

Investment Outlook & Strategy Commentary

SUSTAINED RECOVERY OR DOUBLE DIP?

The economic recovery has decelerated sharply since April, with consecutive negative surprises, raising the question of whether the economy is in a sluggish phase or, absent additional stimulus, entering a double dip recession. Among the disappointing economic data has been the decline of the Reuters/University of Michigan consumer confidence index by almost 10 points to 66.5 in early July 2010. In addition, the U.S. Leading Economic Indicators and the ISM Purchasing Manager Survey suggest a slowing lies ahead. The S&P dropped from its recent peak of 1217 on April 23, 2010 to 1070 on July 22, 2010, accompanied by declines in commodities and other asset classes. Investors have fled for safety to the dollar, gold and U.S. Treasuries.

Over two-thirds of U.S. GDP growth in the past two quarters reflected inventory restocking. Excluding the impact of the inventory buildup, real final sales increased only about 1.5% over the past year. With the 2009 U.S. policy stimulus bill and inventory cycle now dissipating and state, local and global government fiscal austerity programs presenting a headwind, a slower and bumpier recovery lies ahead. In this more challenging environment, economists have reduced their U.S. growth forecasts for the first time since the recovery began in mid-2009, with recent forecasts reduced to only 2% growth in real GDP for 2Q10 (down from 3-3.5%) and in 2H10 to 1.5%, well below consensus estimates of 2.7%.

Fiscal policy in the United States is almost in gridlock since Congress seems unable to pass legislation that materially lowers the budget deficit or stimulates the economy despite Obama's push for net new stimulus. The Republicans will blame the Administration if the recovery falters by the November elections.

While we are in this soft patch, investors will vacillate between worries about whether this slowdown will lead to a double dip and optimism that the recovery is in its early stages. Selloffs provide attractive investment opportunities for disciplined investors as some equities will discount the worst. We believe the economy is in the early stages of what is likely to be a 5 year recovery and equity valuations are attractive. Therefore, well selected quality equities should prove quite rewarding investments whereas U.S. Treasury bonds will likely show negative total returns over the long term. Catalysts for a market recovery will be a narrowing of credit spreads, a steepening yield curve, improving employment above 200K private sector jobs a month and a rebound in commodity prices. Within the equity market the defensive Consumer Staples and Utilities sectors held up best and, while down, outperformed during the recent market correction. We believe Energy, Information Technology, Industrials, Consumer Discretionary and Medical Technology stocks are likely to be leaders while these defensive sectors lag when the market turns around.

Four key concerns impacting the outlook for the next twelve months – 1) Slowing U.S. economic growth, 2) Deflationary pressures, 3) The Eurozone crisis, and 4) Slowdown in China - are elaborated on below:

SLOWING U.S. ECONOMIC GROWTH

Year-to-year percentage gains in real GDP will become increasingly difficult because the inventory cycle is over, with the ratio of inventories to orders now back to its long run average of 55 in June 2010. Inventory restocking accounted for two-thirds of the increase in U.S. GDP in the last two quarters and stimulus programs drove much of the balance. Recent heightened worries about a double dip reflect the end of inventory restocking, the winding down of stimulus which has been 75% spent already, double-dip concerns for the Eurozone, slowing growth in China, the disappointing employment trends, limited credit availability and the overhang on housing of impending foreclosures and REO sales at discounted prices. The task of bringing spending and taxing into better balance (spending now equals 175% of tax receipts) and bringing down the soaring Federal deficit is daunting long term, but near term the fiscal drag from the necessary tightening in the state and local sector is also a drag on GDP growth.

States are being forced to implement tax increases, job cuts and reduced spending, with 49 states constitutionally required to balance budgets. We believe this fiscal austerity by states will in the next twelve months more than offset remaining federal stimulus programs but will represent a greater drag after that.

Pending house sales plunged 30% in May versus an expected 12.5% decline, and housing may be facing a double dip in some geographies. There will be a hangover from the expiration of the home buyers' tax credit, which pushed sales into the first half of 2010 and pressure on prices are likely from mounting foreclosures, which are estimated at one million homes this year. Retailers' sales have decelerated since April and auto sales have weakened -4% in June, along with housing, reflecting a weakening of the consumer sector, which appears to be spreading to other sectors.

