
MARKET COMMENTARY: A "NORMALIZING" MARKET

- The stock market has recovered substantially from the March lows. At this point, it is appropriate to ponder "*what's next?*".
- In April, we wondered: "*is this merely another 'bear market rally' soon to be rendered invalid by the overwhelming amount of negative sentiment and economic data?*" We then made the following assertion: "*We believe that investors should be prepared for two things: a) the continuation of this rally well past expectations and b) another sell off of some magnitude later this year.*" **We maintain this near term outlook.**
- Fundamentally, more "green shoots" of economic recovery become evident each month. Yet, the economy remains buffeted by considerable headwinds. This tension will persist for the foreseeable future. On balance, however, there is ample justification for a growing sense of optimism.
- Markets are forward looking, and it appears that both the bond and commodities markets are "pricing in" higher inflation in the future. Meanwhile, the stock market is attempting to return to the levels that existed prior to the Lehman bankruptcy in September 2008.
- Last Fall's overriding concern – i.e., systemic market/economic collapse – is no longer "on the table". For that, we owe a debt of gratitude to our policy makers. While some of their actions have been controversial, we believe that their responses were appropriately aggressive. We believe the market has shifted its attention away from stabilization efforts and toward renewed growth.
- Mohamed El-Erian of PIMCO describes a "new normal" in terms of economic activity characterized by substantially lower amounts of leverage and much slower growth. As the markets continue on this process of "normalization," investors will debate this point of view as well as the unintended consequence of policy measures implemented to avert crisis – namely, inflation.

Note that all charts, tables, and graphs utilized in this analysis were obtained from the Bloomberg Financial Markets system unless otherwise indicated.

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- With regard to the broader economy, there was a massive inventory drawdown from October through March. Companies simply shut down production given general uncertainty and the lack of trade financing. We have seen a pick up in production activities associated with a rebuild of inventories. What is difficult to discern, at this juncture, is whether this inventory rebuild is **normalizing** and sustainable or whether it is simply a rebound from late last year.
- Similar to 2008, the market's concern has shifted away from systemic collapse in the Spring (i.e., Bear Stearns in March 2008; all banks in March 2009) to inflation from commodity price surges in the Summer. In 2008, political pressure was exerted on the Fed to **raise** interest rates in response to surging oil prices. Likewise, in 2009, there is growing concern that the Fed and other central banks should **remove** stimulus and, perhaps, **raise** interest rates to pre-empt inflation.
- We believe the parallels between 2008 and 2009 are otherwise limited. We do not fear for a repeat of last Fall's upheaval which was in direct response to the collapses of Fannie, Freddie, Lehman, and AIG. Further, we acknowledge improvement in the following areas: a) systemic collapse has been averted; b) China's stimulus package is having a tangible, positive impact; and c) there are notable "green shoots" of economic recovery.
- We remain worried about the following: a) systemic crises in Europe that affect our capital markets; b) rising unemployment; and c) pressures on the Dollar.
- For the near term, the market could be providing an opportunity to buy intermediate Treasuries again. We continue to favor TIPs and Gold (at lower prices). We also believe the S&P 500 could be range bound – 750 – 1100, perhaps. The lower end of this range corresponds with the November 2008 low, and the upper end corresponds with the index value prior to Lehman Brothers last Fall.

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WHITHER INFLATION?

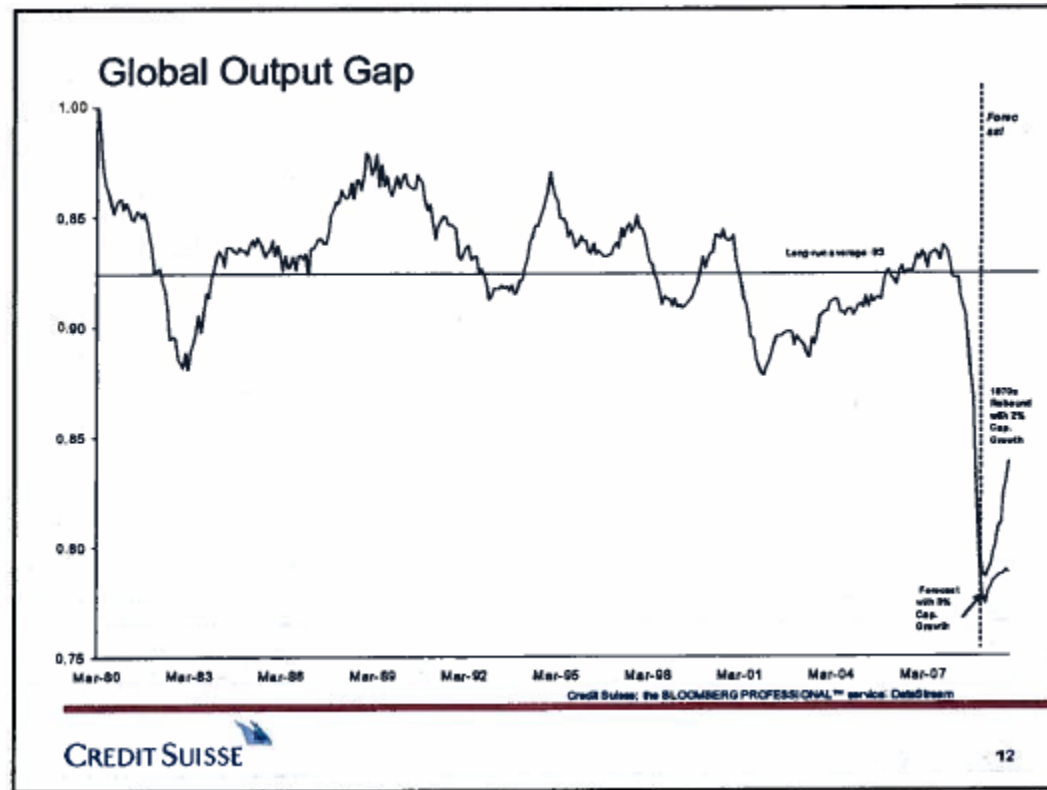
- The charts on the next two pages were developed by the Credit Suisse economics team in late May. They depict the global output gap – a measurement of actual GDP growth versus potential GDP growth. When the output gap is less than 1.00 (i.e., 100%), it implies there is slack in the economy.
- Earlier this year, the output gap fell to less than 0.80. This suggests that global economies were operating at less than 80% full capacity. The long run average, as depicted in the first chart, is 0.93. This is **non-inflationary** as it implies that companies lack pricing power and there should be minimal pressure from labor costs.
- The chart on page 5 depicts the correlation between the output gap and inflation for the G-3 economies.
- Richard Berner, economist for Morgan Stanley, acknowledged in a recent report that massive monetary intervention has boosted inflation expectations. However, he feels that because of persistent slack in the global economy, “core” inflation should actually decline over the next year. He notes that “slack in the US economy has rarely been larger” and that “operating rates [are at a] record low 69%.” (Morgan Stanley research report, 6/15/09)
- Further, Mr. Berner points out that slack in the labor markets has begun to promote a **deceleration** in wages.
- Despite the legitimate concerns over latent inflationary pressures resulting from the massive monetary stimulus, we feel that global efforts to reflate economies must contend with ongoing deleveraging (a deflationary force). We believe inflationary pressures will not emerge until 2011 or 2012. Thus, we express our concern over a premature “unwinding” of many of the government’s support programs, and we acknowledge that such actions in late 1936 arrested a nascent recovery and prolonged the Great Depression.

