

**OBSERVATIONS REGARDING THE ECONOMIC
AND FINANCIAL MARKET OUTLOOK**

JULY 5, 2010

Throughout the past year we have expressed the view that the global economy was in the recovery stage of a multiyear expansion with a long-term trend GDP growth rate of 3.5% to 4.0%. We predicted that this expansion would be paced by the leading emerging economies of China, India, and Brazil, with growth rates ranging from 6.0% to 10.0%, but retarded by the U.S., Europe, and Japan, who would stumble along with subpar growth of 2.5% to 3.0%. Our outlook also expected this global expansion to extend, with intermittent corrections, the equity and commodity market rallies dating back to March, 2009. A consensus of economists and market strategists endorsed this positive outlook through April, when the International Monetary Fund (IMF) raised its 2010 global GDP forecast from 3.8% to 4.2% and the Standard & Poor's 500 Index advanced to a post-recession high. As the 2nd quarter progressed, however, the European sovereign debt crisis and slowdowns in the U.S. and China led a growing number of economists to predict a "double dip" recession: some warned it would usher in a new bear market. A May and June decline in global stock and commodity markets and a flight to the perceived safety of gold and U.S. Treasury securities testify to investors' fears of a return to the dreadful conditions of 2008 and early 2009 (see our "Review of the Second Quarter, 2010"). Although we believe the current global "soft patch" warrants caution and vigilance, we continue to think that a multiyear global expansion accompanied by a revival in stock and commodity prices is still the most probable scenario.

Economic historians point out that "soft patches" in economic recoveries are common. We are not surprised by the current global slowdown, which might have been expected as the anti-recession, stimulus packages implemented by governments and central banks wind down and, in some cases, are reversed to guard against inflation, asset bubbles and/or mushrooming budget deficits. There is also a tendency for manufacturing to slow once recovery from massive inventory liquidation has run its course and for consumer spending to ebb when the initial surge arising from pent-up demand has been satiated. On the other hand, double dips, in which the economy lapses into recession within a year of exiting a recession, are very rare. For example, there have been 11 U.S. recessions since 1945 but only one double dip, and this occurred in the early 1980s when Fed Chairman Volker, confronted with double digit inflation, induced recession by hiking rates to unprecedented, high teens levels.

Our global GDP growth forecasts of 3.0% in 2010 and 3.5% in 2011 may seem excessively optimistic to some readers, yet they are well below the consensus outlook of Wall Street firms. For example, Merrill Lynch in its July 2 Global Economic Weekly

declared "...both leading and coincident data are a long way from signaling a recession. The canary in the coal mine is not dead; it's just sleeping." They predicted 4.5% growth in 2010 and 4.3% in 2011. Similarly, on July 2 the Deutsche Bank Global Markets Research team asserted that "we think the risk of a dramatic slowdown or double dip recession remains small" and forecasted 4.5% growth in 2010 followed by 4.1% in 2011.

We continue to expect the leading emerging economies of China, India, and Brazil to provide the strongest and most assured growth. In recent months, their stock markets have retreated as their governments and central banks have adopted restrictive policies to curb rising inflation resulting from above-expectation growth (see our May 12 blog "International Stock Markets: Searching for Goldilocks"). The focus is on China. Here the manufacturing sector and the overheated housing market are cooling in response to the government's restrictions on bank loans. Also, exports to Europe (China's biggest market) are expected to be negatively impacted by the government's decision to allow the yuan to appreciate, the decline in the euro, and reduced consumer demand as European austerity programs kick in. We disagree with the vocal minority of commentators who are convinced that China's economy is about to implode. Echoing our view is last week's forecast by Goldman Sachs of 8% growth in the 2nd half of 2010. We also endorse their assertion that this slowdown is a highly favorable development. In a June 8 comment on China, which we think could also be applied to India and Brazil, Donald Straszheim of highly-respected International Strategy and Investment (ISI) wrote "...we think there are many reasons to be thinking about buying China. Rather than as a dangerous, high-risk market, China should be regarded as a relatively low-risk, safe haven from sovereign debt issues." In particular, we recommend the stocks of consumer-related, financial, and infrastructure companies who are profiting from providing goods and services to the mushrooming middle classes in these emerging economies.

Evidence that the U.S. economy is struggling is widespread: weak employment data, soft consumer spending and confidence data, steeper than expected declines in both service industry and manufacturing indexes issued each month by the Institute for Supply Management (ISM), discouraging housing market reports, etc. The decline in the stock market is itself considered to be a leading indicator. There are also some looming headwinds. Chief among these is that states and municipalities, burdened with balanced budget requirements, are already slashing spending and will need to confront the necessity of further cuts to programs and employment. Also, significant tax increases are scheduled to kick in unless the government takes preventative action before yearend.

