
MARKET COMMENTARY

- GDP posted a rather remarkable **5.0%** annualized recovery rate in Q4 2009. Since that time, however, economic momentum has been dissipating. Q1 2010 witnessed only **3.70%** growth, and early reports for Q2 2010 indicate a much more tepid **1.60%** growth rate. Those developments have sharpened the focus on what appears to be the central concern among many market participants: is the US economy headed for a “double dip” recession?
- It is widely acknowledged that the US faces a formidable structural unemployment challenge for the foreseeable future. Structural unemployment refers to jobs that were permanently destroyed during the recession. It implies that while new jobs are being created, there is a mismatch in the skill set of available labor capital and the needs of employers.
- As our economy struggles to create new jobs, those that are employed are discovering that credit terms have tightened significantly. The bear case basically concludes, therefore, that our economy will endure a lengthy period of consumer retrenchment. Until the economy can demonstrate sustainable growth without the need for fiscal or monetary stimulus, the bear case recommends caution, especially with respect to the outlook for financial assets.
- While these pressures could prove overwhelming, the bullish argument focuses on the dramatic improvement in the corporate sector. Eventually, those companies will need to hire people. Many companies utilized the Financial Crisis of 2008 to improve inefficient systems, eliminate redundancies, cut costs, repair balance sheets, and establish a more stable financial structure in anticipation of the recovery. On balance, companies emerged from the recession with much less leverage and in generally better condition than when they entered.
- The markets have also been exceptionally volatile. Three contributing factors, addressed to a certain extent in this Outlook piece, include the raging debate over **inflation vs. deflation**. Markets are also concerned about the impact of tighter **regulations**. In the US, regulation will disproportionately affect three massive industries: **health care; financial services; energy**. Finally, in the US, there is also uncertainty associated with **tax policy**.
- It is important to remember, despite all the global uncertainties, that **opportunities always exist**. It pays handsomely, on occasion, to be a contrarian.

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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PERFORMANCE OF VARIOUS ASSET CLASSES

Market Performance Analysis						
SYM*	Description	Category	Total Return			
			YTD 2010	Q3 2010*	2009	2008
	S&P 500 Total Return Index	Large Cap Equities	-3.28%	3.61%	26.46%	-37.00%
	DJIA	Blue Chips	-0.90%	4.35%	22.68%	-31.93%
	NASDAQ Composite	Tech Dominant	-5.09%	2.10%	43.89%	-39.98%
	Lipper International	International Equities	-5.35%	6.22%	35.30%	-43.62%
	Russell 2000 Composite	Small Cap Equities	-1.38%	1.19%	27.17%	-33.79%
	Shanghai Composite	Chinese Stocks	-17.86%	10.99%	79.59%	-64.89%
	Barclays Cap Govt/Credit	Govt & Corp Bonds	6.73%	2.08%	5.24%	5.08%
LQD	iShares iBoxx IG	Inv Grade Corp Bonds	10.64%	4.00%	8.46%	2.40%
HYG	iShares iBoxx HY	High Yield Bonds	4.31%	3.95%	28.57%	-17.58%
GLD	SPDR Gold Trust	Gold Bullion	12.77%	-0.55%	24.03%	4.92%
EWZ	iShares Brazil		-7.55%	11.09%	121.86%	-54.30%
EWC	iShares Canada		0.64%	5.83%	53.13%	-44.45%
EWA	iShares Australia		-6.40%	11.54%	68.13%	-47.95%
EPP	iShares Pacific ex-Japan		-3.07%	10.58%	63.49%	-47.57%
EFA	iShares EAFE Index	Europe, Australia & Far East	-7.02%	8.62%	26.95%	-41.04%

* Symbol refers to the Exchange Traded Fund that tracks each Index. Performance through market close on August 27, 2010.

- There was a sharp rebound among International sectors during the quarter, especially those regions that benefit from growth in **China** (e.g., **Brazil; Canada; Australia; Pacific ex-Japan**).
- Bonds continue to outperform stocks, on a year to date basis, but global equity markets have recovered during this quarter. Most of that recovery occurred in July.

