



Pugh Capital 4Q11 Market Outlook/Strategy

As we close the book on 2011 and look forward to a new chapter in 2012, we unfortunately find the same “cast of characters” in leading roles. Global deleveraging, fiscal austerity, high unemployment, below potential growth and sovereign debt crises will continue to create headwinds over the next few years. On a positive note, the U.S. saw some encouraging economic momentum in the fourth quarter. The consensus forecast for 2012 GDP is 2.1%.¹ Pugh Capital’s baseline forecast is for modest, below consensus growth that will prove insufficient to close the output or employment gaps.

Policy missteps will be a key risk in 2012, as turnover in global political leadership combined with large deficits and growing public unrest present unusual challenges. The method of resolution for the European sovereign debt crisis is the most immediate and significant concern. However, the U.S. also faces tremendous uncertainties. The 2012 landscape includes Federal elections, political gridlock, deficit reduction strategies, and the overhang of new regulations including Dodd Frank, the Volcker Rule, Basel III, and housing reform. Given the wide-ranging outcomes and the impact these issues could have on growth prospects, we expect 2012 to be another volatile year. The potential for another U.S. recession must be considered given potential political, fiscal and market risks. However, our base case is that the U.S. avoids a recession in 2012.

While there are clearly risks on the horizon, investment opportunities have begun to appear as a result. With current spreads in most sectors trading well above their historical averages, much of the risks of slower growth and some of the contagion concerns have already been priced in. These available spreads represent an attractive entry point for diligent investors who have retained dry powder. Pugh Capital is well positioned to take advantage of these opportunities as they arise in 2012.

Our interest rate outlook is for a trading range of 1.50 – 2.40% for ten year treasuries, with a central tendency of 2.00%. The Fed will be on hold through at least mid 2013 as inflation moderates and growth disappoints. We expect the yield curve to generally flatten with short rates anchored at current low levels. Therefore, we plan only modest deviations from the benchmark’s duration to adjust positioning within the trading range.

Pugh Capital’s bias will be to increase allocations to the spread sectors. The corporate sector is fairly unique in that it is not overwhelmed by too much debt, there is reasonable supply available and spreads are attractive. European sovereign and bank financing needs will be significant during 2012 and there is a strong possibility that financing challenges will trigger a spread widening episode in risk assets. We will look to utilize any “flight to quality” episode to implement our next phase of increasing credit exposure. We also continue to like taxable municipals and CMBS for their attractive yields, limited issuance and stable credit profile. Agency mortgage securities should also perform well as supply/demand technicals are quite positive.

¹ Bloomberg December 2011 GDP forecasts for 2012