The key to economic growth lies in employment. U.S. payrolls need to grow 200k per month to keep the economy growing at a reasonable pace. Employment growth in May and June 2010 was disappointing with only 41,000 and 83,000 net new private sector jobs, well below the consensus expectations and down from the average over 200,000 per month in March and April 2010. These modest increases are less than what is needed to keep up with population growth. The unemployment rate fell to 9.5% in June 2010 from 9.7% for the wrong reason - a decline in the number of people looking for work. No wonder consumer confidence dropped sharply to 52.9 in June from 62.7 in May 2010.

DEFLATIONARY PRESSURES

The 2-year U.S. Treasury note just declined to only 0.56%, the lowest yield on record. This yield implied that the Fed will keep short term rates low for 2 years as a result of deflationary pressures. With the large gap between actual and potential output due to unused industrial capacity, core consumer inflation is expected to decline to around zero by the end of next year. Fed-engineered interest rate increases are likely to remain on hold throughout much of the next 12 months, and the Fed will then hike rates only gradually in a subdued recovery with low inflation.

The reduced expectations for inflation and economic growth since April are reflected by the drop in yield on the 10-year U.S. Treasury note to a 15-month low of 2.9% down from 4.01% on April 5, 2010 when projected growth was stronger.

EUROZONE CRISIS

The euro has been in crisis and several forecasters expect the Eurozone's GDP to decline later this year with fiscal austerity programs being launched to address budget imbalances. Risks of a double dip have increased and a sluggish economy for several years is likely as countries in Europe revert to fiscal tightening.

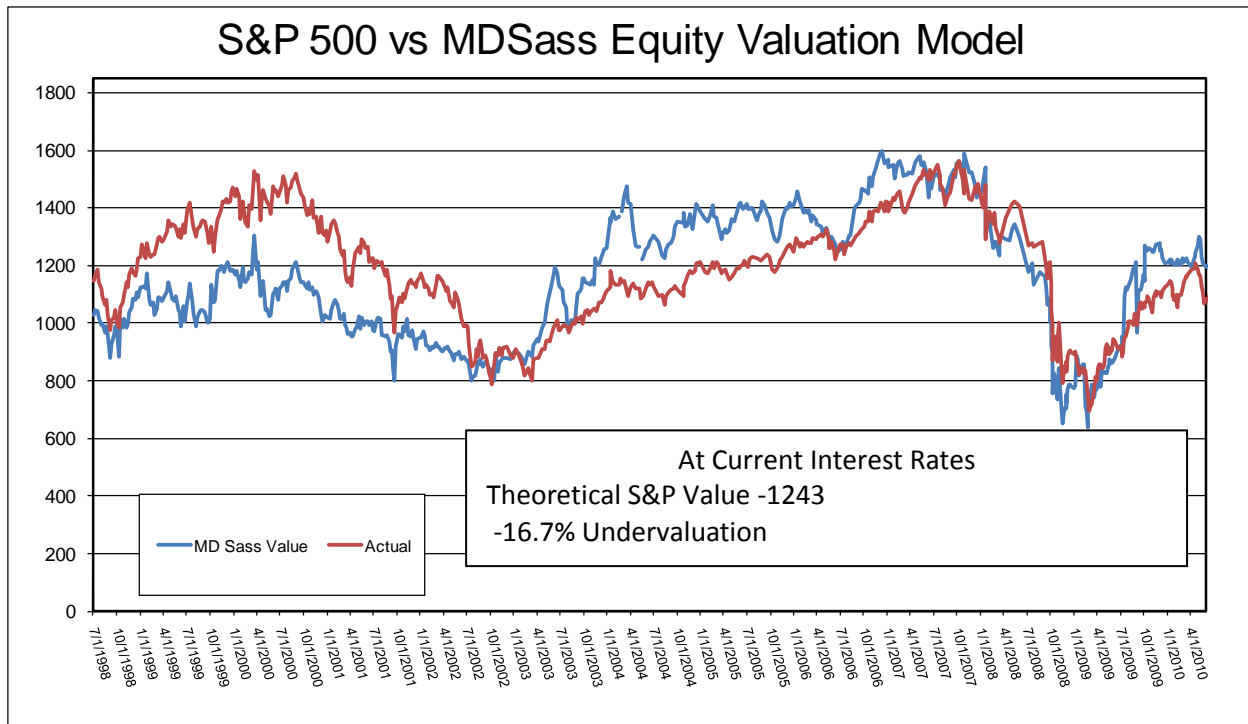
The debt crisis in the private sector (households and financial sector) has now morphed to the public (sovereign) credit sector in Southern Europe. Sovereign credit was substituted for the credit of financial institutions which was shunned by counterparties following the bankruptcy of Lehman Brothers in September 2008. Although the situation is fragile and risks have escalated, comparisons to the 2008 meltdown are exaggerated. A "tail event" could be a recession, credit crisis and market drop in Europe, but we believe the likely outcome will be continued global growth and a relief from widening sovereign spreads.

