

GLOBAL PERSPECTIVES ON 2011 AND 2012



By: Jim McGovern (CEO)

As we enter 2012, many of the overriding macro issues in 2011 are still prevalent on the minds of investors. These are the same issues that made investing and trading capital markets in 2011 very difficult. They are as follows:

1. U.S. debt and deleveraging
2. Eurozone crisis
3. China economic slowdown
4. Japanese fiscal situation

1. Too Much Debt...Still!

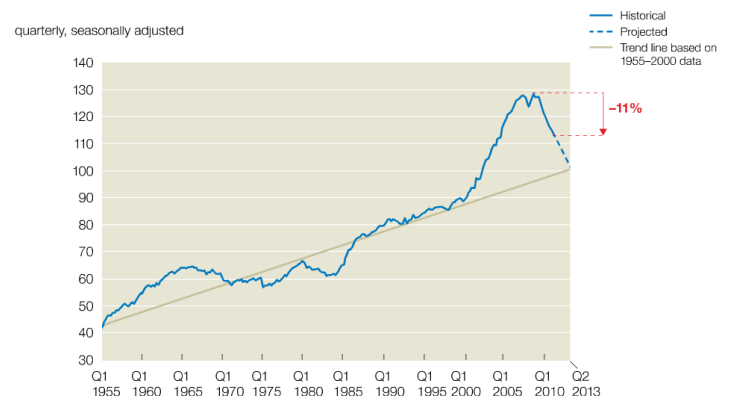
The global debt problem resides at both the government and the individual (consumer) level. It is arguable that little progress was made in 2011 when one looks at the Western world.

Taking the U.S. as our example (see Chart 1 below), the annual deficits are clearly not under control and the absolute level of gross debt continues to rise – it is now over 100% of GDP. What has saved the day is record low rates, as the interest expense of some \$200+million is below the 2006 tab when rates averaged

4.8% - an incredible “carry trade”. Given that this is an election year, it is hard to imagine any meaningful progress being made in 2012. The outcome of the election in November, however, should provide some perceived changes in long-term market view. The next President will also have to begin to tackle the entitlement/unfunded social liabilities time bomb as well. The best we can hope for is a bounce in GDP, creating higher tax receipts through improving employment trends and corporate profitability.

Like the government, U.S. households are burdened with too much debt following the binge post-2000. The good news here is that progress has been made, although largely via defaults; the bad news is that there is more to go. Another two to three years is the best case scenario (see Chart 2 below). Real incomes barely

CHART 2: U.S. HOUSEHOLD DEBT AS % OF GROSS DISPOSABLE INCOME

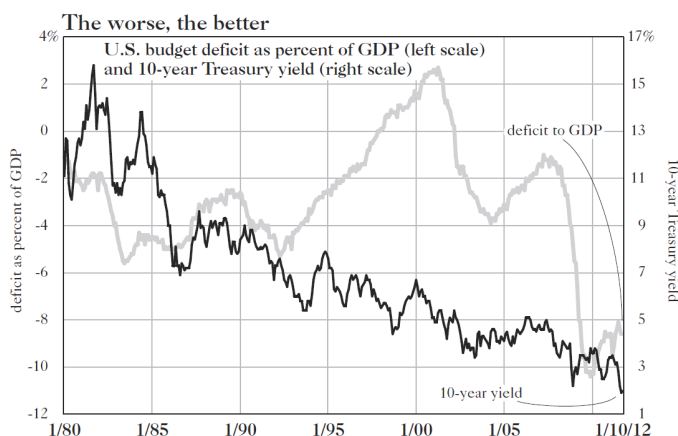


Source: Haver Analytics; McKinsey Global Institute Analysis, January 2012

budgeted in 2011, making debt reduction very difficult. In fact, when one strips out government transfers the picture is still bleak (see Chart 3 on next page).

