

Executive Summary

Some changes are slow.....

The National Bureau of Economic Research (NBER), the official arbiter of the U.S. economic cycle, came up short in its ability to declare the death of the latest recession. While members informally believe the contraction concluded sometime in mid-year 2009, the potential for data revisions and/or a double dip have kept their official ruling at bay. Recognizing this as more of a formality, we can all appreciate this year's 2.7% annualized rate of growth in the first quarter versus the contraction of 6.4% in the comparable period last year.

The underpinnings of each recession are different. It naturally follows, therefore, that the characteristics of economic recovery – timing, trajectory, duration, etc – are also diverse. The recession just experienced was financial in nature, stemming from excessive debt and inflated asset values – primarily in residential housing. These kinds of imbalances require years of adjustment, even after the acute pain of contraction subsides. At present, we are in the throes of this economic rebalancing. A slower rate of economic growth should be expected as compared to other, consumption centric recessions.

The intent of the foregoing preamble is to point out that the capital market weakness experienced in the second quarter was, in part, a reflection of an adjustment of growth expectations. Too many investors overlaid prior recovery trajectories on top of an economic contraction rooted in less traditional factors. There are tremendous benefits to this adjustment. Market valuations now more accurately reflect a slower rate of economic recovery. Expectations for economic fundamentals should be more accurate, which should lead to fewer surprises and less market volatility. Lastly, policy makers will have a better target to shoot at when formulating economic strategies.

During this “recalibrating” quarter, the S&P 500 was down 11.4%. Strength in the U.S. dollar created additional headwinds for both commodities as well as international investments. The MSCI EAFE index returned -14.0%. Fixed income investments performed well, delivering low single digit returns.

.....other changes are fast

The dichotomy between quarter start and end was truly amazing. In the early days, the IMF warned that high and rising oil prices could pose economic headwinds – oil proceeded to drop about 20%. Stocks began at 18 month highs only to drop materially by quarter end. Market volatility, initially at two year lows, doubled in three months. The 10-year Treasury yield pushed above 4% and was expected to never look back. It ended the quarter with a yield below 3%. China started the quarter on the verge of being named a “currency manipulator” but ended with a declaration of a managed Yuan float. Economists, once debating over the Fed's capability, willingness, and timing of exit, were scratching their heads over what levers were left to pull for added economic support. High yield investors, all but ignoring covenant protections at the start, effectively shut the financing window to several companies at quarter end. Finally, equity valuations began the period very stretched but ended at much more reasonable levels.

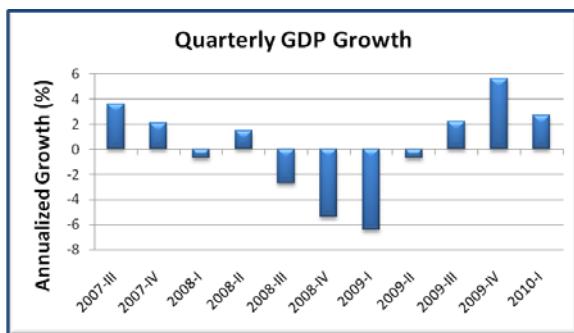
In effect, the “pro-growth” trade became significantly less popular and heavy selling of risk assets ensued. Investors have reset their economic expectations, in an appropriate way, and struck a healthier balance between the desires to achieve both a return *on* capital as well as a return *of* capital.



Economic Review and Outlook

Economic Growth

On an annualized basis, gross domestic product (GDP) grew 2.7% in the first quarter of 2010. Growth was driven by gains in personal consumption and private investment – primarily from increased inventory. State and local government spending was a negative along with an increased drag from net exports.



Data Source: U.S. Department of Commerce

Inventory adjustments have acted as an amplifier to economic contraction as well as growth in recent periods. These swings will likely diminish in future periods considering the first quarter marked the first actual inventory increase following eight consecutive quarterly declines.