CHINA SLOWDOWN

China is the major driver of global economies and of increasing concern. The Shanghai Composite has plunged into a severe bear market reflecting fears of overheating and the formation and bursting of asset bubbles. China's property market bubble is already bursting. Beijing residential property sales have plummeted 80% from the December 2009 high and prices are coming under pressure. China's government is slowing growth by instituting loan quotas, withdrawing liquidity, tightening collateral rules and introducing other initiatives to prevent a boom-bust cycle, especially after injecting massive stimulus in 2009. Real GDP growth was 10.5% 1Q10 and likely to slow to around 7-8% by year end. We consider this slowdown welcome because growth was running at an above trend level and China has the world's most room to maneuver fiscal and monetary policy.

EARNINGS AND EQUITY VALUATION

First quarter 2010 earnings for the S&P 500 rose about +53%, which exceeded 75% of analysts' forecasts and second quarter earnings also look strong. It's likely that future positive earnings surprises will be far fewer due to the likelihood that GDP growth forecasts will be downshifting.



Note: Theoretical value is based on interest rates, corporate earnings, discounted future dividends and asset prices which are only estimates and are based upon subjective forecasts and assumptions about circumstances that have not yet taken place and may never do so. There is no guarantee that such estimated results will occur and the results should be viewed for comparative purposes only.

The stock and bond market vigilantes are pricing in the risks to earnings with slower growth. Equities are 17% undervalued based on our equity valuation model, reinforcing our belief that the equity market decline which has been underway since April 23, 2010 will prove to be a correction in a cyclical bull market.

Fixed Income Outlook

As discussed above, faltering economies in Europe and Japan combined with sluggish growth in the U.S. and stubbornly high unemployment have created fears of a double dip economy, caused global investors to flee to the presumed safety of the U.S. dollar and reduced concerns about Fed tightening.

Short term interest rates were already close to zero and had little room to decline, but as shown in the chart below, intermediate and longer issues saw sharply lower interest rates.

	<u>3/31/10</u>	<u>6/30/10</u>	<u>Change</u>
3 MONTH	0.150	0.170	0.0203
6 MONTH	0.231	0.217	-0.0142
1 YEAR	0.379	0.305	-0.0743
2 YEAR	1.016	0.601	-0.4145
3 YEAR	1.571	0.964	-0.6068
5 YEAR	2.544	1.773	-0.7702
7 YEAR	3.275	2.412	-0.8630
10 YEAR	3.826	2.931	-0.8945
30 YEAR	4.713	3.889	-0.8244

As we anticipated, municipal bond yields came under pressure and increased even though Treasury and U.S. Government Agency yields declined. In response to heightened awareness of their fiscal and potential financing problems, several states and municipalities have begun curtailing expenditures through reduced funding for programs, layoffs, furloughs, benefit reductions for new hires and the like. For several it may be too little and too late to prevent their financing costs from escalating even as the attractiveness of tax exempt status increases along with federal and state tax rate increases. For many middle income and affluent investors a default of a major municipal issuer, even if it is one that they don't own, will be a shock to their confidence in the markets and cause them to re-think their appetite for all forms of risk assets. Such a shock could easily spread to the general credit and equity markets in the same manor (but much larger) as concerns about Greece's financing infected global capital markets. Slowing growth in the U.S. and continuing high unemployment will only exacerbate the funding issues for state and local bond issuers.