As with the government, lower rates have eased the burden of carrying the debt but it has not translated into the income growth that is much needed to more quickly reduce it. As we and

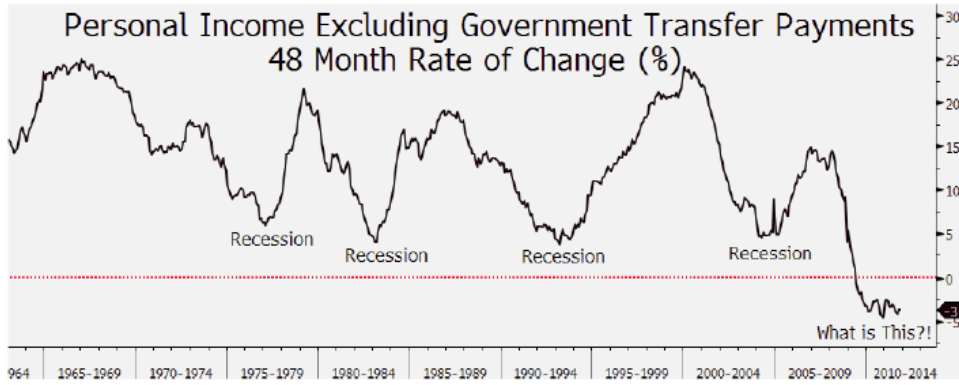
CHART 1: U.S. BUDGET DEFICIT AS % of GDP & 10-YR TREASURY YIELD



Source: Grant's Interest Rate Observer/ Bloomberg, January 2011

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CHART 3: PERSONAL INCOME EXCLUDING GOVERNMENT TRANSFER PAYMENTS 48 MONTH RATE OF CHANGE (%)



Source: Morgan Stanley, January 2012

others have noted before, deleveraging is an explicitly deflationary process. ([click here](#) to read my blog post on Irving Fisher (July 29th, 2011)). The credit expansion needed to fuel growth appears moribund. It appears that 2012 will bring us closer to the "riot" point with respect to government spending/austerity. Fiscal and monetary policy has bought us time but also additional risks (and opportunities!).

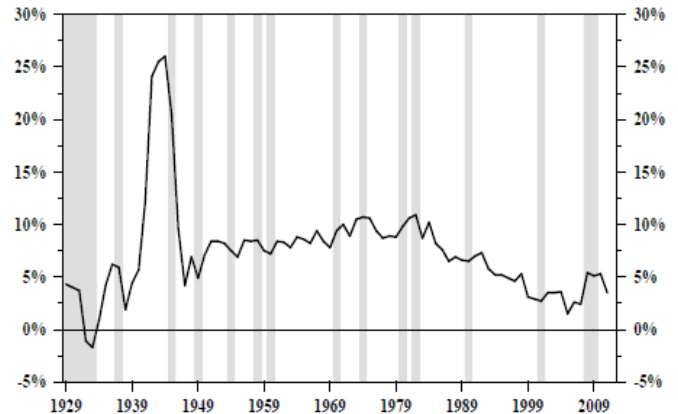
While deficits and debt continue to pile up and GDP slows, total government spending as a percentage of GDP has been falling since Q3-2010 (includes defence, non-defence and state and local spending). LSR estimates that this negative trend amounted to a 1% hit on GDP growth, which on a 2% level, is substantial (See Chart 4 below).

Furthermore, U.S. personal savings rates are back at very low levels – well below the long-run average of 7%. Some of this is undoubtedly related to tax incentives on consumer durables (autos etc.), but it does signal that spending is likely to be very lacklustre in 1H-2012.

ECRI and others still suggest that a U.S. recession is more likely than not, based on the data. A weakening consumer, likely higher taxation, a fall back in capital spending, reduced government expenditures, and a slower global economy will all conspire to at last keep U.S. GDP growth very subdivided. Of the key western economies, the U.S. appears to be the best of a bad bunch. That being said, it still has options. The Federal Reserve is expected to do another round of quantitative easing later in 2012.

