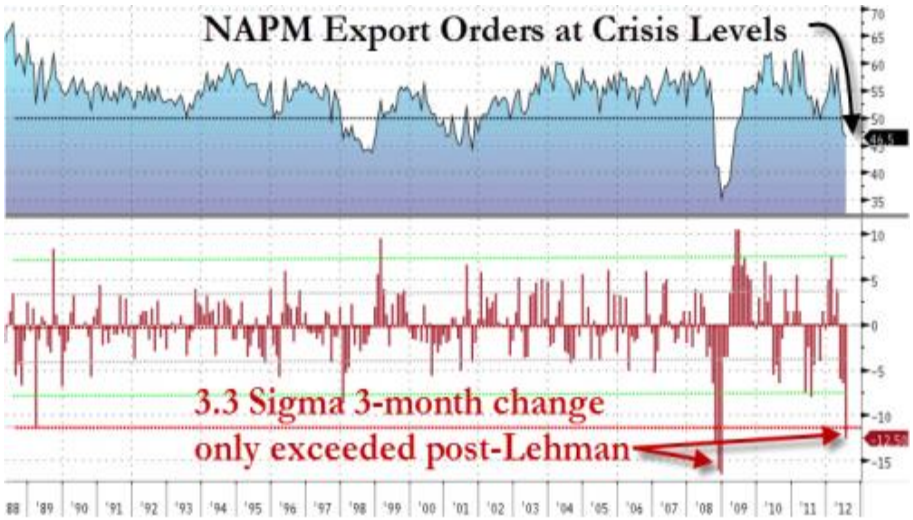
US Merchandise Deficit
-$63.5 billion May 2012

Growth in US exports of goods was only $0.4 billion in May, continuing the very weak growth trend we have seen since March 2012. The fragility in export growth was more than matched by a $1.6 billion decline in imported goods. Total goods exported were $183.1 billion, while total goods imported were $231.8 billion, creating a merchandise deficit of $48.7 billion (down from $50.6 billion in April).



Despite the improvement in the merchandise deficit, the decline in import activity is yet another piece of evidence demonstrating the weak pace of spending seen throughout the economic accounts. The trend for imported goods began to recede toward the end of Q1. Weakness in Q2 matches the trend seen in retail sales and the consumer segment of GDP. While the net numbers are largely positive for the overall GDP accounts (a smaller merchandise deficit is GDP positive because of the way economic variables are estimated by the BEA), anecdotally the import slowdown is perhaps far more important for what it says about the pace of spending within the overall US economy.

The downward trend for imported goods largely coincided where expected given the environment for global commodity prices (-$3.6 billion in imported industrial supplies and materials), but the segment of imported consumer goods actually decreased as well (-$0.4 billion). The lack of follow-through spending beyond industrial goods tempered by falling commodities prices is significant to the growing evidence of a real slowdown in US consumer spending.



On the other side of the ledger, Eurozone problems are creating pressure on export activity. Export orders have fallen at a pace not seen since 2008, adding to the toll on manufacturing activity due to domestic constraints.

The next International Trade release is scheduled for August 9, 2012.
The next International Transactions release is scheduled for September 18, 2012.

REAL ESTATE & HOUSING

Conditions in residential real estate have improved almost uniformly since the middle of 2011, largely due to multi-family structures. It is difficult at this point to attribute this to any specific causes with any sort of certainty, but anecdotally there is evidence that banks and investment trusts are actively managing their foreclosure backlog and REO's with sales and real estate prices in mind. Active management in this way may help the overall sales and price environment, but there is still a large shadow supply that will need to be addressed at some point.

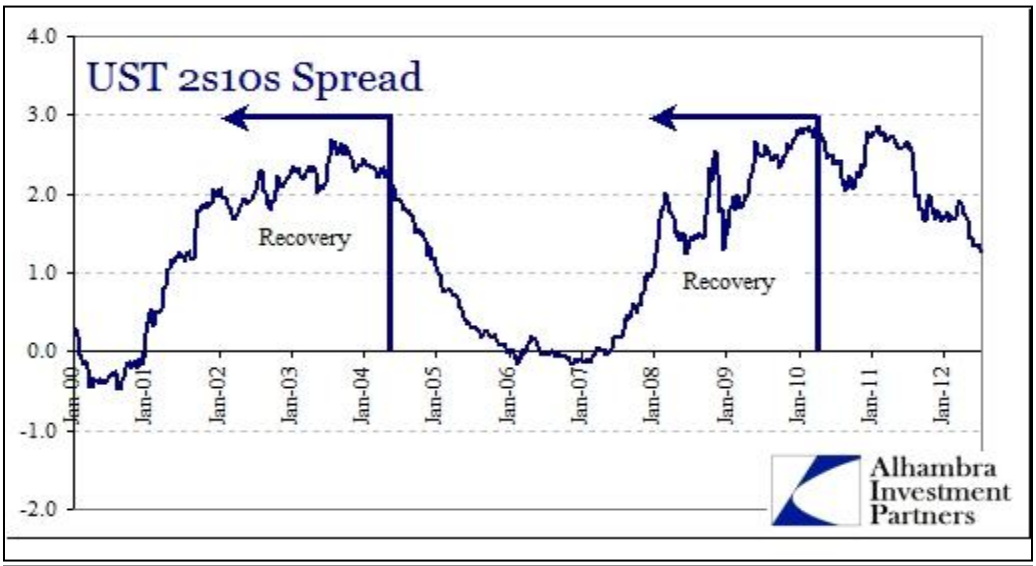
The likely effects on the overall economy, however, will likely be more muted owing simply to the scale of the collapse in home building activity. It is unrealistic to assume that a renewed housing market will bring back construction activity (jobs) to a degree that will be significant enough as a base for an organic macro-level recovery.