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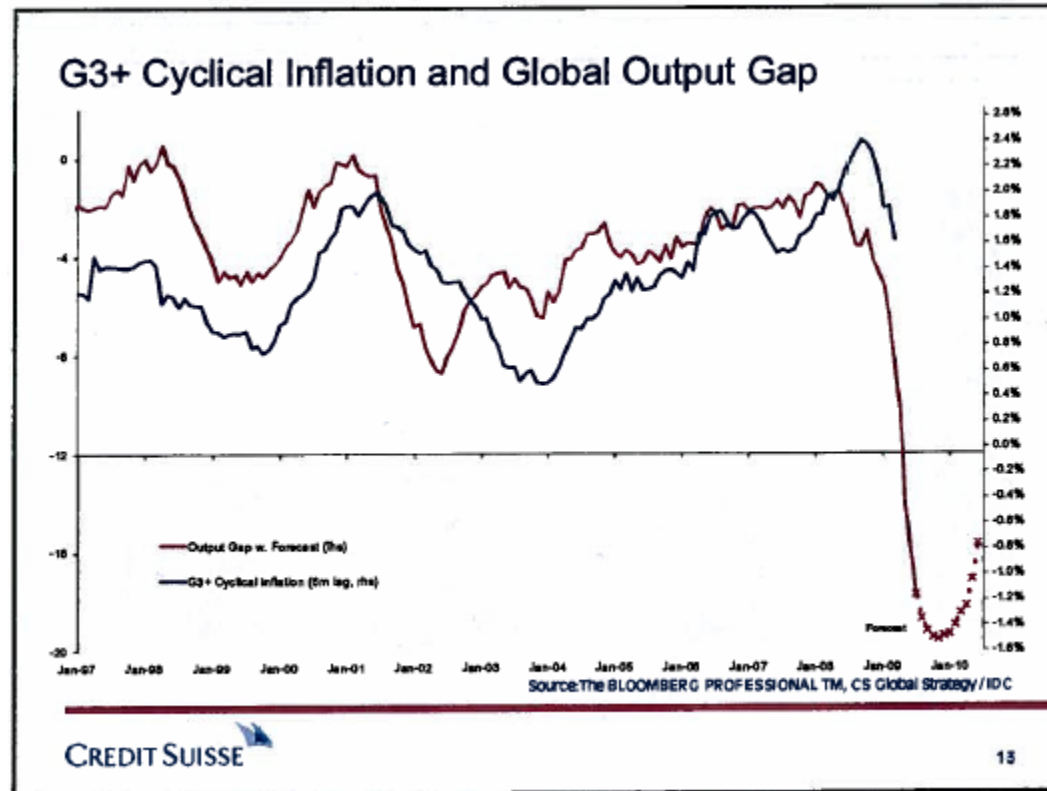
GLOBAL GDP REMAINS WELL BELOW POTENTIAL



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UNTIL THE OUTPUT GAP CLOSES, DAMAGING INFLATION IS UNLIKELY



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WE CONTINUE TO RECOMMEND A WELL DIVERSIFIED APPROACH

In general, we favor business models and asset classes that do not depend on leverage. Until we emerge from this recession, we also favor business models that depend on non-discretionary income as opposed to discretionary income.

1. Nominal yields available on **high grade corporate bonds** remain attractive. From a spread perspective, this sector is no longer as compelling.
2. Nominal yields available in **high grade, tax free municipals** are also attractive. If tax rates rise as expected, municipals will only increase in their appeal as an asset class.
3. We favor **gold** as a hedge against devalued currencies. We believe gold will remain inversely correlated with the Dollar, and as such, we view this commodity as an effective hedge against future weakness in our currency.
4. As a hedge against inflation, we recommend instruments like **TIPS (Treasury Inflation Protected Securities)**. With a recovering economy, we believe investors will need to hedge themselves against latent inflationary pressures.
5. **Equities**: Remain **defensive**, but think long term and be **opportunistic**: We prefer stocks with attractive dividend yields. Our favorite sectors correspond with our long term investment themes (see next page).
6. **Commodities** sectors: this is the sector with the most direct leverage to a resumption of growth in Asia and the global infrastructure build out.

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LONG TERM INVESTMENT THEMES

Financials: selective inclusion of certain franchises with solid balance sheets and sustainable business models. We feel it is important to maintain limited exposure to this sector, but we do not advocate complete avoidance. Mohammed El-Erian of PIMCO believes that bank business models, in a world with substantially less leverage, will resemble those of utilities – i.e., negligible growth potential; low valuation; restrictive capital structures; attractive dividend yields. Fundamentally, the sector is unlikely to experience demonstrable improvement absent massive consolidation.

Energy: the collapse in crude prices could discourage exploration and production, as it did in 1998. Long term, this dynamic renders the sector attractive as supply shortages will facilitate prices to rise over time.

Agriculture: We favor investment opportunities along the entire “food chain”: hybrid seeds; fertilizer; equipment; processing; storage. Driven by commodities prices, this sector is also prone to occasional price spikes that render valuations unjustified.

Water: perhaps the most important environmental and economic issue facing the world. We believe investment in all aspects of water development -- irrigation; sanitation; delivery; purification – are vital.

Alternative Energy: until a particular type of energy source becomes prevalent, we favor a “basket” approach using diversified ETFs. However, we feel that this sector, too, represents an important long term investment allocation.

Global Infrastructure: much hinges on the continued rapid expansion and build out of emerging Asia, particularly China and India. We believe many US companies are well positioned to provide the resources necessary for the Eastern hemisphere to improve its standard of living.

Tax-Free Municipals: given US fiscal pressures, we anticipate higher tax rates in the future. High quality tax-free municipal bonds could provide a stable source of income with attractive nominal, as well as taxable equivalent, yields.

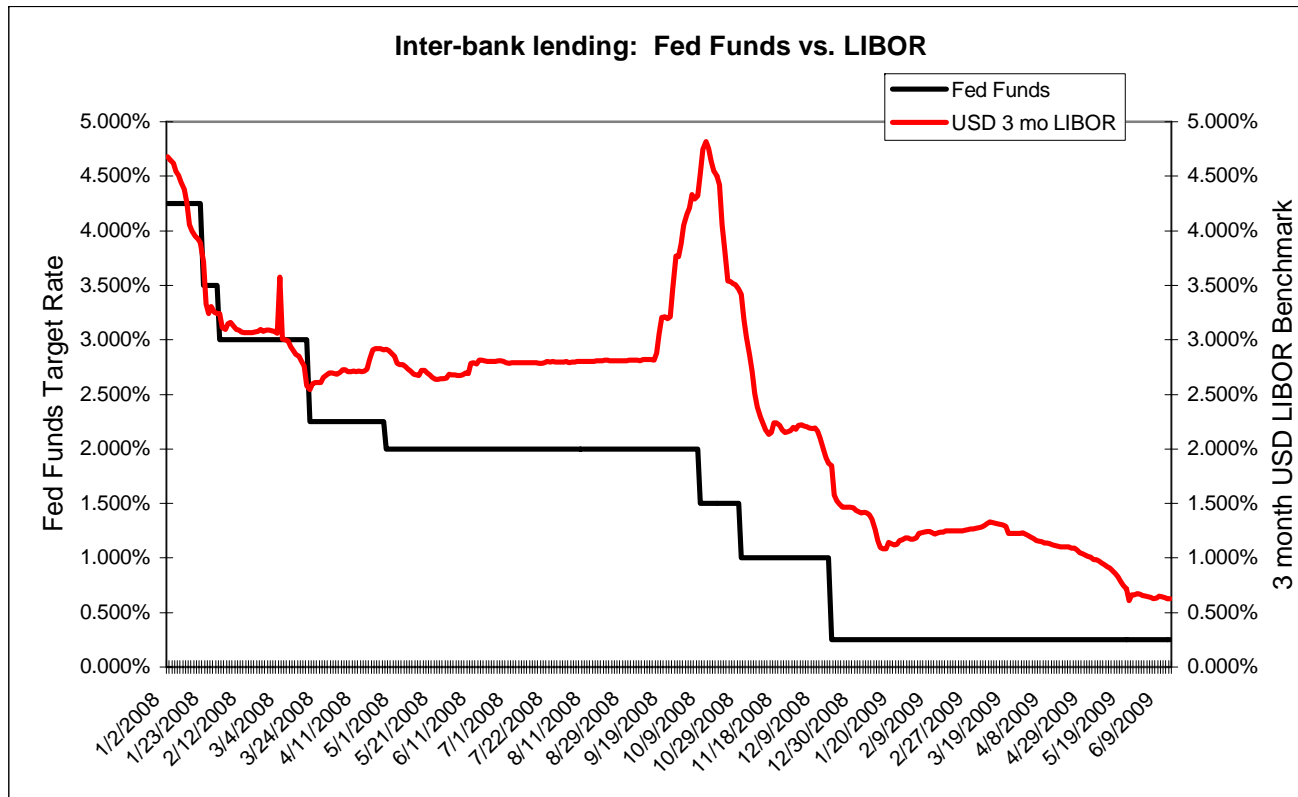
International: no economy will be immune from a global slowdown, but we feel certain countries are better positioned long-term than others. Brazil, in particular, has the potential to become both an agricultural and an energy superpower.

