

EQUITY INVESTMENT OUTLOOK

April 12, 2010

The stock market has covered a lot of ground since that rough period one year ago, but it is still below the levels at which Lehman Brothers declared bankruptcy and sent the financial system into crisis mode. Central banks around the world took coordinated actions to intervene and provide liquidity directly to banks as well as capital markets. Corporate America responded in an unprecedented fashion, slashing jobs and other expenses and reducing capital spending to a much greater degree than expected. As a result, non-financial companies generally came through this recession in much better shape than expected. During the first quarter, 2010 sell side earnings forecasts for large cap stocks were revised up an average of 8%, among the largest such revisions on record. We expect the backdrop of economic recovery coupled with operating efficiencies to drive strong bottom line results, albeit with some headwinds challenging growth on the top line.

Despite the passage of time from the equity market bottom in March 2009, there is still a healthy amount of investor fear in the marketplace. This might seem counterintuitive because of the market's 60%-plus move from the trough, but many investors have not participated in the rally as a result of reallocating money into bonds during the recession. Although funds have begun to shift back into equities, an enormous amount of money is still effectively on the sidelines as investors wait to dip their toes back into the equity pool. **While there are still some trouble spots which concern us, we are inclined to embrace the recovering economy and encourage investors to hear the all-clear signal that is ringing today.** During the first quarter we have steadily increased the portfolio's weighting in consumer discretionary stocks and added exposure to the auto industry in recognition of the changed dynamics. In this note we explore our constructive outlook in more detail.

There is an abundance of data indicating that the economy is clearly in recovery mode. While we would prefer to see stronger metrics for employment and housing, even in those areas the statistics are slowly but surely showing signs of improvement. Unemployment claims have declined to an 18-month low, and the latest readings from the Bureau of Labor Statistics household employment survey have shown big additions, which has historically been a precursor to improvement in the payroll survey data. Temporary jobs, another historically reliable leading indicator of more permanent hiring, are also suggestive of broader job growth on the horizon.

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Supporting the employment data, the monthly ISM manufacturing survey also continues to trend higher. After being in a prolonged drawdown mode, manufacturers reported in March for the first time in many years actually building inventory to support their customers' needs. The ISM non-manufacturing survey, representative of the larger services-oriented nature of the US economy, has been trending higher for five months in a row and is now at a level clearly indicative of economic expansion. Along with forecasts we have seen for growth in capital expenditures on new plant and equipment, this should be a harbinger of hiring activity. On the subject of housing, the S&P/Case-Shiller Home Price index continues to trend higher, and in the most recent measurement period, all 20 cities saw improved prices. Residential construction is turning positive, and the Moody's index of commercial real estate prices has shown improvement for three consecutive months. Interest rates remain at levels conducive to affordable mortgages. Considerable risks remain, such as an unknown but large quantity of foreclosures on the horizon, but it is our belief that the worst of the economic drag from housing is behind us.

Capital markets activity has also been strong. IPO activity has been robust and the first quarter saw the highest level of junk bond underwriting ever reported in a quarter, evidence that the market is willing to provide capital to new ventures in addition to existing, leveraged ones. Durable goods orders continue to be strong, having increased for three months in a row. Leading economic indicators continue their upward trajectory from March 2009 and indicate moderately improving economic conditions.

On the debit side, while Greece has taken default off the table for the next year because of the EU's rescue plan, the conditions of this rescue plan remain unclear at this juncture, and the austerity forced upon Greece and other fiscally-challenged countries seems likely to have a depressive impact on the Euro. This may lead to an in-depth examination of the Euro concept and whether its very existence is fundamentally sustainable. Milton Friedman famously predicted that the Euro would not survive Europe's first serious recession, and he may turn out to be right. A weaker Euro will prove to be positive for European exporters, and likely a headwind for US exporters competing with them, but at this point it is difficult to see how this event is likely to seriously impede our own recovery.

Inflation is another bugaboo which is widely discussed, but today's high unemployment and still relatively low capacity utilization rate should keep a lid on any pressure. So far, the Fed continues

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to believe inflation is not likely to be an issue any time soon and is inclined to continue its low interest rate policy. The Fed has also been slowly reducing the liquidity it injected into our economy in late 2008 and early 2009, most recently by ending Fed purchases of mortgage backed securities. Spreads have not widened, indicating that the market no longer requires Fed intervention. Some Fed governors believe rates should be hiked prospectively in order to offset inflation, but for now such a course does not appear likely.

We were concerned about China earlier this year when it indicated it would restrain lending growth at its banks, but so far this restraint has not led to any materially negative economic reactions for its trading partners. There has been plenty of talk about a Chinese bubble, although lending standards for real estate in China have been and continue to be much more rigorous than we experienced in our recent real estate bubble. China's economy continues to appear healthy, and we believe the Chinese are likely to allow their currency to de-link from the dollar and appreciate to some degree. This could potentially be a win-win situation, as it will alleviate inflationary pressures in China relating to imported goods while at the same time providing a tailwind to US exporters who sell goods into China.

Last on our list of pre-eminent concerns is the fiscal state of the US economy. For the time being our country continues to be able to sell bonds at relatively low rates, the proceeds of which are used to finance our budget deficit. We are in a fortunate situation now with other economies and regions struggling with their own issues (most notably the Euro zone, the UK, and Japan), which help make our currency more desirable in a relative sense. However, our present debt level relative to GDP, if left unchecked, could ultimately create a scenario where higher rates would be required to attract investors to government bonds, and the higher interest rate payments would begin to crowd out other activity in our economy as well as other types of government spending. This is the so-called 'bond vigilante' mechanism by which market forces compel governments to get their fiscal house in order. Standard & Poor's is currently reviewing the sovereign debt rating of the United States, but a downgrade seems unlikely. We appear to be in the clear for now, but it would be an excellent time for our government to show some fiscal restraint and discipline.

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