WINTHROP Capital Management

The developed countries in the world, which include the United States, United Kingdom and Japan, generally have two problems: they have too much debt and the growth they are experiencing is too slow. The result is that developed countries will have significant difficulty reducing their debt burdens through continued stimulus initiatives as they attempt to inflate their economies. Unlike other post-recession periods where stimulative central bank policies allowed for expansion, the economies of developed countries are not responding. We still believe that the austerity measures of Europe, which are designed to curb spending, will help to shrink the debt burden over the next three to five years. However, it comes at a great price – slow economic growth. Furthermore, until the European banking system is recapitalized, which includes shrinking the balance sheets relative to the existing capital levels, Europe will not experience sustained economic growth. Ultimately, we expect Europe will be a drag on the global economy over the near term.

The Coming Recession in Europe

We have written extensively about our conviction that Europe will experience a deep recession as a result of forced austerity measures from the European Commission. Last fall, our analysis of the economic projections from both the International Monetary Fund and the Eurostat databases showed only Greece was projected to contract. At that time we believed the projections were overly optimistic given the size of the austerity measures required and the negative impact on private credit expansion as the European banks strengthen their capital positions.

Last week, the European Commission, the executive body of the European Union, revised economic forecasts for 10 European countries sharply lower. Last fall, the European Commission had forecast that the Eurozone economic activity would expand by 0.5% in 2012; that has been revised to a -0.3% contraction in economic growth.

We believe the length of the expected contraction in the Eurozone, as well as the severity, will be a function of three things: expected global demand, the ability of the European banks to support private credit expansion, and the stability of the global financial system.

Greece Defaults on its Debt - Finally

Standard and Poor's rating service downgraded the debt of Greece from CC to selective default this week, making Greece the first Eurozone member to be officially rated in default. The downgrade was a result of the Greek Parliament's initiative to retroactively add collective action clauses to its sovereign debt which essentially force minority bondholders to accept the proposed bond swap. This paves the way for Greece to receive €130 billion in rescue aid along with the write down in outstanding debt. Greece was forced to take its cod liver oil.

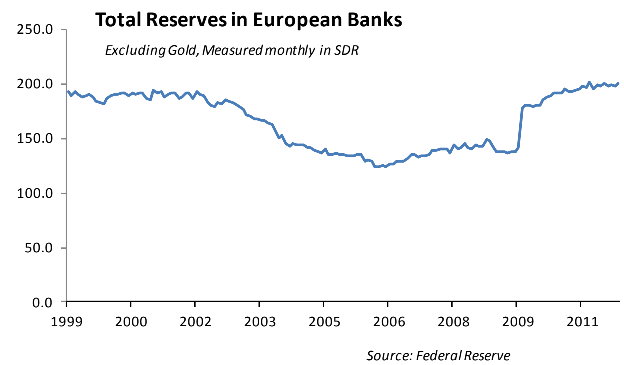
The bailout of Greece has taken the better part of two years and has been a huge focus for European leaders. The default sets a new precedent in financial engineering of a sovereign issuer including the initiative to force holdout investors to accept the terms of the majority. Unbelievably, it is still not clear if this action classifies as a default which will trigger payouts on the Credit Default Swaps of Greece. The cumbersome process and financial jiggering required to bailout Greece will now be applied to Portugal. In addition, we expect other countries, lead by Ireland and Spain, to begin a prolonged process of re-negotiating their individual deals for austerity measures with the European Commission. Spain's ratio of budget deficit to GDP for 2011 was targeted at 6%. However, Spain reported this week that its budget deficit for 2012 came in at 6.51% of GDP, missing its target by a significant margin. Given the expected 1% contraction in Spain's GDP growth for 2102, we expect that the 4.4% target for the budget deficit will be nearly impossible to reach. There will be a pattern of European governments requesting more lenient austerity targets over the next several years which will be necessary to sustain economic growth, but result in a slower mending of the debt problem.

The European Banking Crisis has been Abated

Prior to Mario Draghi taking the helm of the European Central Bank, the leadership did not view the role of the ECB as the "lender of last resort". Rather, the ECB's role was limited to executing monetary policy throughout the Eurozone in order to maintain price stability. During the Financial Crisis of 2008, the ECB was slow to act and never provided liquidity measures designed to prop up the banking system in the manner that other countries, including the United States and United Kingdom, did. In 2010, the member states of the European Union agreed to form the European Financial Stability Facility (ESFS) which was funded by the member states and the IMF. By leveraging the ESFS (another form of elegant financial engineering that got us all into this mess), the ECB created a balance sheet that is in excess of €2 trillion that it can now use to provide much needed liquidity to the European banking system in order to normalize operations and interbank lending.

The ECB completed its second round of direct lending to European banks, and we believe it has been tremendously successful in providing stability to their shattered banking system. After lending nearly €469 billion in December of last year, the ECB yesterday completed another round of low interest rate loans to European banks totaling €529 billion. Again, these loans were priced at a rate of 1% for a three year term. The European banks rely more heavily on wholesale funding (which includes institutional Certificates of Deposit and bonds) instead of more stable retail deposits like the banks in the United States and Canada. As a result, their funding base is less secure. These loans from the ECB allow the banks to shore up their funding needs for the next several years removing any doubt of their ability to roll over their maturing liabilities. Total Reserves of European banks excluding gold are at their highest levels in over ten years.

To be clear, this adds additional debt to the European system but allows the necessary liquidity to work through the system in the hopes that private credit expansion will be sustained and grow. We view this as an interim step that is necessary to maintain confidence in the European banking system. The next step is to execute the plans to reduce the debt burden over the next several years. The European members have shown a consistent inability to hold to a fiscal discipline that embraces austerity and controls spending.



Investment Strategy

In our opinion, the global economy still faces major downside risks as the tepid recovery continues to be threatened by stresses coming from the Eurozone. We are surprised to see stocks, bonds and gold rally so far this year, and at the same time volatility is trending back down to its 52 week lows. We believe in being compensated for the risks we're taking investing in financial assets and in harvesting the winners in the portfolio. We are actively hedging the equity exposure of the portfolio and continue to shorten the duration of bond portfolios where appropriate. As volatility has declined, so have credit spreads. As a result we are looking for opportunities to move up in quality since the cost to do so has become a lot less.