Europe seems to have gotten the message that profligate spending will not be financed by bond investors. Their fiscal stimulus programs are history and they are focused on more austere budgets and reducing budget deficits. These measures include such unpopular policies of reducing social programs, increasing minimum retirement ages, tax increases and other budget deficit reduction measures. In contrast (and possibly temporarily so), the U.S. currently has the luxury of a safe haven currency and a Treasury bond market with low interest rates. Many politicians in the U.S. are calling for another round of stimulus spending to prop up the economy and hopefully create jobs.

Cynics might conclude that the coming November elections play as important a role as sound long term economic planning. Their mantra is spend now and reign in the deficits later. Later may be sooner than they expect in today's currently volatile currency and capital markets.

The following currency relative value chart illustrates how volatile macro investors' preferences are and how rapidly their preferences can change.

U.S. Dollar Index (USDIX) Versus A Basket Of 6 Major Currencies



With the U.S. dependant on foreign capital to fund our budget and trade deficits, shifts in capital flows can make it difficult for domestic policy makers to stimulate the economy if and when global investors either begin to lose confidence in the dollar or have compelling investment opportunities or needs in emerging markets (including their own).

Proposed U.S. and European legislation and regulations for financial institutions continue the momentum of de-leveraging. As a consequence of financial institution de-leveraging, credit is scarce, credit standards have risen and fears of eventual increases in interest rates have caused investors to choose low yielding money market investments in order to be certain that they will have ample liquidity. Against this background U.S. corporations have hoarded more than \$1 trillion in cash, U.S. investors, overall have \$2.8 trillion in money market instruments. When these short term assets, which are currently earning close to 0%, shift into higher return, longer term investments remains to be seen, but it is a potentially powerful fuel for capital market price increases. Over the long run, few investors' portfolios can achieve their objectives with a large allocation to such low yielding assets. So why are they doing it? The major reason is fear that the current low level of interest rates cannot persist and that by

staying in cash they will have more compelling investment opportunities in the foreseeable future. For reasons discussed below, we agree. However, in the interim our 1 year, 2 year and 3 year targeted duration U.S. Government Agency portfolios performed very well on both an absolute and relative basis and provide compelling increased yield while also providing liquidity and substantial monthly cash flow from interest and principal payments.

If you thought the sub-prime mortgage crisis was scary...

For several years we have been writing about the negative financial implications of the interaction between:

- the aging baby boomers,
- retirement and health care entitlement programs,
- advances and costs of life prolonging medical technologies
- complex tax policies and
- budget deficits at the federal and local levels.

We are not big fans of horror shows and therefore reluctantly read the, non partisan, Congressional Budget Office's June 2010 Budget Outlook. We were hoping for a happy ending. The following is a link to it. Beware that it is scary, very scary. www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf

The report is about 100 pages and has scores of graphs and charts. It is well written and does not require an advanced degree to comprehend it. The CBO's reports often end up as sound bites by politicians on both sides of an issue who take bits of it out of context to support their views. Before getting into some of the details it is worth noting that the American democratic process is spectacular in its transparency and free flow of information. This report is a case in point. The United States is not Greece, hiding its financial problems. The information is out there; however the complacency of the electorate and its elected officials is also spectacular. It is as if someone (the CBO in this case) yells fire in a crowded theater and people line up to buy marshmallows at the concession stand.

In the quotations below, we added the bold type emphasis.

“Under current laws and policies, an aging population and rapidly rising health care costs will sharply increase federal spending for health care programs and Social Security. Unless revenues increase at a similar pace, **such spending will cause federal debt to grow to unsustainable levels.** If policymakers are to put the nation on a sustainable budgetary path, they will need to let revenues increase substantially as a percentage of gross domestic product, decrease spending significantly from projected levels, or adopt some combination of those two approaches.”

What does “unsustainable” mean? Simply put, you can't borrow any more money. Before that happens, your credit rating deteriorates and it cost a lot more to borrow

money. The combination of increased debt and increased cost of the debt makes matters worse fast. Investors holding high credit quality, highly liquid short term bonds (such as our M.D. Sass U.S. Government Agency 1, 2 and 3 year strategies) will benefit in this scenario by being able to invest in higher interest securities.

The report goes on to say that while budgetary conditions were exacerbated by the recent recession, spending is the main issue to be dealt with.

