

Investment Outlook & Strategy Commentary

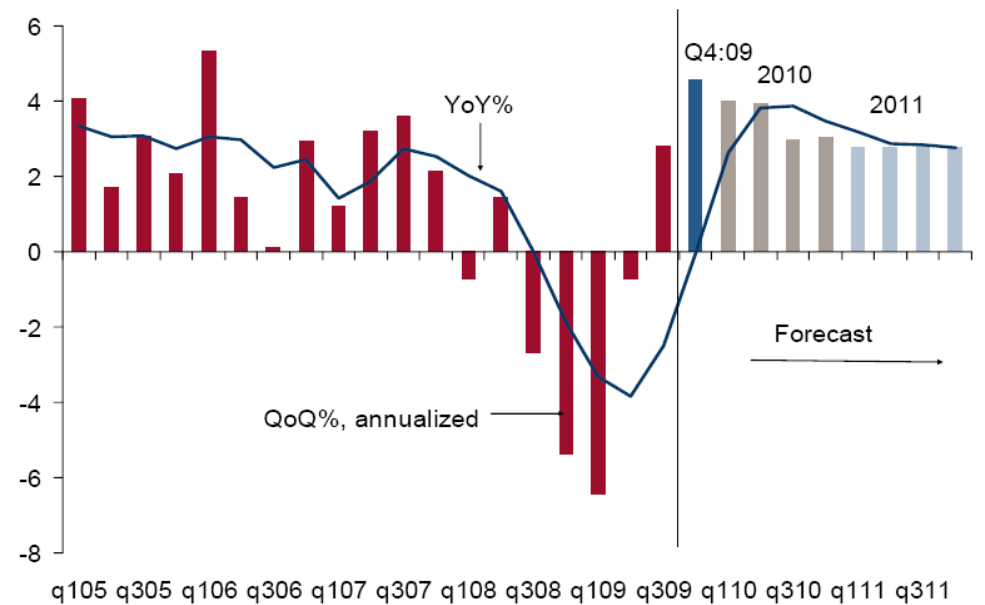
2010 - A Watershed for Global Economies and Markets

Global economies and financial markets are at a watershed. We experienced the largest globally coordinated liquidity injection and biggest credit market rally ever in 2009. In the aftermath of the unprecedented financial crisis and “Great Recession” of 2008-9, we expect the following as we begin 2010:

1) GDP growth should exceed consensus expectations – Fourth quarter GDP growth of +5.5% should be a positive surprise, although the gain was driven by policy stimulus and the inventory cycle, while final demand growth was modest.

Consensus GDP estimates are for 2.6% growth in 2010. We expect U.S. GDP growth of 4% in 2010, with a stronger gain in the first half and some slowing over the remainder of the year as the policy stimulus and the inventory rebound begin to fade. Although this is above consensus growth it is a subpar recovery relative to the 6-8% pace of historical recoveries from prior severe recessions, due primarily to the headwind of deleveraging.

