Quarterly Market Letter

Second Quarter 2010

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- Near end of equity market correction
- Expect economic recovery to be uneven and challenging
- Core CPI under 1%, multi-decade low
- Maintaining shorter relative duration
- Short-term interest rates to stay extremely low

Introduction

After an almost continuous rise over the last 12 months, the equity market is finally undergoing a correction. The 2nd quarter finished at a low point, retreating a full 15% from the highs set in late April. For the quarter, all the major domestic equity indices were down 10-12%, and international markets didn't fare any better with the EAFE (Europe, Australasia and Far East) index down almost 15% in U.S. dollars. On the other hand, fixed income markets are now once again moving inversely to stocks. As fears of a global growth slow down increase, the relative safety of fixed income has led investors to bid up prices, especially for the highest rated securities, U.S. Government bonds. The Barclays U.S. Treasury index produced a 2nd quarter return of +4.7% and is now up almost 6% year-to-date where as the S&P 500 is down 6.6%.

While many investors entered the quarter with some skepticism after a 12 month 60+% run up in stock prices without a single pull back of 10% or more, the severity of the May / June plunge in the averages has taken almost everyone by surprise. The re-emergence of financial problems in Europe has taken center stage, but has been accompanied by several other major economic problems including the tragic Gulf of Mexico oil spill and the growth slow down in China. Fortunately, we see these problems diminishing over the next 3-6 months. While we have shaded down our already soft economic outlook, we still believe that this long overdue correction will reverse as the global economy continues to grow into 2011.

Domestic Economy

The U.S. economy was unable to sustain last year's strong 4th quarter momentum during the 1st half of this year. Beset by numerous headwinds and a more temperate consumer, the final revision for the 1st quarter GDP (Gross Domestic Product) registered growth of 2.7%, which was decent but not great. So far in the 2nd quarter, indications are for another similarly tepid increase in GDP of 2.5% to 3%.

With economic growth less than 3% in the 1st half, the current recovery is falling short of potential GDP as well as the typical snapback seen after previous recessions. It has been and remains our contention that since the severe recession of 2008 – 2009 was primarily due to a financial crisis and not a more traditional business cycle contraction, that this recovery would be uneven and challenging. As a consequence of the financial meltdown, a protracted period of deleveraging on the part of consumers, businesses and eventually even governments is defining this recovery. The direct result has been reluctance on the part of consumers to spend, businesses to hire and the government to renew fiscal stimulus. Therefore while the economy is growing, it is doing so at a much slower pace than in prior cycles. Nevertheless, it remains our belief that while the economy may be stumbling around trying to gain traction, it is not about to stall out.

One of the more forceful headwinds to develop has been the Euro debt crisis. It has sorely buffeted the global financial markets as well as clouded the outlook for the economy. Europe's sovereign debt woes, Greece's in particular, has forced the very conservative ECB (European Central Bank) to adopt their version of a bailout by employing monetary easing to stave off defaults. The price that is being paid by the EU (European Union) is a weakened Euro currency, slower near-term economic growth and a move towards austerity. The impact of all this turmoil to the U.S. economy is expected to be modest and not sufficient to derail the U.S. recovery. Exports to Europe last year were $461 billion and accounted for an estimated 30% of all U.S. exports. While this seems like a large number, it is a little less than 3% of total GDP activity. If exports to Europe were to be cut by 20% (an unlikely scenario) that would deduct only 0.5% from our 2010 economic forecast, a very modest hiccup at worst. In addition, U.S. banks' ownership of the weakest of the Euro zone sovereign debt is estimated at only just over 5% of all liabilities. Banks in general are now much better capitalized and well able to withstand any possible damage caused by a European credit crisis. One benefit from the European situation is that the FOMC (Federal Open Market Committee) is now exercising greater caution in their outlook for the U.S. economy. As a result, interest rates are likely to stay extremely low even longer than previously expected.

A second overseas development that has caused some consternation in the financial markets is China's efforts to curb property speculation by tightening credit. China has been and should continue to be an engine of global growth for some time to come. It is important for maintaining global growth that Chinese authorities orchestrate a soft rather than a hard landing in their attempt to cool down what was becoming an increasingly overheated economy. China's GDP grew at close to a 12% annual growth rate in the last quarter. A slowing to a still strong 8% – 9% annual rate by next year would achieve the desired soft landing. With about 27% of our exports flowing to Asia, continued growth in that region can offset lackluster demand from Europe. The recent move by China towards greater currency flexibility is also very constructive for the U.S. in the long term. Allowing the Yuan to move upward against the dollar, even if only by 2%

so far, makes our exports less expensive and will potentially stimulate greater consumption on the part of the Chinese.

