First Quarter, 2010

Summary
The U.S. economy has delivered two consecutive quarters of positive Real GDP growth. Robust export orders and inventory restocking have driven this growth. Still, various concerns persist, and a "Wall of Worry" remains in place. Nevertheless, growth is expected to continue, albeit at a below trend pace.

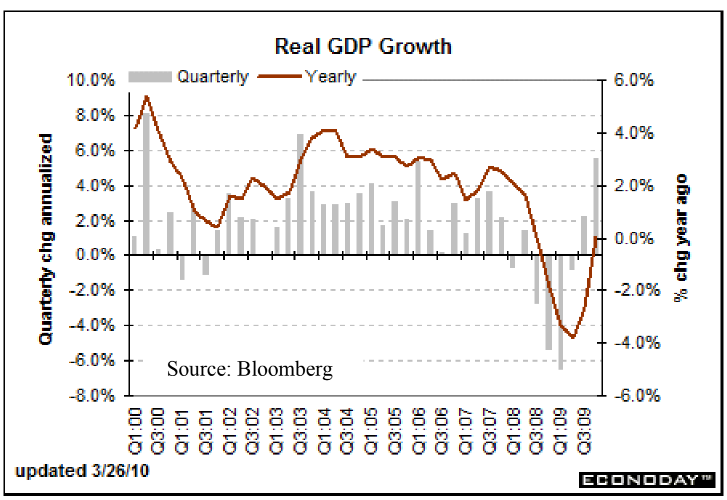
Financial conditions are accommodative, as indicated by spreads in the credit markets. The commercial paper market has shown signs of improved health, and even subprime mortgage debt instruments have exhibited improved pricing strength. However, most of the Federal Reserve's stimulus programs have now come to an end, and the Fed is weighing various options for withdrawing excess stimulus. Trends related to these measures would imply that the Fed has good reasons for withdrawing stimulus at a measured pace.

Technical and sentiment indicators reflect short-term "overbought" conditions within the equity markets. Longer-term measures remain constructive. Ultimately, the current upward bias could prevail as long as improving economic and corporate growth, rising earnings, and rising earnings estimates continue. Thus far, the corporate profits/earnings recovery has been progressing at a healthy trajectory.

We view current economic/market conditions as generally positive, and we remain optimistic. Real growth has returned to the economy, and corporate sales and earnings continue to improve. The steepening of the U.S. Treasury yield curve continues to signal stronger growth, and assuming modest inflation in the future, conditions may remain favorable. A hand-off of the Fed's monetary support to self-sustaining, financial intermediaries would be the next step toward health in the economy and markets.

Climbing the Wall

As of year-end, 2009, the U.S. economy had experienced two consecutive quarters of positive Real GDP growth. These encouraging signs, along with current forecasts for modest growth this year and next, follow a truly dismal period, in which GDP contracted in five of six quarters. Heading into the second quarter, it appears that the path of least resistance may have turned upwards.



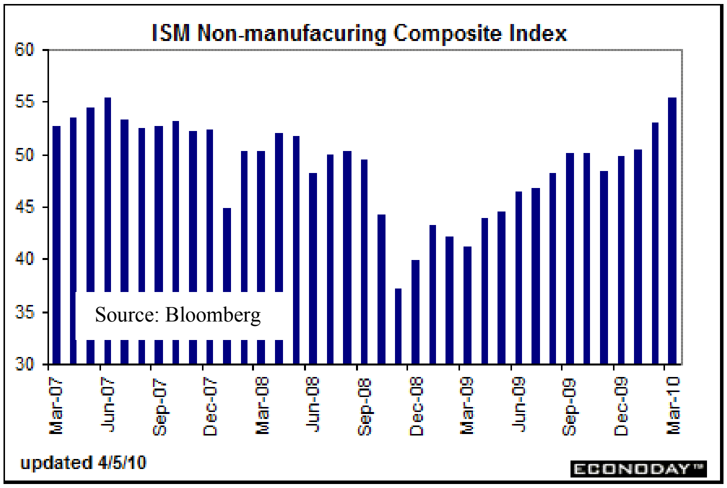
Similarly, equity markets have made an amazing recovery, with the S&P 500 Index rising 74.8% from its March 9, 2009, bottom. Still, that index has only recovered to the level immediately preceding Lehman Brother's failure, in September of 2008.

Understandably, the litany of concerns remains both enormous and controversial, e.g., inflation (or deflation), excessive government spending and debt (or not enough), tax policy (too much or too little), energy prices (too high for strapped consumers or too low for long-term reinvestment by producers), weakness in the U.S. dollar (positive or negative for the U.S.), the possibility of sovereign debt defaults (what to do about Greece), etc. All seem to agree that consumer debt burdens, though declining, need to continue to improve and that whatever recovery we are enjoying remains "jobless" by prior standards. Similarly, worries persist about the durability of the current equity market rally and the possibility of a double dip recession, among other issues.