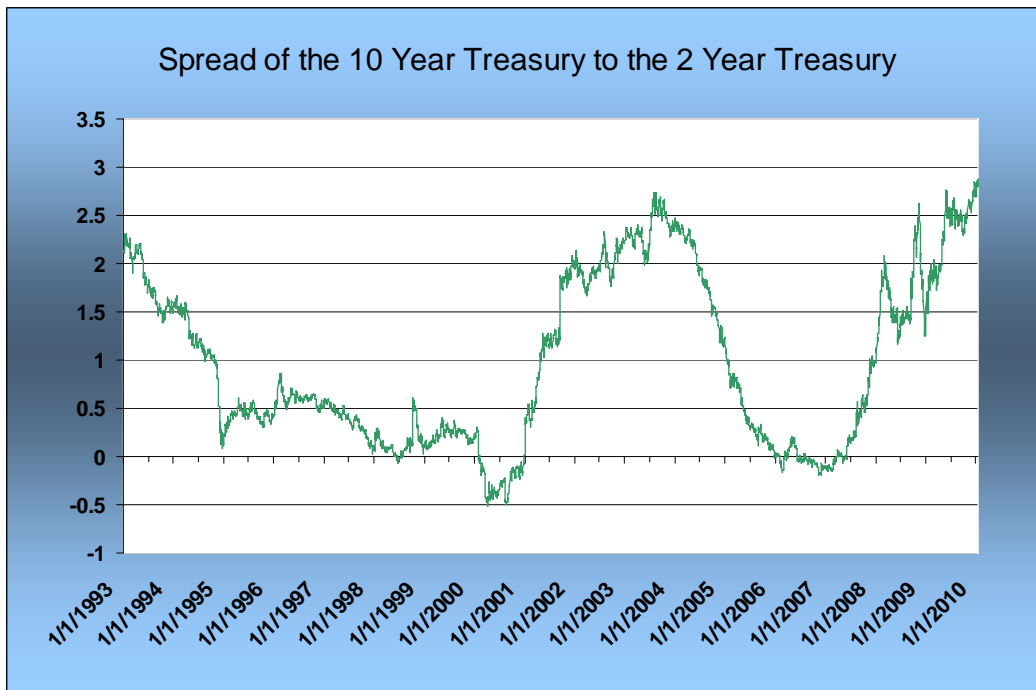
GDP Growth



We don't expect a double-dip recession because if the economy were to significantly weaken in the second half of 2010, additional fiscal and monetary stimulus would be implemented. The Administration is committed to doing "whatever it takes" to insure a successful "handoff" from government-led stimulus to a self-sustaining private sector led recovery and from an inventory rebound to a strong recovery in final demand.

Typical economic recoveries last an average of approximately 4 years, so, if typical, this recovery is still in its very early stages and we expect the drivers of emerging market growth and global rebalancing will continue. Global GDP growth is expected to accelerate to 5% in 2010, driven by an estimated 6.5% GDP growth in emerging economies, led by China at 10%, India at 8%, Russia-5.3% and Brazil 4.8%. The recovery is expected to be weaker in Europe, which may grow at only about 1.5% in 2010, and while Japan, which should grow at a mere 0.5% in 2010.

3) The target Fed Funds rate should remain near zero at least through the first half of 2010. This favors risk-related assets. The short-term risk of deflation currently is stronger than the risk of inflation so the Fed is unlikely to hike the funds rate until unemployment starts declining. However, the Fed will begin to gradually reduce the Fed's Balance sheet policies, starting with exit of the program to purchase Agency mortgage-backed securities. The yield curve from 2 to 20 years has never been steeper.



Source: Bloomberg

This “bull steepener” suggests investors aren’t yet very worried about long-run inflation or fiscal problems, and we believe a cyclical bear market for Treasuries is some months away.

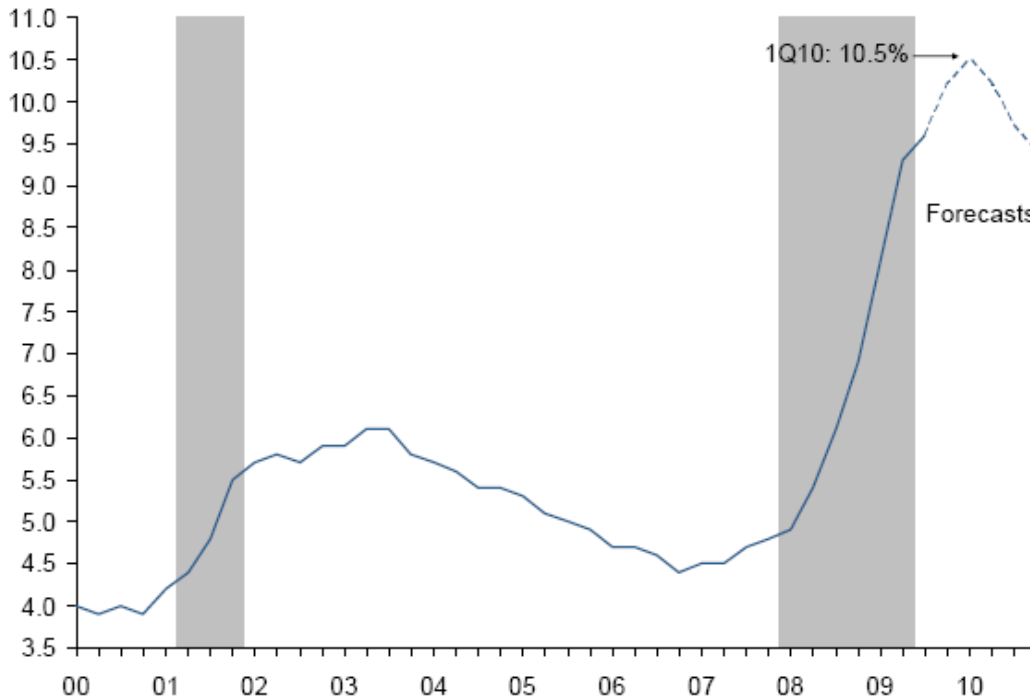
The yield curve will eventually flatten on concerns about Fed interest rate hikes on the short end of the curve. This should trigger an equity market correction. However, it is unlikely to derail the cyclical bull market because it would reflect an expectation of economic growth and a normalization of the economy.