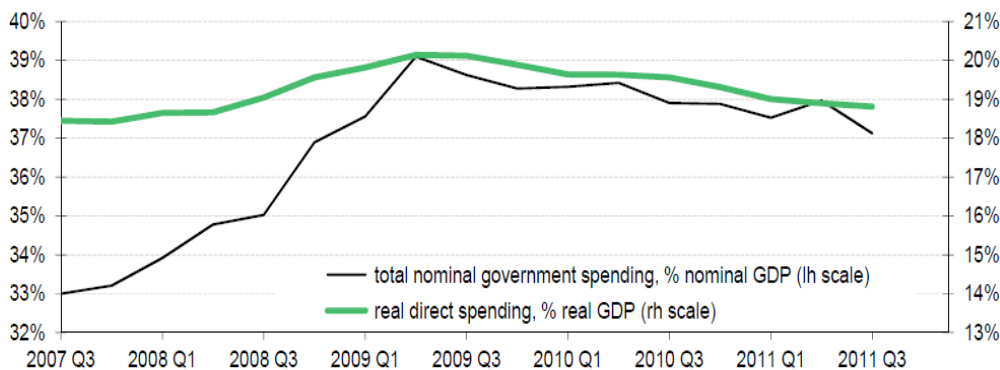
The U.S. does have one new advantage in that its competitiveness relative to China looks good. Chinese inflation and policy has

CHART 5: PERSONAL SAVING RATE (annual)



Source: Hosington Investment Management/Bureau of Economic Analysis, January 2012

CHART 4: US GOV'T SPENDING, % OF GDP, QUARTERLY



Source: Lombard Street Research, January 2012

moved up its labour costs some 20% and this could lead to a better balance of trade for the U.S. and to more cap-ex spending as manufacturing continues its renaissance in the U.S.

2. The Eurozone Crisis is for Real!

While the U.S. has its issues, Europe is in dire straits. While much has been made of the indebtedness of the PIIGS countries, the real issues are the lack of growth and fiscal irresponsibility. Low growth, coupled with high borrowing costs (especially for Italy and Spain) mean it will be difficult to escape a death debt-

spiral. Where the rubber hits the road is in the European banking system, which is highly leveraged to the very sovereign bonds under severe pressure. That pressure is made more challenging by the recent bulk downgrade of many Euro sovereigns, including France, by S&P.

The ECB will definitely have to step into the market to buy sovereign debt more aggressively. While providing temporary relief to Eurobanks (a few would have gone bust without USD funding), the LTRO is not a long-term solution for propping up the sovereign debt market. Euro banks need to delever – a task made more difficult by the rollover risk associated with €700BN in their debt due this year. Undoubtedly a more dovish ECB with Mario Draghi will help, but as Peter Treadway notes, the ECB will have to “talk German, act Italian.” Additionally, liquidity and support will have to occur in early 2012 but it is hard to imagine Greece and Portugal being spared a debt default.

Monetary policy aside, the fundamental/long-term issues remain unsolved – namely, a massive competitiveness gap between Eurozone members (see Chart 6 below) and a lack of fiscal union. Rhetoric aside, it is very tough to imagine how these are solved. The idea that the euro can be abandoned is now being discussed openly – Nobel laureate Robert Barro offered his suggestion in WSJ op-ed earlier this month ([click here](#) to read). With European households even more indebted than their U.S. counterparts, the austerity that will be undertaken by the Club Med governments that will force cut backs in consumer spending, will be doubly

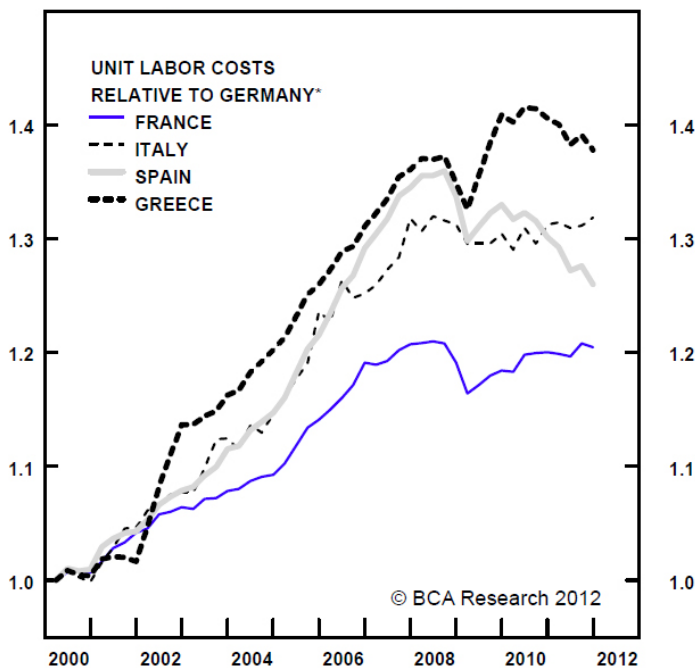
difficult. At the same time, the private savings rate in Germany remains stubbornly high, providing little in the way of consumer growth to offset the damage.