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FED ACTION HAS UNCLOGGED THE SHORT TERM CREDIT MARKETS

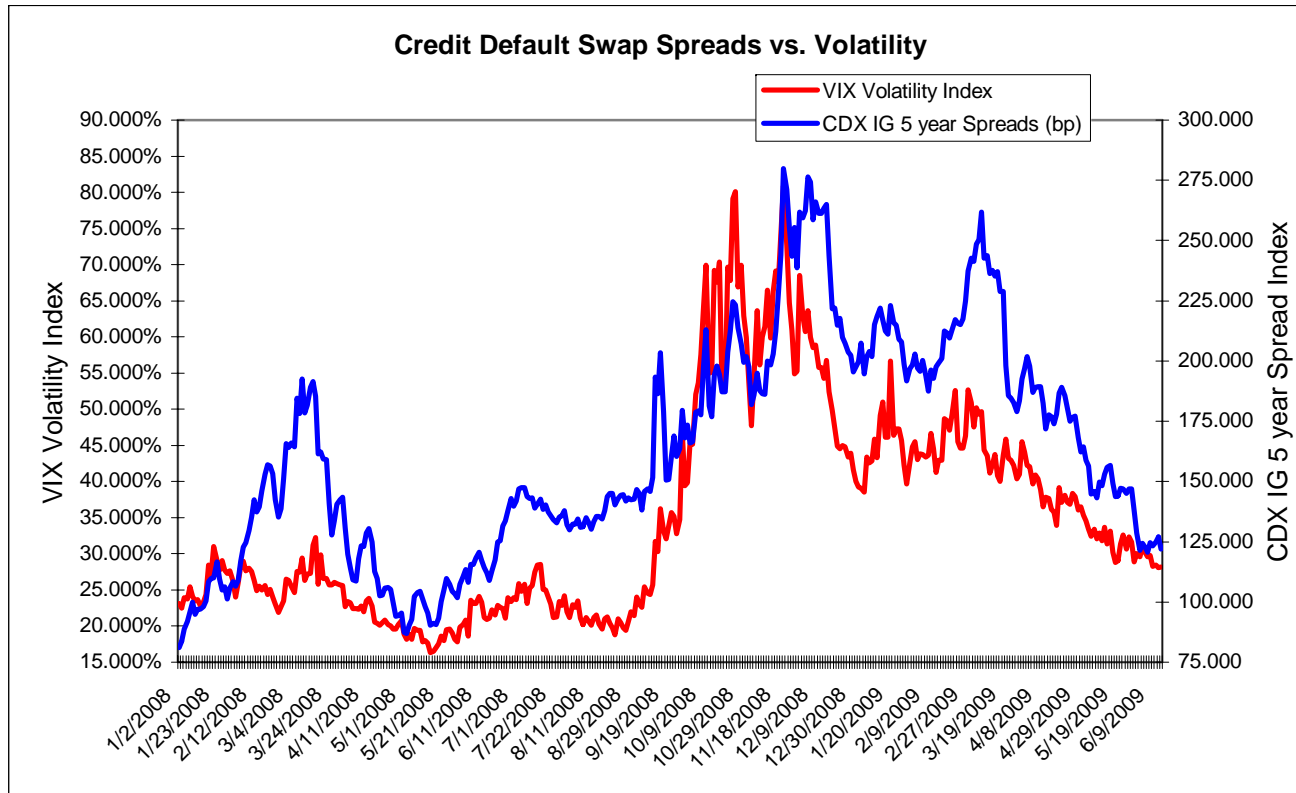


- The various emergency programs implemented by the Fed have succeeded in thawing the credit freeze in the interbank lending markets. Note how LIBOR is approaching its historical relationship to Fed Funds.

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AS CREDIT CONDITIONS HAVE IMPROVED, VOLATILITY HAS SUBSIDED

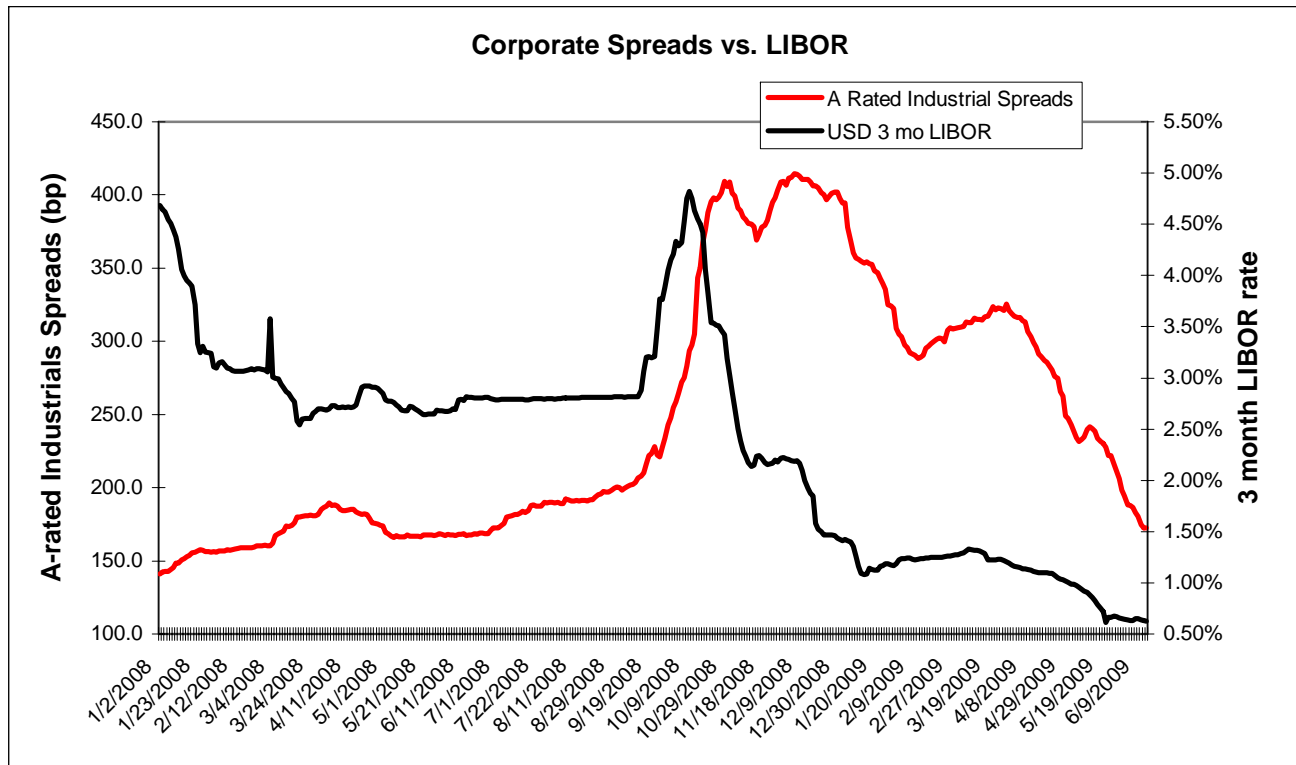


- Tighter spreads on Credit Default Swaps are a sign of rising confidence among investors. This indicator is further supported by declining volatility.