3) We believe core consumer inflation will decline to near zero in 2010 – There is an increasing debate about the outlook for a resurgence in consumer inflation (due to massive stimulus) versus Japanese style deflation (due to the credit crisis). Neither extreme seems likely. Monetary and fiscal reflation should prevent a prolonged slump like the one in Japan during the 1990s. The headline PPI will rise near term primarily reflecting higher energy and food prices, but core inflation (excluding energy and food) should decline to around 0% in 2010 from its current level of 1% reflecting large output/unemployment gaps with most industries operating at 70-75% of capacity, weakness in residential rentals, deleveraging and global disinflationary pressures.

4) We are near an inflection point where unemployment will likely peak at 10.5% – There has been a sharp decline in jobless insurance claims but not much evidence of a recovery in hiring yet. Job creation will only be modest in 2010 because of the influx into the labor force from the large number of “discouraged workers,” totaling 7 million. It will take GDP growth of 4% or more for the unemployment rate to meaningfully decline. Thus we expect unemployment to act in a similar way as did the last two “jobless recoveries,” which we expect will keep the unemployment rate high with a peak of around 10.5% in the first half. We believe a shift in payroll growth to around 100k per month should occur in 2Q10, but it is unlikely to be sufficient to bring down unemployment.

After the worst post-WWII drop in percentage of jobs lost from peak employment, we likely are approaching an inflection point where job losses will stop. The trend is encouraging and early next year employers should start hiring, albeit at an anemic pace.