“As the economy recovers and the policies adopted to counteract the recession and the financial turmoil phase out, budget deficits will probably decline markedly in the next few years. But over the long term, the budget outlook is daunting. The retirement of the baby-boom generation portends a significant and sustained increase in the share of the population receiving benefits from Social Security, Medicare, and Medicaid. Moreover, per capita spending for health care is likely to continue rising faster than spending per person on other goods and services for many years (although the magnitude of that gap is very uncertain). **Without significant changes in government policy, those factors will boost federal outlays sharply relative to GDP in coming decades under any plausible assumptions about future trends in the economy, demographics, and health care costs.”**

Well how bad is it. Is the CBO being overly pessimistic? This is what they have to say. We have said it for years.

“In fact, CBO’s projections understate the severity of the long-term budget problem because **they do not incorporate the significant negative effects that accumulating substantial amounts of additional federal debt would have on the economy:** Large budget deficits would reduce national saving, leading to **higher interest rates, more borrowing from abroad, and less domestic investment—which in turn would lower income growth in the United States.** Growing debt would also reduce lawmakers’ ability to respond to economic downturns and other challenges. **Over time, higher debt would increase the probability of a fiscal crisis in which investors would lose confidence in the government’s ability to manage its budget, and the government would be forced to pay much more to borrow money.** Keeping deficits and debt from growing to unsustainable levels would require raising revenues as a percentage of GDP significantly above past levels, reducing outlays sharply relative to CBO’s projections, or some combination of those approaches. Making such changes while economic activity and employment remain well below their potential levels would probably slow the economic recovery. However, the sooner that long-term changes to spending and revenues are agreed on, and the sooner they are carried out once the economic weakness ends, the smaller will be the damage to the economy from growing federal debt. Earlier action would require more sacrifices by earlier generations to benefit future generations, but it would also permit smaller or more gradual changes and would give people more time to adjust to them.”

We could go on, but you get the picture and our mission is to help our clients’ structure portfolios to mitigate these risks, principally higher interest rates amid slower long term growth, longer term weakness in the dollar and rising inflation in the U.S. Unless (and

even if) U.S. policies regarding taxing, spending and investing in productivity enhancing capability changes radically and soon, the retiring baby boomers will be forced over time to liquidate their investments to support their declining life styles. As a group they will go from being buyers of stocks and bonds to sellers. The generations below them will be higher taxed and therefore save less as they pay for the entitlement programs supporting the baby boomers, support themselves and support their children. Many economists have opined that growth in foreign economies will provide capital to invest in the United States and foreigners will invest more in the United States due to our developed markets and legal system. That may have been true decades ago but opportunities are opening up rapidly for investors to invest globally. Money will flow to the best opportunities. Under the CBO forecast some of the best opportunities may be elsewhere and U.S. investors would be foolish to rely on foreign capital flows to take the place of baby boomers' sales. Investment patterns formed in the aftermath of World War II, when the United States had the only vibrant economy and capital market will probably not endure now that there are high growth opportunities in Latin America and Asia.

A HOLISTIC VIEW OF ASSET ALLOCATION

A portfolio is a tool to accomplish specific objectives that, while possibly similar to some other investors, needs to address each individual investor's unique cash flows, investment horizon, preferences (utility functions) for reward vs. risk, base currency and tax circumstances among other factors. Proper portfolio management requires investors to identify measure and mitigate risks to acceptable levels. M.D. Sass has proprietary models to assist clients in these calculations. Projected cash flow models can assist investors in determining the future required rate of return they need (after taxes if applicable) over the long term and its sensitivity to various inflation assumptions. Once this calculation is done, investors should also determine increases in the required rate of return resulting from interim portfolio value declines. This can help us and our clients to define in advance the level of risk they can mathematically accept and still meet their required future needs. It will also provide our clients with a means to help them determine the level of risk and required trade-offs in potential return that they can psychologically tolerate. A proper portfolio must contemplate both financial and psychological factors that investors will have to navigate in future uncertain and volatile market environments. It is a marriage of quantitative and behavioral finance. M.D. Sass' financial planning models are designed to do this in close collaboration with clients and their advisors.

Asset Allocation (as distinct from market timing) should focus on determining which mix of assets is likely to accomplish each individual client's return objective over the appropriate longer term time horizon and within the acceptable level of risk. It is a strategic decision that principally addresses issues such as:

- longer term demographic trends,
- political and geopolitical factors,
- inflation/deflation,
- interest rates and forecast changes of them,

- technological developments,
- changes in consumption patterns (for example, digital vs. analog data, energy usage, protein consumption etc) and
- relative country GDP and base currency considerations.