In sum, a "Wall of Worry" remains in place, even as the prevailing fears have shifted from economic collapse to the scope and effects of intervention. Nonetheless, both the economy and market seem to be moving in a constructive direction, with the latter having further to climb, we hope and suspect.

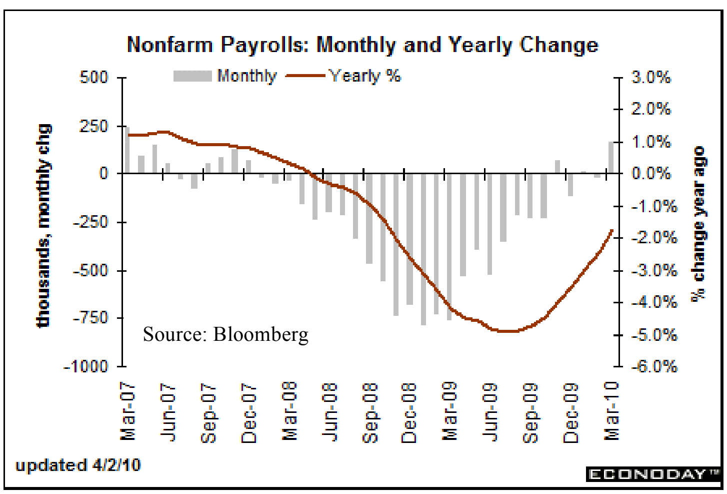
Economic Trends

The Institute of Supply Management (ISM) purchasing managers index offers convincing evidence of recovery in the manufacturing sector, with a March reading above 50 (indicating expansion) for the eighth consecutive month. Robust export orders and inventory restocking have driven this growth. Similarly, the larger and more significant ISM service index showed its third consecutive month of growth, with new orders rising and employment improving at the best readings since December of 2007. Especially strong export orders indicate that demand from Asia is pulling the global economy forward.



Separately, retail sales recently have fared far better than expected. March same-store sales within a sampling of 31 U.S. chain stores rose 9% year-over-year, the biggest gain since March of 1999. Pending sales for existing homes jumped 8.2% in February, while factory orders continued to rise on the strength of transportation and machinery purchases. Industrial production also advanced for the eighth consecutive month. Signs of positive job growth, not just fewer layoffs, also appear to be emerging.

Not all the news is rosy, however. Unemployment remains stubbornly high at 9.7%. Commercial real estate and construction spending remain soft, with housing starts running at levels that are only half what they were twenty-years ago. While consumer sentiment has improved, credit continues to decline as consumers pay down credit card debt, and personal income growth remains tepid. Nevertheless, growth is expected to continue, albeit at a below long-term trend pace.



Financial Conditions

In December of 2008, just before commencement of the Federal Reserve's bond-buying program, the spread between the 10-year U.S. Treasury note yield and the average U.S. 30-year fixed mortgage rate was 3.07 percentage points, the widest since 1986. Investors demanded higher payments to compensate for higher mortgage risks. At the end of March 2010, the difference had shrunk to 1.14 percentage points, narrower than the 20-year average of 1.65 percentage points. Spread indications have narrowed in most credit markets, implying that financial conditions are favorable and accommodative. The once frozen commercial paper market has shown signs of reviving health, and the corporate bond market has extended its rally for the fourth straight quarter, the longest streak since 2004. Even subprime mortgage debt instruments, all priced not long ago as if default were certain, recently have risen in value.

March 31st marked the end of the Federal Reserve's program of purchasing mortgage bonds, providing liquidity to cash-strapped banks. The Fed now expects an orderly handoff of the diminished risks to re-capitalized banks, pension funds, and private investors with ample capital to invest.

Monetary Trends

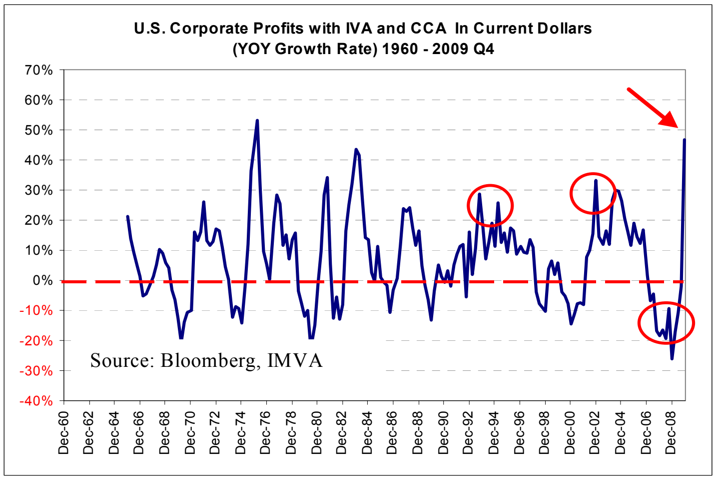
On March 30, 2010, the Federal Open Market Committee voted to keep the Federal Funds target rate at 0.0%-0.25% and vowed that it would remain low "for an extended period of time." Still, we see this pillar of the stool slowly weakening, providing less support for the economy and markets going forward. Most of the Fed's stimulus programs have now come to an end, and the home purchase tax credit program will be withdrawn this April. Since December, the Fed has openly conducted operations in preparation for removing excess stimulus from the economy. In past recovery cycles, the Fed has moved more quickly to raise interest rates and tighten credit. We believe that the credit tightening process has begun, but it may last considerably longer in this cycle, depending on perceived changes in inflation, employment, resource utilization, and the relationship between slack and production capacity. Thus far, trends related to these measures would imply that the Fed has good reasons for withdrawing stimulus at a measured pace.