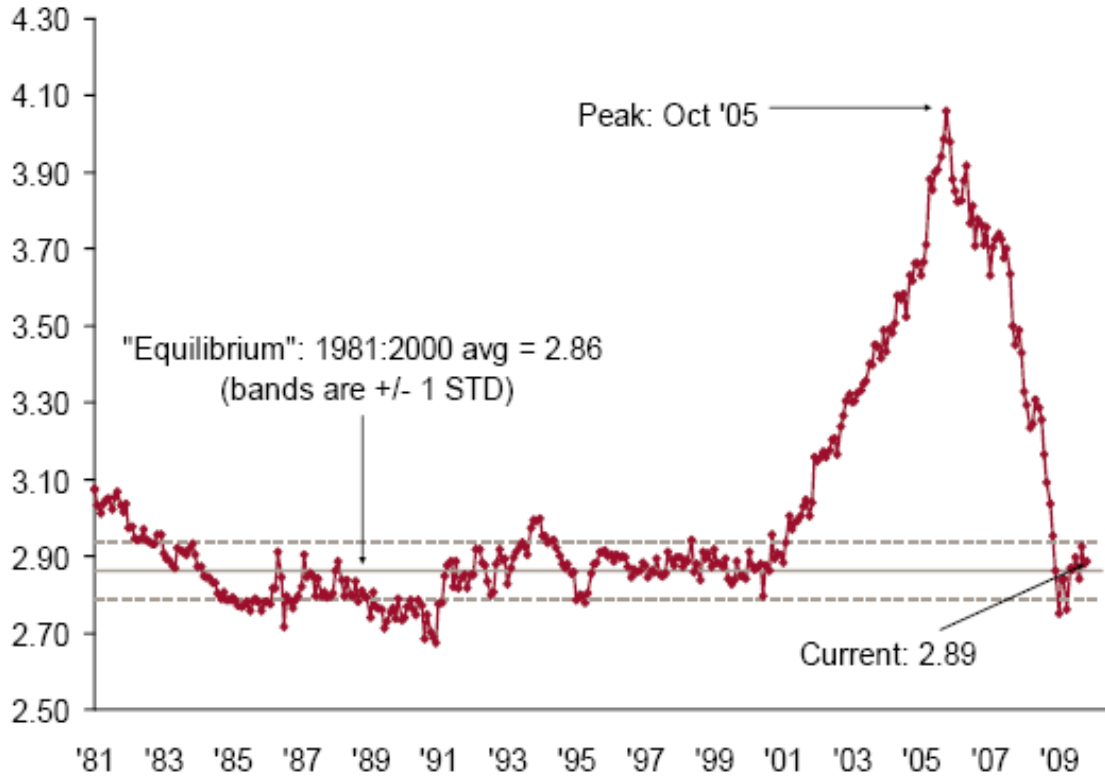
Exhibit 11: Unemployment Rate



Source: BLS, Credit Suisse

- 5) Residential Housing starts will likely bottom in 2010 and Commercial Real Estate will bottom somewhat later – We believe the bulk of the decline in housing is over, with housing starts down a huge 75% from the 2006 peak. Nationwide prices could fall another 5-15% from current levels due to significant oversupply and the outlook for more foreclosures with one in four mortgages higher than the value of the underlying house. Demand is picking up, reflecting the clearing of resale inventory, now down to 6.5 months' supply, and greater affordability as the ratio of home prices vs. median family income is approaching equilibrium.

Home Price Affordability Is Approaching Equilibrium



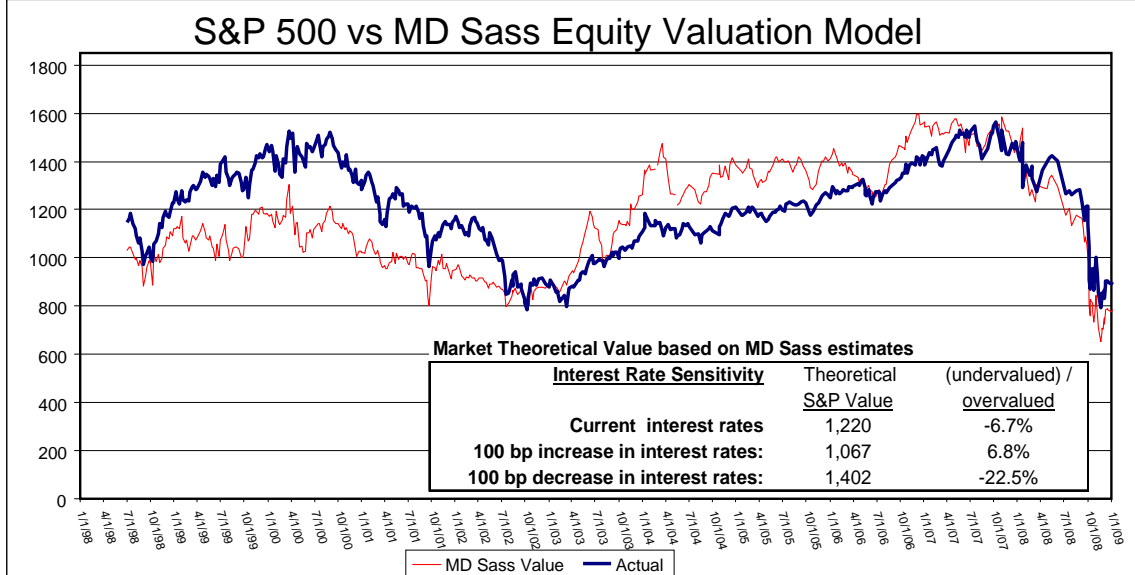
Source: NAR, Census, Credit Suisse

Commercial real estate prices continue to weaken with a decline of 44% from the peak in October 2007 is likely to bottom later than residential real estate prices.

Equity Market Outlook

The U.S. equity market is modestly undervalued based on our proprietary equity valuation model. Markets will be choppy after the huge rally from the lows without any meaningful correction, slowing growth from stimulus programs and the inventory cycle, and gradual exits by central banks in the second half of 2010. However, sharp corrections should be met with buying from investors who will continue to move capital out of near zero return money markets into higher return assets.