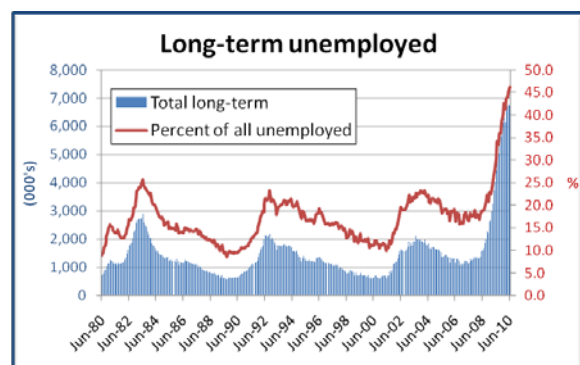
Despite economic uncertainties and a tepid recovery compared to those in the past, the first quarter's level of real GDP stood only 1.1% below the pre-recession peak. Economic output in the second quarter likely eclipsed prior records.

Economic forecasters are generally in agreement with the index of leading economic indicators, which portends continued growth. On that point, most economists believe there is little chance of a double dip recession and anticipate

moderate growth of 3.0% from now through the end of 2011. Aided by strength in emerging economies, the global growth picture is even brighter. According to the IMF, fast growing developing economies will help fuel global growth of better than 4.0% over the next two years.

Employment

The extent and sustainability of economic recovery may seem a mystery to those with an appreciation of the challenges posed by the labor market. After last year's steady improvement in initial jobless claims, this metric of the newly unemployed has flat lined at best and remains at a disturbingly high level. The same goes with continuing jobless claims. Following suit, the number of unemployed workers has held steady at about 15 million for the past year while the average number of weeks of unemployment continues to rise. As the following graph illustrates, workers considered long-term unemployed (over 27 weeks) have shattered previous records in both nominal terms as well as percentage of total unemployed individuals.



Data Source: U.S. Department of Labor

The unemployment rate, 9.5%, is down from a peak of 10.1%, but has been aided



by workers leaving the labor force and others accepting part-time work. These facts are not economic positives.

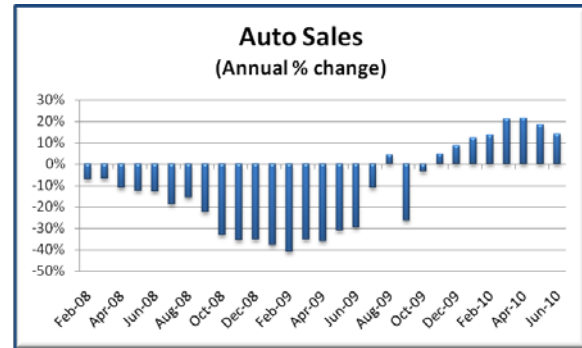
Adjusting for temporary census workers, employment growth so far this year has managed to keep up with population growth, but no more. Considering expectations for modest future economic growth, few have hope for the labor picture to change quickly. Lending credence to that thesis, Goldman Sachs recently suggested the unemployment rate at the end of 2011 will be unchanged from where it is now.

The Consumer

By the end of the first quarter, household net worth had risen for four straight quarters to \$54.6 trillion. While the trend is positive, consumer wealth still remains \$11.3 trillion below the peak in 2007. The realities of diminished prosperity and high debt loads have manifested themselves through weak lending activity and fickle consumer behavior. Retailers report consumer spending to be volatile and unpredictable.

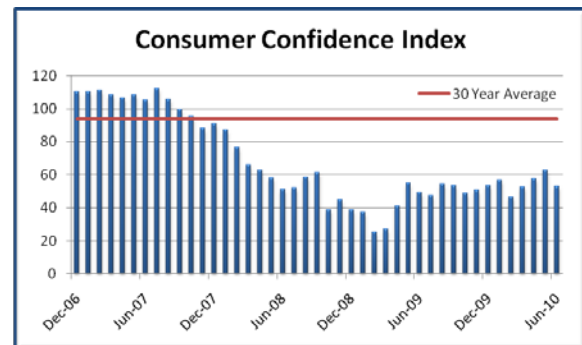
Personal bankruptcies jumped in March and April and, as might be expected, the majority of Americans are pessimistic about the economy. Sixty-two percent of individuals indicate the economy is on the wrong track and only one-third believe it will improve over the next 12 months.