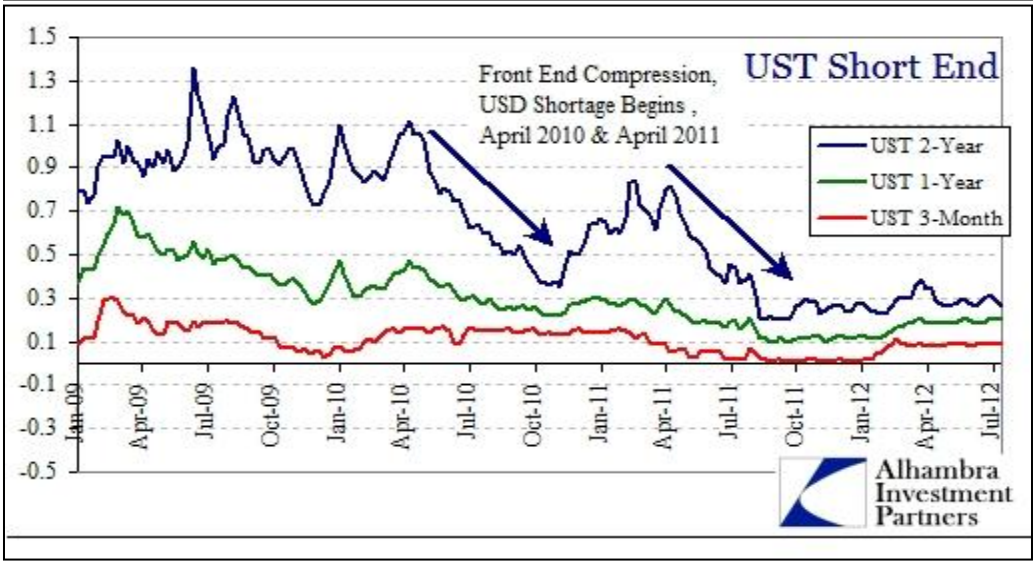
There is also a noticeable mismatch between housing starts (indicated by the chart above) and completions (below).

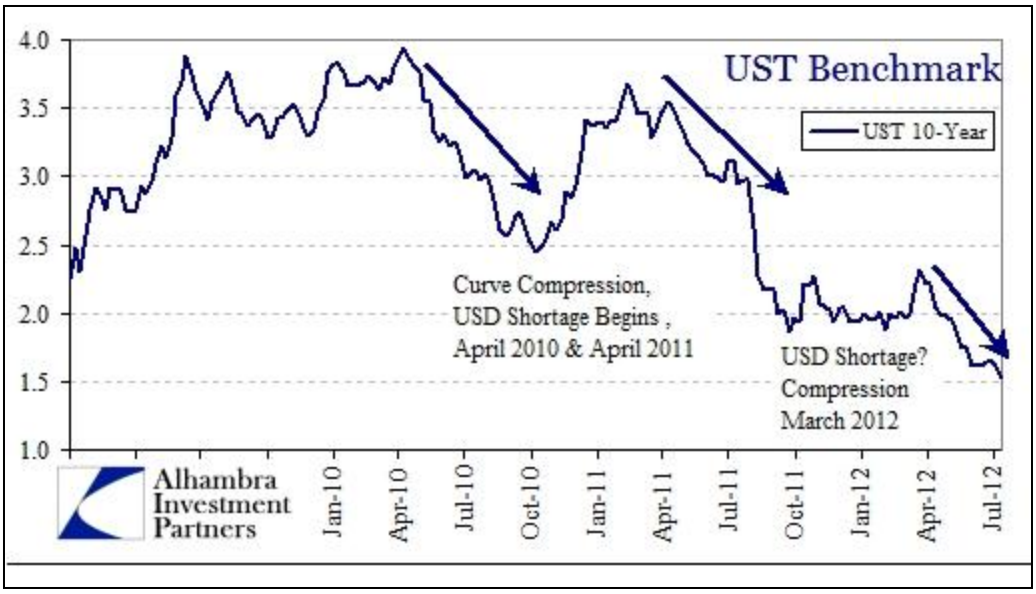
How durable this trend ultimately becomes is still the biggest question. The rumors of a renewed monetary stimulus for mortgage-related credit demonstrates that there are still persistent worries about real estate and the durability of any rebound in the US – at some point shadow inventories must be cleared by being entered into markets. Chairman Bernanke would not be discussing alternate forms of advancing mortgage credit into the marketplace if the Federal Reserve itself was not still concerned about a potential downward inflection or renewed dip in home prices.

