EQUITY INVESTMENT OUTLOOK

September 8, 2010

Stall Speed

Last month we used the title "Two Steps Forward, Two Steps Back" to describe the pattern the market and the economy have followed this year, moving up and down but not making any real progress. True to form, August marked a give-back of July's gains, accompanied by growing fears of a weakening economy and the potential to slide back into recession (the "double dip"). These fears were stoked by signs that the so-called "soft patch" in the economy is intensifying, with very weak housing starts, worsening employment figures, a weak and very promotional consumer staples environment, downward revisions in 2nd quarter GDP, and a few technology bellwethers giving cautious outlooks for the upcoming quarter.

While our belief continues to be that a double-dip scenario is unlikely, we think the odds that we may be headed back into recession have increased ever so slightly. In our opinion the economy is moving along at a rate of growth akin to stall speed, an aeronautical concept that describes the speed below which an airplane cannot create enough lift to sustain its weight. The longer our economy proceeds at this low level of growth, the greater the chances in our view that some exogenous factor or event could be enough of a headwind to push the economy into recession.

In accordance with this slightly more cautious view, we have incrementally reduced our cyclical exposure and increased our risk tool exposure. In addition, we added a few stocks to our newest investment theme, Asian Exposure. Incorporated in this theme is our belief that companies which derive meaningful revenues from Asia should outperform because those economies are growing at faster levels than the US.

Taking notice of the apparent weakness, the Federal Reserve indicated that it would be willing to do what was necessary to ensure a continuation of the recovery, and it also made clear that it was not out of options with respect to its toolbox for use in monetary stimulus efforts. These tools include the possibility of more quantitative easing (QE) and purchasing of mortgage backed securities (MBS). For most of 2010 the Fed has been gradually shrinking its balance sheet to implement its exit strategy from various forms of monetary stimulus, but earlier in the month decided to put that exit strategy on

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hold. These comments may have spooked investors and acted as a catalyst for the August market decline, since they were an admission that the economy is not yet healthy enough for the Fed to shrink its balance sheet further. While the economy in August provided some evidence of a slowing trend, Chairman Bernanke noted that it is still growing at a solid pace and should continue to do so, even if at a slower rate than earlier in the year.

Our base case scenario that the US economy will not slip back into recession is supported by an abundance of still positive data. Second quarter earnings grew 38% on average over the same quarter last year on sales growth of 9.5%. M&A activity has recently picked up, and investment in capital equipment and software by businesses grew 20% in the first half of the year. August's Institute for Supply Management (ISM) report marked the 13th consecutive month of expansion for the economy. In addition, for the first time in this business cycle, the Fed's senior loan officer survey from major US banks indicates that large companies are now seeking to be net borrowers. Historically, these loans have led inventory growth by four to six months, an indication that inventory expansion should continue to contribute to growth in our economy. August employment data were better than expected, and June and July's readings were revised upward. Weekly unemployment claims have also fallen for two consecutive weeks. Lastly, industrial production rose 1% in July, a higher rate than had been forecast. This rate of production fits with what we believe is the most likely course for the economy, a recovery which is somewhat tepid yet still strong enough to keep us out of recession.

As well, we are increasingly of the belief that the political environment may play a growing role in shaping stock market sentiment over the coming months. Headlines over the past few weeks have noted the growing negative sentiment towards incumbents, and the polls indicate that the Democratic Party may be at risk of losing control of the House of Representatives. Historically investors have embraced political gridlock where one party controls the House and the other the Senate, as the lack of cooperation reduces the chances for passage of potentially damaging legislation and regulations. The significant number of new laws that have been passed by this Congress (the most in any single Congressional session since 1965*), makes the potential for gridlock arguably a more important concept for the stock market than usual.

Many voters have been frustrated with the administration's fiscal stimulus efforts, and appear ready for a different approach. Although elections are still two months away, early results are generally tilting towards conservatives and their negative views on government spending. Even Republican

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incumbents are feeling the heat, as exemplified by Alaska senator Lisa Murkowski, who just lost in a primary election to her Tea Party-affiliated opponent Joe Miller. Should the GOP's fortunes change enough that the party also wins control of the Senate, it is possible that the market could respond quite favorably given the possibility of reductions in government spending and regulatory pressures. We believe that a combination of negative poll data for the Democrats in addition to better than expected economic data were largely responsible for the market's upward move during the first week of September.

There are two factors countering our incrementally more bearish view. First, while a number of fiscal headwinds are anticipated in 2011, the government may consider new fiscal stimuli and/or QE to moderate the effects of these headwinds, and such efforts could buoy the market. Second, it is safe to say that many investors are currently leaning in a bearish direction, either on the sidelines with plenty of cash or bonds or positioned conservatively with respect to sectors and stocks. We remain vigilant to the possibility that this is a crowded trade.

* The Obama Economy, Wall Street Journal, September 7, 2010.

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