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PERFORMANCE OF S&P 500 SECTORS

S&P 500 Sector Performance Analysis				Total Return			
SYM*	Weight**	Description	Category	YTD 2010	Q3 2010*	2009	2008
XLY	10.30%	Select SPDR Cons Disc	Consumer Discretionary	3.62%	5.36%	40.57%	-32.97%
XRT		Select SPDR Retail	Retail Stocks	4.33%	3.70%	77.43%	-38.02%
XLP	11.70%	Select SPDR Cons Staples	Consumer Staples	1.99%	4.67%	14.28%	-15.02%
XLE	10.91%	Select SPDR Energy	Broad Energy Stocks	-7.87%	4.87%	21.79%	-38.97%
XOP		SPDR Oil & Gas	Exploration Stocks	-4.89%	0.33%	40.17%	-42.69%
XLF	15.73%	Financial Select SPDR	Broad Fin Svces	-4.23%	-0.58%	17.61%	-54.97%
KRE		SPDR KBW Regional Bank	Regional Banks	-1.77%	-5.98%	-21.92%	-18.57%
XLV	11.69%	Health Care Select SPDR	Broad HC Services	-7.27%	1.31%	19.51%	-23.31%
XLI	10.62%	Industrial Select SPDR	Industrial Companies	4.28%	4.78%	22.07%	-38.74%
XLB	3.61%	Materials Select SPDR	Basic Materials Cos	-4.25%	10.61%	48.17%	-44.05%
XLK	21.56%	Technology Select SPDR	Information Technology	-7.62%	3.14%	51.32%	-41.51%
IYZ		DJ US Telecomm	Telecom Stocks	2.25%	7.77%	26.23%	-42.04%
XLU	3.89%	Utilities Select SPDR	Utilities	2.35%	10.19%	11.71%	-28.93%

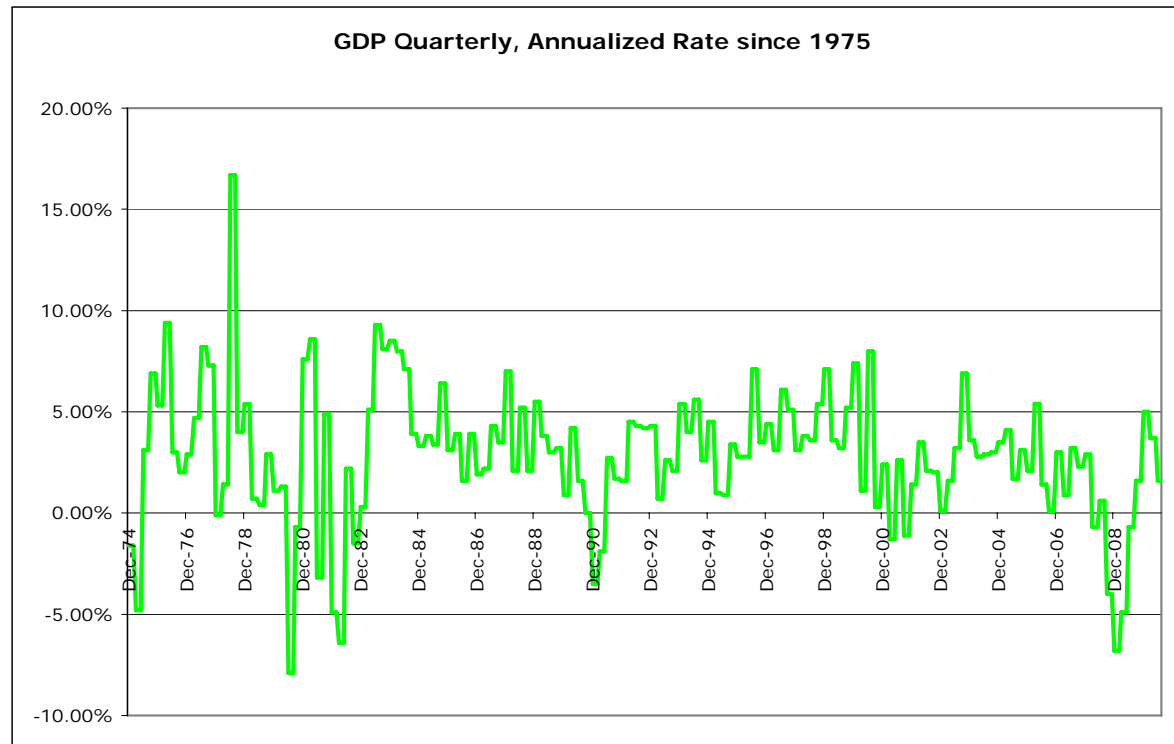
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 ** Sector weight in the S&P 500 Index.

