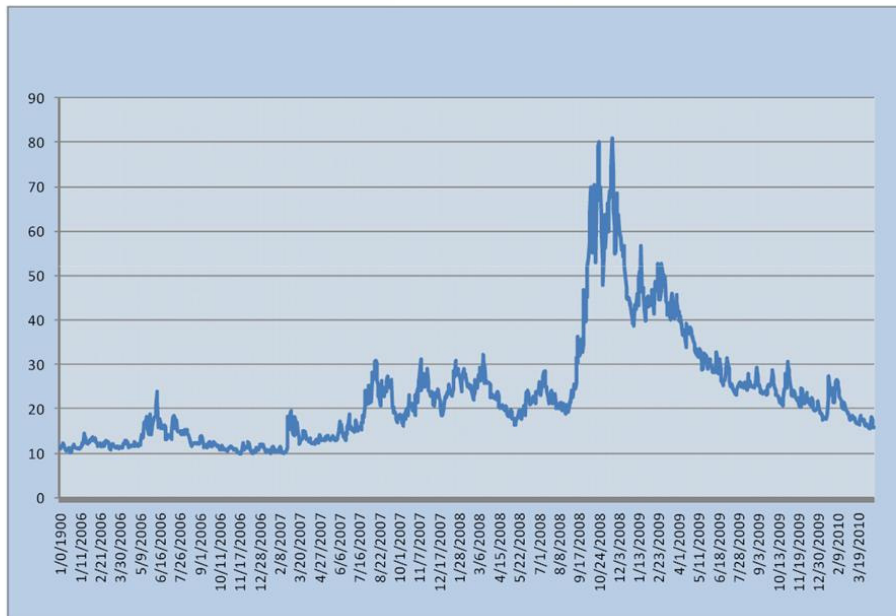


## Investment Outlook & Strategy Commentary

### GETTING BACK TO NORMAL

The broad-based market rally, narrowing of corporate credit spreads and accelerating global economic recovery are all steps of a process of returning to normal. Market sentiment has become more complacent as investors have become less worried about a double-dip and both consumer and business spending are helping fuel the economic recovery. The SEC's aggressive civil fraud suit against Goldman Sachs and fears of additional litigation in the financial industry combined with the ongoing Greek debt crisis may put a temporary damper on the powerful U.S. equity market recovery. U.S. stock market volatility, as reflected in the VIX measure of equity market volatility, has returned to that of late 2007 that existed before the economic and market meltdown.

### VIX INDEX OF S&P 500 VOLATILITY DEC 2005 - APRIL 21, 2010



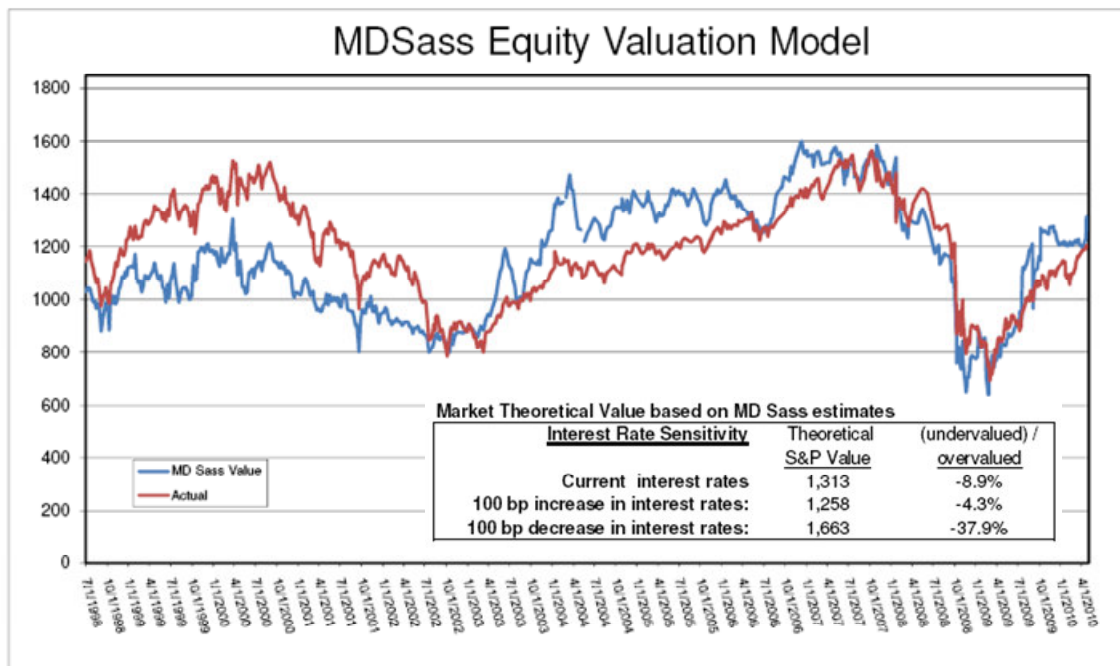
Source: Bloomberg.