US CREDIT MARKETS

The similarities between the yield curve shape in the 2002-04 recovery and the shape in the 2009-10 recovery suggest parallels in the relative perceptions and outlooks for credit investors of both periods. The vital difference, however, is the appearance of perpetual ZIRP (zero interest rate policy). The longer end of the yield curve is compressing to catch up with the shorter end. Record low interest rates are appearing at all points along the curve, and there is little doubt that the combination of continued economic weakness and expectations of non-stop monetary interventions are playing a role in these extreme rate movements.







In terms of financial liquidity, compression in short-term yields in the 2010 and 2011 episodes were stark indications of the renewed US dollar shortage. The Fed's re-opening of global central bank dollar swaps (after cutting the penalty rate to OIS + 50bp in December 2011) alleviated near-term pressure on dollar funding.

Recent EUR/USD basis swap prices indicate that the market for dollars is again relatively tight. While still slightly below the OIS + 50 threshold, there is every reason to believe that, given the funding environment in Europe, international financial firms are pursuing liquid collateral amongst a growing number of terms and tenors.

The global banking system is short anywhere between $1.5 Trillion - $6.5 Trillion

At issue is, as it has been for decades, the persistent overhang of the mismatch of dollar assets and euro liabilities (denominated in other Eurozone currencies before the adoption of the euro). There is still no hard estimate to just how short in USD the global banking system remains, but there is little doubt that it is somewhere above $1.5T. Unfortunately, the "evolution" of global banking makes it much more difficult to navigate potential dollar illiquidity as firms have grown more accustomed to using OTC and bespoke funding mechanisms, particularly repo funding and related rehypothecations.

Without a definitive indication of the USD funding environment, we are forced to rely on secondary indications, such as the behavior of UST assets. In April 2011, as in September and October 2008, repo stress was largely evident through negative US t-bill rates and repo fails in the treasury space. Anecdotally, there is some evidence that repo buyers (cash lenders) have shifted preferences toward any liquid USD credit asset, rather than focusing on just the short-end of the UST curve.

Complicating this analysis is, of course, the ongoing Operation Twist. How much of an effect this Fed intervention is having is difficult to ascertain. But we know that the

effects on the shorter-end are very muted, at best. Despite the selling end of Operation Twist, the overall US curve is steadily declining toward zero (as noted above). The flattening of the entire curve may be much more than just Operation Twist, as the credit environment appears to be shifting toward a new paradigm. This potential shift requires more study and attention, especially in conjunction with the euro funding environment, but the appearance of the compressed, flattened curve toward zero is an echo of Japan in the 1990's and the US in the 1930's. Liquidity preferences, once embedded, become huge obstacles to "normalizing" funding environments for real credit and asset prices.

EUROPEAN CREDIT MARKETS

Swiss 2Y	-0.43%
Germany 2Y	-0.09%
Denmark 2Y	-0.26%
Holland 2Y	-0.01%
Finland 2Y	-0.05%
Italy 2Y	3.74%
Spain 2Y	4.83%
Portugal 2Y	8.15%
Swiss 10Y	0.47%
Germany 10Y	1.23%
Denmark 10Y	1.02%
Holland 10Y	1.54%
Finland 10Y	1.33%
Italy 10Y	6.33%
Spain 10Y	7.17%
Portugal 10Y	11.04%
Germany Target II (June 30)	€728.566 bn +4.3%
Spain Target II (June 30)	-€337.206 bn +17.2%

Attention is focused on Europe because of the political implications of the euro currency against the backdrop of mismatched credit asset prices and the economic imbalances that have been created by such mismatches. Political forces are continuing to keep the euro together such as it is, but market forces appear to be moving in the opposite direction.

Despite the LTRO's from only six months ago, market conditions have deteriorated to levels that are potentially far worse than conditions as they existed before the LTRO's. Rumors of retail deposit flight (or jog) have been largely confirmed by credit market prices and the ongoing Target II "mania". At first, monetary movements exhibited a euro favor, simply moving from the "periphery" to the "core" (from Greece to Germany, then from Spain and Italy to Germany). Now, however, it is clear from credit prices that marginal money flows are seeking funding arrangements and assets free from the euro altogether.

The fact that a large section (from the short-end into the middle) of the Swiss government yield curve sees persistent and significant (record) negative yields attests to the demand for Swiss francs. Concurrent to the flow toward the franc, Danish government bond prices have largely mirrored Swiss prices (Denmark still uses the Kroner). The apparent and largely unseen movement of money out of the euro forced the Danish central bank to reduce its target deposit rate to a negative yield.