Europe is clearly the epicentre of financial volatility. How the troika and the various governments manage the crisis will likely dictate the direction of capital markets.

3. China to the Rescue?

Our third macro issue is China and whether a hard or soft landing is in the cards for 2012. China is at risk of a further slowdown in their economy, as shown by the recent PMI data at only marginally above 50. This is the result of weak export growth due to a EU recession, slow growth in Japan and the U.S., and a sharp correction in property markets. Quarterly GDP growth steadily fell over 2011 ending at 8.9% in Q4. This is expected to continue to fall as tight credit conditions continue to negatively impact property prices. Real estate investment has been 10% of China’s GDP growth – the fight to rein in prices has cooled off private investment substantially with the government now trying to “fill the gap” with affordable housing projects. Without a doubt, the 2008 binge in fixed capital investment created problem loans for local governments and Chinese banks. However, the questions of solvency will be managed in the short run since the Chinese authorities have both monetary and fiscal firepower to prevent a major downturn, at least for now. That being said, it is doubtful that any massive future stimulus program in the form of more capital intensive investment in infrastructure is coming. Fixed investment in China is over 45% of GDP – the highest of any major economy (see Chart 7 below).

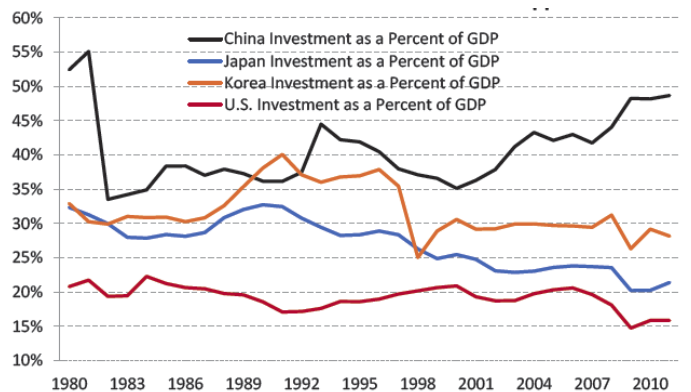
CHART 6: THE EURO’S MAIN PROBLEM: A COMPETITIVE GAP



* ALL SERIES REBASED TO JAN. 2000 = 1. OECD DATA.

Source: BCA, January 2012

CHART 7: CHINA MUST REDUCE RELIANCE ON INVESTMENT TO SUPPORT GDP



Source: Bloomberg Brief, Economic European Edition, January 2012

What China must do is encourage a fall in its domestic savings rate, which now exceeds 40% of GDP! Household savings rates in particular, the result of migrant workers entering urban centres, could fall if they had greater security (residency rights, social security

etc.). Lower taxes and special consumption incentives could also help and one corollary benefit would be a lower trade surplus with the West (see Chart 8 below).

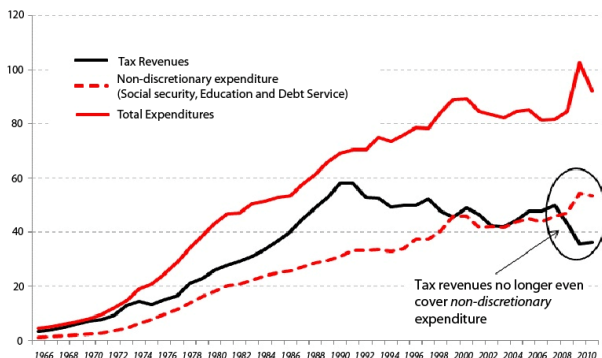
CHART 8: WAGE-TO-GDP RATIO FALLS AS CONSUMPTION'S SHARE DECLINES