Turning back to the domestic economy, a flurry of recent disappointing reports have raised doubts over the sustainability of the recovery. Consumer confidence for the month of June, as measured by the Conference Board's Consumer Confidence Index, fell an alarming 10 points to 52.9 due to concerns over the job outlook. Additionally the ISM (Institute of Supply Management) manufacturing index came in at 56.2 for June, a six month low. However, bear in mind that a reading above 50 indicates that expansion is still ongoing in the manufacturing sector and that June was the 11th consecutive month above 50. Manufacturing has been an important source of job creation over the past few months and it is important that this sector remains stable.

Housing has been in disarray in the aftermath of the expiration of the new home buyer tax credit at the end of April. In May, existing home sales fell 2.2% while housing starts declined 10%. Even more alarming, new home sales collapsed 32.7% to the lowest reading on record. It is becoming abundantly clear that the housing sector, particularly without the benefit of substantial tax credits, will remain depressed and not provide any boost to the economy anytime soon. Finally, the consumer continues to show restraint in their spending due to persistently high unemployment as well as the need to improve stretched household balance sheets. Consumption is definitely lagging income growth, so the savings rate is moving up. As a result, May Retail Sales fell 1.2%, the largest decline in the past eight months.

Despite these recent downbeat reports, there continues to be a number of important positives underpinning this recovery. Capital spending, especially on equipment and software, remains quite robust. After the massive decline in business spending during the last recession, Capital Expenditures have been growing at an over 10% annualized rate since the 4th quarter of last year. Another double digit increase is expected for the 2nd quarter of this year. Corporations have a record amount of cash on their balance sheets and we expect them to continue to deploy excess cash to replace their rapidly depreciating capital stock in order to maintain margins and stay competitive. Despite Europe's malaise, U.S. exports should be a solidly positive contributor to GDP as consumption patterns of leading emerging economies such as China, Brazil and India remains strong. Inflation continues to be remarkably tame even with the economy entering its second year of expansion. Virtually all inflation measures, whether the core CPI (Consumer Price Index), core PCE (Personal Consumption Expenditure Index) or the core PPI (Producer Price Index), are within a range of 1% - 2% on a year-over-year basis, well within the Federal Reserve's comfort zone. Core CPI has recently fallen to under 1%, a multi decade low, reflecting the substantial amount of slack that still exists in key parts of the economy. Low levels of inflation should allow the Fed to keep current historically low interest rates unchanged into 2011. The benefit to the economy of near zero short-term interest rates can't be understated.

The recent mixed signals given off by the labor market has worried investors and called further into question the economic recovery itself. Job creation in the private sector has averaged only 58,000 over the past two months, well below expectations. Still it is important to note that the economy is adding rather than shedding jobs. The unemployment rate did drop to 9.5% in June due mostly to a large number of individuals dropping out of the work force. Progress in the labor market is crucial to incomes, consumption and ultimately the sustainability and the pace of the recovery. The current state of the job market does reinforce the notion that the pace of the economy is slowing as we enter the 2nd half of the year.

While there may be some highly visible storm clouds hovering over the economy, we are not one of the increasing number of forecasters calling for a “double dip” (a slide back into negative GDP for at least one quarter). We believe that prospect is quite remote. Rather, the 2nd half of the year should feature an economy that finds itself in transition from being infused with substantial fiscal stimulus to one reliant more on the private sector to create jobs and provide traction. Recognizing these headwinds, we are scaling back our full year 2010 real GDP growth forecast from 3.0% to 2.5%. Our inflation forecast remains very subdued calling for a headline rate of just below 2.0% and core CPI of only 1.2%.

Certainly judging by the performance of the stock market in the 2nd quarter, it would appear that investors have already made an adjustment to the perceived slowdown in the economy. Looking out further into 2011, the opportunity for more favorable returns from the financial markets should be much improved as the economy continues to expand.

Fixed Income

Uncertainty in the domestic financial markets, triggered by continuing foreign events, resulted in a significant flight to quality in the second quarter. This benefited U.S. Treasury security yields at a time when it is most needed, by lowering the net interest cost to the Treasury of frequent bill, note and bond auctions. These underwritings are needed to finance the huge budget deficit that is projected to exceed last year's $1.4 trillion of red ink. The 2-yr, 10-yr and 30-yr maturity issues saw their yields decline by 41bp, 89bp and 82bp, respectively for the 2nd quarter and are now yielding only 0.60%, 2.93% and 3.89%. While the 2-yr yield is at a record low yield level, the 10-yr and 30-yr issues are still considerably above the lows of 2.02% and 2.58% set at the worst point of the financial crisis at the end of 2008.

