

MONTHLY RECAP

Markets continued to experience high volatility in November, although the month ended relatively flat. The S&P 500 lost just 0.22%[^] (YTD +1.08%[^]) and the S&P/TSX lost 0.21% (YTD -7.13%). Credit Markets significantly underperformed with the broad Merrill High Yield Master II Index declining 2.21%[^] (YTD +1.86%[^]) and the Canadian HY Index -0.23% (YTD +1.63%). Intermediate Term Treasuries produced a small gain +0.81%[^] (YTD +11.45%[^]) and remain the best performing asset class.

COMMENTARY

Equity markets ended essentially flat but only after a near 5% rally on the last day of the month. The European sovereign debt crisis dominated the headlines for much of the month and a coordinated currency swap facility to provide USD funding to European banks led to the month end rally. The underperformance of credit markets is directly related to the constant selling of USD credit products by European banks who cannot fund these instruments in the interbank lending market. We think that while stocks rallied hard on this news, the fact that credit markets did not move as aggressively suggests that this is more temporary than lasting. There is no doubt that helping European banks replace funding normally provided in the interbank market is a positive event. However, the core problem is not a lack of funding for otherwise strong banks, but rather insufficient capital in the banks and solvency of the peripheral European governments whose bonds are held by the banks.

We are actually encouraged that the Euro leaders are finally beginning to understand what needs to be done.

1. The banks must be recapitalized;
2. Austerity programs must move government deficits downward and into surplus;
3. Smaller countries likely have to default;
4. Maturing debt rollovers must be supported by some combination of the EFSF/ESM, a Eurobond and the ECB;
5. The ECB must be highly accommodative to offset the fiscal drag of the austerity programs.

Basically, they need to fund the maturing rollovers in Italy and Spain until the austerity programs move government finances into surplus.

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[^] Indices are denoted in US dollars.

We are more optimistic than one month ago that these policies are closer to reality. We cannot help but point out though, had Italian and Spanish bond yields not breached 7% or Germany suffering the ignominy of a failed bond auction, we don't think the politicians would be moving quickly or at all. The catalyst for successful deleveraging of every country we have studied has been a crisis in its government bond market. A 100% historical precedent does not ensure a 100% certain outcome, but we believe it is prudent to protect your portfolio from this event when history is 100%.

We are gently moving our portfolios to the positive side of neutral as Europe appears to be moving in the right direction. The improving data from the U.S. is also encouraging this action. Adding small amounts of risk to the portfolio does not imply we think we are near the end of the period of sovereign debt problems, high market volatility, poor liquidity, elevated correlations and risk of material market draw-downs. We will see shortly if Europe's leaders can make real progress and if markets can break the pattern of unbridled optimism prior to the EU Summits followed by their revisiting of the painful reality. Once Europe has dealt with the bank solvency and government liquidity we will then be faced with a long period of economic adjustment as the deleveraging process unfolds. We will also need to see if the USA can become the only country in our research spectrum to voluntarily lower its debt/GDP ratio without a crisis in its government bond market.

Initiated: Sprint Nextel (debt), CDX Index Swaps (debt), Bonavista Energy (equity), Paramount Resources (equity), Veresen (equity).

Closed: Westaim Corp. (equity), Clayton Williams Energy (debt).

Thank you for your continued interest in the Fund. For further information, please contact your regional Arrow Capital representative.