4. Turning Japanese? I Really Think So!

On the surface, it is beyond belief that a country could amass a debt-to-GDP ratio of over 200% - a level twice that at which Reinhart and Rogoff suggests a red alert for solvency. Japan has never really recovered from the late 80's property bubble, its economy burdened by deflation, low growth and a demographic time bomb. Japan has reached the point where servicing its debt load and deficits by "internal" Japanese individuals and companies via record-low interest rates may be nearing an end. The population base is shrinking, "more people are leaving the workforce and soon they will have more people de-saving than saving" (BCA, January 2012). It is very difficult to see how spending cuts (over 50% of spending is on social security and 25% is on interest!) or raising taxes will solve their problems. Japan's debt issuance is expected to surpass its tax receipts for a fourth year in a row.

CHART 9: JAPANESE GOVERNMENT TAX REVENUES

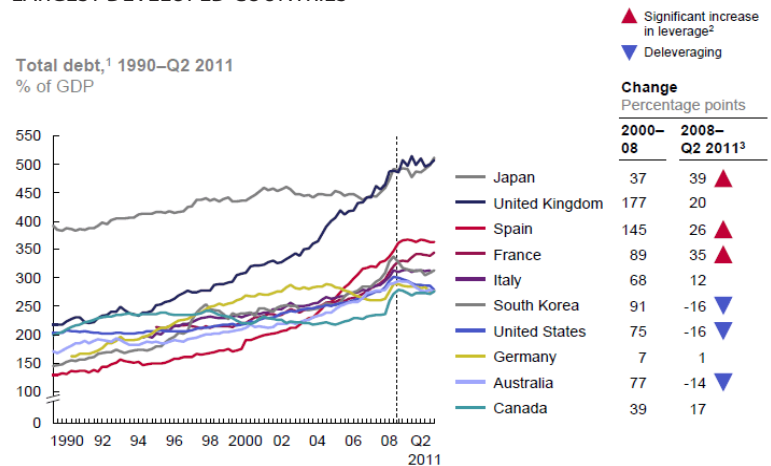


Source: Societe Generale, January 2012

Its multinational companies are in rough shape thanks to its ever-appreciating currency (due to high real interest rates, thanks to deflation) and consistent trade surpluses (although 2011 will be the first annual trade deficit in 30 years due to the tsunami). Japan is now heavily tied to Asian growth (55% of its exports) which is a relatively good thing, but a synchronized global slowdown would threaten this positive.

The Japanese fiscal and monetary position is a good example for other countries on how not to handle a credit crunch. Absolute debt levels have continued to rise unabated largely on the back of the government (see Chart 10 below) - and, by the way, look at where the UK stands now as well!

CHART 10: DELEVERAGING HAS ONLY JUST BEGUN IN THE TOP TEN LARGEST DEVELOPED COUNTRIES



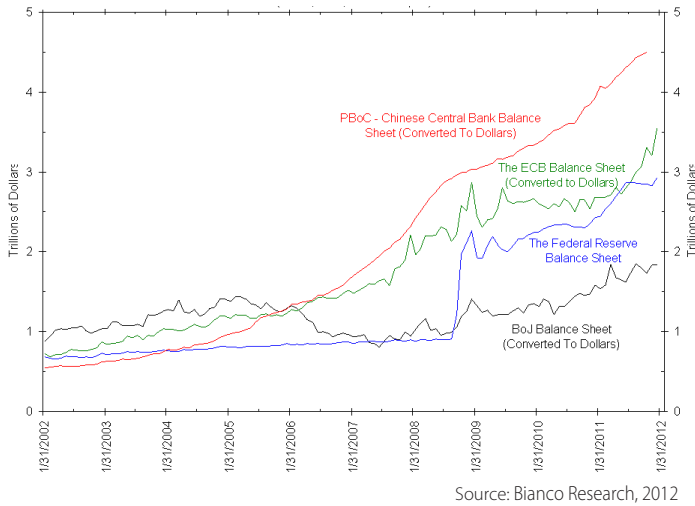
1. Includes all loans and fixed-income securities of households, corporations, financial institutions, and government.
 2. Defined as an increase of 25 percentage points or more.
 3. Or latest available.