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ALL CREDIT MARKETS HAVE IMPROVED SIGNIFICANTLY

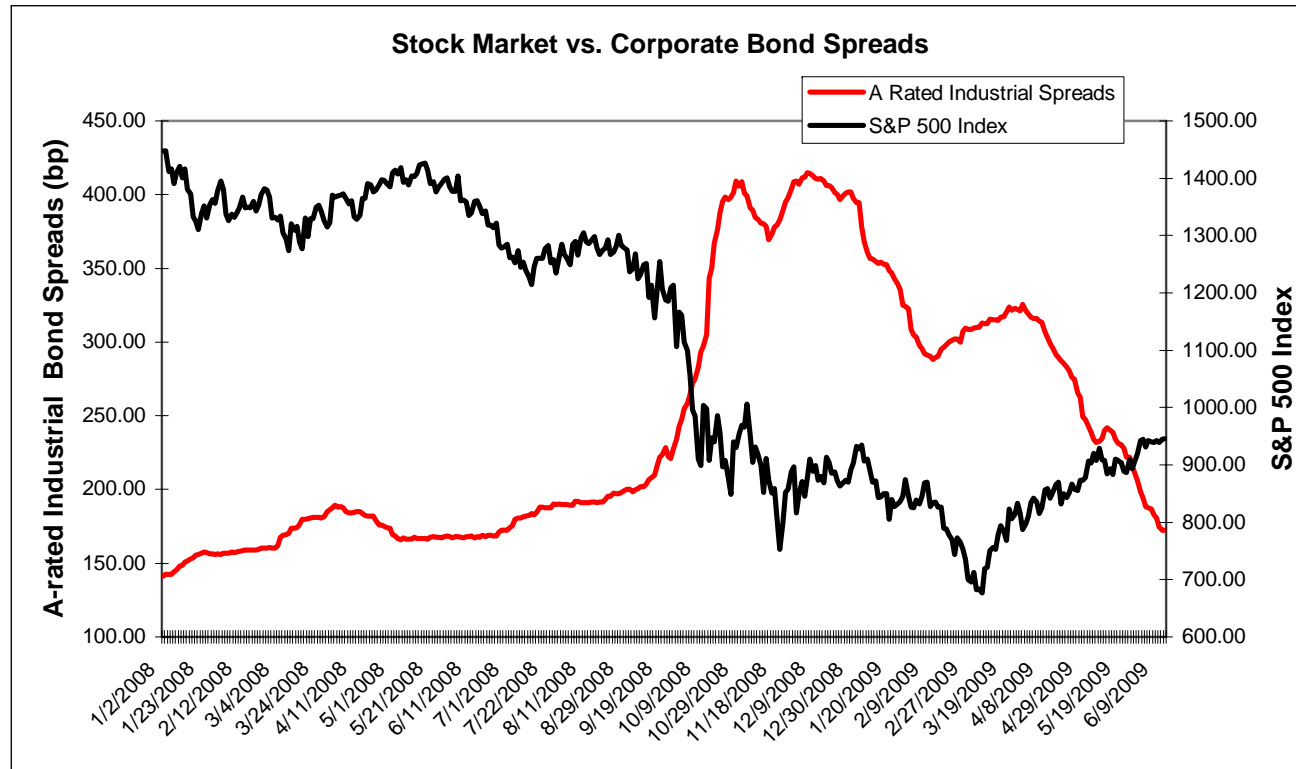


- In 2008, disruptions in the short term funding markets led to a cascade of liquidity problems in all other markets. As short term conditions stabilized, other markets followed suit.

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AS CREDIT MARKETS HAVE STABILIZED/"NORMALIZED", THE STOCK MARKET HAS RESPONDED POSITIVELY

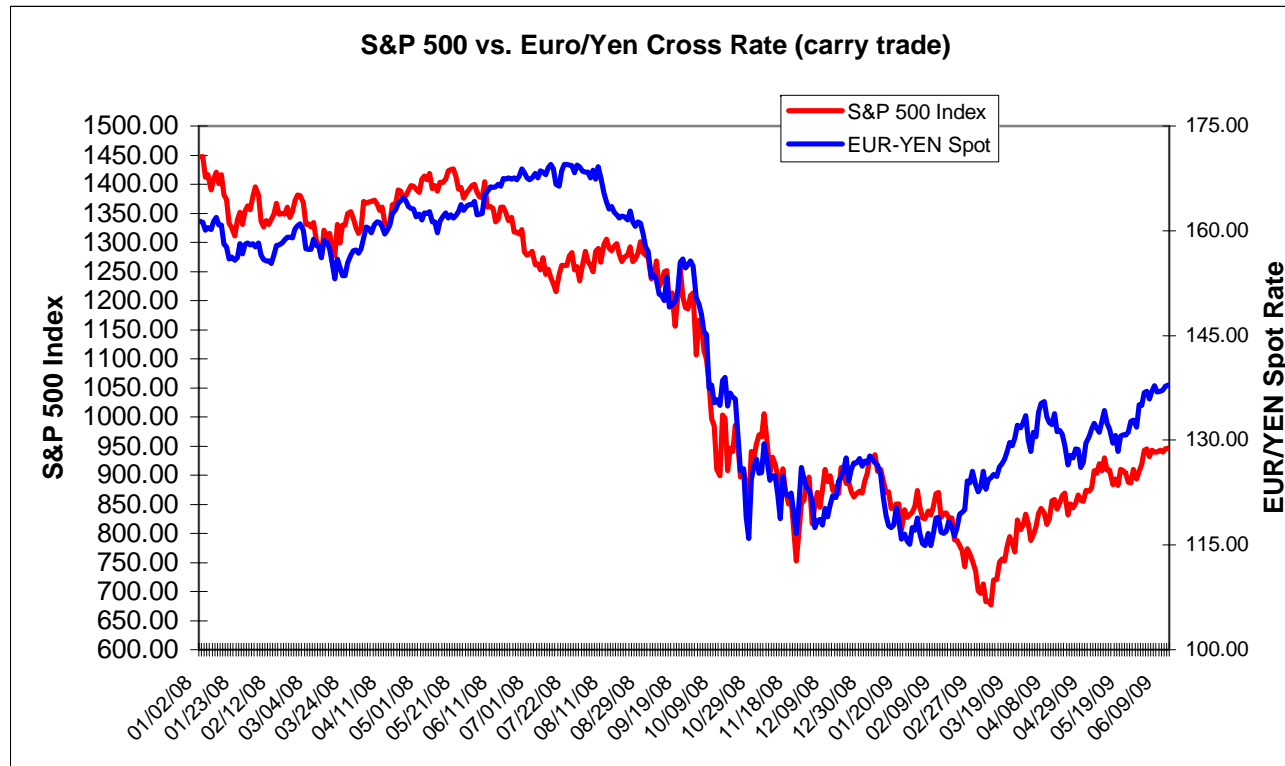


- This crisis began in the credit markets, and it stands to reason that as credit conditions improved, other markets would follow.