The next phase of the stock market will be earnings driven, rather than P/E driven from the macro dominated marketing for much of 2009, when all stocks declined in a high degree of correlation. Our equity valuation model currently suggests fair value of 1219 for the S&P 500 in 2010, which would put the S&P at 13.5 times estimated S&P earnings in 2011.



Notes:

1. Theoretical Value is based on interest rates, corporate earnings, discounted future dividends and asset prices.
2. EPS estimates for the S&P 500 are \$75 for 2010, and \$91.80 for 2011, after subtracting financial provisions and write-offs of \$31 in 2008, \$23 in 2009, and \$9 in 2010.
3. The discount rate of 4.94% is based on a blend of 10yr Corporate A / BBB bonds.
4. The S&P 500 is a value weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500 are those of large publicly held companies that trade on either of the two largest American stock market companies; the NYSE Euronext and the NASDAQ OMX. The index is unmanaged and cannot be invested in directly.

Note: The figures listed 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.

Like other rallies after steep bear markets and recessionary periods, the greatest gains from the market trough have come from low quality stocks, which have outpaced large cap, higher quality names by a large margin. The market has now transitioned from macro-driven in 2008 and the first half of 2009 to being driven by fundamental drivers (i.e., free cash flow, earnings growth, undervaluation, etc.) which favors superior stock selection. Low quality stocks which showed the sharpest gains in 2009 are the most vulnerable to selling in 2010. During the next market phase, a transition in leadership to lagging, higher quality stocks is likely.

The U.S. is also faced with structural risks due to serious economic and financial imbalances and cyclical ones as outlined below:

- 1) Increased risks from removal of stimulus and exits by Central Banks - We believe the Fed will begin to eliminate unconventional emergency liquidity tools that support market functions (versus monetary policy that targets growth and inflation). The Fed will taper off asset purchases by March 31, as part of an exit

from unconventional policy. We wouldn't be surprised to see an equity market correction when the Fed starts liquidity withdrawal and/or in anticipation of a Fed rate hike in the second half of the year. A correction would provide a buying opportunity. The uptrend in markets will likely continue since it would signal improving employment and a return of the economy to normal.

The Fed has not committed to anything beyond its clear statements since March that it will keep rates at exceptionally low levels" for "an extended period". This continuing message suggests substantial monetary ease and extremely easy global liquidity conditions for a protracted period, especially since the core inflation rate has drifted below 1.5% over the past year and Fed officials want to keep the core rate around 2% or slightly below. Easy liquidity does not imply easy credit for many businesses and consumers with low cash flows and weak balance sheets. They will struggle for a while, be forced to deleverage and this will suppress growth.

The risks associated with continuing the stimulus include creating excessive reliance on foreign creditors, keeping unproductive banks afloat and stoking inflation over the long term. Rising deficits threaten bond markets due to crowding out from the surge in supply of government debt. Accordingly, Congress may also be compelled to take the painful steps of preemptively reducing the deficit through a combination of reduced spending and higher taxes; both of which suppress economic activity.

2) The risk that asset inflation will create asset bubbles - After the recent bursting of the real estate and credit bubbles, asset price bubbles will be an emerging concern. Asset prices will matter more than consumer prices in 2010 because high unemployment, deleveraging and excess capacity will hold core consumer inflation in check next year. Potential asset bubbles range from low yielding U.S. Treasuries (side effects of a zero fed funds rate and the debt burden), to soaring Asian property prices, and to record gold prices.

Fixed Income Outlook

As expected, interest rates remained essentially low and stable on short term, high grade fixed and floating rate securities, but rose dramatically on longer duration ones.

We have advocated keeping maturities in very high grade and short to intermediate duration issues. The 1.89% increase in interest rates for a 30 year bond is a price decline exceeding 30%. For 10 year issues the 1.45% increase is a loss exceeding 10%. Accordingly, yield hungry investors paid a high price in their search for extra income instead of total return (income plus change in price).