While spread product, both corporate and municipal, provided a higher level of excess returns during the 1st quarter, the tables were turned in the 2nd quarter as Treasuries led the positive performance parade. In fact, as measured by the Barclays Family of Fixed Income Indices, only the High Yield sector reflected negative results for the recent quarter coming in at -0.11% for the overall index. In essence, the reality of stronger headwinds to the economic outlook has resulted in some degree of risk aversion to the more speculative grade of fixed income investments. The investment grade Barclays Credit Index OAS (Option Adjusted Spread) which had narrowed in early April to only +127bp, widened in a volatile fashion by quarter-end to +179bp, just short of the high spread of +182bp for this year.

Despite the difficult market conditions, the Barclays Government / Credit Intermediate Index achieved a positive return of 2.97% for the 2nd quarter. Added to 1st quarter results this brings the cumulative year-to-date performance to just over 4.5%. Therefore an allocation to a diversified taxable bond portfolio of investment grade bonds has provided a good positive buffer to the volatility experienced in the equity markets.

Taxable Strategy

Currently we are maintaining a shorter relative duration bias for our portfolios. At this point in the interest rate cycle, absent another systemic meltdown, it is hard to foresee interest rates declining significantly. However, there may be times when it is prudent to be neutral or long to the index duration target because of market over-reaction to an event.

Likewise, we will maintain our overweighting to corporate bonds, as we believe there has been a silver lining to this weak recovery as corporate balance sheets have improved dramatically. This has occurred due to a lack of significant capital expenditures, delays in adding to staff and de-leveraging. The improved cash flow positions have been used broadly to repay short term bank borrowings and reduce the need to issue intermediate and longer term debt. Essentially, it has translated into fewer taxable bond underwritings. Lower levels of new offerings, stronger credit metrics and improved balance sheets should continue to provide favorable results for investment grade corporate bonds. We look for corporate spreads to stay within a tight range and provide near term excess returns.

We will also maintain our reduced TIPS (Treasury Inflation-Protected Securities) exposure (now neutral weighted) given the changing dynamics of the CPI series. As we drop out the larger positive monthly changes of 2009, the 2010 CPI will trend downward. We are also maintaining an underweighted exposure to Government Agencies given the narrow risk premium spreads that prevail and the likely increase in supply dynamics as the GSEs (Government Sponsored Enterprises) accelerate the purchase of mortgages into their asset base replacing the Fed's purchase program which has expired. The exposure to treasury securities will remain neutral weighted, at least on a contribution to duration basis, as a hedge against further uncertainties.

Municipals

The 2nd quarter ended on a firm note with yields declining across the maturity spectrum. However, the absolute level of decline was small relative to treasury securities, ranging from only 2bp to 19bp, with the 7-yr to 10-yr maturities being the main beneficiary. With investor demand remaining constant, the main driver of the change in yields was a reduced supply of tax-free bonds due to increased use of taxable BABs (Build America Bonds) by the bigger issuers. BABs are 25% of the new issue supply this year which has reduced the primary and secondary sources of traditional tax-exempt municipals. However, with the flight to safety and quality focus, the Municipal / Taxable Treasury ratios increased to more attractive levels, 85% at 2-years to over 111% at 30-years.

Headline risk is a constant factor in the marketplace. We believe this will continue for some time. Furthermore, as we have already experienced, the same stories will be repeated ad-infinitum using different twists to heighten the fear factor. The stories will vary from budgetary stresses, unfunded pension liabilities, OPEB (Other Public Employee Benefits) and potential defaults. We believe most of the stories are overstating the negative near term effects, and that there will not be widespread defaults. Investors need to recognize that unlike the possible limited life of a corporation, State and or local government entities will continue to exist. That fact is relevant when reviewing the statistical disparity for levels of default. The most recent available data reflects that investment grade muni defaults are now less than 0.2%, with a majority occurring in the health sector. While we agree that there will be events of default in this environment, it should not occur in the more mainstream issuers and those with more seasoned tax bases and favorable demographics. Rather, defaults may be a factor in smaller communities that are mostly residential. We continue to avoid these entities along with the weakly covenanted structures that include COPs (Certificates Of Participation), Tax Allocation, lease obligations and Special Assessment Districts. The bigger near-term risk for many municipalities is down grade risk and its effect on the pricing of existing securities. This situation also requires constant monitoring.

We believe that unfunded public pension liabilities have been given heightened near term sensitivity when it really is a long term problem and it cannot be used as grounds for defaulting on debt obligations. There are solutions to shore up the gap including the issuance of taxable POBs (Pension Obligation Bonds). It should be noted that recently released statistics show that on average State and local government pension plans were over 80% funded. That statistic does not support an imminent implosion by municipalities. If investment returns come up short of expectation and shoring up the deficit is not addressed it will become a significant problem in time but it is not an immediate crisis.