- Investors took a decidedly defensive turn during the quarter as **Utilities** and high yielding **Telecom** stocks were in favor. This seemed to be balanced by a “barbell” strategy that included Materials.
- The three sectors most affected by regulation – **Energy; Financial Services; Health Care** – were some of the laggards.

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HISTORICAL US GDP GROWTH RATES

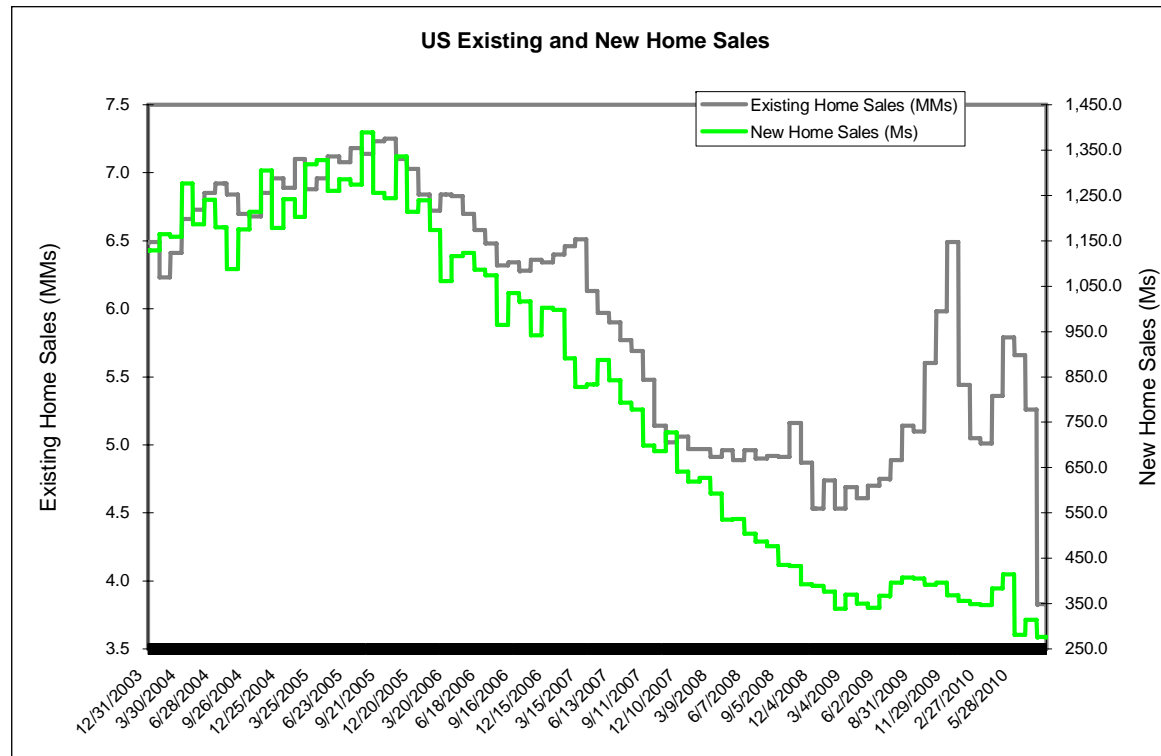


The chart above tracks annualized GDP, reported on a quarterly basis, since 1975. Using GDP as a yardstick, one could argue that the recession of 2001 – 2002 was extremely mild compared to the contraction that began in late 2007. The current recession/contraction was the most severe since the early 1980s. The late 1970s (far left of the chart) witnessed some extremely volatile economic performance with large declines followed by large upswings.