The financial reform bill currently before Congress calls for tighter regulation. It is lengthy, complex and has both potential positive and negative implications: positive if it prevents abuses and increases transparency, but there is a risk that empowered politicians may overreact, stifle innovation and become excessively restrictive. The financial sector's profits have rebounded dramatically, aided by the steep yield curve and the return to normal. However increased regulation, high loan losses and feeble credit growth suggest that financial profits as a percent of total corporate earnings are unlikely to return to their previous peak for a long time. Huge Greek financing needs and the size and structure of the bailout raise sovereign risk concerns with potential collateral damage to other fiscally weak eurozone countries. Additionally, the impending withdrawal of monetary and fiscal stimulus around the world will lower future growth rates in many countries. These potholes, at a time when investor complacency has increased, may surprise investors and result in higher future market volatility. Weaknesses should be used as buying opportunities because of the strengthening global economic recovery. We believe the recovery will be sustainable with continued rapid growth in the emerging economies and slower but positive growth in the developed economies.

The global economic rebound will likely continue to surprise the consensus on the upside through 2011, aided by the lagging impact of synchronized fiscal and monetary stimulus programs and improving consumer spending. Leading Economic Indicators in March were up +11.7% y/y, which is more than the last two recoveries at this time and non-defense capital goods orders jumped at a 7.7% annualized rate in the first quarter, supporting our thesis that the economy and financial markets are returning to normal. After investing through several major economic cycles, this looks like a relatively normal progression from recession to recovery to self-sustaining expansion. U.S. GDP probably will post a new high in the first quarter, above the peak in 2008 and real GDP growth should beat the consensus with a healthy gain approximating 4%. The global manufacturing purchasing managers' surveys have hit a new high for the cycle and remain consistent with a record 10% rate of global industrial production growth. With strongest growth coming from Brazil, India, China and other emerging economies, we believe global GDP should positively surprise investors with gains of 4.5-5% per annum in 2010 and 2011. We believe emerging economies will drive growth even more so than in the past, as they will account for 75% of global growth during the 2007-2012 period (according to IMF estimates), up from 55% in the 2000-2007 period. The developing countries as a whole are not facing the same headwinds of consumer deleveraging and rising government interest expense as are the U.S. and other developed countries.

As a reference point for "normal" the average duration of the last 9 recoveries was 5+ years, and we expect this recovery to be a similar multi-year recovery. The broadening of stock market leadership and a return to normal stock market volatility and credit spreads reinforce our view. Many corporations now have huge cash positions for share repurchases, higher dividends and acquisitions

and many are benefitting from improved operating leverage, due to drastic cost-cutting during the recession. This leverage is driving a powerful earnings recovery and 83% of reporting companies have beaten consensus analyst forecasts for the first quarter. S&P 500 earnings reported so far for the first quarter of 2010 are up 39% year over year on about a 10% increase in sales. We expect an even higher year over year earnings gain of roughly 45% in the second quarter. However, the sharp rally in stocks over the past 13 months has already discounted much of this earnings improvement as shown by our equity valuation model. The forward P/E for the S&P 500 based on the next 12 months estimated earnings has now returned to close to its long-term average.