Since June 30th is the end of the fiscal year for many state and local governments, we expect to see numerous headlines regarding the ramifications from the delay in establishing required balanced budgets. The tough decisions of slashing services, raising taxes and fees will be facing every State and local government. So far we have seen evidence of these negotiations successfully occurring across the nation. The process will be slow and painful but they all will have to keep working to cut costs. This is not the first time governments have over spent in the good times and then had to rein in their budgets.

Strategy

While some investors might find the current municipal environment disconcerting, we view it as one of opportunity for those issuers and structures that we deem acceptable. We feel there is value in the general obligations of select states debt that may be the victims of negative press. As such, we continue to favor essential service revenue issues which have performed well in this environment. Also, pre-refunded exposure is a must if adequate documentation is obtained and yields meet breakeven requirements. We are maintaining our duration target at this time which is consistent with our taxable styles. Finally, due to municipal / treasury ratios rising significantly, we will be transitioning blend style accounts to all municipals if breakeven requirements are exceeded.

Equity Outlook and Strategy

The equity market is suffering from the difficult realization that the economic recovery is not going to be as robust as had been optimistically forecast at the beginning of the year. It has not reacted kindly to being derailed from its 60% year-over-year rise. The reality is that the forecasts were too high and a correction was inevitable. The bad news is that we are in a correction, but the good news is that it is a correction. There is a lot of difference between 2-3% GDP growth, and one or more negative quarters which would constitute a double dip recession. We are likely to experience a slow but methodical march forward which will see continuing positive earnings growth generated from modest economic and top line revenue growth as the economy slowly recovers. The positive earnings growth along with current P/E ratios of 12x based upon 2011 earnings should provide the market with a base within 5% of current levels and a foundation to move significantly higher over the next 12-18 months.

We had been expecting that economic growth would be slower than the consensus projections at the beginning of the year. Thus we had slowly shifted the portfolio towards more defensive sectors such as healthcare and staples, and away from cyclical holdings in energy and materials. In May and June the price of oil dropped more than 15% and energy stocks moved downward almost in lockstep. Since we think that the global growth situation will remain muted, we do not look for a recovery in this area until 2011. Oil prices could even drop temporarily into the $60s as both the U.S. and Chinese economies seem to be slowing at the same time.

With the recovery underway, companies are willing to spend some of their excess cash to increase both capacity and efficiency, as is reflected in the very high reported productivity increases in the U.S. This approach emphasizes technology and software. On the other hand, companies do not feel a need for major additions to plant and equipment, as utilization rates remain low and demand is growing quite slowly. So increased expenditures for heavy capital goods have been almost entirely due to government programs and Asian demand. With stimulus spending peaking in 2010, we have continued to emphasize technology as a more durable beneficiary of the recovery.

Congress has been very busy during the first six months of the year. Their most recent efforts on the financial regulatory front comes to over 1,300 pages as the new Dodd-Frank bill. This bill will force banks to take less risk and, we think, earn less money in the future. While it will take several years for the full impact to be felt, the earnings recoveries for these companies will be stunted by caps on many parts of their most profitable businesses plus much higher compliance costs with the new watchdog Consumer Financial Protection Agency. We are also waiting before making new purchases until these companies restore their dividends which now looks like it won't be until well into 2011.

The health care sector is still trying to get to the bottom of the reform bill passed in March. As most of the changes were well advertised, the sector underperformed last year and in the 1st quarter of this year, but has now begun to outperform. While more regulation hurts the sector, the valuations of many healthcare companies are the lowest in more than a decade, so these stocks look quite attractive on a longer term basis.

Though 2nd quarter earnings should be good and year-over-year comparisons to the 2nd quarter of 2009 should make the headlines sound quite healthy, there are several negative influences that will have to be closely watched. Slow economic growth, the recent decline in the value of the Euro which effects international profits, changing tax rates and a cautious consumer will all contribute to companies reporting better current profits, but issuing very conservative future guidance. This will all reaffirm the slow growth pathway and that we are going to have to live with it as we grind our way up the hill.

Conclusion

While equity markets have taken a significant setback, we see this as a normal reaction to the huge gains of the last 12 months. Doubts about economic growth will continue to occur sporadically, but this is normal in most recoveries. Even though these are trying times, we look for both the economy and the markets to make solid progress over the next 12-18 months and with prices now more than 10% below last quarter we find many stocks very attractive.

The market will likely fly along on auto-pilot for the next few months being rocked by turbulence from every gust of wind and storm on the horizon. But there is still fuel in the tanks, all motors are running and it is slowly picking up speed. Now is the time to tighten your seat belt, keep a firm hand on the controls and search for new opportunities.