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NEW & EXISTING HOME SALES – NOT A PRETTY PICTURE

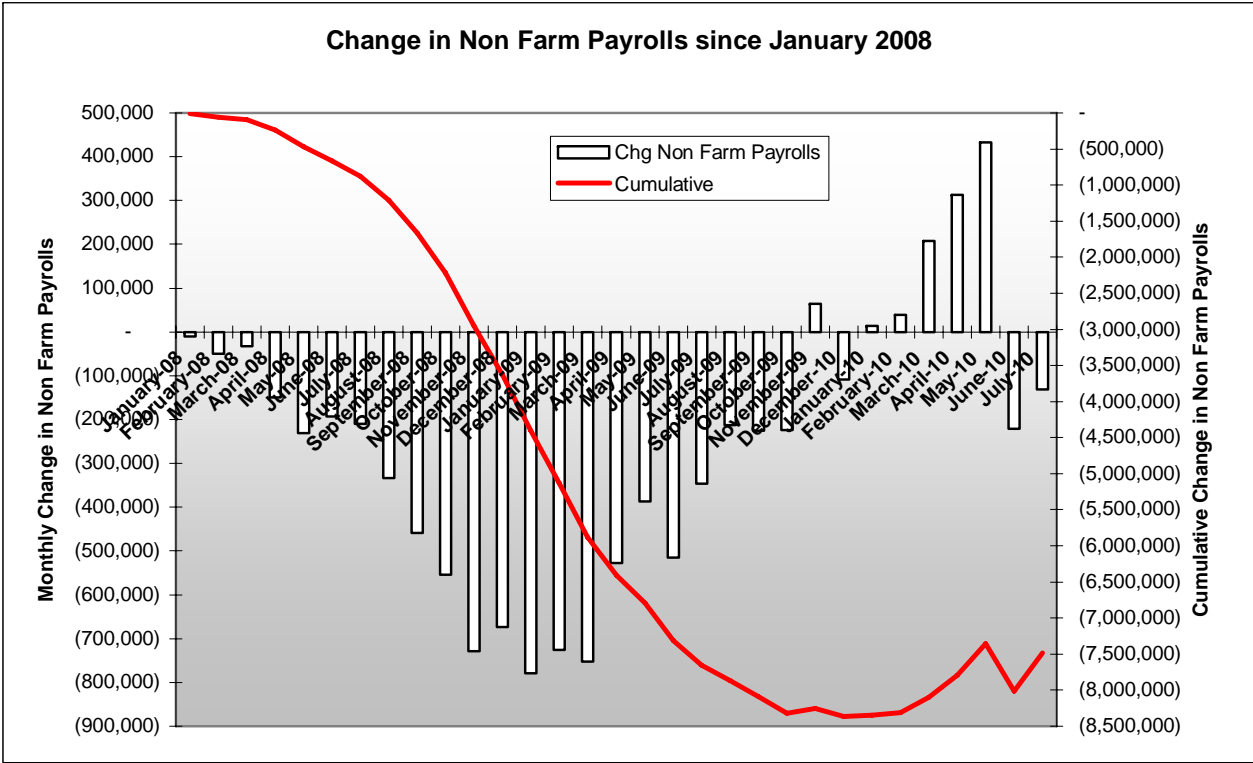


The chart above that tracks both New and Existing Home Sales since 2004 captures the magnitude of the housing bubble. For example, Existing Home Sales (grey line; left hand axis) averaged more than 6.5 million units annually from 2004 through 2007. Most recently, they collapsed to 3.83 million annualized units, a level not witnessed since 1995! New Home Sales collapsed to 276,000, a level not witnessed in decades. This represents a tremendous decline from the greater than 1.0 million units that were sold each year from 2004 through 2007.

