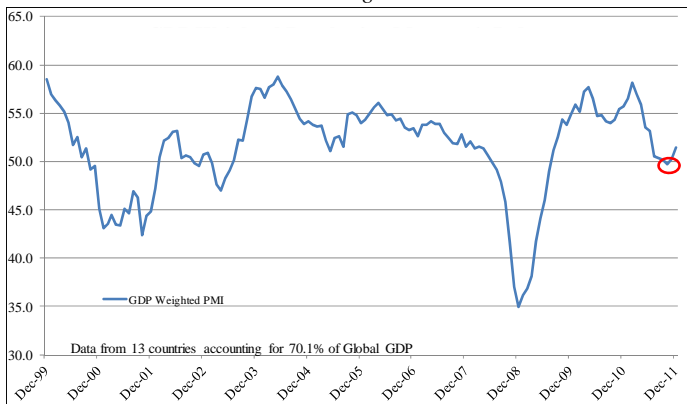


When economic developments run contrary to conventional wisdom, there is potential for a pronounced market movement in a direction that causes significant pain. At the end of 2011, the world was largely operating on the investment assumption that interest rates in the U.S. and Europe would remain “low for long.” In fact, after the Fed committed to keep rates low until mid-2013, we jokingly changed our forecast to “low for EVER.” There are many reasons why the expectations for low rates are reasonable. First and foremost is B-52 Ben’s promise (helicopters are so old school) to keep rates low for the next two years and then to telegraph rate increases. However, economic data and the simmering debt crisis in Europe point towards unchanged or perhaps even lower rates across the globe. Here is some of the data we have observed confirming an environment in which rates can be expected to remain low:

**Manufacturing:**

Monthly, we monitor the Purchasing Manager’s Index and have created a proprietary GDP weighted index from it. Our measure includes data from 13 nations, accounting for 70% of global GDP, and has been in a downturn since peaking at 58.1 in February 2011. We saw the index briefly drop below the recessionary 50 level in early December, but subsequent data has come in stronger and we are now just a touch higher at 51.3 (see Chart 1).

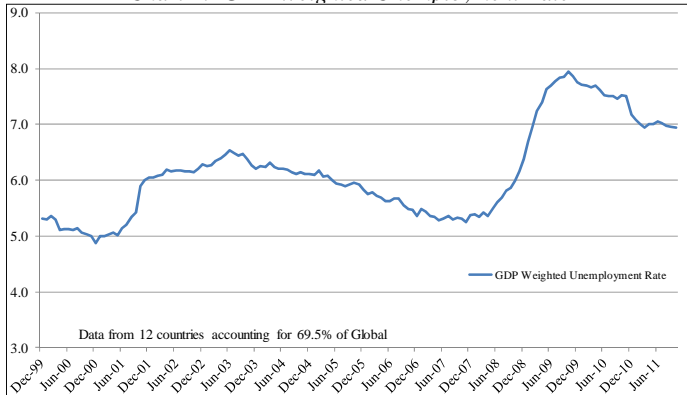
Chart 1: GDP Weighted PMI Index



**Employment:**

Global payroll data has been improving since the trough in October 2009. However, progress stalled in March 2011 and our internal GDP weighted measure of unemployment is still well above the levels seen in 2007. In fact, the current reading of 6.9% is still higher than the worst levels seen during the 2000 to 2003 global recession (see Chart 2).

Chart 2: GDP Weighted Unemployment Rate



**China**

As one of the biggest growth engines over the past ten years, developments in the Chinese economy are closely watched for signs of deterioration. Recently, signs suggest that growth is indeed slowing, which could ultimately have global repercussions. These signs include a sharp drop in equity prices, weakness in real estate developer shares, and continued pressure on local copper prices. Taken together, the observations suggest that China will not be the primary driver of growth in 2012 (see Charts 3, 4 and 5).