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WITH CREDIT MARKETS IMPROVING, RISK APPETITE HAS RETURNED TO THE MARKETS

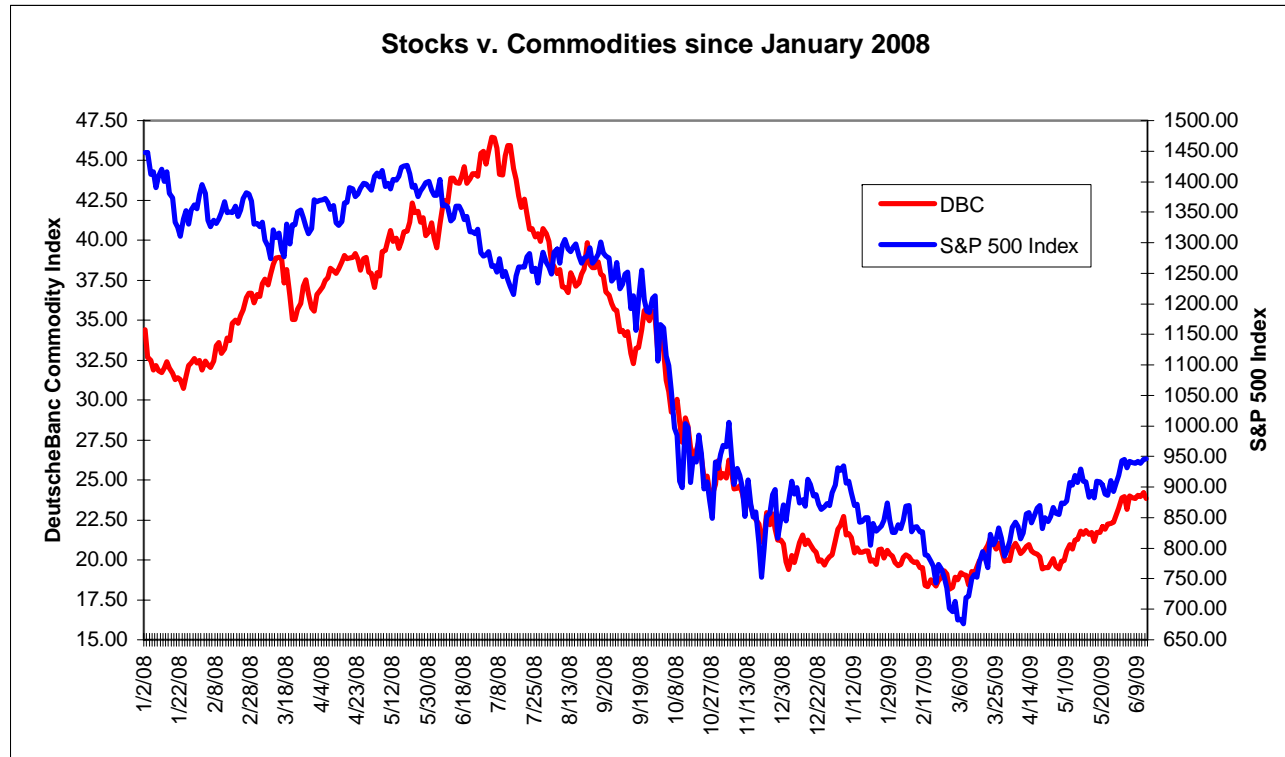


- The Euro/Yen exchange rate is considered by many to be a reliable gauge of global “carry trades” – i.e., large institutional investors that seek to arbitrage between low yielding currencies and higher yields available elsewhere. It is further considered to be an indicator of risk aversion – when the Euro/Yen is falling, risk aversion is on the rise; when the Euro/Yen is rising, risk aversion is on the decline.

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COMMODITIES APPEAR TO HAVE BOTTOMED. HAVE STOCKS?

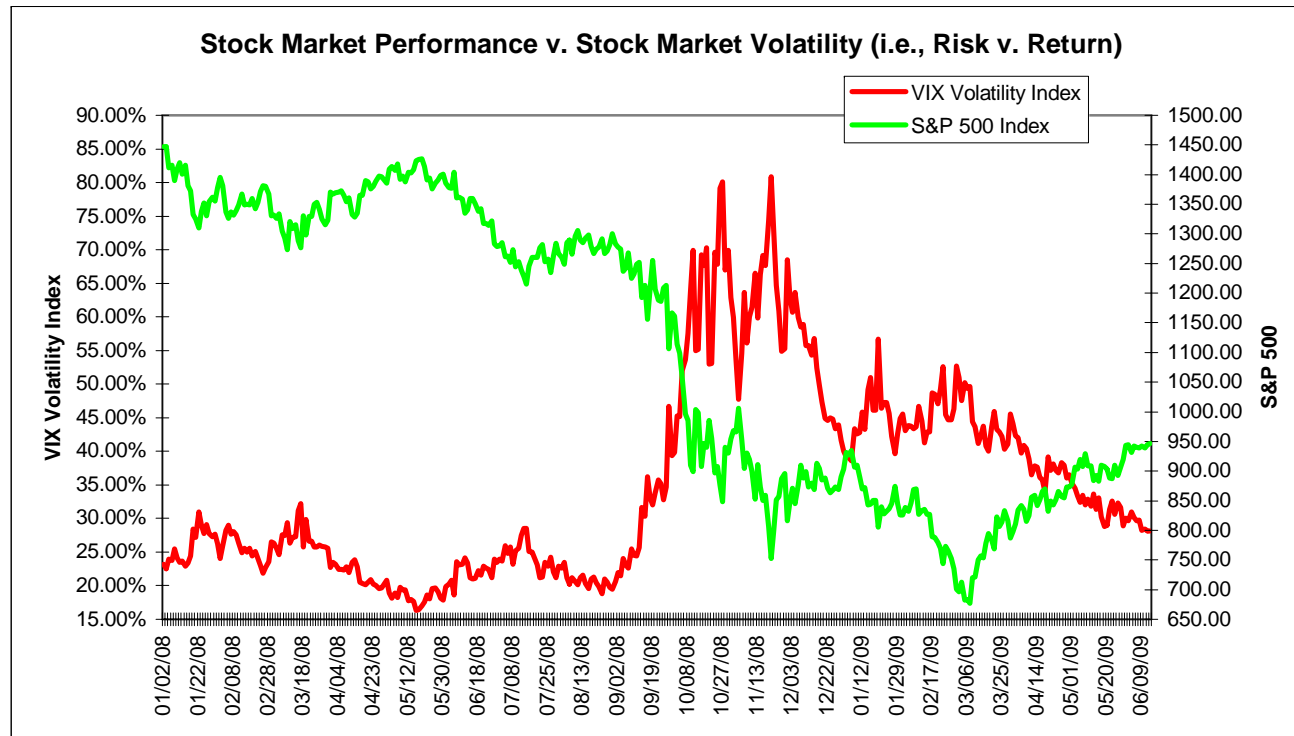


- Since July 2008, stock and commodities markets have been positively correlated. We view this year's improvement in both markets as a lead indicator of global economic recovery.