We think the recent economic reports are disturbing, but point to a soft patch rather than a dip into recession. Growth is slowing, but it is still growth. In addition, there are positive developments that are often overlooked in the midst of the current pervasive pessimism. For example, very low inflation is enabling the Federal Reserve to extend its accommodative policy that is conducive to very low interest rates. This is a major benefit to corporate, state and municipal, and consumer borrowers. One result is that in early July the average 30-year fixed mortgage rate fell to 4.58%, which was the lowest level since records began in 1971; an increase in refinancing activity will put cash into consumer pockets and an improvement in the affordability of housing should help this beleaguered industry. Another example is that strong corporate profit growth has

resulted in a pick up in spending on equipment. Nor are future employment prospects entirely bleak. The Business Roundtable recently revealed that 39% of CEOs plan to boost hiring in the 2nd half of this year, which is the highest percentage since mid 2007. We reported in a June 8 blog a disclosure from the National Federation of Independent Business that their index of small business confidence rose in April to a 20-month high, and that their poll of small business hiring plans registered its first positive reading in 19 months. Yet another example is the July 2 observation by Merrill Lynch that several studies show that the shape of the U.S. Treasury yield curve is the best single indicator of recession risk, and the current sharply positive yield curve predicts a boom, not a bust.

The slowdown is prompting economic forecasters to reduce U.S. GDP growth estimates rather than forecast recession. For example, on July 6 ISI dropped its estimates for both the 3rd and 4th quarters to 2.5%; Merrill Lynch on July 2 cut its 2010 projection from 3.2% to 3.0%, and added “the odds of an outright recession remain low.” The latest polling of economists by The Economist provides a consensus prediction of 3.3% in 2010 and 3.0% in 2011. The revisions are resulting in a downward drift of forecasts toward our January 4 prediction of 2-3%, which we continue to hold.

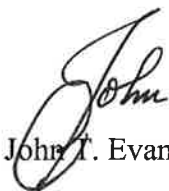
We expect the U.S. stock market in the near future to remain volatile and possibly hit more air pockets, but we think the longer-term positive case for stocks is persuasive and will eventually prevail. We have pointed out in a May 24 blog on “Global Financial Market Turmoil,” the decisive impact on the U.S. stock market exercised by U.S. and international hedge funds. Many of these firms rely on short term strategies implemented by computers programmed to respond almost instantaneously to the latest news release or shifting volume and price movements in financial markets (an investment approach known as technical analysis). For longer periods, however, we remain convinced that fundamental developments (changes in the economic and financial market landscape) will determine the outcome of stock, bond, commodity, and currency markets. Here the outlook for U.S. stocks remains promising:

- U.S. and global economic growth should support a rise in stock and commodity prices as it did during the last expansion of 2003-2007.
- We also anticipate low inflation and interest rates, coupled with assurances from the Federal Reserve that it will continue its accommodative policy.
- Corporate profits are strong with upward revisions. Bloomberg reports that S&P 500 earnings in 2010 will climb 34% over 2009, whereas on March 29 the projected increase was 27%.
- Valuation is attractive. The S&P 500 Index is currently trading at its cheapest valuation on estimated earnings since the bull market began in March 2009.
- Alternative investments have limited appeal. Money-market funds and bonds provide very low yields, and real estate remains hazardous.

We were not optimistic regarding the Euro Area economies and stock markets at the beginning of 2010, and we are now even more cautious. The sovereign debt crisis in Greece, Portugal, and Spain is not about to go away and may spread to other countries. The possibility of sovereign defaults and/or a credit crisis involving the leading banks of Germany, France, and Switzerland, which have massive holdings in sovereign debt, will likely haunt financial markets well into 2011. Even more ominous is that the remedy prescribed by many European governments may be more life threatening than the illness. Government programs to reduce bloated deficits through austerity programs, which have become the rage and now include Germany and other countries lacking debt pressures, have ignited a lively debate whether austerity programs promote or retard growth. At this point we share the fears of Keynesian economists that drastic deficit reduction surgery will prove to be economically lethal. Investments in some European companies that have strong exports to emerging economy markets and/or benefit from the weak euro are attractive, whereas European stock markets, although oversold, have limited appeal.

Our outlook for the U.S. and many international economies and equity markets may be positive, but we are not encouraging investors to be aggressive. Rather, we think this is a time to maintain broadly diversified portfolios of high quality securities, and to continuously reassess the positive case in light of new developments. Above all, the past several years were fraught with surprises and sudden investment market shifts; investors need to be vigilant and flexible.

With the June 30 yields on 2-year U.S. Treasury notes at 0.61% and benchmark 10-year notes at 2.93%, we view these securities to have appeal only as safe havens. Further, the fragility of the U.S. economic recovery will probably induce the Fed to extend the low-interest rate environment well into 2011. In these circumstances, tax-exempt portfolios should consider investment-grade corporate bonds with short to intermediate maturities. Caution in the tax-exempt sector is recommended: The budgetary plight of many state and local issuers strongly suggests that investors select very high quality, short maturity bonds, but the yields on these securities is discouragingly low. Here, too, high grade corporate bonds may be an alternative.



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