Source: Haver Analytics; National central banks; McKinsey Global Institute, January 2012

These four "big" issues have at their core a very unhealthy dose of debt. In some respects, it is the central banks who are now the key players in how and when this debt is paid down. The answers to these questions, as Bob Dylan would put it, are "blowing in the wind". Chart 11 (on the following page) shows the extent of the leverage on the major central banks' balance sheets. As if these factors were not enough, one could add Iran, North Korea and a host of other geopolitical hot potatoes to add to the pot. It would appear that all of these major issues have resulted in a market that is fragile at best with a very high "wall of worry". In particular FX, commodities, and rates are at significant fundamental crossroads and technical levels that look set to be tested early in 2012.

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CHART 11: CENTRAL BANK BALANCE SHEETS (China, ECB, U.S. and Japan)

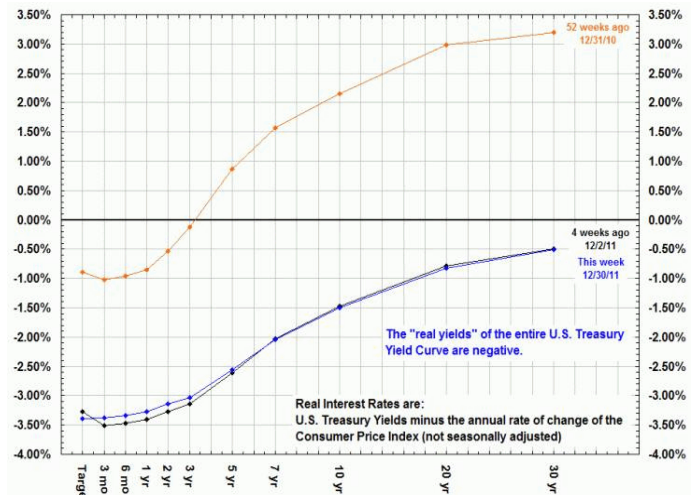


earnest. Given the economic predicament in Europe, bunds look to be the best bet. While one could actively “trade” other European sovereigns, that is far too risky a proposition for Arrow.

Finally, the Australian bond market, one of the best in 2011, should continue its winning ways in 2012 given our outlook for Asian growth. But, the currency will have to be hedged.

The investment grade and high yield markets look more attractive given the spread widening that occurred in 2011. Corporations

CHART 12: REAL U.S. TREASURY YIELD CURVE



FX

In broad terms, as measured by the DXY index, the USD appears poised to break out of the top end of its range (80) as speculators have seen signs of “green shoots” in recent U.S. economic data. We have heard plenty of false breakouts in the past but for many a rising USD equates into lower stock prices and higher government debt prices. In particular, the critical crosses to watch in 2012 will be USD/EUR as the ECB ultimately prints money and lowers rates further. The Australian dollar crosses will also be important to watch given its dependence on China. Despite QE III, we expect the USD to be a strong currency this year.

Rates

The direction of sovereign bond yields is the subject of great debate. Most forecasters had U.S. yields set to rise but clearly the exact opposite occurred in 2011 (See Chart 12), despite the U.S. losing its’ AAA-status. U.S. government bonds are clearly still the risk-averse “go-to” investment despite what everyone knows on a real basis is a losing proposition. Unless the U.S. is Japan in drag, this is untenable and the risks over the intermediate term are yields rising. That being said, there is room for continued flattening of the yield curve thanks to the Fed and the expected QE3 targeting the MBS market later in 2012.

In Europe, Trichet’s tightening in early 2011 was quickly undone in Q4 but there will clearly be more easing coming. Look for the ECB to continue to inflate its balance sheet and money printing will start in

in general are in extremely good shape with respect to their balance sheets. That being said, hedging will be very important, especially credit in the high yield space. As we noted before, recession risks in the U.S. are still elevated and the default rate is extremely low. Relative to equities, credit looks particularly attractive (see Chart 13 below).