We believe the short end of the yield curve in Agency Mortgage-Backed Securities (MBS) continues to offer compelling relative values and opportunities to acquire securities at inefficient below market prices. When we speak of high grade issues, it is worth noting that aside from U.S. Government and Agency issues, there are only four Aaa corporate bond issuers left: Automatic Data Processing, Exxon Mobil, Johnson & Johnson and Microsoft. They remain Aaa because they are consistently very profitable companies with little debt outstanding relative to their shareholders' equity and profits. The ranks of Aaa's have also been severely reduced by excessive leverage, poor earnings coverage or both. In contrast, the government backing for U.S. Government Agency Mortgage-Backed issues remains strong and was recently strengthened to remove any doubt about the government's intention to support these cornerstones of the housing industry and a huge component of bank and insurance company portfolios.

As we enter a new decade, we would like to break our investment considerations into two time frames: The recovery from the "Great Recession" and related capital markets meltdown, and secondly, the visible longer term issues that will confront investors. Lastly, we will summarize some investment strategy recommendations.

The Short Run – What is likely Over the Next 12 - 18 Months?

1. The trajectory of the U.S. economy will be positive but bumpy. On the low end of the bumps, concerns about a double dip may resurface providing entry point opportunities for patient investors who feel they have missed the market.
2. Job creation will be slow and unemployment will remain stubbornly high. Low skilled workers will bear the brunt of intractable unemployment.
3. In the United States unemployment will, for a while, look as if it is declining as the government adds approximately 700,000 temporary employees for the 2010 census.
4. Congress and the President will be concerned about the impact on the Senatorial and Congressional elections in November, creating the possibility of new stimulus programs but at the cost of a further expansion of the U.S. budget deficits.
5. Consumer spending will remain sluggish as consumers seek to pay down expensive debt and restore their financial equilibrium. (See Baby Boomer Retirement Plan discussion below).
6. Continued high levels of Treasury offerings, mortgage financings and municipal bond offerings will exert upward pressure on the intermediate and longer end of the yield curve while the Fed attempts to keep short term interest rates low to energize the economy and create a very profitable "carry trade" for U.S. banks to enable them to restore their balance sheets without further overt government assistance.

7. High growth Asian economies will likely remain fast growing but will feel the impact of lower U.S. and European consumer demand. They will use infrastructure spending and domestic consumption to keep workers employed and political stability intact.
8. Economic problems in Greece, Turkey, Iceland and Spain (among others) will likely put pressure on the concept of a homogenous Euro as the lesser performing countries will not be able to stimulate growth and employment by deflating their currencies to create demand for their products and services.
9. Central and Latin America, led by Brazil and Mexico, will continue to grow, fueled by energy, agricultural products, raw materials exports and in the case of Brazil, manufacturing.
10. In the United States, we believe inflation will remain low, but inflation concerns will pose a danger to the bond market as investors become increasingly concerned about the longer term inflationary outlook fueled by increasing government debt.
11. U.S. income tax receipts may get a temporary boost in 2010 and 2011 as some holders of large traditional IRA's convert to Roth IRA's. In so doing they will pay the income tax in these years on the accumulated taxed deferred retirement accounts funded over many prior years. Subsequently, they will not have to make mandatory withdrawals or pay income taxes on the principal or income. In so doing, the government is essentially front loading these tax receipts into 2010 and 2011.

Intermediate Term Considerations for the Next 5-10 Years

The markets are a discounting mechanism, factoring in both future cash flows and risks to them. How quickly investors shift focus from the near term issues to the longer term ones is quite variable and unpredictable. For example, the housing bubbles lasted for several years after abuses of sub-prime and Alt-A mortgages fueled unsustainable price levels. Their related problems were well known, but the timing and ultimate consequences were not. Below we list a few of the major currents we believe that investors will have to navigate at some point in time in the future. When they will impact the equity and debt markets and from what levels is uncertain, but they will. Consequently, investors need to keep them in mind and have a disciplined investment strategy that addresses them.

Tax Revenues are Under Pressure and So is Credit Quality

Federal, state and local tax receipts are funded by income taxes, capital gains taxes, sales taxes and real estate taxes. High unemployment, declines in equity markets, low interest rates and declining property values reduce tax revenues. At the same time, unemployment benefits, increased "forced retirement", cost of living adjustments, the aging baby boomers beginning to collect Social Security payments and Medicare/Medicaid benefits plus the costs of the likely new health insurance legislation will swell government payments. The combined impact will create large government deficits for the foreseeable future for the federal

government as well as many states and municipalities in addition to the enormous, long term and well known federal financing needs.