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“NORMALIZING” VOLATILITY WILL HELP SUSTAIN THE STOCK MARKET’S RECOVERY

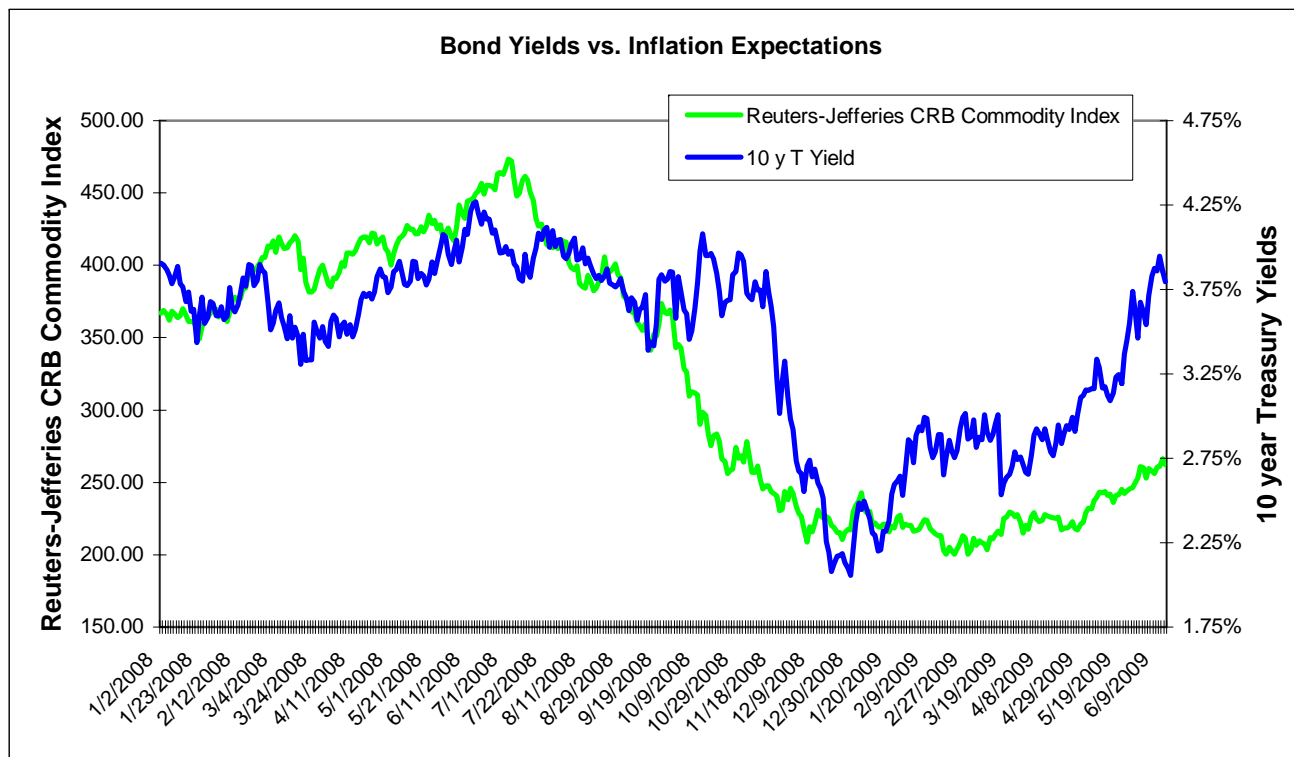


- While market volatility has yet to fully return to levels prior to last year’s market collapse, the trend is quite favorable and supports the notion that confidence among investors is slowly being restored.

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INFLATION'S REBOUND COINCIDES WITH RISING TREASURY YIELDS

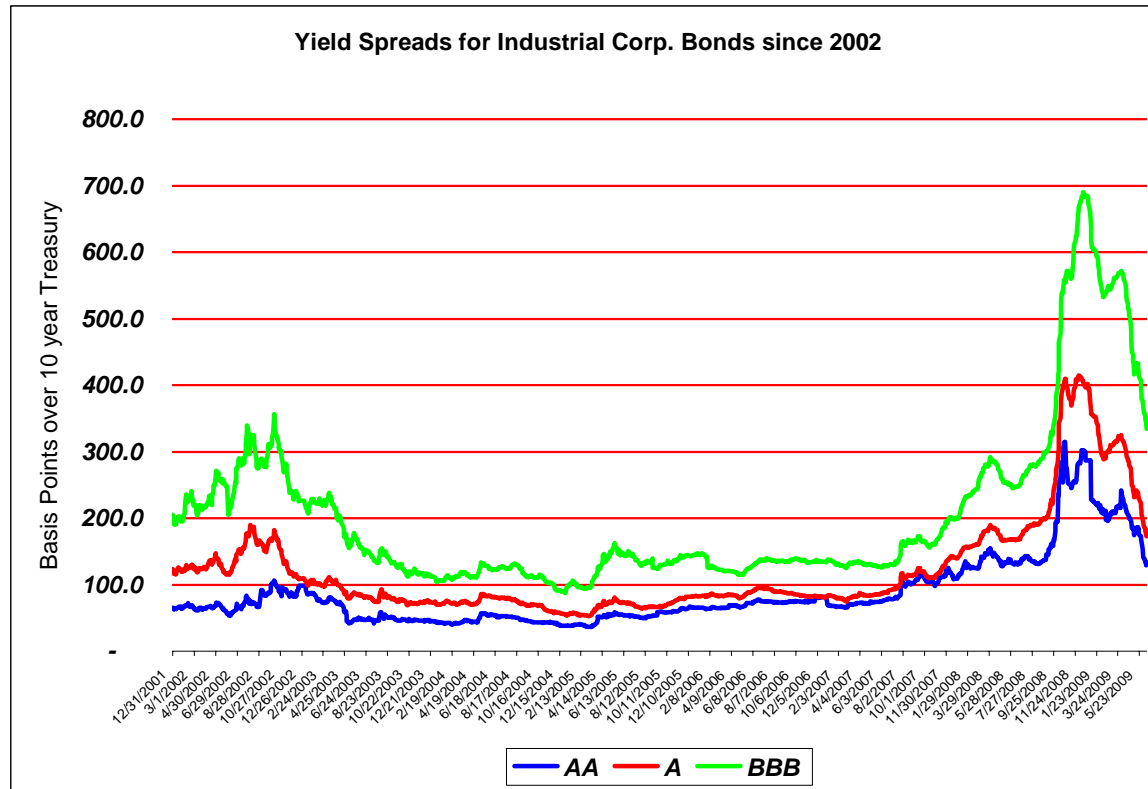


- Market participants have quickly shifted their attention away from deflation and toward inflation. This is manifested by the sharp rise in Treasury yields. Yet, Treasury yields have merely returned to levels that existed prior to last Fall's upheaval. The question now becomes: **where do they go from here?**