Chart 3: Shanghai Composite Index

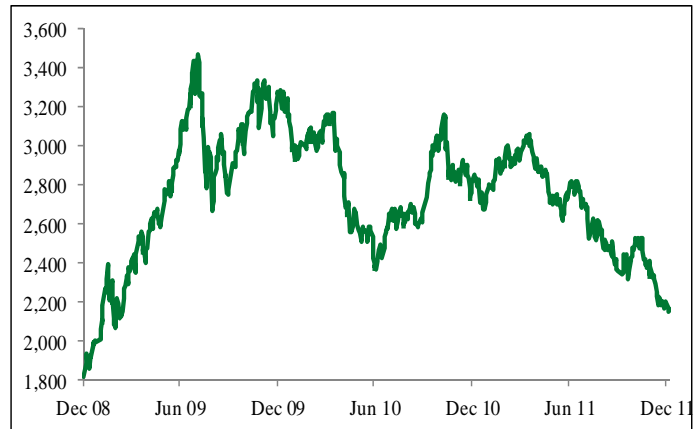


Chart 4: Shanghai Property Index

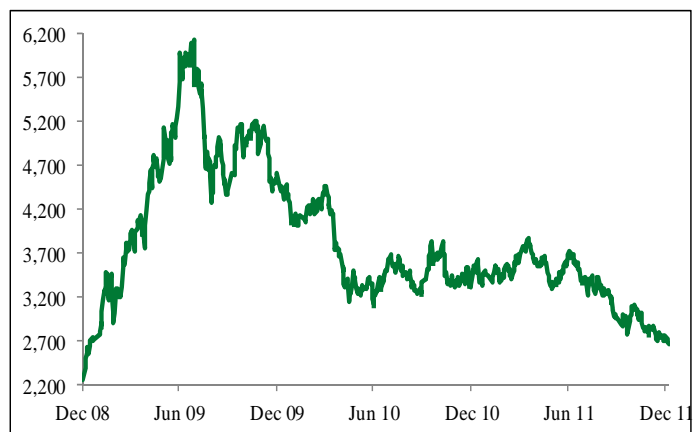
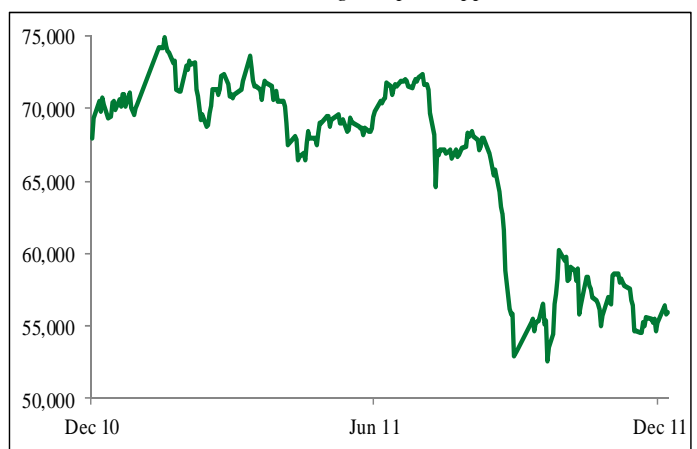


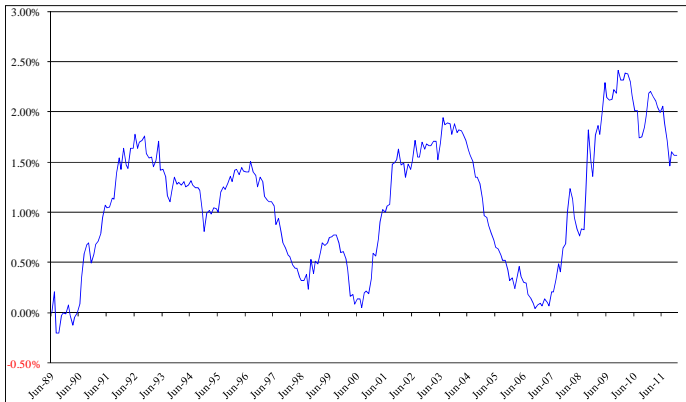
Chart 5: Shanghai Spot Copper



### Interest Rates

The weakness in global economic data combined with slack in the larger developed economies has led to a significant drop in longer-term interest rates. Our measure of the GDP weighted G-7 yield curve has dropped by 86 basis points since peaking in November 2009 (see Chart 6).