Lending credence to the schizophrenic nature of the consumer, restaurant activity has picked up and year-over-year auto sales, shown in the following graph, rose in June for the eighth month in a row.



Data Source: U.S. Department of Commerce

Notwithstanding various positives and negatives, consumer confidence is low versus historical averages and disappointed in June. Current levels, essentially flat-lined for the past year, do not support consistent consumer spending growth in excess of 2%.



Data Source: The Conference Board

Going forward, consumer headwinds will remain and diminishing government stimulus will intensify challenges. Among other things, government transfer payments – a whopping 20% of aggregate household income – will fall significantly over the next year if unemployment benefits are not extended.

Real Estate

There are no quick or easy fixes to the nation's housing market, which remains mired in foreclosures and oversupply. Fresh industry statistics and the expiration of government subsidies have most



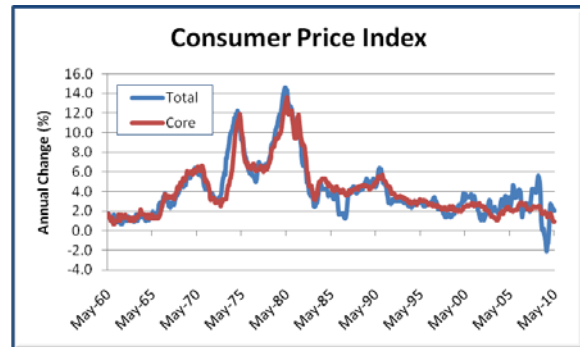
economists expecting a decline in home prices this year with continued challenges through 2012. Key statistics include:

- The number of homeowners missing at least one payment in the Q1 2010 rose to an all time record of 10%.
- Over 4.6% of homes were in foreclosure in Q1 2010, a record.
- Home repossessions hit a new record high in May, 94,000 properties, up 44% year-over-year.
- The inventory of unsold homes was up 12% in April to just over 4 million.
- Mortgage applications to purchase new homes dropped by 35% in May, to the lowest level since 1997.
- Sales of new homes fell 32.7% in May to a record low of 300,000
- Banks and investment trusts had 1.1 million foreclosed houses on the books – up 20% from last year. Another 4.8 million properties were at least 60 days late or in foreclosure.
- Moody's estimates 1.9 million homes will be lost to foreclosure this year followed by 1.1 million in 2011. This compares to 2 million in 2009 and 600,000 in normal times.
- Shadow inventory, homes to be sold once conditions improve, is high. At current rates, it is estimated that it will take years to sell shadow and foreclosed properties.
- The majority of mortgage modifications are in default within a year.

Inflation

Developed economies across the globe are fighting deflation while emerging markets are increasingly seeing signs of inflationary pressures.

The U.S., with inflation at a 40+ year low, is not immune to this dichotomy (see below).



Data Source: U.S. Department of Labor

The Federal Reserve regularly and consistently states inflation is not an issue due to slack in the economy. The Fed's estimate, which is the same as that of the IMF, is for inflation to run at or below 1.5% in 2010. It appears the near-term domestic concern should be focused on deflation rather than inflation.

The Government

Economic challenges that surfaced and/or intensified during the quarter put policy makers back into fire-fighting mode. The International Monetary Fund (IMF) pronounced that risks to the global economy have risen significantly. The group also astutely recognized that there is little room left to provide support. Regrettably, in some cases, they acknowledged policy initiatives have been exhausted.

Acrimonious gridlock in Washington D.C. has provided further impediment to progress. The nation's citizens have expressed discontent, to say the least, with political leaders. On that topic, the Pew Research Center recently published a report



indicating trust in government is at an “historic low” of only 22%. Having recognized diminished firepower further undermined by a challenging political environment, what follows is a summary of major initiatives currently underway or under consideration.