The October 2009 unemployment rate of 10.1% was probably the cyclical peak. Even the so-called “underemployment rate” (U6) - which includes marginally attached workers and people working part-time for economic reasons- peaked at 17.4% in October 2009. The March job report marked a turning point wherein we believe the job creation phase has commenced and businesses go on the offensive. This was initially reflected in more hours worked and is now being seen in employment growth. April employment growth should approximate 350,000 or more, as suggested by the latest drop in unemployment claims, which made a 19 month low. With employment prospects improving, consumer spending should continue to rebound nicely and reinforce the self-sustaining recovery which we believe is underway.

## **NORMALIZATION OF THE FED'S ULTRA-ACCOMODATIVE POLICY**

From the standpoint of Fed policy, core inflation is declining and a fall into deflation at some time over the next 12 months. With core CPI and the core PCE deflation up only 1.3% year over year inflation remains restrained by the gap between actual and potential output (capacity utilization is running at only 72%). This relieves pressure on the Fed to remove stimulus. We are just beginning the Fed's normalization cycle, where expiration of the stimulus programs, the completion of asset purchases and normalization of the discount window takes place. In the next phase, the Fed will try to transfer assets from its balance sheet back to the public markets. The Fed will also next drain liquidity via reverse repos, term deposits, perhaps paying interest on deposits at the Fed and the sale of securities. The final phase will be tightening. Tightening will be preceded sometime in the next few months by the Fed softening its "extended period" language, its mantra since March 2009. We expect the Fed's ultra-accommodative policy to be maintained for most if not all of 2010, as long as inflation remains low, the unemployment rate stays high, and in advance of the November elections. When the Fed eliminates its "extended period" language, it will likely trigger a market correction, but the market will recover as long as the economic recovery remains on track and profits continue to grow. Despite such short-term market corrections, stocks do well in the early stages of Fed tightening cycles because Fed tightening should confirm self-sustaining recovery and rising employment.

Taxes next year will be increasing. Pending expiration of the Bush administration tax cuts, the fading tax relief from the stimulus package, new corporate tax proposals and meaningful federal budget shortfalls will cause focus to turn to higher taxes. There will likely be meaningful tax increases starting in 2011 for higher income tax payers and on capital gains and dividends. The healthcare legislation also included several new tax increases. We may also start the debate on the possibility of entirely new taxes (i.e., Value Added or National Sales tax and/or an energy consumption tax). Each of these tax initiatives can have profound implications for the securities markets.

