Roosevelt Investments

EQUITY INVESTMENT OUTLOOK

November 12, 2010

Quantitative Pleasing

On the heels of the Fed's announcement regarding QE2, the mid-term election, and a host of good economic data and corporate earnings reports, we are starting to feel incrementally more optimistic about the near-term. Nevertheless, our view continues to be that the most likely path forward will be the slow, plodding recovery providing periods of softness accompanied by volatility. QE2 is all about wealth creation as a vehicle to jump-start a moribund economy, and if successful it will create jobs and improved levels of economic activity.

The first week of November delivered a trifecta of good news: Federal Reserve Chairman Bernanke announced the details of the Fed's plans for quantitative easing (QE2), the Republicans took control of the House, and the government's monthly report on payrolls exceeded expectations. In other words, clear and strong signals about monetary stimulus, better odds for a more business-friendly climate ahead, and evidence of improving economic conditions all improve the odds that the market will continue to lift. We now know that the Fed has targeted the purchase of $600 billion in bonds, and this program, in combination with the reinvested proceeds of maturing mortgage-backed securities held by the Fed, will equate to $110 billion of monthly bond purchases through the end of June 2011. It is important to note that these purchases will be reassessed on a regular basis to guard against any undesired effects from all this liquidity.

What does QE2 mean for the market and the economy going forward? Based upon past experience and our understanding that monetary stimulus has generally worked with a lag, we assume that the economy could experience gains in hiring and reflationary pressures in six to nine months to the extent that those events are directly related to QE2. While interest rates are already quite low, QE2 should push rates incrementally lower. This is positive for corporate and individual borrowers who can refinance their debt at lower rates, and should be generally supportive for capital markets. All else equal, lower rates also create an incentive for investors to shift into riskier asset classes, perhaps from government bonds to agencies, corporates, or even to equities and other assets.

The biggest risk is clearly inflation. However, Bernanke believes there is sufficient slack in the economy to prevent inflation from becoming a problem. That said, he has indicated he is willing to use whatever tools are required to ward off inflation. Unfortunately commodity prices have already

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been rising across the globe, and because of spikes in the prices of both cotton and a variety of food ingredients that have occurred even before the initiation of QE2, a number of apparel and food makers recently warned that they will very likely be taking price increases next year. We have responded to the threat of inflation by incrementally increasing our exposure to materials and also reassessing the ability of the companies in the portfolio to pass through input cost pressures.

Now that the Fed has outlined its monetary policy, it will be interesting to see what the Obama administration and Congress are able to achieve on the fiscal policy front. With the House in the hands of the Republicans, the tone out of DC may change in a more business-friendly way. If the government is able to adopt policies that clear away some of the uncertainty for business decision-making, the economy should see increased hiring and capital investment. Taxation and environmental policy are two logical places to begin. Hopefully the politicians will not get mired in gridlock, although even a gridlocked Congress would be incrementally positive following the wave of new regulations emanating from Washington over the past year.

Economic data has improved markedly in recent periods, with the latest ISM report suggesting a pickup in activity at the start of the fourth quarter. GDP growth for the third quarter was reported at 2%, a slight acceleration from the second quarter. September retail sales were stronger than forecasted, and this was borne out by quarterly results from credit card companies indicating that consumer spending has increased at the highest quarterly pace since the third quarter of 2007. Importantly, an increase in disposable income, not additional borrowing, seems to be fueling consumer spending since overall debt levels continue to decline. In addition, car and truck sales grew to an annualized pace exceeding 12 million units in October, nearly half a million more than had been expected. And while the unemployment rate held steady at 9.6%, monthly payroll data was much stronger than expected, while prior period data was revised upward to reflect stronger conditions than were previously reported. Furthermore, we have learned that holiday-related retail hiring is off to its strongest start since 2006, and initial unemployment claims have now fallen to their lowest level in four months. These data suggest that the labor market may be in the early stages of a recovery.

On the micro side of the ledger, third quarter corporate earnings have been quite robust. As of November 11th, 86% of the companies in the S&P 500 index had reported their quarterly results, and 76% exceeded sell-side estimates. Two-thirds of the companies were able to show an improvement in margins, which is an impressive result given the widespread excess capacity among U.S. manufacturers and some significant increases in input costs. These strong results have been

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accompanied by growth in capital spending and forward guidance that indicates more of the same in future quarters. According to Empirical Research Partners, capital spending trends are now clearly positive and should remain in an uptrend after troughing in the third quarter of 2009. Such trends have typically been a powerful harbinger of hiring activity. Historically, after every recession there has been a spike in productivity levels in the subsequent recovery, as firms hesitant to hire workers produce more and more output from the existing workforce until the point is reached that further productivity gains are hard to generate. This typically is followed by gains in employment as firms finally relent and add the workers needed to increase output. At this stage unemployment begins to decline. We believe that we may be nearing this inflection point.

Based upon statements of Bernanke and other members of the FOMC, the Fed clearly understands that the stock and bond markets as well as the value of the US dollar have already responded positively to the Fed's references to QE2 over the past two months. It is our belief that QE2 will continue to exert its beneficial effect upon equity prices, interest rates, inflation expectations, and the value of the dollar. In accordance with this view, we have incrementally reduced our hedge tools during the month, while at the same time slightly increasing the portfolio's overall beta. A longstanding maxim of investing is "don't fight the Fed", and we think that is an appropriate stance at the moment.

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Please visit our new website at www.rooseveltinvestments.com

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