TERRA NOVA
ASSET MANAGEMENT

U.S.Financial Markets
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This was an unusually stable and favorable period for the stock market until April 30, as Europe centric fears eased following the strong intervention by the European Central Bank (ECB) to provide liquidity to the banking system. With Europe less of a threat, investors took confidence from the steadily improving fundamentals of the domestic economy. The corporate sector was in fairly pristine shape and the strong labor market gains in the first two months of the quarter raised hopes of a stabilizing household sector. As a result, the stock market produced one of its best performances in years with the S&P TRA Index up11.8% as per April 30. The recent softer economic readings, particularly in the labor market, however, appear to be indicating that the economy may not be that robust. It is unclear at this point whether the weaker domestic economic data in recent weeks is seasonal or an early sign of loss of momentum. Furthermore, Europe, has taken center stage again with changes in French and Greek political leadership creating a heightened level of insecurity in the markets. However, U.S. banks have eliminated their exposure to banks in Greece, Ireland, Portugal, Spain and Italy, and have significantly reduced their exposure to French banks compared to a year ago, according to official data which reassured the U.S. markets. Furthermore, according to Deutsche Bank Securities, New York, about 17% of the profits of the companies in the S&P 500 Index come from Europe, mostly Germany and UK, and most European exposure is in in the Technology, Industrial and Energy sectors with profit growth driven more by global growth than local GDP. We are globally in a gentle deleveraging process with governments tightening their fiscal policies while central banks expanding their monetary policies. The fiscal cuts are slowing economic growth, but are counter-balanced by the central banks providing stimulus. The outcome of this balancing act will be reflected in the stock and bond markets' valuations around the world. We expect this process to continue and as a result markets to remain volatile.

Capital Markets

Non-investment grade bonds have outperformed equities since September 2011 and returned 8.3% this year as investors seek yield. Speculative-grade companies have reported strong profits in Q1and low default expectations have reduced risk aversion. Corporate earnings and credit fundamentals continue to be stable to slightly improving; however, until we gain additional clarity on the impact on corporate risk caused by the European sovereign debt crisis and the slowdown in emerging markets, we have to be cautious. If the situation in Europe deteriorates, the emerging markets descend into a hard landing, or growth in the United States dwindles, the contagion from heightened credit risk will hurt the corporate bond markets and spreads will widen across the board. However, if we gain additional visibility that these issues are alleviated, then we think corporate credit spreads will resume their tightening trend as stable corporate fundamentals and positive technical indicators provide greater demand for corporate bonds. Although capital gains have been robust and average high-yield bond prices rose above 100 cents on the dollar for the first time in eight months, further capital gains will be limited.

Central Banks

Six months ago the slightest hint of trouble for banks or sovereign borrowers would have upset the interbank-lending market and increased funding costs especially for European banks. As the Fed, the ECB and other central banks have aggressively kept the financial markets liquid since the financial crisis in 2008 markets have been largely unfazed by Greece being unable to form a new government, the nationalization of the third largest Spanish bank, and J.P. Morgan Chase losing $2 billion in failed derivatives trades. Although central banks freed the markets from the trauma of systemic risk, they also created a false sense of security incentivizing investors such as, J.P. Morgan Chase to take risks because they believed that central banks would bail them out. One other reason why the money markets are likely to remain liquid is that the banks have stopped lending to institutions from troubled peripheral euro-zone nations as they are more concerned with their own balance sheets and more comfortable with their existing exposures.

Economy

Market participants have grown increasingly concerned about slowing activity in Europe and China potentially impacting US economic growth. We continue to believe that these risks are overstated because the U.S. economic outlook is likely to be driven by domestic demand in the coming quarters. Exports have made an outsized contribution to growth thus far in the cycle, but this is unusual. Typically, they only account for approximately 13% of real GDP (goods exports are about 9.5%), while personal consumption is responsible for roughly 70% of economic output. In fact, over the past three quarters, the contribution to real GDP growth from consumption has steadily increased from 0.5 percentage points in Q2 2011 to approximately 1.5 percentage points in Q4 2011. Business fixed investment has also continued to make steady positive contributions to growth.

Labor Market on the Mend

Although February and March employment was revised up, the April employment report was softer than expected and the pace of job creation over the past two months, an average of 154k, is still well below those of December, January and February with 252k, ignited concerns that the economy was beginning to stall. We consider this a consolidation, but not a start of a prolonged slowdown as job growth was too fast, ahead of private sector final demand. Private companies especially in professional and business services, engineering and software design, as well as healthcare and manufacturing, fueled the growth, whereas governments cut payrolls by 15k. Manufacturing job growth was especially solid in Q1, in fact the strongest since 1997 on a three month moving average. This is a positive development for the broader economy, because manufacturing jobs are generally higher paid jobs and are also a significant driver of employment in service sectors, such as trade, transportation and professional/business services. Since last August the unemployment rate has fallen sharply from 9.1% to 8.1% and is expected to fall 7.8% by the end of 2012. As such, for the Q1 as a whole, aggregate income rose only 1.8% in April, rose 5.6% (quarter-on-quarter annualized), which is the second fastest quarterly growth rate in the post-recession period.

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Corporate Earnings

The first quarter 2012 earnings season has not only surprisingly turned out to be above pre-season expectations, but also above those of 4Q. Total earnings for the 67% of S&P 500 companies that have already reported are up 6.9% from the same period last year versus 5.5% last quarter. Most of the earnings growth came from top-line gains, with margins essentially flat compared with year-earlier level. Revenues for the companies that have already reported are up 5.7% year-over-year, though only 39.5% have come out with positive revenue surprises, with a median surprise of 1%. The Tech- (mainly due to Apple) and Finance sectors, which account for 19.5% and 14.9% of the S&P 500 index's market cap have been the major growth drivers, though overall growth is fairly dispersed. Earnings estimates have only moderately started to go up, however, earnings growth in Q1 is expected to be the lowest this year, with a meaningful improvement starting in Q2. Margin expansion will be a key driver of earnings growth in the next two years.

European Crisis

Despite a rebound of German GDP in Q1 preventing the Euro Zone from entering a recession, Italy experienced a worse-than-expected contraction of 0.8% q/q, leading Moody's to downgrade 26 Italian along with 16 Spanish banks by multiple notches, citing economies back in recession, mounting asset quality challenges, and restricted access to funding markets. The ratings outlook for all of the affected banks remains negative. Furthermore, the ECB is increasingly refusing liquidity requests from Greek banks, adding concerns about a run on Greek banks, which have been hemorrhaging deposits. It is no mystery why top Euro zone officials have been talking openly of a Greek exit, European bank stocks have broken support, and funding and sovereign spreads are widening. Although U.S. exports to Europe are small as a percentage of U.S. GDP and U.S. banks' exposure to Europe is minimal, contagion is a serious risk with a likely compounding effect.

Outlook

The debt crisis in Europe has led to a market correction, especially in higher beta, more economic-sensitive stocks, thus wiping out most of this year's gains with the S&P now up just 3% year-to-date. Uncertainty will dictate the markets. Therefore, we have been reducing equity exposure during brief rallies. Furthermore, we have lowered beta in our equity exposure considerably below the market by adding low beta dividend paying stocks for the most part of this year.

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