Chart 6: G-7 GDP Weighted Yield Curve (Ten-Year vs. Two-Year)



### Inflation Expectations

Driving the flatter yield curve has been a lowering of inflation expectations in much of the developed world. For example, since peaking in May 2011, the five-year breakeven rate in the U.S. has dropped from 2.47% to 1.59%, or nearly 90 basis points (see Chart 7). Similar moves have been seen in the U.K. and Germany (see Charts 8 and 9).

Chart 7: U.S. Five-Year Breakeven Inflation Rate



Chart 8: U.K. Five-Year Breakeven Inflation Rate

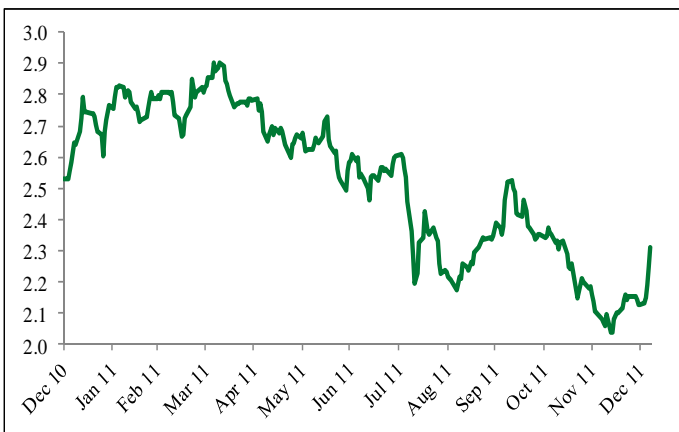
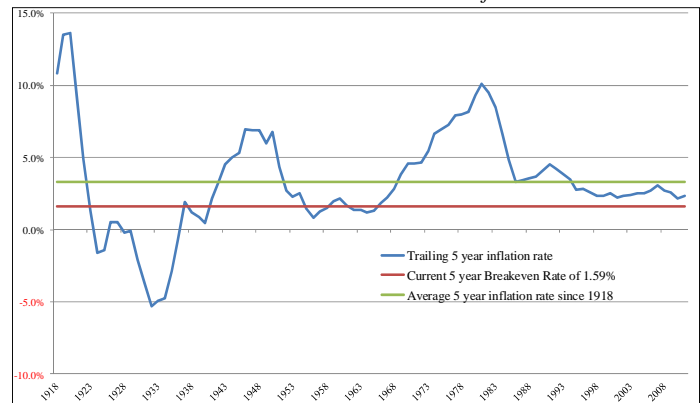


Chart 9: Germany Five-Year Breakeven Inflation Rate



Perhaps most remarkable is how low current inflation expectations are compared to historical experience. Since 1918, the five-year average inflation rate in the U.S. has been 3.3% while current market pricing implies expectations of 1.6% for the next five years, a level not seen in over 45 years (see Chart 10).

Chart 10: Historical Five-Year U.S. Inflation Rates



While we are inclined to favor the deflationary camp in the near term (excess capacity, high unemployment, large debt overhang, etc.) this seems to be a consensus view and thus, a crowded trade. If inflation expectations begin to ratchet up, we expect to see outsized Treasury moves given the surprise this would imply. With ten-year bonds yielding 1.9% in both Germany and the U.S., there isn't much coupon income to offset a rise in rates. One possible catalyst for a spike in longer-term yields would be a move by the Fed to pull back from its commitment of "low for long." So we ask the question: "What is the appropriate federal funds rate in the current environment?"