CHART 13: S&P 500 vs. HY CDS vs. SINGLE BOND SPREADS vs. XLF



Equities

In 2011, U.S. equities turned in their best relative performance with the S&P 500 up 2.1% while the MSCI World Index delivered -5.5%. The main driver was the steady improvement in corporate earnings. Equities may in fact be “tired” of all the negativity that these four principal headwinds have created or may have “priced in” all the bad news. The multiple on the S&P 500 contracted last year, while earnings continued their upward move to the surprise of many. Today, it is hard to make the case that earnings will be materially higher – profit margins are at historical highs, Europe is likely in a recession, global growth is slowing with monetary and fiscal policy tools stretched. A case could be made that equities are cheap, but the Case Shiller P/E does not confirm this view point.

OUTLOOK FOR 2012

We believe 2012 will be a good year for our funds. While we expect some high-stress periods (although shorter than 2011), and there should be lower overall market volatility. Dispersion should also increase this year, meaning that correlation should be lower between stocks and asset classes, making it a more favorable environment for long/short strategies. With lower volatility and coming off a difficult year for most assets classes (other than investment grade bonds), this should be a better year for most strategies. If any red lights start flashing, we are prepared to swiftly hit the brakes.

The economic data suggests the U.S. is slowly starting to recover and valuations look reasonable. Geographically, Asia and LatAm still show decent growth prospects. Low interest rates, reasonable valuations and record amounts of cash on corporate balance sheets all mean M&A is picking up, all good signs for the event driven crowd. Some of the other themes we expect to play out in 2012 include good opportunities across the capital structure, and excellent macro trading opportunities in sovereign debt and commodities.

One our managers, Mike MacBain, from East Coast summed it up nicely in his recent letter: “The other interesting dynamic in the market today is the significant dichotomy between the yields of sovereign debt of troubled countries (tier 2) and those that are viewed as stable countries (tier 1). Most of the tier 1 country (US, UK, Japan and Germany) bonds are trading at yields of 2% or less while the yields of tier 2 country (France, Italy, Spain, Portugal and Ireland) bonds are trading between 3 1/2% and 8%. This is a

significant difference in funding costs yet the debt to GDP ratios and annual budget deficits are not that different. My thought is that the flight to quality tier 1 country bond buying is close to being overdone and that there is a growing risk that the tier 1 country funding costs will rise given their growth prospects and elevated debt levels. We continue to monitor this situation every day and will look to take advantage in 2012.”

Some highlights from our platform looking back at 2011, and heading into 2012, are:

1. Curvature Market Neutral Fund +6.4% in 2011

Curvature is a market neutral strategy that focuses on North American small-mid cap equities. It is slightly negatively correlated to the market, and thus tends to be flat-to-positive when the equity markets decline, while underperforming when the equity markets rally sharply. Since inception, Curvature has provided consistent returns with less volatility than the market. Managers James Hodgins and Geoff Phipps are invested in the strategy and have over a decade of experience investing in similar strategies for Ontario Teachers’ Pension and Canaccord.

2. SG U.S. Market Neutral Fund +6.8% in 2011

SG invests in U.S. small-mid cap companies (\$500M - \$4B) using a market neutral approach that employs bottom-up fundamental research to identify estimate profits that are different from market expectations (sentiment + earnings). With short-term, active investing, they go long stocks that will beat consensus, and short those that will miss consensus, or as it relates to other news-worthy events. SG Capital’s offshore equity market neutral strategy was rated 4th in the Barclays’ database for the period from Oct. 2008 to Sept. 2011 (as appeared in Barclay Managed Funds Report - 4th Quarter 2011 - page 11).

3. Raven Rock Income Fund +5.9% in 2011

Raven Rock is managed by an experienced 3-person portfolio management team with a proven track record. It invests in U.S. high yield and convertible bonds and typically has low correlation to the corporate bond market. The Fund pays approximately 6.4% annualized yield at 100% return of capital.

