Background

Whatever the causes of the Financial Crisis of 2008, we are living with the consequences today. As the financial system was on the verge of collapse and the credit markets froze, the government stepped in with the $700 billion Troubled Asset Relief Program (TARP). Along with the Federal Reserve's financial rescue programs and a new monetary policy initiative called *quantitative easing,* TARP has helped the banks to regenerate capital and the financial system to slowly heal from the damage inflicted during the Crisis.

The aggressive and coordinated moves by the Federal Reserve and the US Treasury have helped to reignite domestic economic growth. But, they do not come free of charge. The cost of these initiatives has saddled our nation with a high debt burden and has only served to postpone the tough decisions that we still must face. Our debt burden is compounded by the growth in municipal debt, unfunded pension liabilities and the rising cost of entitlement programs. Our federal debt is now in excess of 85% of GDP and this excludes $2 trillion in municipal debt. Our current form of fiscal austerity is more about incurring cheap debt than about reducing expenditures that directly relate to our standard of living.

Our domestic economy and capital markets are burdened with structural challenges that will make sustainable growth difficult in the face of cyclical economic progress. These structural issues include a persistently high rate of unemployment, difficult credit conditions, a huge debt burden, growing unfunded pension liabilities, and excess capacity, all of which will act as headwinds to economic growth. We are concerned that the cyclical economic progress, which was aided by the inventory cycle and the government stimulus package, will begin to wane in the face of these structural challenges.

The Global Debt Crisis

While Dubai was in the headlines for its excessive debt levels and restructuring challenges late last year, Greece has dominated the headlines in 2010. The Eurozone's inability to deal quickly and decisively with Greece's growing excessive debt and lack of fiscal discipline underscores the problem of how the euro is structured as a currency. Germany and France are the dominant savers among the countries making up the Euro, while Spain, Portugal, Italy, Ireland, and Greece are saddled with excessive levels of debt. Last week, markets were set in turmoil as Greece was downgraded to junk levels and Spain and Portugal were both downgraded to BBB levels.

Greece is a volatile credit situation. There is obvious difficulty in combining both Eurozone and private support for Greece's debt problems which has prolonged Greece's debt challenges. The contagion is at the doorstep of the European banks which hold much of the debt of Greece (as well as the debt of Spain and Portugal). Greece is more than a liquidity challenge, it is a solvency issue. While the recently announced $146 billion bailout of Greece should help to stabilize the region, it has only served to further delay the fiscal challenges faced by Spain and Portugal. In addition, we expect the bailout will likely insure a persistent recession in the country which may ultimately lead to political unrest.

The Euro is a currency without a country. If the Eurozone cannot implement consistent measures of fiscal discipline and austerity, the Euro currency will be in jeopardy. However, at this point we view the events in Europe as deflationary which is consistent with our current view of the economic activity in the United States. Our concern is that the deterioration in the troubled sovereign debt eventually spreads to the European financial system potentially impacting European credit markets.

Today, the debt burden of the United States is as serious as that of Europe. The time is now for a comprehensive plan to deal with the bloated debt levels of the United States, including a plan to harness Fannie Mae and Freddie Mac. With the sustained high rate of unemployment, excess capacity and no real initiative to stimulate business growth we believe that we are in a deflationary cycle through the remainder of 2010. However, without a plan to address the debt levels, once the excess capacity is marginalized, we expect the risks in 2011 will turn quickly to an increase in the rate of inflation.

The US government has shown through history that once it accumulates excessive levels of debt, it has difficulty reducing the debt burden, sometimes taking as long as a decade. The goal of the Federal Reserve is to exit its

unconventional policies that it implemented during the financial crisis in order to improve its flexibility to implement monetary policy. Without fiscal discipline, the risks to heightened levels of inflation will grow. Our capital markets have not experienced inflation since the early 1990s and the shock to the capital markets could be severe.

Investment Strategy

We believe that investing in this market is not about making a lot of money, its more about not losing money.

The risks inherent in our capital markets are very high currently. Whenever a country has structural issues gripping its economy and capital markets, appreciation in financial assets will be challenged. The structural issues we currently are facing are complex and very real. The Federal Reserve is balancing the extraction of its massive stimulus initiative without destroying economic growth and a fragile financial system. Financial regulatory reform is quickly becoming the latest badminton game between Democrats and Republicans in Washington DC. Ultimately, we expect the result effectively will be a tax on the banks which will dampen lending and economic growth. And, while the economy is showing solid growth, we don't see it as the "V shaped" recovery that we've experienced after other recessions. *Because of these structural issues, the markets are not pricing risk efficiently*. When this happens, investors need to pull back and reassess the risk/reward relationship.

We expect fixed income returns will be challenged for the remainder of the year. The yield curve is still near historically wide levels (2 year to 30 year UST yields are 281 basis points). However, at some point the Fed will allow short term interest rates to shift higher. We are looking for opportunities to build inflation protection into the portfolio. This includes shortening duration, and investing in floating rate securities as well as TIPs. While spreads are tight on investment grade debt, we still see opportunity for excess return in the bank and insurance sectors.

While we acknowledge the problems in credit deterioration and believe that the ratings in many cases do not reflect the real risks inherent in the credit, we believe high quality municipal bonds are undervalued. Sadly, in many situations credit ratings are as useless to an investment decision as a flashlight is to a blind man. However, the default rates on high quality general obligation bonds and essential service revenue bonds are extremely low. We like municipal bonds in the short maturity area.

We have been active investors in the preferred stocks of companies in regulated industries. While we still like the hybrid securities of domestic banks, we are reducing exposure to hybrids in the European banks. The European banks, particularly Germany and France, are the primary holders of Greek debt. We expect their balance sheets will suffer at the margin with the bailouts of Greece, Spain and Portugal which could have a negative impact on performance of their hybrid securities.

We are approaching investing in the US equity market as a range bound market. The cyclical themes of inventory rebuilding and increased spending due to the stimulus money are offset by a weak housing market, problems in commercial real estate, and the structural challenges in our capital markets. We expect as the Federal Reserve reduces the leverage in the system, the general market basis will likely subside. And, without improvement in top line growth, corporate earnings will muddle along.

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