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MARKET COMMENTARY **JULY, 2010**

Stock markets around the world took a beating in a tumultuous second quarter, bringing to a halt the powerful rally from the market's March 2009 lows. The S&P 500 declined almost 12% in the quarter and ended the first half of 2010 down 6.6% (total return). The month of April began promisingly enough, with strong first quarter earnings providing further evidence of a sustainable economic recovery. Just as the earnings reporting period was winding down in late April, however, the market came under an onslaught of negative news, exogenous shocks, and macroeconomic fears:

- High profile SEC fraud suit against Goldman Sachs and associated Congressional hearings
- Gulf Oil spill, the worst oil spill and environmental disaster in U.S. history
- European financial, banking and currency crisis which began over questions of Greek solvency and sent all of Europe reeling for a period
- Extraordinary government intervention into the U.S. economy in the form of historic health care and financial services\banking reform and regulation; whatever the merits and ultimate outcome, the resulting uncertainty stifled private hiring and investment and inhibited economic growth in the second quarter
- Fears of a slowdown in China's economy, the new global bellwether

Negative News Cycle Overwhelms Markets in Second Quarter

These headwinds would have been difficult for the market to navigate under the best of circumstances. A significant correction was also inevitable given the 70% rally off the March 2009 market bottom. But with investor and consumer confidence still fragile in the wake of the financial crisis from which we are still emerging, the market decline was deeper and marked by higher levels of fear and pessimism than in a typical market correction. For almost ten straight weeks from late April through June we were subjected to daily news videos of oil gushing nonstop into the Gulf, riots and demonstrations in Greece as Europe struggled with its own messy financial bailout, and Goldman Sachs management in the Congressional docks trying to defend themselves (and all of Wall Street) against charges of fraud in the sale of CDO's (collateralized debt obligations, the mortgage backed toxic junk that Wall Street managed to swamp the planet with from 2005-2007). Sounds depressing, and it certainly had that effect on investors, consumers and businesses.

Not surprisingly, the U.S. economy also began to show signs of slower growth midway through the second quarter. A soft patch in our economic recovery is not unusual, but given all the concerns cited above, by the end of June fears of a "double dip" recession had grown acute. Ten year U.S. Treasury bonds yielded 3%, a depression like level, and money poured into money market and bond funds. Bonds were the inverse of stocks, with the JP Morgan 10 Year Bond Index up 12% in the second quarter 2010. Moreover, the Financial Times has reported that money market funds recently had their biggest weekly inflow of funds in 18 months and some of the largest fund managers are holding up to 40% in cash. Before the financial crisis they held as little as 5% cash according to the Financial Times. All sounds pretty scary doesn't it; are things really that bad? Interestingly enough, this type of behavior tends to be associated with market bottoms and good entry points for stocks. Even more importantly, on a fundamental level there are also a number of offsetting positives that should support the economy and markets. And some of the events that plagued the market in the second quarter are close to resolving or at least receding in impact and importance.

Light on The European Horizon

The European situation has stabilized and even given rise to some offsetting positives. Of all the second quarter macro concerns, this was and continues to be the most significant. Just a few weeks ago, the market feared a devastating monetary crisis that could destroy the European Union. Doomsayers came out of the woodwork to predict a total collapse of the Euro currency, paralyzing the economies of Europe and precipitating a depression era decline in world trade…you get the picture. To paraphrase Mark Twain, however, the reports of Europe's demise have been greatly exaggerated.

The Euro zone is enduring its first major financial shock. The ECB (European Central Bank) was initially slow to react – many said the same thing about our Fed in the summer of 2008 – but responded with a $1 trillion (750 billion Euro) "Sovereign Rescue Fund" and bond purchase program in May. Over the ensuing weeks the banking system and credit markets have gradually stabilized and the Euro has now recovered from its lows and stabilized, at least for the moment, above $1.20 per Euro.

It is important to put the recent decline in the Euro in the context of the currency's still relatively short history. The Euro was introduced in January 1999 at an exchange rate of $1.19 to the Euro. After being fully implemented across Europe by early 2001, the Euro then began to appreciate (its low was $.83 per Euro in October 2000) and has been above parity with the dollar since December 2002. It reached a high of $1.57/Euro in July 2008 and currently trades at $1.25/Euro – within 5% of where it first traded eleven years ago. Far from collapsing, the Euro has remained remarkably stable.

Moreover, Germany and Northern Europe are benefitting from the recent decline in the Euro. German exports rose 9.2% in May and are growing at the fastest pace since the early 1990's. German industrial production also accelerated in May (Financial Times, July 8, 2010). UPS, the global shipping and logistics giant, recently cited a pick up in activity in Germany and the Euro zone.

Longer term, Europe has to restrain government spending and impose fiscal discipline (sound familiar). Its economies have experienced chronically slow growth for years and face the demographic headwinds of a declining and aging population. But it is way too early to write off Europe in either the present or in the longer term.

