

June 2010

## QUARTERLY REVIEW AND OUTLOOK

“High Anxiety” is the most appropriate description of the mood of investors and the state of global securities markets during the past two months. Following improved conditions in most markets during March and April, a confluence of events caused a sudden shift in confidence about economic fundamentals and financial system stability. Because anxiety feeds upon itself, disparate incidents such as the Gulf oil rupture, sovereign debt concerns in Europe, potentially stringent new financial industry regulations, China’s economic prospects, heightened tensions in Korea and the Middle East, and uncertainty about tax changes in several key countries resulted in sharply increased market volatility and downward price pressures in the majority of world stock and bond markets.

It is always instructive to observe the reactions of individuals and groups to the realities of supposedly anticipated or predicted occurrences when they actually arrive. For a prolonged period, numerous market observers and experienced investment strategists had been maintaining that a “correction” in the global equity markets would be a healthy event, given the widespread and large price gains since March 2009. As stock and bond prices began to slip in early May, the desired beneficial correction quickly raised fears of a new “bear” market because of perceived slowing economic momentum in the U.S. and worries about the capital adequacy of many European banks. Be careful of what you wish for!

So, now we are once again assessing the important questions of growth in the U.S. and the global economy and whether the Eurozone has adequate policies and sufficient financial firepower to deal with the solvency issues confronting certain nations and the liquidity facilities to support the banking sector. These issues are clearly serious and have widespread implications. We are not in the Pollyanna category, and we recognize that these questions cannot be answered with complete assurance. But, we do believe that the fundamentals thus far are supportive of outcomes far better than those in the pessimistic camp.

Much has been made recently of the sluggishness of U.S. private sector employment growth and the slowing in the index of leading economic indicators. While everyone would prefer V-shaped recoveries in all economic measures to be the rule, there are unique conditions at work in each cycle; and, these forces have to be understood and evaluated in the proper context. The sharp economic contraction of two years ago was precipitated and exaggerated by the collapse of the housing and commercial real estate industries. The resulting turmoil in the banking and credit market sectors led to sharp reductions in employment levels for virtually all business areas because of liquidity concerns and a drastic reduction in bank lending.

A return to sustained employment gains in the important housing/real estate areas will likely be very slow. Service industries are just beginning to expand employment as consumer incomes have stabilized and confidence surveys have improved. The broad technology and manufacturing sectors are experiencing positive sales growth and are beginning to accelerate already-positive hiring trends. On balance, it seems realistic to expect sustained, but moderate, improvement in employment in the next eighteen months as corporate sales expand, average work week measures return to normal, and smaller businesses regain greater access to bank credit.

Another prominent worry has been a slip-back into recessionary conditions in the U.S. The obvious headwinds working against a ramp-up in near-term economic growth include the restrained tone of consumer spending, the lack of recovery in housing, the financial strains in state and local governments, and the uncertainties posed by potential regulatory and tax changes. Providing positive impetus and support are the growing flows of project-targeted stimulus funds, rising foreign demand for an expanding array of U.S.-sourced products and services, continued gains in productivity measures, further growth in corporate profits and cash flow, new capital spending, inventory restocking, and accommodative monetary policies. As we wrote nine months ago, and feel the same today, the underlying demand trends coupled with the financial strength and balance of our diverse corporate sector keep us confident that the economic upswing will be sustained, even though the quarterly rate of GDP growth will likely be below the average of recent cycles.

Outside our borders, but still of prime importance to investor confidence are the issues of European credit markets and banking stability and, also, the uncertainty regarding China's growth prospects. Understandably, there was a rising tide of fear that the debt and budget crises unfolding in southern Europe would spread to other countries and financial institutions in the European Community leading to another implosion in global credit markets. So far, the worst fears have not been approached, much less realized. As a result of the crisis management experience gained during the past two years and the stabilization achieved by the broad-scale actions taken in the U.S., the European Central Bank and the International Monetary Fund moved efficiently to provide liquidity and credit facilities to prevent a seizing-up of financial markets. In addition, the European Central Bank is making purchases of the bonds of the various governments on both an open-market basis and directly from banks.

Contrary to the earlier crippling sub-prime mortgage contagion, there are no layers of derivatives piled on these debts. So, there is greater probability of transparency and far less risk of counter-party deficiencies. Nevertheless, there are still concerns about contingency debts which are within the European banks. Stress tests are currently underway to determine the capital adequacy of banks under harsh assumptions. This testing, combined with healthy funding facilities, has led to a more stable market environment for government, bank, and corporate debt issuance. In the weeks ahead, we will learn more about proposals aimed at reducing budget deficits in several key countries as well as more detailed results from the bank stress testing.

While there has been justifiable concern about the volatility and weakness in the Euro currency, there is growing evidence that European export-oriented businesses are seeing rising order rates which, if sustained, would result in increased tax revenues for many governments and reduced deficits and improved credit ratings. Time will tell.

It now appears that the gloom about China as a still-powerful economic engine is abating. Restrictive bank reserve requirements have been relaxed, and the announced decision to allow its currency more flexibility in world markets could have several positive results. As to the bank reserve policy, the earlier-imposed increase was effective in curbing the speculation and inflation in real estate activities. The change in currency alignments should help to further reduce inflationary pressures more effectively than a change in interest rates. This expected currency adjustment would also stimulate domestic consumption and increase demand for foreign-sourced goods while reducing the likelihood of punitive tariff actions which would hurt China's export-oriented companies. Overall, the net impact on aggregate domestic economic growth in China may be modest. But, if growing consumer appetites can be met without meaningful reduction in necessary infrastructure development, future growth rates should remain in the 8% - 10% range annually.

Given the multitude of "moving parts" in the critical areas of economic policy, financial industry realignments, tax and budgetary dilemmas in all sectors, competitive pressures within industries and between countries, and volatility in geo-political priorities, we expect investors to remain cautious. While U.S. Treasury issues have benefited in recent weeks as investors sought a safe harbor, we believe this environment of caution and restraint can prove to be rewarding for patient and perspicacious investors. A focus on the equities and bonds of companies having strong balance sheets, above-average momentum in earnings and cash flow, and established market positions bolstered by creative and cost-efficient product and service development should provide positive market performance.

In the fixed income sector, we continue to prefer high-grade corporate and government agency issues with intermediate maturities. Inflation worries ebb and flow, but these categories have strong interest coverage and offer very attractive yields versus Treasury issues. We recognize the necessity and value of tax-exempt securities for certain accounts, and we will continue to focus on the budgetary developments at all levels.

Our equity outlook is remaining consistent. We think the best opportunities for growth of principal and income are in sectors where the leading companies are continuing to gain market share, offering products or services that improve productivity or help control costs, and have the financial capability to make strategic acquisitions. Many of these companies are prominent operators in specialized health care, technology, and industrial equipment and systems. Additionally, we recognize the opportunities in various developing economies. The need for essential raw materials, energy, and infrastructure expertise is enormous and long-lived. Potential new additions to the equity segment may also include leading global consumer product companies and certain exchange-traded-funds which focus on specific geographic areas. Many emerging markets have declined during the recent period of uncertainty and are worthy of close attention and evaluation.