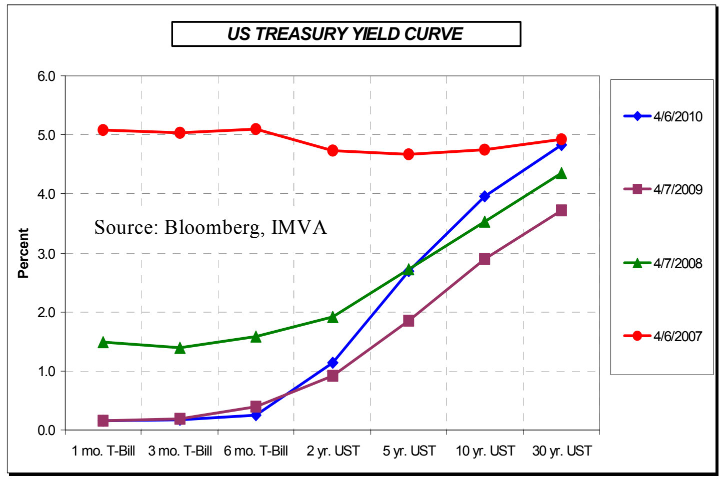
Technical Market Trends

Current technical measures reflect short-term "overbought" conditions within the equity markets. Longer-term measures remain constructive. Ultimately, the current upward bias/momentum could prevail as long as improving economic and corporate growth, rising earnings, and rising earnings estimates continue. From the beginning of the equity market's recovery, in March of 2009, there have been four minor corrections, ranging between 2% and 5% across various U.S. equity market indices, and one more significant correction, in the January-February timeframe, of approximately 6%-8%. We would not rule out a continuation of this type of volatile market action, accompanied by changes in leadership across capitalizations and the quality spectrum. Current leadership remains the province of the more cyclically oriented companies.

Sentiment Indicators

Investor sentiment measures have a long history of being good "contrary" short-term indicators, especially at extremes. Many of the indicators that we watch currently show a high degree of bullishness and/or complacency, making us cautious about the short-term. On the other hand, equity mutual fund redemptions remain high this year on a net basis, as investors generally have flocked toward bond funds, apparently chasing higher yield and perceptions of lower risk. In the long-term,





this type of investor reaction almost always signals an inflection point that favors exposure to equities.

Equity Market Earnings & Valuation

It now appears that consensus thinking believes in the economic and equity market recovery. This view would imply that the market has transitioned into its growth phase of recovery where earnings and revenue growth are required in order for equity prices to advance further. Equity markets normally lead an economic recovery in anticipation of improved fundamentals. As seen in the corporate profit chart, an earnings recovery has been progressing nicely. Nevertheless, given the market's current position, much of the potential future growth could already be priced in or reflected. Therefore, going forward, actual earnings growth needs to continue in support of these expectations.

One cautionary data point can be found in the steepening yield curve. Rising interest rates and inflation are highly correlated, and they generally pose challenges for equity prices, often in the form of contracting multiples. The long end of the yield curve has been rising, and it appears only a matter of time before the Fed moves to normalize short-term interest rates. As long as the move is only toward a more normal yield curve, equities may not be extremely challenged. So far, only modest inflation has returned – providing a measure of relief, in fact, to those who feared a deflationary spiral not long ago.

Conclusion

It is clear that many economic, fiscal, and geopolitical challenges remain potential drags on the recovery. Nevertheless, we view current economic and market conditions as generally positive, and we remain optimistic. Modest, real growth has returned, and corporate sales and earnings have continued to improve. The upcoming release of first quarter earnings will be closely watched for confirmation of continuing improvement. Sparse, early indications have been better than expected. The steepening of the U.S. Treasury yield curve continues to signal stronger economic growth, and assuming modest inflation in the near future, conditions may remain favorable. A hand-off of the Fed's monetary support to self-sustaining, financial intermediaries, who can manage risk and deploy capital productively, would be the next step toward health in the economy and markets.

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