In June 2012 the German Target II surplus grew by only 4.3%, a significant decline to its pace from previous months. At the same time, not only were Swiss and Danish credit rates moving further into negative yields, the price of the euro itself has fallen dramatically. Together, these indications suggest that the movement of capital has now shifted from within regions of the Eurozone, to without the Eurozone entirely (at the margins).

Recent breaks to these trends on comments from ECB officials (notably Mario Draghi) now place enormous pressure on the ECB to deliver as advertised. For US investors in USD assets, the potential for a euro-related crossover event is likely a

combination of retail deposit movements and sovereign bond pressures on repo eligibility at French, Belgian and other Northern European banks.

Retail deposits form the hub and spoke schematic that has developed over the last twenty-five years, affording Eurozone banks the luxury of collecting local deposits and turning them into USD assets though London-based subsidiaries operating in the eurodollar market. Pressure on the local deposit base, such as we have seen in Spain in 2012 (cash flight equal to 26% of GDP), eventually reduces the ability of multi-nationals to fund those USD positions.

Liquidity conditions in repo markets have largely been attributed to Italian sovereigns. Drastic conditions seen in the latter half of 2011 were due in most part to French bank exposure to Italian subsidiaries. Italian sovereign bonds at that time were far more pressured than even their Spanish cousins, leading directly to the LTRO's (and a temporary stay of execution). Re-recession in Europe and the basic math of Spain's plight has renewed pressure on Italian securities. As Italy goes, interbank markets will follow.

The last two weeks have seen some very dramatic, volatile swings in PIIGS debt prices and yields. The Spanish yield curve nearly flattened entirely as the 2-year traded down in price to yield almost a level matching the 10-year. Flattening to that degree at such a high nominal curve level was last seen in Portugal, Ireland and Greece just before bailouts. Almost as soon as the Spanish curve had imploded, Draghi's comments and hints of further ECB action reversed the selling pressure on the short end, easing the Italian equivalents to some fair degree. From an intraday high above 7%, the Spanish 2-year has eased all the way back below 4%.

INTERBANK INDICATIONS

Money prices and interest rates in money markets throughout the world have been subjected to heavy doses of monetary interventions and are now thoroughly in the realm of surreal. This is especially true as rates persist in close proximity to the zero lower bound. Short-term money rates are not "forbidden" from crossing the zero threshold, but are kept in a near-comatose state by central bank measures.

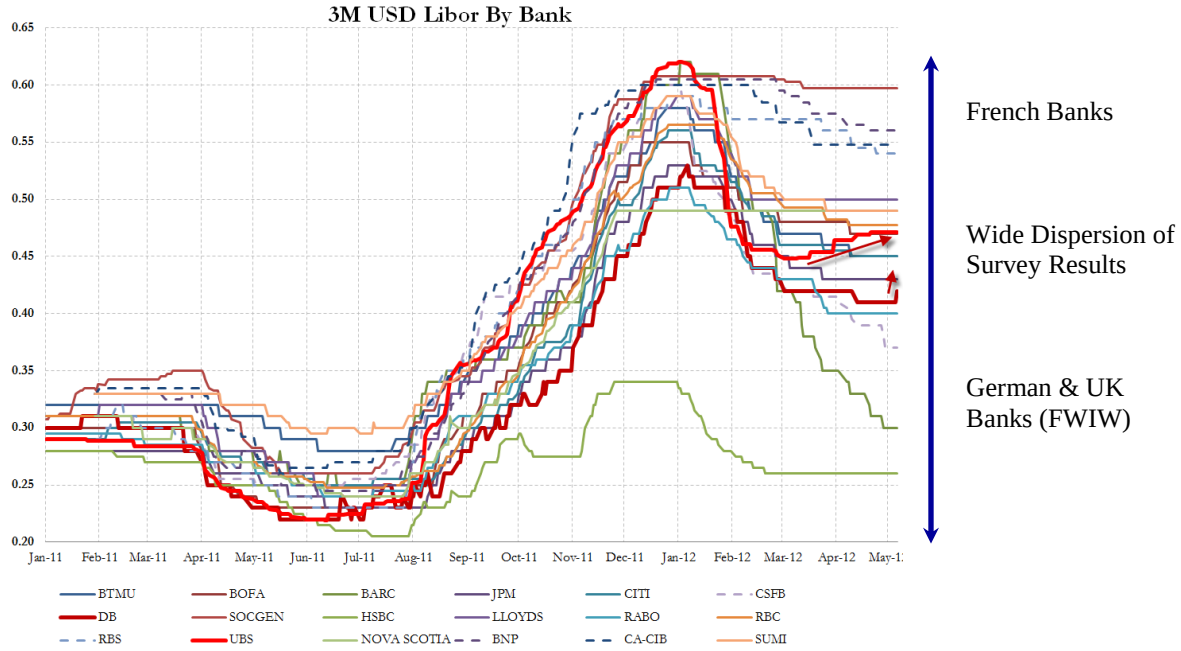
For instance, the once-popular FRA-OIS spread (the measure of 3-month LIBOR to the Overnight Index Swap) was meaningful in the run-up to last summer's growing crisis. Since late last year, however, the measure has been falling at a measured pace. Even LIBOR indications would have you believe that interbank conditions are largely at "normal" operating levels, but we know without much doubt that conditions are very stressed in global interbank markets (as noted above). Much of this disconnect has to do with interbank markets themselves. Unsecured lending, what is denoted by LIBOR fixings, is really a figment of the past, an anachronism to today's liquidity environment. As such, LIBOR rates are relatively meaningless.