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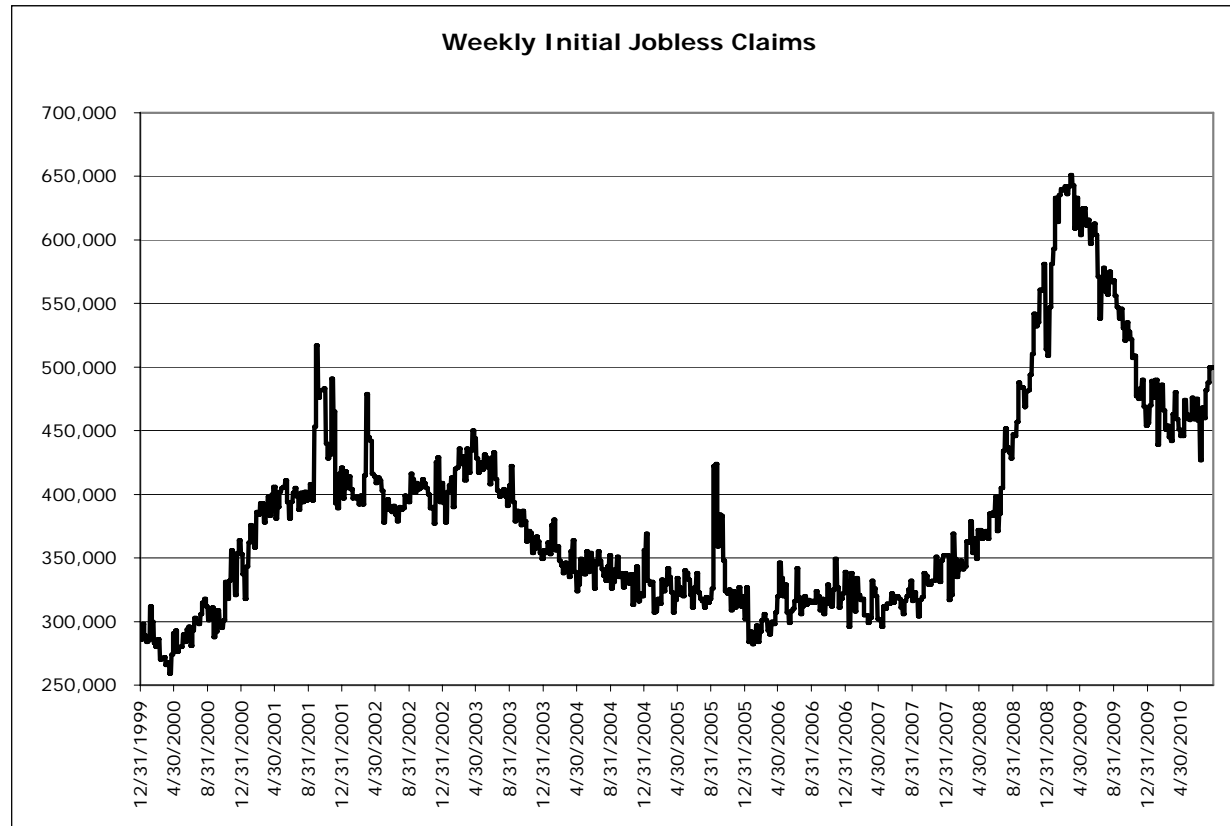
JOB CREATION REMAINS THE KEY TO FUTURE ECONOMIC GROWTH AND FED POLICY



The chart above depicts the most worrisome aspect of this economic recovery, and it provides the greatest support for the bearish “double dip” forecast. The red line tracks the cumulative number of jobs that have been eliminated since January 2008, a figure that peaked close to 8.5 million. The bars represent the net new jobs created or lost each month. While skewed by the 2010 census, job creation during this recovery has been subpar using historical standards.

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POLICY FOCUS IN 2010: JOB CREATION