Unfunded Municipal Pension Funds

Wilshire Associates reports that the 59 state plans that reported FY 2008 data had a funding ratio of 77%, down from 88% for those plans in FY 2007. *(Our note: this shortfall exceeds \$400 billion of future unfunded obligations to an aging population of state and local Government employees and at a time when many municipalities are already under extreme budgetary pressure.)*

Are You Getting Paid for the Risks in Municipal Bonds

Despite the concerns about long term municipal credit problems, investors are demanding relatively small premiums to buy muni bonds vs. Treasuries. Below is a chart of the current yield spreads assuming a 35% tax bracket. The average owner of muni bonds is in a 28% tax bracket.

As can be seen, in the 2 through 7 year maturities investors actually receive lower after-tax income by owning Aaa muni bonds than they would get owning Treasuries. A year ago, in the recent market crisis muni yield spreads soared creating large losses for muni bonds holders. Credit problems and an avalanche of new issues could precipitate another scare in the muni market.

MUNICIPAL INTER-MARKET YIELD HISTORY				
	1	2		
	GO-AAA	TREASURY	SPREAD	
	12/31/09	12/31/09	(+/-BPs)	%
1 Yr	0.310	0.320	-1	96.8
2 Yr	0.620	0.749	-13	82.8
3 Yr	0.890	1.082	-19	82.3
4 Yr	1.240	1.415	-17	87.7
5 Yr	1.660	1.761	-10	94.3
7 Yr	2.430	2.223	21	109.3
10 Yr	3.260	2.550	71	127.8
15 Yr	3.860	2.988	87	129.2
20 Yr	4.070	2.996	107	135.8
25 Yr	4.430	2.977	145	148.8
30 Yr	4.470	3.013	146	148.4

Source: Bloomberg

Strategy Recommendation:

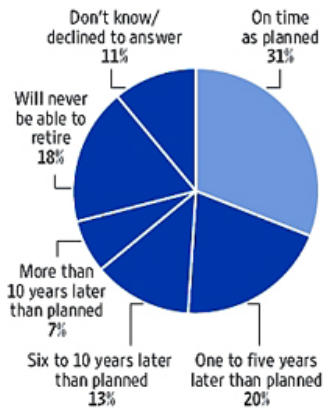
Investors should restrict fixed income portfolios to 1-7 years with a 3-4 year average duration at most and holding only Aaa pre-refunded, general obligation and essential service revenue bonds. Ignore credit rating derived solely from municipal bond insurance companies and look only to the underlying credit of the issuer. Alternatively, investors should consider taxable U.S. Government Agency (Aaa) Mortgage Backed issues in the 1-3 year duration range. They provide higher after tax returns than comparable municipal issues, as well as higher credit quality.

Consumer Spending Makes the States Go 'Round

Consumer spending accounts for approximately 70% of U.S. GDP. The Baby Boom Generation and retirees account for more than 30% of the population above 20 years of age (i.e., the people, earning money and presumably, with money to spend).

Delaying Retirement

When asked how the financial crisis has affected the timing of their retirement, surveyed workers said:



Source: Bankrate Inc.

Only about one-third of workers, according to a survey in September by Bankrate Inc., said the recession hasn't affected their planned retirement date. One in five workers said they anticipated leaving the office between one and five years later than first planned.

Nest Eggs

Only about one-quarter of workers age 55-plus have savings and investments (excluding homes or pensions) that total \$250,000 or more, according to the non-partisan Employee Benefit Research Institute, based in Washington, D.C. More worrisome: **59% of this group reports having less**

than \$100,000. (Emphasis added. Our note: tie this into healthcare spending reported later in this Outlook).

Almost half of workers, according to the Employee Benefit Research Institute, ended up leaving the office earlier than anticipated. The primary reasons: health problems or disability (42%) and changes at their company, including downsizing or closure (34%).