Even money that has flowed to the ECB's deposit account seems to be creating a distortion on spreads. Without the ECB to soak up excess money (that would normally be looking for unsecured lending) it is very likely that the OIS or EONIA overnight rates would be negative, and probably significantly so. That means that the deposit and overnight facilities are masking stress that would otherwise be apparent through normal indications – liquidity preferences rule the day in wholesale money markets.

The change in the deposit rate to zero did cause a flow of money out of the ECB's deposit account, but into another overnight account that pays no interest. Unless the ECB decides to follow Denmark into negative yields on deposits, we are not likely to see any meaningful indications out of interbank rates. That means that stress is still largely hidden in these anecdotal outlier events and prices. Is that a net positive?

Hidden stress is still stress no matter which way it comes out in the wash. In fact, it may end up being worse/counterproductive if the only outlet for such stress is through unprecedented means. Severely negative interest rates and curves may end up signaling the very thing central banks have been conspiring to prevent: deflation.

We do know that interbank markets are under extreme strain, and that chains of rehypothecation have been broken through various central bank "liquidity" measures. Only a few weeks ago we saw collateral rules dramatically weakened at not only the ECB, but the Bank of England. The BofE activated an "emergency" collateral funding (ECTR) regime that had remained dormant even through the worst of the 2011 crisis. That begs the question of exactly what is going on in interbank markets if secured lending is now being stressed in sterling as well as dollars and euros.



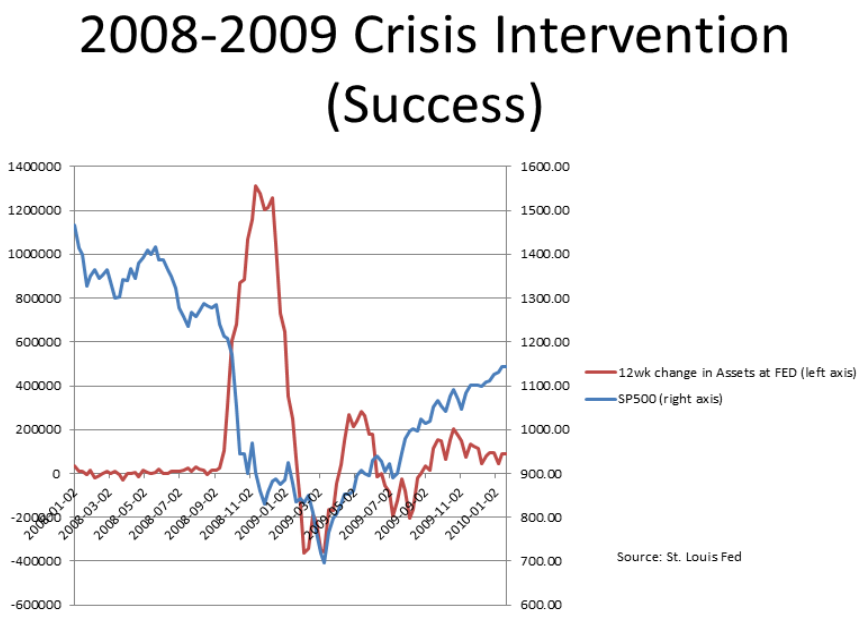
MONETARY POLICY NOTES

When contemplating the Fed, one needs to be aware that monetary policy is not an exact science. The Fed will definitely try to effect policy; but, to a great extent, they are a reactive bunch. The Fed attempts to stay ahead of the curve and anticipate if/when the broader economy needs restraint or accommodation, but there are a few problems. First, the economy is a large animal, full of lots of hormones and inertia. Fed policy initiatives to slow a charging bull, for example, will often be initially ineffective. Fearful that the animal will not tire or abate, the Fed can over tranquilize the economy and it may then need mechanical resuscitation. Second the Fed wants to be a nurturing institution. Knowing that its actions can induce mania or depression, it is careful about wielding its heavy hand.

Here are the important data points the Fed has identified in its own self-evaluation over time.

- They are poor forecasters of when and how much they are needed.
- It is hard to judge in the short term, and impossible to judge in real-time, the effect of an initiative.
- They have large weapons, if needed, but prefer to use smaller ones.