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SPREADS ON CORPORATE BONDS HAVE FALLEN FROM THEIR PEAKS

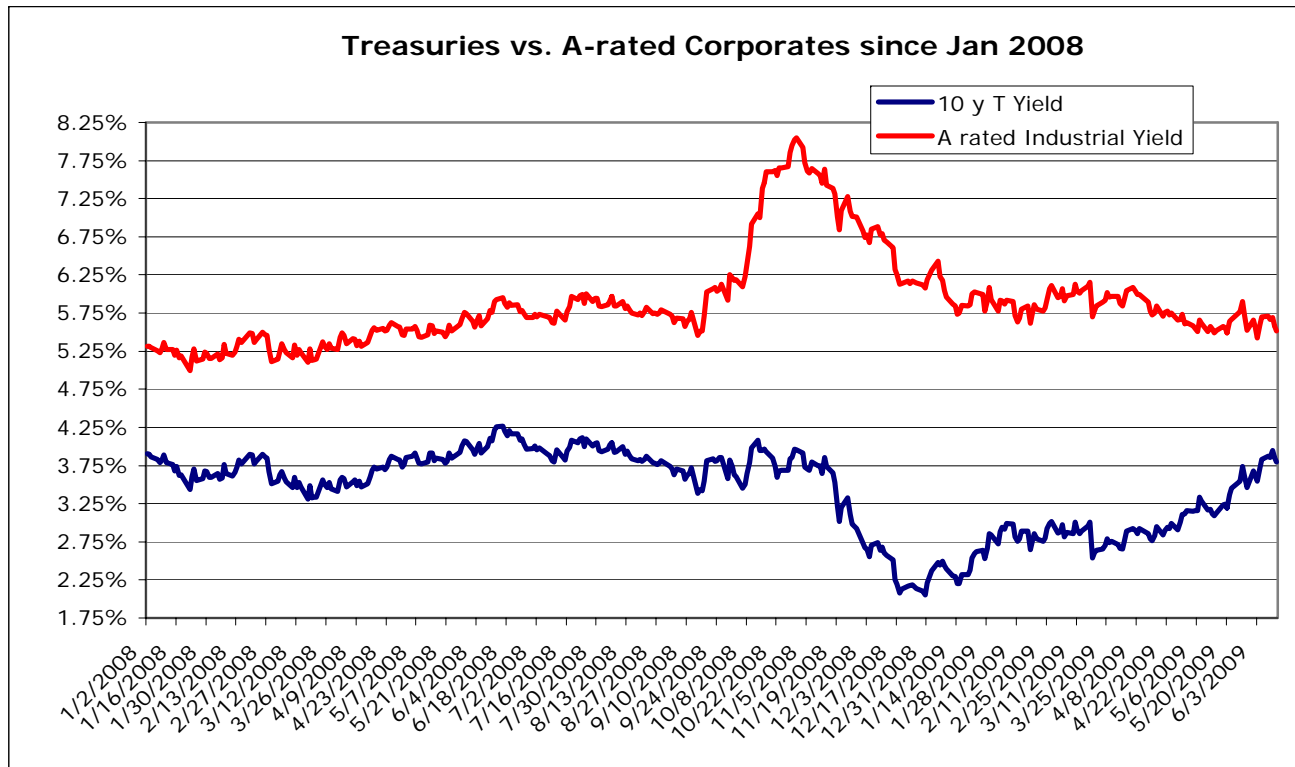


- In yet another sign of “normalizing” markets, corporate spreads have fallen from the crisis levels of last Fall.

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CORPORATE BOND YIELDS HAVE "NORMALIZED"

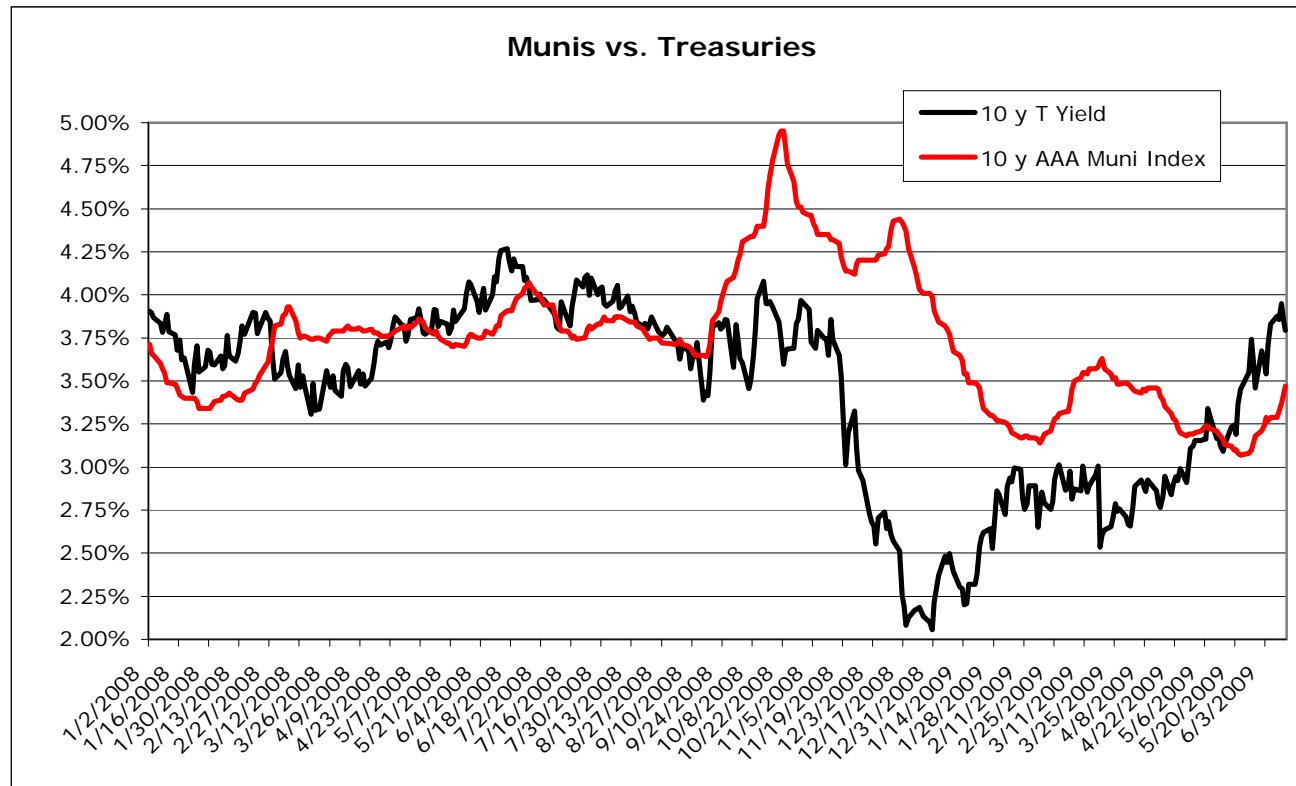


- As with Treasuries, nominal yields on Corporates have returned to “pre crisis” levels of last Fall. For the near term, yields seem to have “normalized”. Corporate bonds have significantly outperformed Treasuries, however, and on a nominal basis, their yields remain relatively attractive.

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YIELDS ON TAX-FREE MUNICIPALS HAVE ALSO "NORMALIZED"

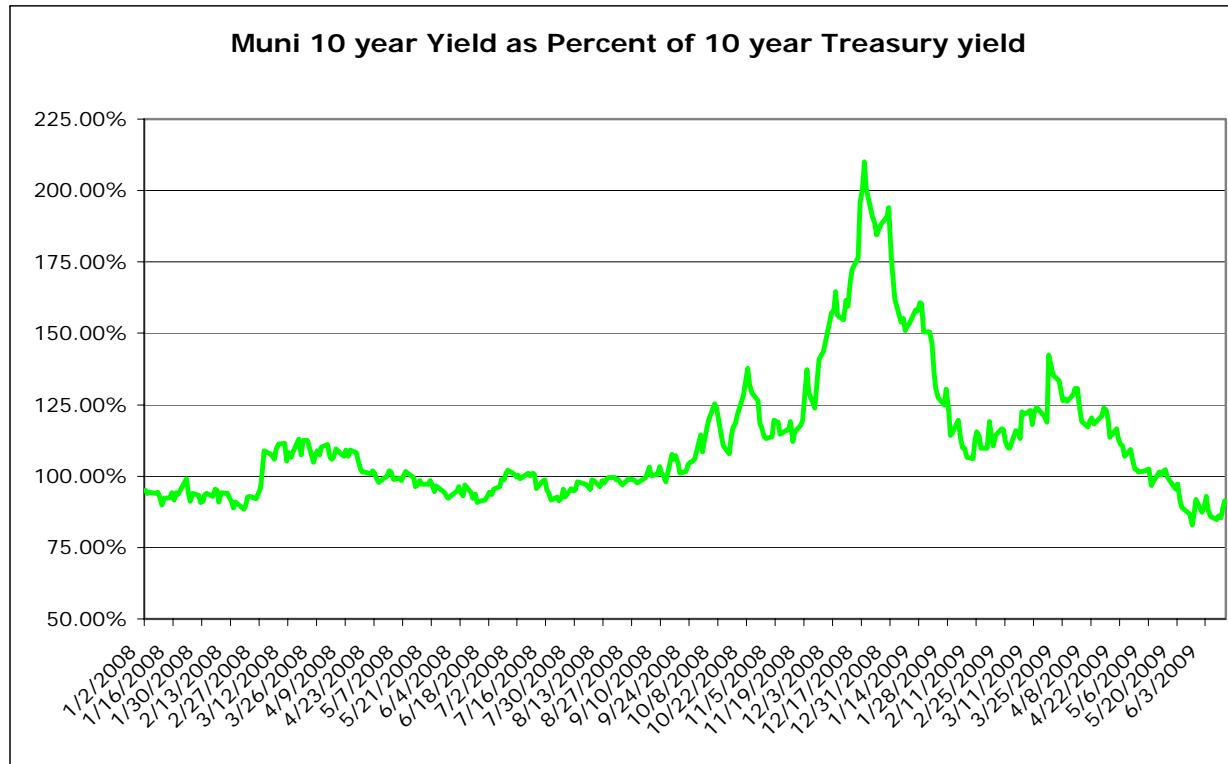


- Yields on tax-free municipals have "normalized" in that their nominal yields are now less than Treasuries.