With these considerations in mind, investors can set minimum and maximum allocation ranges for asset classes and refine portfolio allocations within the sector allocations as cyclical factors and relative price changes drive assets above or below these ranges. Cyclical factors and relative value issues should be addressed with smaller interim adjustments within the sector allocations to reflect their out or under performance in the context of then forecast GDP, interest rate, inflation/deflation, technological changes and the like. Tactical adjustments should be still smaller and reflect shorter term considerations. This focus should be more on individual investments than on sector allocation.

Risk definition – the probability of future cash flows not being sufficient to service obligations during any relevant time horizon. The goal of asset allocation is to reduce the risk that cash flows will insufficient to meet the client’s objectives. Risk is always forward looking and for many assets will be materially different than the past, i.e. bonds of the same credit quality are much more risky at 3% yields than 10% yields (duration is longer and interest payments do not cushion price declines). Risk is often related to **time horizon** and holding power, i.e. 1 month vs. 5 years.

Purchasing power risk is the risk of liabilities growing faster than assets due to inflation or base currency declines. Mitigants:

1. Short duration high-quality bonds (such as our U.S. Government Agency short duration investment strategies)
2. High cash flow real estate with low or no leverage
3. Natural resources/commodities
4. Foreign currencies invested in 1, 2 and 3 above

Liquidity risk – ability and/or cost to access cash and/or convert an asset into cash for spending or reinvestment into more desirable assets. This risk can be priced and is like selling a time put that causes you to have to own the asset longer than your preference. Investing in less liquid assets should always include a premium potential return to compensate for liquidity risk. Mitigants:

1. Liquidity barbell – sufficient highly liquid, high quality assets to service foreseeable cash needs for a 5 to 10 year period without being forced to sell assets at an inappropriate time (such as our M.D. Sass U.S. Government Agency short duration investment strategies).
2. Excess funds can be invested to earn higher returns if liquidity premiums justify the risk.

Optionality – imbedded or explicit asymmetric outcomes in terms of probability of gain vs. loss and/or quantity of gain vs. loss. You are either buying or selling insurance.

Currency risk – asset base currency vs. liability or cash needs base currency (example: earning returns in dollars and having liabilities (cash needs) in yen).
Mitigants:

1. Industrial and precious metals
2. Energy
3. Emerging markets

Default/credit quality risk/spread risk/counterparty risk and interrelated indirect co-variance – the risk that a security's price will decline due to a perceived or actual increase in the probability of future default by the issuer or a significant counterparty of the issuer. Mitigant:

1. Short duration high-quality bonds (such as our M.D. Sass U.S. Government Agency short duration investment strategies)

Interest rate related risks (duration, convexity, yield curve risk, currency) - the risk that the net present value of a security will change due to a change in interest rates changing the discount rate applied to that security's future cash flows. Mitigants:

1. Short duration high-quality bonds (such as our M.D. Sass U.S. Government Agency short duration investment strategies)

Tax Efficient Asset Allocation (for taxable investors)

Taxable client portfolios should optimize the benefits of tax deferred vehicles (IRA's Deferred Compensation Account, etc.), the differential tax rates that may apply to capital gains, interest income and dividend income as well as efficiently using any existing capital loss and current, or anticipated operating and capital losses and carry forwards. Even for non taxed or tax deferred investors, the proposed changes in the tax rates applied to dividends, interest earned and capital gains will impact taxable investors' investment preferences and impact the prices of securities.

SUMMARY AND CONCLUSION

Over the near term, the markets will react to cyclical factors such as economic growth, employment trends, fiscal and monetary policies and potential exogenous factors such as terrorism and natural disasters. Over the long run, the success in addressing the structural deficits while stimulating growth will be a critical determinant for various U.S. capital market sectors. The outlook for politicians becoming statesmen and properly addressing these issues, in time, is uncertain. This poses a significant risk because by definition the government cannot bail itself out when its credit deteriorates. It is appropriate for investors to hold high allocations in shorter term high credit quality investments and to seek opportunities in non-correlated alternative investments, in addition to carefully selected undervalued and actively managed U.S. equity investments.

7/23/10