As such, the Fed and all Central Banks have developed a manner in which they communicate to the world. If you've ever been a parent you will appreciate what the Fed attempts to do. They want to establish explicit expectations and clearly communicate the paths that can be taken. Then, they broadcast the help or punishment forthcoming depending on how events transpire. They want you to know that there are no idle threats and that they can and will follow through.



Lastly, the Fed will be there for you in your darkest hour.

So when investors analyze the Fed and Monetary Policy, much that we take away is from experience, interpreting how Dad is likely to react given his past reactions and his current rhetoric.

The past 4 years provide a fairly good road map to the environment and to the role the Fed is and will play given dynamic challenges in our economic situation.

In 2008, there was a 911 call placed. Here is what it looks like when the Fed is there in your darkest hour.

In addition to the direct government initiatives,

(Treasury opening its coffers to Freddie Mac and Fannie Mae, the Housing and Economic Recovery Act, SEC bans on short selling, the Capital Repurchase Program buying equity in banks, ESF-Exchange Stabilization Fund-money market guarantees, Emergency Economic Stabilization Act-establishing TARP-Troubled Asset Repurchase Program, Auto bailout and FDIC interventions)

The Fed did the following:

- TAF, term auction facility and its expansion
- TSLF, term securities lending facility, also expanded
- PDCF, primary dealer credit facility, subsequently expanded
- Maiden Lane, credit facility for sale of Bear Stearns
- Line of credit for Fannie Mae and Freddie Mac followed by increases and extension to FHMLC
- Swap lines and increases with the ECB, BOJ, Bank of England and Bank of Canada, Reserve Bank of Australia, Sveriges Riksbank, Danmarks Nationalbank, Norges Bank, Swiss National Bank, New Zealand, Banco Central do Brasil, Banco de Mexico, Bank of Korea, and the Monetary Authority of Singapore
- Loans directly to AIG, followed by cash
- AMLF, asset backed commercial paper money market mutual fund liquidity facility
- Commercial Paper Funding Facility AIG cash for toxic debt swap, increase in swap lines, expansion of commercial paper funding facility
- MMIFF, money market investor funding facility
- Procurement of an IMF short term funding facility
- Conversion of financial institutions to Bank Holding Cos.
- Maiden Lane II, restructured AIG bailout LLC to purchase CDO's and MBS's
- TALF term asset backed lending facility, expansion of acceptable collateral, extension of duration
- GSE debt purchase program...

The programs were expanded and extended for much of 2009.

2010 saw QE2, an additional $600bln to facilitate market growth. 2011 saw the initiation of Operation Twist and swap lines extended to Europe to facilitate liquidity.

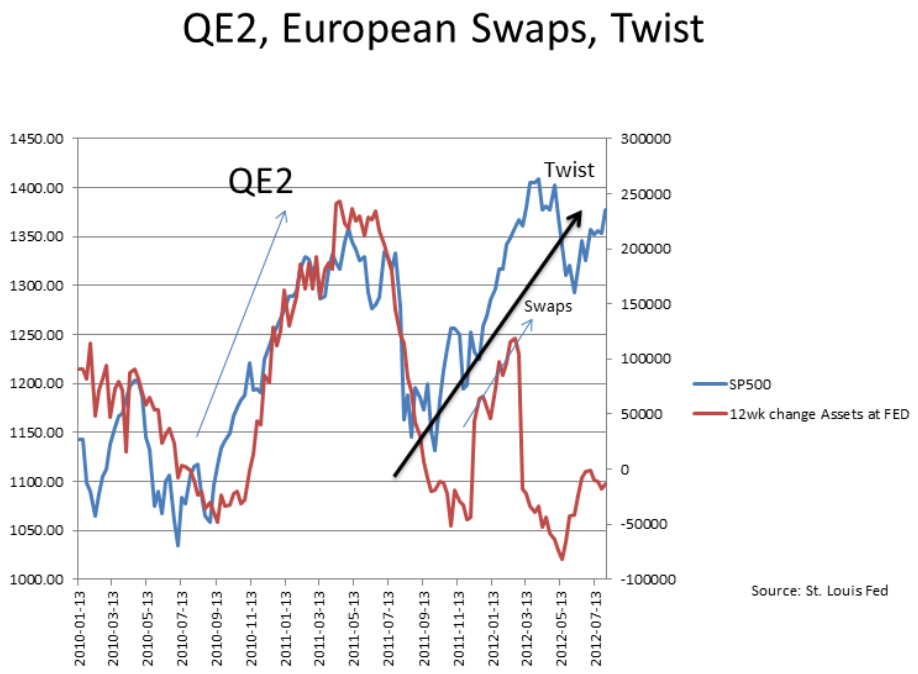
The progression of monetary intervention started with the Fed as lender of last resort, essentially a fire fighter. It moved to facilitator of asset inflation. And now would be

classified as aiding fire fighters elsewhere and inducer of short-term activity.