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RELATIVE YIELD OF TAX-FREE MUNICIPALS

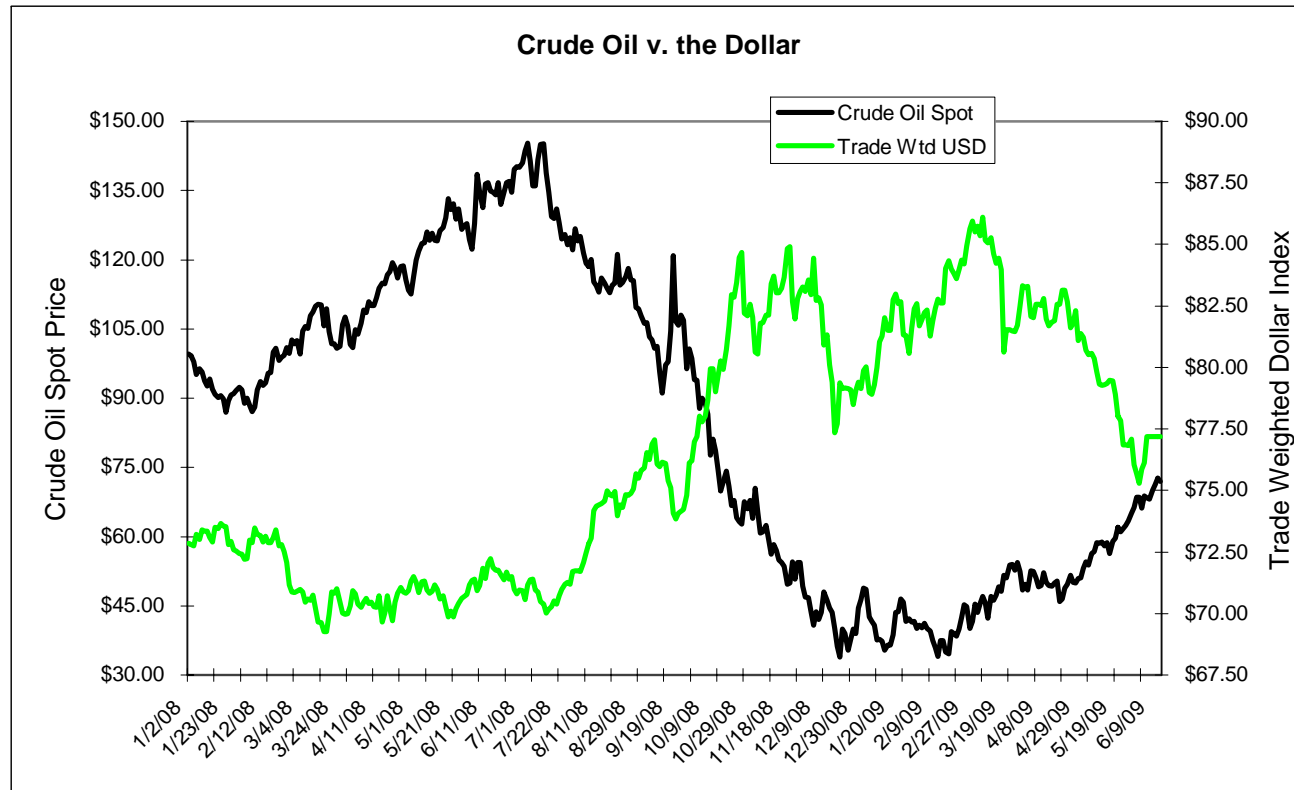


- In April, we believed that yields on tax-free municipals would “normalize” relative to Treasuries. **They have.** In fact, they are now trading at their historical average of **80 – 85%** of Treasury yields.

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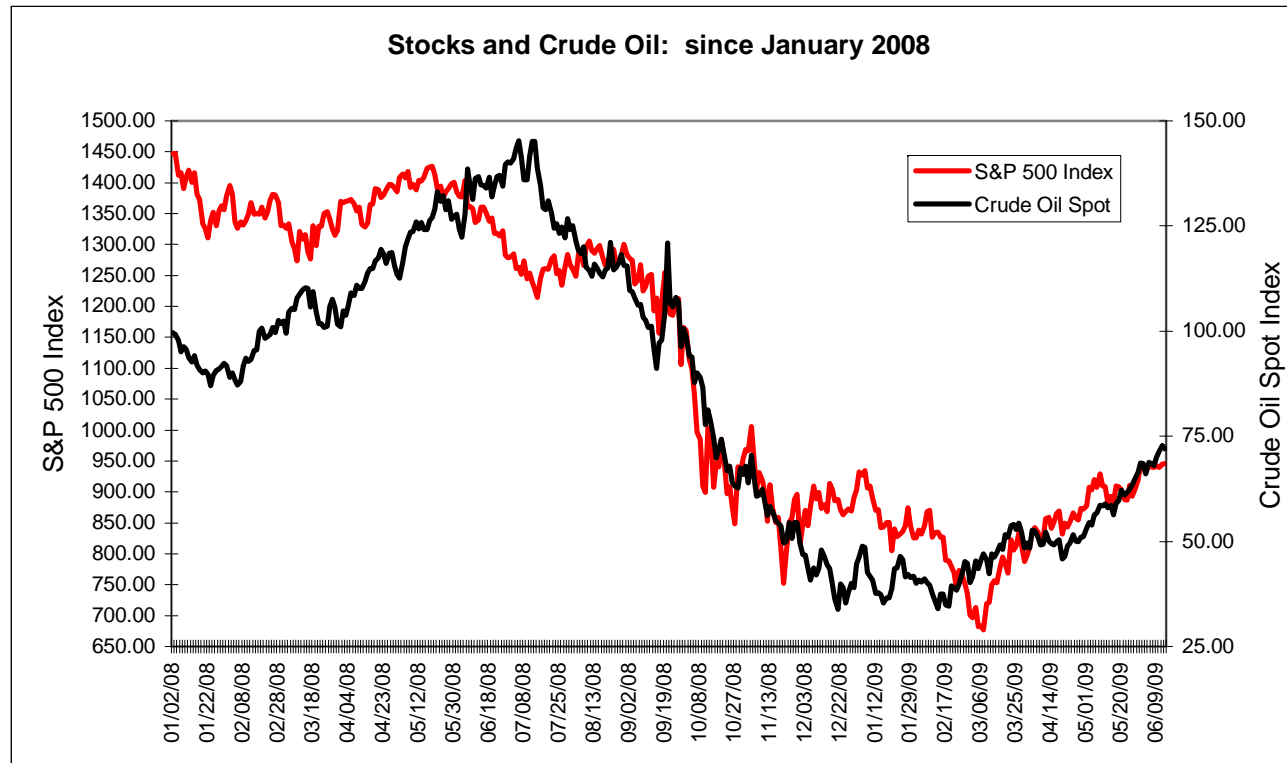
A REBOUND IN COMMODITIES PRICES HAS COINCIDED WITH A WEAKENING DOLLAR



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AS CRUDE OIL PRICES HAVE REBOUNDED, SO HAS THE STOCK MARKET



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