U.S. Recovery Should Continue Through Current Soft Patch

While the U.S. economic recovery may be in a period of slower growth, most economic indicators still show decent growth and are supportive of an ongoing recovery. The June U.S. Manufacturing PMI at 56.2 and U.S. Services PMI at 53.8 both still indicate solid growth (readings above 50 indicate economic expansion, below 50 contraction) and are above long term averages. Job growth has clearly been disappointing – particularly the anemic May and June reports - but there has been positive private sector job growth now for six consecutive months. Employment is a lagging indicator, and was also very slow to gain momentum coming out of recession in the early 1990s.

The massive Congressional and regulatory overhaul of healthcare and banking has created uncertanties that have inhibited private sector hiring and investment. This is evident from the recent disappointing May and June employment reports. At least the legislation is now behind us and some of the uncertainty can be removed (we still have to figure out what it says and what it means). The Obama administration also appears to be offering, temporarily at least, an olive branch to business. Recent comments and initiatives are more growth and business friendly: e.g. increased export financing; capping capital gains rate and most dividend taxation at preferred 20% rate; acknowledging the need for reducing uncertainty and government interference in the private sector and asking for suggestions from industry as to how to do so.

Of note, we have again entered the season of corporate earnings reports and the early returns on second quarter earnings have been very encouraging. CSX reported good growth in freight and rail traffic; Alcoa raised its outlook for global aluminum consumption and cited strength in aerospace, autos and transportation, and power generation. Intel reported the best quarter in the company's history (record revenue and profits), pointing to strong global demand and a surge in corporate and enterprise spending for computers and technology.

China and Emerging Market Strength

Worldwide GDP growth is driven today by emerging economies, not the established and mostly western economies that have driven it during our lifetimes. And corporate profits are driven by global GDP growth, as was powerfully illustrated in the Intel second quarter report. China and emerging markets should continue to show strong growth in the second half and in 2011. China looks to be successfully engineering a "soft landing", cooling its economy from torrid 12% growth at its peak earlier this year to a still impressive but more sustainable 7.5% - 9% level in the second half of this year and 2011.

Conclusion: Value Is There For The Investor Who Steps Into The Arena

The market represents good value by historical measures. Corporate balance sheets are in terrific shape with cash at record levels. The S&P 500 currently trades at about 13 times 2010 consensus operating earnings of $80, but also at only 15 times more pessimistic $70 earnings that could result from a weaker global economy. According to Bloomberg, the average PE over the past 60 years is about 16.4. Many stocks also offer an attractive yield and growing income stream, contrasting favorably to 10 year U.S. treasury bonds yielding just over 3%. In fact, the majority of companies in our portfolio have been able to raise their dividend during the past year. Valuation should continue to support the market during this period of heightened economic uncertainty.

Long term challenges remain formidable and volatility is likely to remain high in coming quarters. But the outlook for corporate profits is also promising due to emerging market strength and global growth. Valuations reflect very little in the way of future growth. Perhaps it is fitting to conclude with a recent comment from the world's most famous fixed income manager, Pimco's Bill Gross, explaining a movement toward equities at his firm:

> *"Corporate equities, however, in terms of valuation are selling at very low (price-earnings) ratios and in some cases might even be perceived to be almost as safe or almost as secure as the sovereigns themselves because of their international exposure and their private nature."*
> (CNBC Interview, June 16, 2010).

Good News

China

- Google's China license renewed
- China adopts looser currency regulation, allowing for appreciation.
- Chinese fiscal tightening waning
- China says it will invest more than $100 billion this year in 23 infrastructure projects in western China. Projects include railways, roads, airports, coal mines, nuclear power stations, and power grids.
- "China Exports Defy Global Fears": June exports surge 44% and lift monthly trade surplus to $20 billion.
- Crude oil imports reached a new high in June at 22.3 million tons, rising 34.1 % y/y.
- China's GDP up 10.3% in 2Q2010, June consumer inflation up less than forecasted 2.9% (July 14, 2009 Reuters)

Other Emerging Markets

- S. Korea June Exports up 39.5% y/y, fastest pace since Dec. 2009
- Brazil reports record economic growth in 1Q2010, as GDP expanded 9% topping mean estimates of 7.6% (June 9, 2010 WSJ)
- India's economy, driven by strong domestic demand, projected to grow 8.5% this fiscal year. It rose 7.4% in the fiscal year ended March 2010. (July 12, 2010 WSJ)

Europe

Weak Currency Aides Germany and France

- "German Exports Jump": German industrial production rose 2.6% extending the 1.2% gain the month prior. German May exports rose 9.2% over the previous month, fastest pace since the early 1990's.
- French industrial production was also strong in May, and is up at 9% annualized rate over past 12 months.