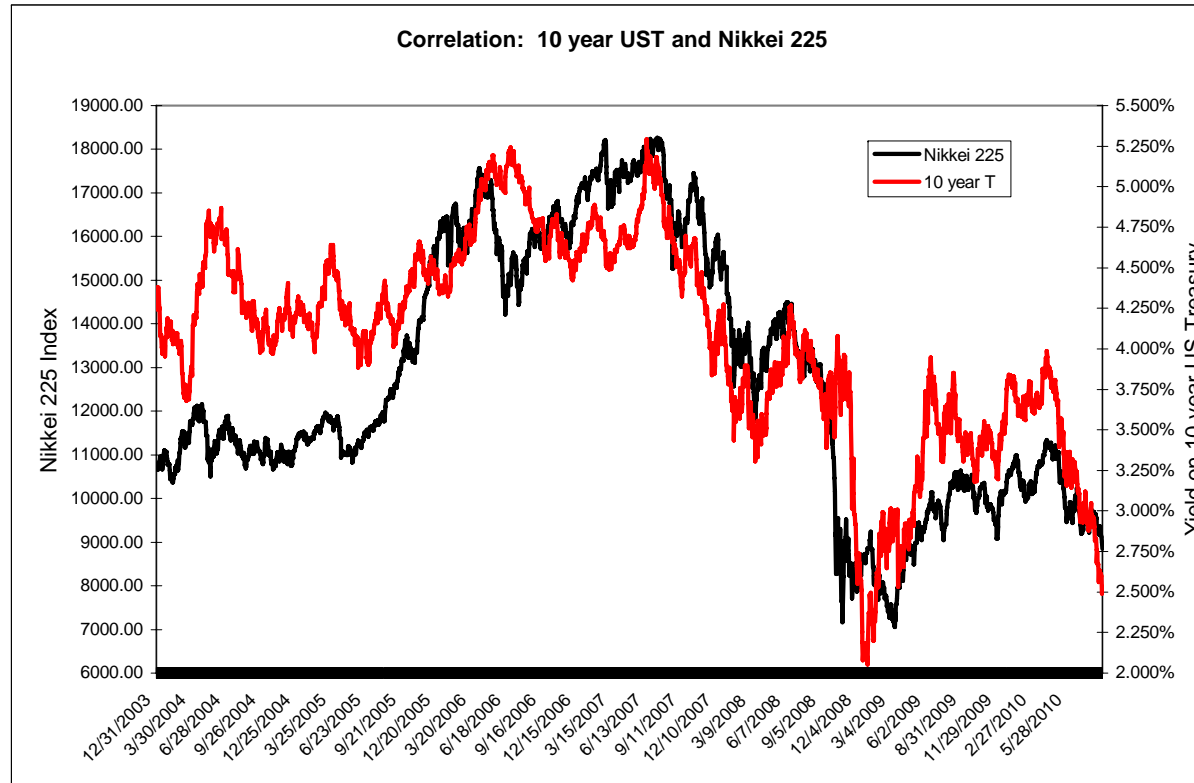


Negative performance with respect to new job creation is confirmed by Weekly Jobless Claims (chart above) that remain stubbornly above 450,000, which is also well above historical averages.

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DEFLATION: IS THE US THE NEXT JAPAN?

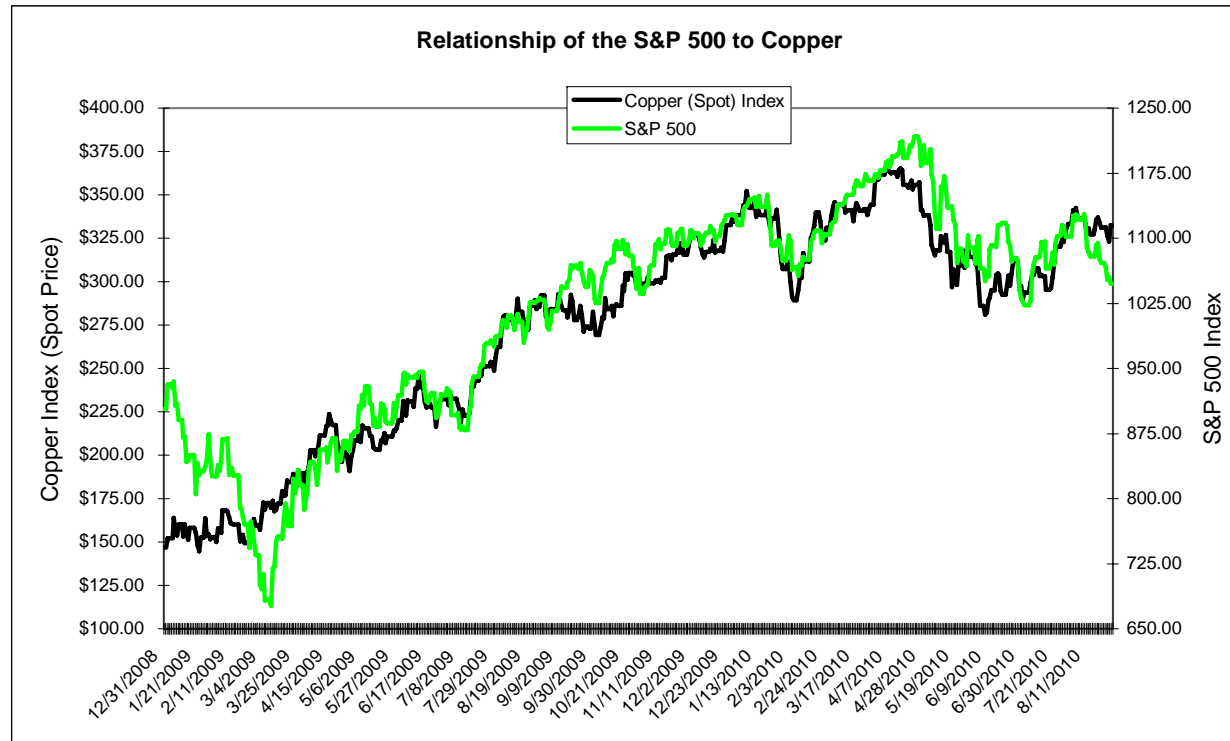


Does this chart confirm deflation? It compares the yield on the 10 year US Treasury against the value of the Nikkei 225 Index. As many are aware, Japan has been combating deflation “off and on” since 1989. In many respects, Japan can serve as a proxy for deflation. In that context, it would appear that the collapse in Treasury yields suggests a high probability that the US will experience deflation.