Monetary Policy

As the first quarter of 2010 drew to a close, investors began anticipating a change in the Fed’s now famous “extended period” language. What a difference one quarter makes! As the second quarter marched to completion, the Fed announced that “financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad.” By quarter end, discussions had changed from an exit strategy to exploration of additional monetary therapies available for an economic patient seemingly heading back to the hospital.

Despite a Fed Funds rate of essentially zero, the broadest measure of money supply, M3, has been contracting since mid 2009. In nominal terms, it was down 4.8% through April. This is normally associated with impending recessions and suggests a muting of the Fed’s economic influence. While this may or may not prove to be the case, it is doubtful the Fed Funds rate will change for quite some time. Economists once anticipating a rate hike by this November now believe the Fed will be on hold at least into the first quarter of 2011. Many economists anticipate no action until 2012.

The potential for additional quantitative easing (purchase of long-term bonds) exists, but Fed officials are hesitant to start this

program again. In the meantime, monetary policy has proved quite lucrative to government coffers. The Fed made \$47.4 billion for the Treasury in 2009 and is expected to deliver \$70 billion in 2011.

Fiscal Policy

The debate du jour throughout developed economies is whether to spend more to coax economies back to self sustainability or to cut spending and raise taxes in order to deal with ballooning deficits.

The U.S. is pushing for continued stimulus, but encouraging governments to develop credible deficit reduction plans for implementation down the road.

The issue of fiscal stimulus is precarious and the potential for policy errors is high. To that point, Ben Bernanke is concerned about U.S. debt and its threat to the nation’s long-term health. Not to be outdone by the current Fed chairman, Alan Greenspan also weighed in with a warning against the assumption of a limitless capacity to absorb government debt. He believes we are much closer to the ceiling than many believe or appreciate. Lastly, the IMF in its twice yearly report cautioned that government demand for credit could crowd out the private sector.

While we wait to observe national responses across the globe, one must remember that fiscal challenges are not just a federal issue. Bernanke sights fiscal conditions at state and local governments as having the potential to hold back the economy. This observation has already proved accurate as declines in state and local government have detracted from economic growth in five of the last six



quarters, subtracting 0.5% from GDP growth in the second quarter alone. State budget gaps are expected to remain for at least two years.

Legislative Action

Key legislative issues during the quarter were financial regulatory reform and extension of unemployment benefits. Both initiatives hit stumbling blocks during the period and neither proved successful by quarter end. Movement on both should be expected in July.

Global Developments

Worldwide developments were very active during the quarter. Economically, the news generally fell into one of two camps – developing versus developed. Developing nations grew increasingly concerned about inflationary pressures and the need to dial back growth to sustainable levels. In the case of China, growth has likely peaked as stimulus spending wears off and Beijing has stepped up efforts to rein in property speculation. China also shifted Yuan policy by ending its peg to the dollar and signaling the intention to allow the currency to float, albeit in a managed fashion.

For developed nations, the issues were achievement of sustainable growth and management of ballooning deficits. On the second point, the IMF indicated sovereign debt issues in Europe, the U.S., and Japan have emerged as the top threat to the world economy. To put the current trajectory in perspective, by 2014 the debt of big rich countries will average 110% of GDP. That is up 40% from 2007 and a far cry from the IMF's suggested target of 60% debt to GDP.

As European sovereign deficits and debt levels came under the microscope during the quarter, interest rates rose and credit ratings fell. Greece, Portugal, and Spain credits were downgraded and France may be next.

Greece, having the most urgent fiscal situation, received a three year \$147 billion bailout package co-sponsored by the IMF and fellow euro zone countries. As financial contagion began to spread, a second program was established as a backstop to all members of the 16 nation euro zone. This €720 billion package was developed as a combined effort between the IMF, euro zone, and European Union.

Despite the bailout initiatives described, or perhaps because of them, banks in Europe have experienced trouble selling commercial paper and other assets to meet funding requirements. In response, European leaders are taking a successful page out of the U.S. playbook and stress testing their largest banks. Results, which will be published, are expected in the second half of July. If the exercise parallels that of the U.S., it will be a market mover, critical turning point for Europe, and a key to re-establishing investor confidence in the euro zone.