We feel Operation Twist was put into place to combat specific incentives in the market place. The Fed's massive intervention left it with a predicament; the forward curve was/is incenting banks to delay lending. The resulting structure of interest rates, indicative of inflationary pressures, means one can extract an excess return by lending one year from now rather than by lending today. Through the Fed's purchase of longer dated securities and sale of short dated securities, they have flattened the yield curve and eased the incentive to delay lending.

The Fed did extinguish the real threats from the mortgage credit collapse. They supported asset markets. And they are now inducing activity.

Do we need QE3? We don't think it is currently necessary. We also think there are very negative longer-term ramifications. We would prefer the Fed save its bullets in the current environment to utilize further intervention as a floor rather than a steroid. As mentioned above, watch the statements closely. Communications released from the most recent FOMC meeting indicate the willingness to use more open ended and less transparent intervention in the future.



As analyzed by our own Joseph Y. Calhoun on August 1st:

"Subtle change in language:

June 20th statement:
The Committee is prepared to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

Today's statement:
The Committee will closely monitor incoming information on economic and financial developments and will provide additional accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

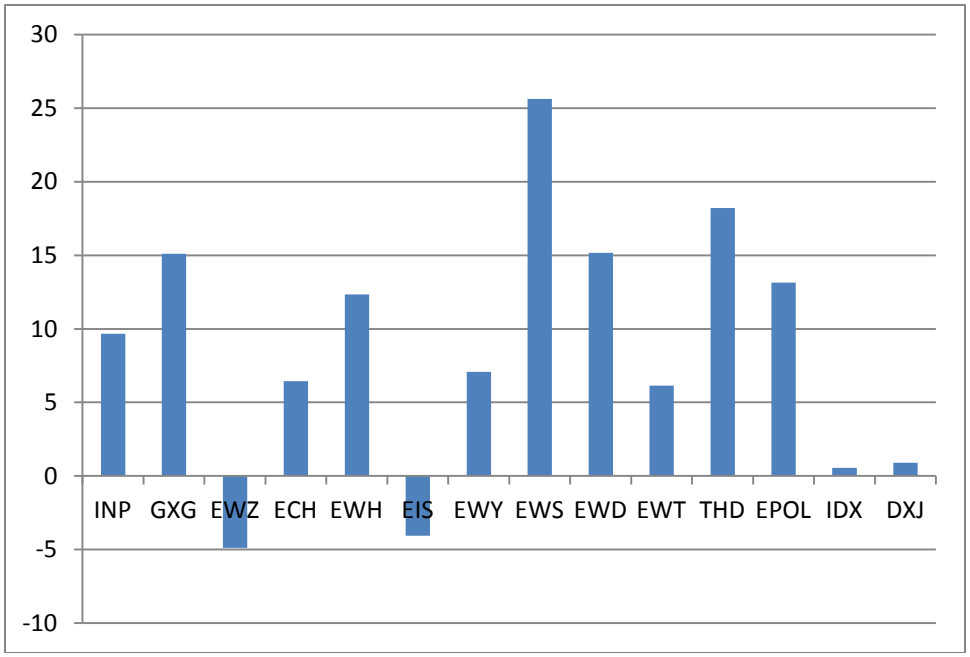
"I could be wrong but this sounds to me like they are moving to a more open ended policy."

In the charts one can definitely see the positive effects of Fed policy. Today's economy doesn't appear completely healthy, but the ole saying on Wall St is, "Don't Fight the Fed."

If/when Europe decides to follow a similar program, prudent or not, who knows what might happen.

OVERSEAS/EMERGING MARKET NOTEBOOK

Overseas markets have generally underperformed the US market this year with the EAFE up 4.8% YTD versus a 12% gain for the S&P 500. There are exceptions obviously and we've been able to find a few of them for our Select Countries portfolio. The returns of the portfolio constituents are shown above. The best performer has been Singapore with Thailand, Colombia, Sweden, Poland and Hong Kong all also outperforming both the EAFE and S&P. Overall the portfolio falls between the two indices in performance, up 8.24% YTD. Our biggest disappointments have come in Brazil and Israel, two markets we've owned for some time. Indonesia and Japan are relatively new additions.



EUROPE

Euro Unemployment 11.2%

Euro PMI 46.5

Bright Spots: Ireland, Switzerland, Central Europe

The economic landscape outside the US is quite unsettling. Obviously, Europe is at the top of everyone's worry list. The situation in Europe is far from resolved and all indicators are that the economic slowdown there has more room to run. Spain's economy contracted 0.4% sequentially in the second quarter and 1% year over year but the weakness is widespread. Eurowide unemployment rose to 11.2% in June, the highest since 1995. The PMI for Europe fell to 46.5 in July, new orders plunged and German private sector activity fell at its steepest rate in over 3 years. Overall, the Eurozone likely contracted for the second consecutive quarter. There are some bright spots: Ireland appears to be recovering slowly with the only manufacturing PMI still above the 50 level. Sweden has continued to perform well; the services PMI was recently quoted at 54.8 in July and GDP expanded by 1.4% in the second quarter. Switzerland is benefiting from capital inflows and an expansion of the central bank's

balance sheet as they try to hold down the franc. Central Europe also appears to be holding up well although Poland has seen some recent weakness. How the entire European mess is resolved is something we can't predict but we do believe that the only alternative long term involves structural reforms of labor markets and a liberalization of all the economies of Europe. How long it takes for the politicians to arrive at that conclusion is anyone's guess but Mario Draghi is keeping the pressure on for real reform.