4. East Coast Investment Grade Fund -2.5% in 2011

East Coast invests long/short in Canadian corporate and government investment grade names. The Fund provides income monthly at 3.5 cents per unit at 100% return of capital (4.5% annual yield as at December 31, 2011). East Coast has the



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flexibility to actively manage the macro side of the market and protect against risks, especially interest rate risk. When rates eventually rise (later this year or early 2013), the Fund will be very well-positioned to protect against this.

At Arrow, it is our goal is to aid in your asset allocation process by providing funds with different risk/return profiles that will complement each other in a portfolio throughout various market conditions. Our funds are much more a defensive strategy than an offensive one, and we are positioned accordingly.

Thank you for your support of Arrow Capital Management.

SECTOR EXPOSURE

ARROW DIVERSIFIED FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT DECEMBER 31, 2011				
	Long	Short	Net	Gross
Consumer Discretionary	7.5%	(2.8%)	4.7%	10.4%
Consumer Staples	2.8%	(2.5%)	0.3%	5.3%
Energy	16.7%	(8.8%)	7.9%	25.4%
Financials	12.1%	(7.6%)	4.5%	19.7%
Government	2.5%	(11.0%)	(8.5%)	13.6%
Health Care	5.0%	(1.9%)	3.1%	6.9%
Indices	3.2%	(7.1%)	(3.9%)	10.2%
Industrials	6.8%	(3.3%)	3.5%	10.2%
Information Technology	7.9%	(1.9%)	6.0%	9.9%
Materials	12.1%	(7.2%)	4.9%	19.2%
Telecommunication Services	2.9%	(0.6%)	2.3%	3.5%
Utilities	1.0%	(0.3%)	0.7%	1.2%
TOTAL	80.5%	(55.1%)	25.5%	135.6%

ARROW MAPLE LEAF CANADIAN FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT DECEMBER 31, 2011				
	Long	Short	Net	Gross
Consumer Discretionary	3.8%	(2.3%)	1.5%	6.0%
Consumer Staples	2.1%	(0.7%)	1.5%	2.8%
Energy	17.1%	(12.1%)	5.0%	29.2%
Financials	6.3%	(7.2%)	(0.9%)	13.6%
Government	2.2%	(8.1%)	(5.9%)	10.2%
Health Care	3.0%	(0.9%)	2.0%	3.9%
Indices	3.0%	(4.8%)	(1.8%)	7.8%
Industrials	3.4%	(1.8%)	1.6%	5.2%
Information Technology	5.9%	(0.8%)	5.1%	6.7%
Materials	21.3%	(10.2%)	11.1%	31.4%
Telecommunication Services	1.7%	(0.5%)	1.2%	2.1%
Utilities	1.1%	(0.2%)	0.9%	1.2%
TOTAL	70.8%	(49.5%)	21.3%	120.3%

ARROW ENHANCED INCOME FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT DECEMBER 31, 2011				
	Long	Short	Net	Gross
Consumer Discretionary	9.0%	(2.8%)	6.2%	11.8%
Consumer Staples	3.5%	(3.8%)	(0.3%)	7.3%
Energy	21.5%	(9.2%)	12.3%	30.6%
Financials	16.6%	(7.9%)	8.7%	24.5%
Government	2.9%	(12.8%)	(9.9%)	15.7%
Health Care	7.7%	(3.1%)	4.6%	10.9%
Indices	3.6%	(6.9%)	(3.4%)	10.5%
Industrials	8.4%	(3.7%)	4.7%	12.1%
Information Technology	8.5%	(2.0%)	6.6%	10.5%
Materials	13.6%	(10.8%)	2.8%	24.4%
Telecommunication Services	3.5%	(1.1%)	2.4%	4.5%
Utilities	1.4%	(0.4%)	1.0%	1.8%
TOTAL	100.2%	(64.5%)	35.7%	164.6%

¹ From January 1, 2010 the returns are for Arrow Maple Leaf Canadian Fund (Class A), from July 2001, returns are for Arrow Focus Fund (Class A), from January 2002, the returns are for Arrow Diversified Fund (Class A) and from January 2005, returns are for Arrow Enhanced Income Fund (Class A). All returns are net of all fees in Canadian dollars.

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