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COPPER SIGNALS ECONOMIC GROWTH



The chart above compares the performance of the S&P 500 against the spot price of copper. Many market participants regard copper as a reliable lead or coincident indicator of global economic activity. Copper is an integral resource in many industries, and trends in copper prices have correlated with the general direction of global activity. Following its trough in early 2009, copper prices have staged a remarkable recovery. The trend line is definitively headed in a favorable direction, and it suggests **global growth and commodity price inflation, not deflation.**

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INFLATION V. DEFLATION

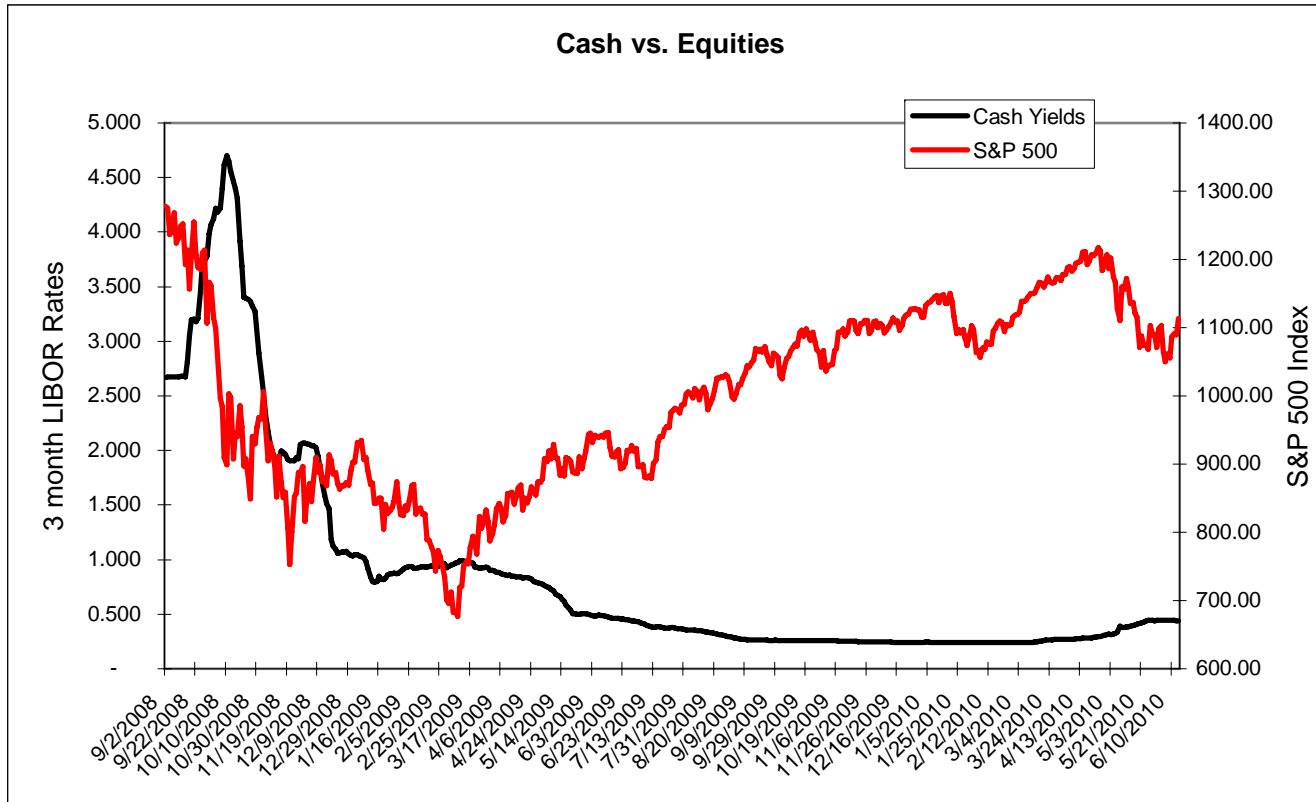
Sources of Deflation	Sources of Inflation
Excess global labor capacity	Commodity shortages (food & energy)
Structural unemployment in the US	Currency devaluation
Global de-leveraging	Monetary policy
General consumer price deflation (apparel; consumer electronics; autos; technology)	Isolated consumer price inflation (health care; education)