If financial uncertainties were not enough to manage this quarter, geopolitical tensions rose up in both Iran and the Korean peninsula. The explosion of BP's Horizon oil rig in the Gulf of Mexico added an environmental disaster of epic proportions to the list of negative distractions and uncertainties.



Capital Markets Review and Outlook

Overview

Stocks started the quarter on a positive note. Indexes were hitting 18 month highs and market volatility was at a two year low. Overconfidence was evident as put/call volume fell to a multi-year low. Further evidence of investor indifference toward risk was seen in the fixed income markets. There, companies were selling junk debt with the weakest investor protections since 2007. In some cases, issues were even more aggressive than those seen at the last market peak. Bullish investment advisors outnumbered their bearish counterparts by three to one.

Meanwhile, the fact that insider selling activity had picked up dramatically was a harbinger of things to come.

The “pro-growth” trade, as it was called by fund managers, unwound in a dazzling display of flight out of risk assets and into the security of traditional safe havens – gold, U.S. Treasuries, and the dollar. Stocks gave up gains for the year, and then some. Dollar strength and diminished global growth expectations conspired to make for a particularly challenging backdrop for commodities. This category, already underwater for the year as the quarter began, furthered its foray into negative year-to-date returns.

Despite the doom and gloom, positives abound. Corp balance sheets are phenomenally strong. U.S. companies are

holding more cash than at any point on record. Non-financial companies had \$1.8 trillion on the books at the end of March, an increase of 26% year-over-year – the largest increase on record. Cash as a percentage of company assets, 7%, is the highest on record.

Earnings recovery and growth have also been remarkable. Nearly 80% of S&P 500 companies beat earnings expectations in the first quarter. U.S. corporate earnings

were up 31% for the period. Earnings growth in the second quarter is expected to be 27% which takes full year 2010 growth projections to 33%. Next year caps an encore performance with consensus growth expectations of 17%.

Capital Market Returns

	2 rd Qtr 2010	Year-to- Date
U.S. Treasury Bills	0.1%	0.1%
Barclays Aggregate Bond	3.5%	5.3%
Barclays Municipal Bond	2.0%	3.3%
S & P 500	-11.4%	-6.7%
Dow Industrials	-9.4%	-5.0%
MSCI EAFE (Int'l Equities)	-14.0%	-13.2%
DJ UBS Commodity Index	-4.8%	-9.6%

Data Sources: Morningstar

Earnings are up, valuations are down, a rise in defensive put buying provides for a better foundation, and investor sentiment is diminished. The go-forward investment opportunity is much better than it was three months ago.

Equity Markets

Domestic equity markets gave up gains for the year. The S&P 500 closed the quarter down 11.4% for a total year-to-date loss of 6.7%.

International equity markets also fell for the quarter. The MSCI developed markets index was down 14.0% and 13.2% for the



quarter and year, respectively. Emerging markets, with a more attractive set of fundamentals, were down 8.4% for the quarter and are down 6.2% for the year. In developing markets, China led the charge down on concerns about policy initiatives to dampen growth.

Fixed Income Markets

Bonds earned their keep as return stabilizers and volatility dampeners during the quarter. Every category, with the exception of high yield, performed admirably. The Barclays Aggregate was up 3.5%, municipals gained 2.0%, and TIPS returned 3.8% for the period. When compared to equities, even the drop of 0.1% in high yield was relatively benign. The 10-year Treasury started the quarter

with a yield of 3.9% and finished yielding only 2.9%.

Similar to equity market observations at the start of the second quarter, bond fund managers see signs of a bubble developing in fixed income. Investors seem to be ignoring red flags, particularly in the muni market. Fundamentals in this space are certainly challenging. State and local borrowing as a percentage of GDP has risen to an all-time high of 22% and is expected to expand to 24% by 2012. The inevitable result of falling revenue, higher spending, and increased debt levels is a lesson we have come to know (and hopefully respect) in recent years. Diversification within this category and across multiple fixed income segments is highly advisable.

Disclaimers

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