CANADA/AUSTRALIA

Developed economies outside Europe are doing somewhat better. Canada's economic growth has been less than expected but is still expanding. Canada's PMI remains well above 50 at 53.05 in July. Australia, despite the slowdown in China, recently reported a rise in retail sales. We are doubtful, however, that Australia can avoid a deeper slowdown if China continues to slide.

EMERGING MARKETS

Tough times for Brazil

Emerging markets have been affected by the slowdown in China and most are in easing mode trying to weather the storm. Brazil has cut rates repeatedly but with little effect so far. Both the services and manufacturing PMIs are solidly under the 50 level that marks expansion although there was a slight uptick in industrial production of 0.2% in June. While we continue to believe that Brazil has made more progress during this current resource-driven growth era, it still has a long way to go. The Olympics and World Cup will not save the economy if other measures to improve competitiveness are not taken. Chile is still the premier economy in Latin America and it has weathered the China slowdown storm best. The central bank recently held rates steady at 5% and economic activity expanded 5.3% year over year in May. Inflation remains under control with the CPI up 2.7% in June. Export related sectors have slumped a bit but domestic demand remains robust. Retail sales were up 8.9% year over year in June. And, oh by the way, the government is running a budget surplus. Chile remains our favorite economy in Latin America by a wide margin.

Chile is still the premier economy in Latin America

Slowdown in Colombia

Colombia is starting to feel the effects of its rising currency and the central bank cut rates for the first time since 2010. Industrial output is down 3 straight months and retail sales also fell last month. Export growth has slowed to 1.2% from 16.1% in March. One ominous sign to keep an eye on is credit which is expanding rapidly although slowing to 18.3% from 22.4% at the end of last year. Overall, Colombia has made major progress over the last decade and we expect the improvement to continue after this slowdown ends.

ASIA

Contraction in Singapore

Asian economies are largely tied to the Chinese and European slowdowns and most economies are suffering. Singapore, which has been a big gainer for us and one of our favorite economies, contracted by 1.1% in the second quarter and its PMI has been trading around 50 for the last year. The economy still expanded year over year by 1.9% but that is a big come down from previous growth rates. Inflation is also running a bit hot at 5%. Taiwan returned to growth in the second quarter, up 0.78% from the first quarter but year over year still showed a small contraction. We continue to believe however that increased ties to the mainland will benefit Taiwan over the longer term.

South Korean exports under strain

South Korea is also feeling the pinch of waning overseas demand with exports falling by 8.8% in July. A fair part of that was in the shipping industry, so it may not be as bad as it sounds. Expectations are rising for more interest rate cuts from the central bank.

India's lights went off last week and that isn't a bad metaphor for the economy as a whole. GDP growth has fallen to roughly 7% with an inflation rate to match.

China's slowdown continues and all signs point to a continuation of the trend. While the official PMI remains around 50, it is hard to reconcile with other indicators. Electricity usage is down and layoffs are widespread in the biggest export zones. Property prices appear to have stabilized for now, but there is still a lot of vacant property. The government has cut interest rates twice and relaxed reserve requirements repeatedly. In a more telling sign of weakness, the government has recently allowed the currency to weaken against the US dollar despite the political storm that might initiate in the US. With a change in political leadership on the horizon it is impossible to say what the government will do in coming months. The best hope for Chinese growth would appear to be a rebound in the US and European economies. Not exactly a lot to hang your hat on at present. Having said all that, if the new government further liberalizes the economy, as we expect, the long-term outlook for China is still fairly positive. It is still a very poor country and has plenty of room for productivity enhancements in the coming decades.

China's official data hard to reconcile with other indications

Japan's valuations remain a top consideration

Lastly, Japan appears to have joined the slowdown with three consecutive drops in industrial production. We remain positive on Japan for the long term due to valuation considerations and our expectation that the BOJ will be forced to push the Yen down in coming years. Japan is rapidly approaching the point where they will no longer be able to finance the deficits internally and with such a large debt outstanding, they will not be able to withstand a rise in interest rates. That being the case, we believe the BOJ will be forced to finance the debt, pushing down the Yen in the process. With the stock market trading at 80% of book value we find the market valuation compelling and a drop in the Yen would be very positive for Japanese corporate earnings. We expect a Yen hedged long position in Japanese stocks to perform well in the coming years.

Yen breaking point?

Alhambra
Investment
Partners

www.alhambrapartners.com