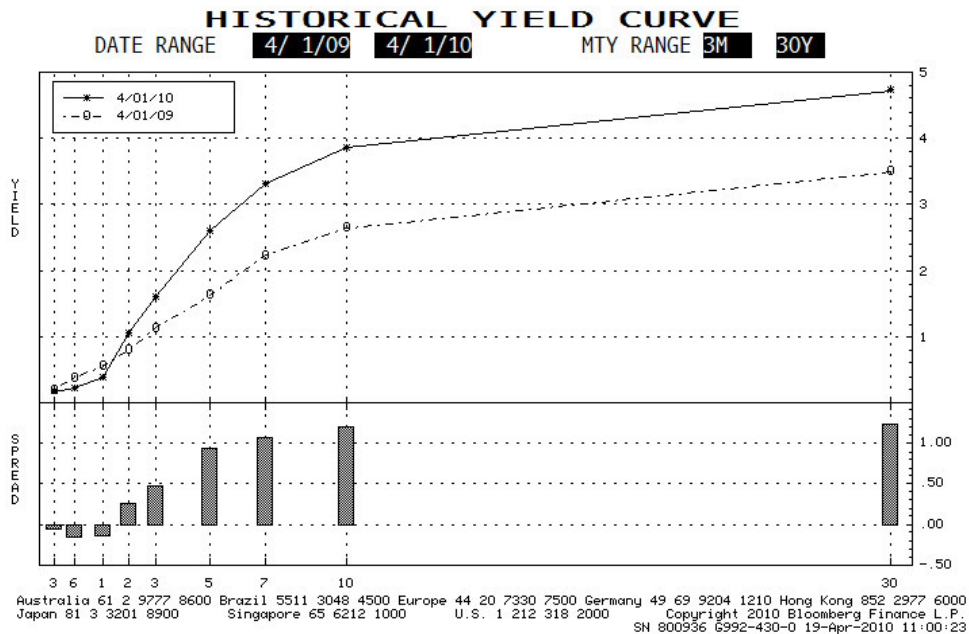
## **The Fixed Income Conundrum**

**Economic growth is both necessary in the short and long run,  
but poses short run risks for fixed income investors**

Without strong U.S. economic growth, federal, state and local tax revenues will be inadequate to fund budgets and therefore require unprecedented bond issuance at every level of government in order to finance operating and capital deficits. The magnitude of this bond issuance, combined with the lending opportunities presented to global investors to invest in high growth emerging market economies, is likely to put substantial upward pressure on U.S. interest

rates at a time when government economic stimulus policies are optimally implemented in a low and stable interest rate environment. Only solid long term economic growth will increase tax revenues enough to provide bond investors comfort that U.S. and local government borrowers will generate future cash flows that will enable them to cover the debt service on existing and newly issued debt and refinance maturing issues at interest rate levels and do not threaten credit impairment (think Greece and possibly California). However, strong US economic growth in the short run will also increase the demand for consumer credit to finance mortgages, credit cards and leases that will inevitably compete for financing with the needs to finance federal and local government deficits over the next several years until unemployment is reduced to mid single digits.

The U.S. is currently attempting to grow out of its *debt spiral* wherein high unemployment reduces tax receipts while increasing stimulus and transfer payments, thereby creating larger deficits and increased debt issuance. Until there is confidence that the momentum of job creation is sufficient to grow the economy out of its “debt spiral”, government policy makers will err on the side of fiscal and monetary stimulus. Fiscal stimulus takes the form of borrowing to spend on transferring money to low and no income people and public works projects to create employment. Monetary policy is largely the attempt to keep interest rates low enough to stimulate private growth by making debt affordable for corporations and consumers. The government can more easily influence short term interest rates than it can longer term interest rates because bond investors require not only confidence in the ultimate repayment of principal and interest, but also that the purchasing power of those future payments will not be eroded by inflation, even if inflation is currently low. Some of the procedures used to keep short term interest rates low can have the perverse effect of increasing the risk of inflation and therefore cause bond investors to demand higher interest rates to protect them and compensate them for the increased inflation risk. We can see this inflation premium in U.S. government bond yields by comparing the yield curves of April 1, 2009 and 2010. During this period inflation remained low, but fear of inflation increased as the supply of debt grew at record rates and to record levels. We are still in the early to mid stage of this cycle. Interest rates on intermediate and longer term issues have already increased, reflecting these concerns even as short term rates have remained very low.



### HISTORICAL YIELD CURVE

DATE RANGE **4/ 1/09** **4/ 1/10** MTY RANGE **3M** **30Y**

	4/01/09	4/01/10	Change
3 MONTH	0.198	0.152	-0.0457
6 MONTH	0.391	0.231	-0.1597
1 YEAR	0.540	0.387	-0.1531
2 YEAR	0.804	1.056	0.2520
3 YEAR	1.132	1.604	0.4721
5 YEAR	1.642	2.587	0.9453
7 YEAR	2.244	3.316	1.0716
10 YEAR	2.654	3.868	1.2146
30 YEAR	3.502	4.728	1.2262

Source: Bloomberg

Take away point:

There is a clear risk of interest rates rising for a sustained period of time and longer term bonds commensurately declining in value. Our strategy remains concentrated on investing in very high credit quality, very liquid securities and durations in the 1 to 5 year range. We believe shorter duration U.S. Government Agency mortgage backed issues remain attractive for these attributes combined with their high relative yield.

April, 2010