Resource Countries Continue to Grow

- Canadian employment in June grows the U.S. equivalent of 550,000 jobs
- Australian employment up U.S. equivalent of 825,000 jobs

U.S. Consumer Balance Sheets Improving

- ABA says number of U.S. consumers behind on their credit card payments fell to an eight year low in 1Q 2010. 3.88% of bank credit cards were past due by 30 days in 1Q 2010 – first time below 4% since 2002.

Bad News

The Three G's Strike Financial Markets in 2Q 2010

- ***Goldman***: SEC sues Goldman Sachs, mid April
- ***Gulf of Mexico***: Explosion and fire kills 11 rig workers, destroys Transocean drilling rig, Horizon, on the BP Macondo prospect in Gulf of Mexico. Ensuing oil leak wreaks havoc on Gulf drilling and U.S. energy sector and is environmental disaster for Gulf Region.
- ***Greece***: Investor concern over Greek debt contagion slams Europe and global markets in early May.

Market Jitters

- "Flash Crash": Sends Dow down nearly 1,000 points intraday May 6 before a rebound lessens losses
- Stocks trade in lockstep more than any time since 1987 crash, reflecting growing influence of investors who trade in and out of the market using ETFs (broad indexes representing baskets of stocks that can be traded electronically) – July 12, 2010 WSJ

Weak European Countries Struggle with Debts

Largest Government Deficits in Europe (2009)

Country	Deficit/GDP	Consolidated Debt/GDP
Ireland	14.3%	64%
Greece	13.6%	115%
Britain	11.5%	68%
Spain	11.2%	53%
Portugal	9.4%	77%

Fears of a U.S. Economic Double Dip, a Second Recession

- Economists lowering their real GDP forecasts as U.S. economy hits a soft patch mid quarter
- Euro zone GDP forecasts lowered
- U.S. job growth remains stagnant, unemployment rate remains high at 9.5%
- Weak commercial real estate threatens bank balance sheets and lending.

Good News (continued)

IPO Market Reawakening

- IPO filings hit post-2007 high
- Agricultural Bank of China IPO biggest in history at over $22 billion (July 6, 2010 Market Watch)

Mergers and Acquisitions Continue

- Global M&A reached $1.1 trillion in first half 2010, up 9% over 2009. Emerging market M&A 32% of volume, up from 19% of volume in 2009.

  Exxon – XTO merger closes in June 2010
  Aon agrees to buy Hewitt Associates
  Reports that Sanofi plans large U.S. acquisition
  Royal Dutch buys East Resources
  Air Products negotiates purchase of Airgas
  Celgene acquires Abraxis Bioscience
  Fidelity National reportedly in largest LBO since financial meltdown
  Sybase acquired by SAP

U.S. Corporate Balance Sheets Remain Very Strong

- S&P 500 companies have over $970 billion on their balance sheets.

US Corporations Continue to Crank Out Great Operating Results

- Intel reports best quarter ever: 2Q 2010 revenue up 34% to $10.8 billion and profits hit $2.9 billion, both record levels.
- UPS' president of International operations indicated the company hasn't seen material weakness in the European regions to which it has greatest exposure (France, Germany, UK). Indeed, he said the decline in the euro has led to increased activity within the Eurozone.
- Fed Ex plans to increase pilot work hours to pre-recession levels "in anticipation of stronger demand, particularly out of Asia." Both Fed Ex and UPS plan to add planes to their Asia network.

Bad News (continued)

U.S. Government Oversight Expands / Hostile to Business?

- U.S. Congress approves what some call "the most sweeping overhaul of U.S. financial regulation since the Great Depression."
- Others disagree: William Isaac, former chair of the FDIC, says "It doesn't reform anything, not anything that needs to be reformed."
- Gulf of Mexico Drilling Moratorium, May 2010. Barclay's estimates oil and gas spending will decline by $1.6 billion as a result of moratorium. Federal district judge blocks the six month moratorium in June 2010. New deep water moratorium issued in July 2010.
- Healthcare Bill creates uncertainties about costs of hiring for companies with 50 or more employees. Impedes job creation.

Jobs, Wages and Employment Remain a Persistent Problem

- Private sector employment edged up by only 33,000 in May and 83,000 in June, both below forecast. The unemployment rate remains high at 9.5%, which some economists say fails to account for a growing number who have given up the job search.

Government Benefits Expand While Private Salaries Shrink

- Record low 41.9% of U.S. personal income came from private wages and salaries in 1Q 2010, down from 44.6% in December 2007.
- Individuals got 17.9% of their income from government programs, 1Q 2010, versus 14.2% in December 2007. An additional 9.8% of personal income was paid as wages to government employees. Economist David Henderson of Hoover Institute says "People are paid for being rather than for producing."

Pick 'Em – Could be Good, Could be Bad

- Financial Times reports money market funds had their biggest weekly inflow in 18 months and some of the world's biggest money managers are holding 40% of their funds in cash.
- U.S. Equities were down 11-12% in 2Q 2010 and JP Morgan 10 year bond index was up 12%.