These two factors—inadequate savings, coupled with a need, in many cases, to tap those savings earlier than anticipated—could place millions of Americans at risk of being unable to maintain their standard of living in retirement. The National Retirement Risk Index, a detailed measurement of Americans' finances published by the Center for Retirement Research at Boston College, estimates that 44% of U.S. households could find themselves in this boat.

Close to half of workers approaching retirement had the bulk of their savings in stocks on the eve of the 2008 market meltdown, according to the Employee Benefit Research Institute. (Twenty-two percent of older workers had 90% or more of their 401(k) assets in equities.)

Vanguard Group, in a survey of its defined-contribution plans, with more than three million participants, found that only one in five workers approaching retirement made the maximum contribution to their employer savings accounts.

Now for the health care tie in. Furthermore, most people continue to underestimate health care expenses when planning for later life. A worker generally retires at age 65 in 2009 without employer health benefits. Starting with out-of-pocket health costs of \$900 in the first year of retirement, how much savings will this new retiree need to have a 50% chance of covering the cost of health insurance premiums (for a Medigap policy, as well as Medicare Parts B and D) and out-of-pocket drug expenses in later life? Again, these figures, from the Employee Benefit Research Institute, represent only a 50% chance of success. (The number for women reflects their greater longevity.) To have a 90% chance of covering health costs in later life, a newly retired man would need \$177,000 in savings, and a woman would need \$221,000. **As stated previously, 59% have less than \$100,000. The money for healthcare will have to come from abstaining from other forms of consumption.**

Social Security

If Social Security, according to the agency's board of trustees, will provide approximately one-third of the amount needed for retirement. The single best cure for a battered nest egg is to work longer. (*Our question: Where will the jobs come from for these older workers?*)

Investment Strategy Implication

After decades of being net savers and investors, in the next 5 - 10 years, the Baby Boom Generation as a group will be forced to liquidate their accumulated savings and retirement fund portfolios to pay for their retirement living expenses. While many individual portfolios are small, as a whole they will represent a very significant change in investment flows from buyers of mutual funds to sellers and perhaps a partial re-allocation from equities to fixed income.

Low Interest Rates Have Helped the U.S. and Other Governments Finance their Stimulus Programs and Related Debt

Currently the U.S. is financing more than \$1 trillion in deficits per year. Interest payments on this new issuance and existing debt are historically low and likely are at unsustainable rates, particularly on the short end of the yield curve. As this debt matures and it, along with new issuance, is sold at potentially higher interest rates, the interest cost alone of this expanding debt will exert enormous pressures on the U.S. budget and, potentially, currency values, inflation and economic growth.

The national debt now exceeds \$12 trillion (\$39,300 per person in the US) and is forecast to grow at \$1 trillion per year for the next several years. Total borrowings to cover new issuance and maturing debt over the next three years exceed \$5 trillion. A modest one percent increase in interest rates on this debt would be an extra \$50 billion a year increase in the budget deficit. Even the White House estimates that the government's tab for servicing the debt will exceed \$700 billion a year in 2019, up from \$202 billion this year, even if annual budget deficits shrink drastically. Other forecasters have much higher estimates. To put this in

perspective, an additional \$500 billion a year in interest expense would total more than the combined federal budgets this year for education, energy, homeland security and the wars in Iraq and Afghanistan. This is without the potential additional costs of the proposed national health care legislation.

These deficits and the related funding costs are on a collision course with the accelerating unfunded costs of Social Security and Medicare resulting from the aging Baby Boomers.

The United States will not be the only government competing to refinance huge debt. Japan, Germany, Britain and other industrialized countries have even higher government debt loads, measured as a share of their gross domestic product, and they too borrowed heavily to combat the financial crisis and economic downturn. As the global economy recovers and businesses raise capital to finance their growth, all that new government debt is likely to put more upward pressure on interest rates.

Summary

1. Equity portfolios always need to be rigorously researched, actively managed with a focus on financially strong companies selling at compelling relative valuations to their projected future cash flows with attractive risk/reward ratios.
2. Alternative investments in high yield direct lending, industrial metals and mining, asset-backed securities and tax liens are compelling strategies that should be considered as a less liquid but higher yielding supplement to both bonds and equities.
3. Fixed income portfolios should emphasize actively managed short duration (1-3 year) U.S. Government Agency MBS.

January, 2010