Weekly Market Commentary

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European Upgrade

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Highlights

S&P's downgrade overshadowed meaningful developments over the past two weeks in Europe which we would call an upgrade in dealing with the debt problems.

The events of the past week show that the rating change at S&P, while warranted, is a lagging indicator of a situation that has been something less than AA-rated for a long time, but has been improving in recent months with more progress made in the past two weeks.

While we have become more positive about the path Europe is taking, these efforts virtually assure a mild recession for Europe in 2012, and reinforce our belief that better investment opportunities lie in the United States and Emerging Markets.

On Friday, Standard & Poor's Ratings Services, one of the three major U.S. ratings agencies, downgraded France and Austria from AAA to AA+ and downgraded seven others (Malta, Slovakia and Slovenia by one notch and Italy, Spain, Portugal and Cyprus by two notches). The downgrades contributed to the second down day for the S&P 500 Index in 2012. However, the S&P downgrades are likely to have a limited impact for a number of reasons:

- The warning on December 5 by S&P that a downgrade of European countries was coming helped to keep it from being a surprise.
- The downgrade is a lagging indicator of credit risk in Europe the markets had already priced in. For example, AAA-rated France and Austria had 10-year yields that were over 100 basis points higher than AAA-rated Germany.
- Not all downgrades are created equal when it comes to their market impact. The downgrade of the United States was a major blow to confidence in a political environment of inaction. Not true in Europe where confidence has been affected by its fiscal situation for some time, and now new governments are taking substantive actions to address it.
- France continues to hold AAA ratings from Fitch Ratings and Moody's Investors Service.
- The headline impact of the downgrade of France may weigh on French Republic President Nicholas Sarkozy's bid for reelection in April. He is already trailing the Socialist party candidate, Francois Hollande. The uncertain impact of a major shift in France's leadership during this critical transition for the eurozone may weigh on the markets, but this is not new news for the markets since Sarkozy has been trailing in the polls for some time now.
- While largely priced in, there was some risk to the stock market that the European Financial Stability Facility (EFSF) would be downgraded due to the downgrade of some of the six EFSF guarantor members currently rated AAA (Germany, France, the Netherlands, Finland, Austria and Luxembourg) before steps toward greater fiscal integration occur.

The last point may warrant further explanation. The leaders of the eurozone decided this past fall to leverage the available resources of the EFSF in part by using it to provide insurance for bond investors. The idea is that the EFSF will take on the first losses, up to a maximum, that investors would face in the event of a sovereign default. The insurance would apply to newly issued

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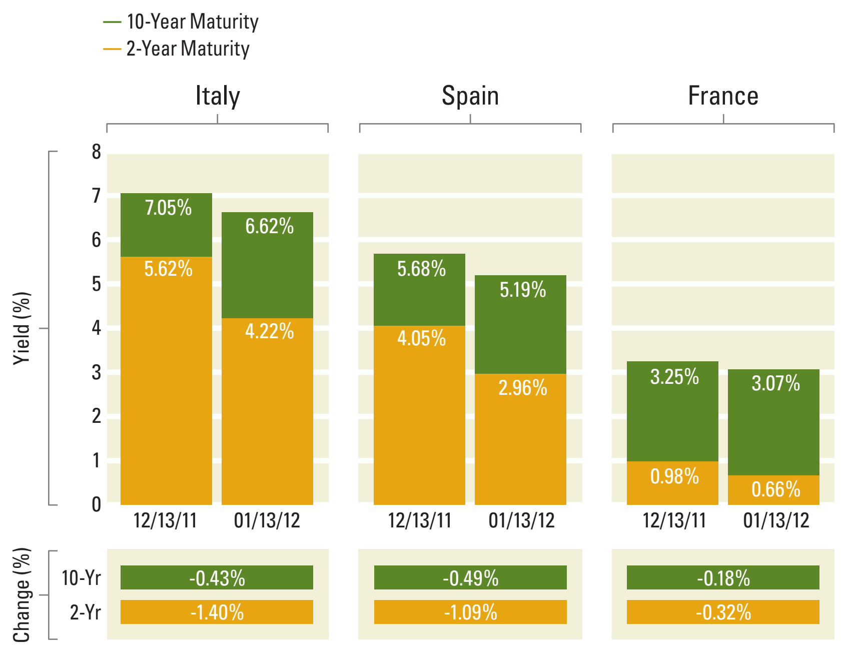
debt sufficient to cover debt newly issued by many troubled European nations over the next few years. A downgrade does not change the overall amount of guarantees provided or the amount of debt issuance covered; but it does suggest a change in the risk profile of these guarantees and a smaller recovery value. Consequently, the yield markets demand may be higher to reflect the higher credit risk of the guarantees. However, the markets are way ahead of the rating agencies on this, and these impacts have already been felt for some time.

1 Yields Falling Over Past Month for Italy, Spain and France



LPL Financial, Bloomberg data 01/16/12

S&P's downgrade overshadowed meaningful developments over the past two weeks in Europe, which we would call an upgrade to the efforts to deal with the debt problems.

- Last week's meeting between Italian Prime Minister Mario Monti and German Chancellor Angela Merkel was significant. In exchange for Monti's passing recent austerity measures, Merkel agreed to an early implementation of the bailout fund known as the ESM (European Stabilization Mechanism), successor to the existing and temporary EFSF, which had been planned to go into effect in July of this year. The key to getting it up and running is German funding, which seems to have been secured this week.
- A second draft of the Merkel-Sarkozy designed "fiscal compact" was presented on Friday, January 6. This agreement on tighter fiscal integration, to be signed no later than March 25, 2012, will establish a credible and enforceable budget discipline across the eurozone in an effort

We continue to expect a mild recession for Europe in 2012.

to avoid future debt problems. The second draft of the original German/French-crafted agreement defines key provisions such as what constitutes a "balanced budget" (a deficit of less than 0.5% of GDP), a target of 60% debt-to-GDP ratio (and a pathway to get there of as slow as one-twentieth per year), and allows for an appeals process for those member countries found in violation of the treaty.

- Recent bond auctions in Europe have gone well. Italy auctioned bills and bonds this week at much lower yields than just a month ago. Spain and Germany also had solid auctions last week and received more bids than the amounts they targeted in their debt sales. This is encouraging since Italy alone needs to issue 220 billion euros of bonds this year.

The events of the past week show that the rating change at S&P, while warranted, is a lagging indicator of a situation that has been something less than AAA-rated for a long time, but has been improving in recent months with more progress made in the past two weeks. With little move in the stock or bond market on the news of the downgrades, it is clear that markets had already made the credit adjustment and are now recognizing improvement. The irony is that the downgrade comes just as the debt situation in Europe is now getting better — not worse.

S&P has assigned more than a dozen European countries a negative outlook, indicating at least a one-in-three chance of a further downgrade in the next two years. The key will be for the eurozone to continue to respond with actions. European leaders are set to meet at a summit on January 30 to discuss how to boost growth and jobs, and Merkel's words on Saturday suggest she will also be looking for faster progress on tighter common fiscal rules.

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An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

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