### Mankiw Model

In a 2001 paper entitled, "U.S. Monetary Policy During the 1990s", Harvard economist, N. Gregory Mankiw proposed a deceptively simple model for U.S. monetary policy:

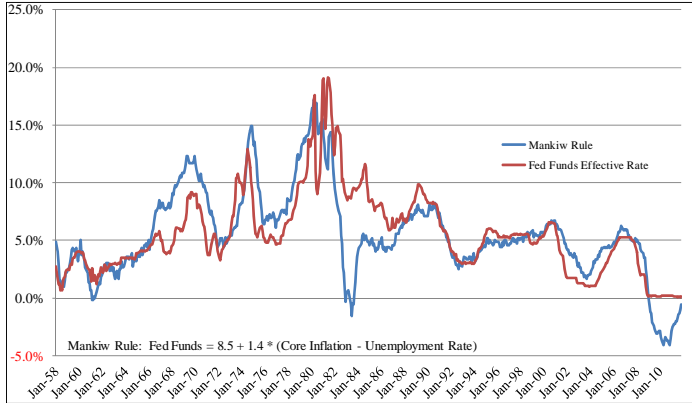
$$\text{Federal Funds Rate} = 8.5 + 1.4 * (\text{Core Inflation} - \text{Unemployment Rate})$$

<http://www.economics.harvard.edu/faculty/mankiw/files/mp90-2.pdf>

Mr. Mankiw states that the parameters for the formula were set to provide the best fit for the federal funds data during the 1990s. We took this formula and applied it to U.S. data going back to 1958 and found a surprisingly good fit. One interesting observation is that the Mankiw model has called for a "negative" federal funds rate from January 2009

onwards. However, the model has recently been calling for higher (less negative) rates during a period when federal funds are pinned at zero (see Chart 11). The key for 2012 may rest on whether an inflation spike forces the Fed to renege on its promise of free money.

Chart 11: Federal Funds vs. Mankiw Model



**Equities**

While bonds are currently an asset class in favor, equities are not. Investors redeemed \$141 billion from U.S. equity mutual funds during 2011, and finished the year with 35 out of 36 weeks experiencing redemptions (see Chart 12). These outflows are occurring during a period when stock valuations are not challenging. The trailing P/E ratio for the S&P 500 is a reasonable 13x, near the lower end of a nearly 60-year range. Emerging markets equities also offer reasonable value at less than 11x earnings (see Charts 13 and 14). These could be viewed as an especially compelling value given the low yields on offer from government bonds.

Chart 12: U.S. Equity Mutual Fund Flows vs. S&P 500

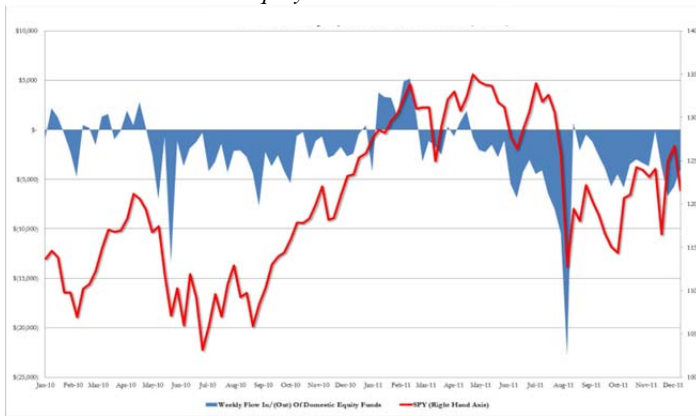


Chart 13: S&P 500 Trailing P/E Ratio

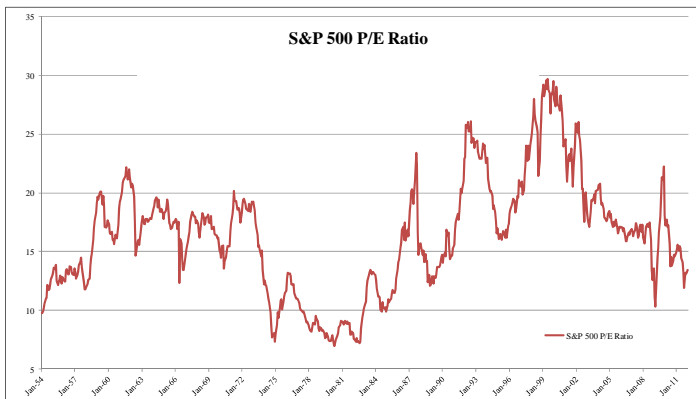
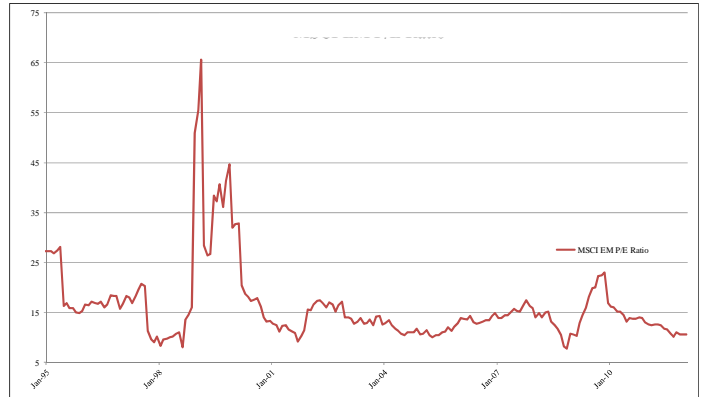


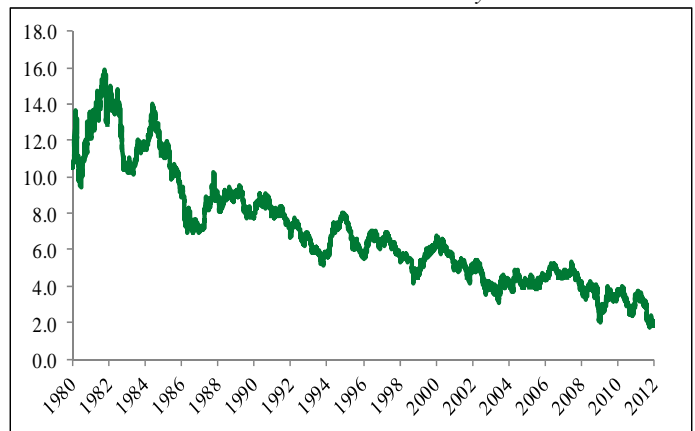
Chart 14: MSCI EM Equities Trailing P/E Ratio



**Bond Market**

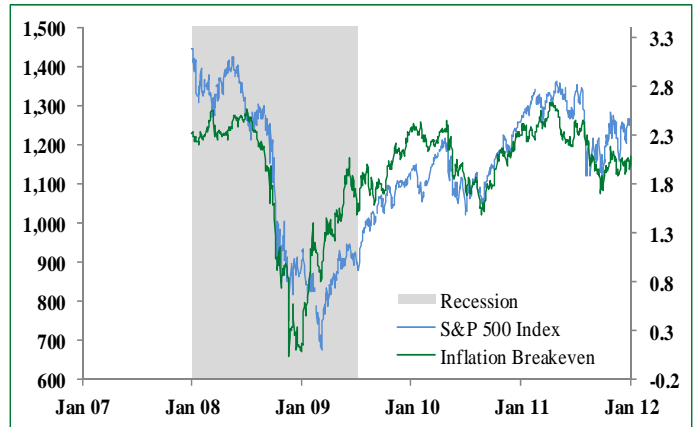
Historically, a strong U.S. bond market has been good for U.S. equities. This was especially true during the 1980s and 1990s as inflation was wrung out of the system, leading to dramatically lower interest rates (see Chart 15). Since the end of 2007, the opposite has been true; when inflation expectations have increased, stock prices have responded in a positive fashion (see Chart 16).

Chart 15: U.S. Ten-Year Treasury Yields



The current consensus trade appears to be out of stocks and into bonds; 2012 has the potential to reward the opposite given market perceptions and positioning. We will soon find out...

Chart 16: S&P 500 vs. Ten-Year Inflation Expectations



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