- With unemployment in the US persistently greater than 9%, that condition confirms excess labor capacity, which is deflationary. There is also **excess labor capacity** globally, although in the natural resource economies, this is beginning to fade (China; Australia; Canada; Brazil). **Global de-leveraging** is highly deflationary. Excess cash flow is devoted to debt redemption as opposed to consumption.
- Inflation can result from **commodity shortages**. This type of inflation tends to self correct because of the substitution effect. High commodity prices are actually beneficial because they spur on investment.
- Inflation is considered by many to be the likely long-term negative outcome of **currency devaluations** – i.e., central bank quantitative easing. This is the great unknown and the key to making money over the next few decades.
- On balance, **deflation is more prevalent at present**. Moreover, deflation is likely to prevail until the global credit system is either fully repaired or completely restructured. At a minimum, leverage will be considerably less in the future. That suggests that inflation is less of a concern today than it was in the 1970s.

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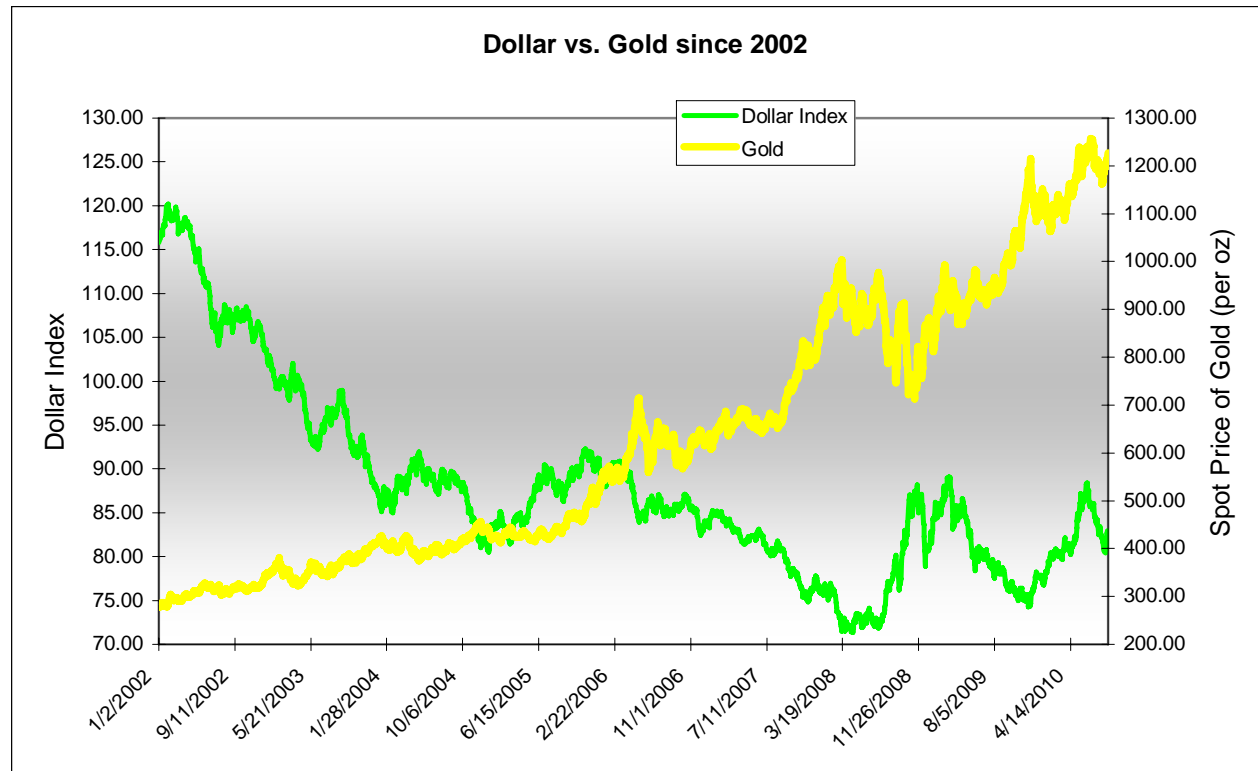
MONETARY POLICY: PENALIZE SAVERS; ENCOURAGE INVESTMENT



In effect, monetary policy discourages savings and encourages investment/consumption. The chart above depicts our economy's dependence on the wealth effect derived from financial assets, such as stocks.

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DOLLAR WEAKNESS = STRONG GOLD !?

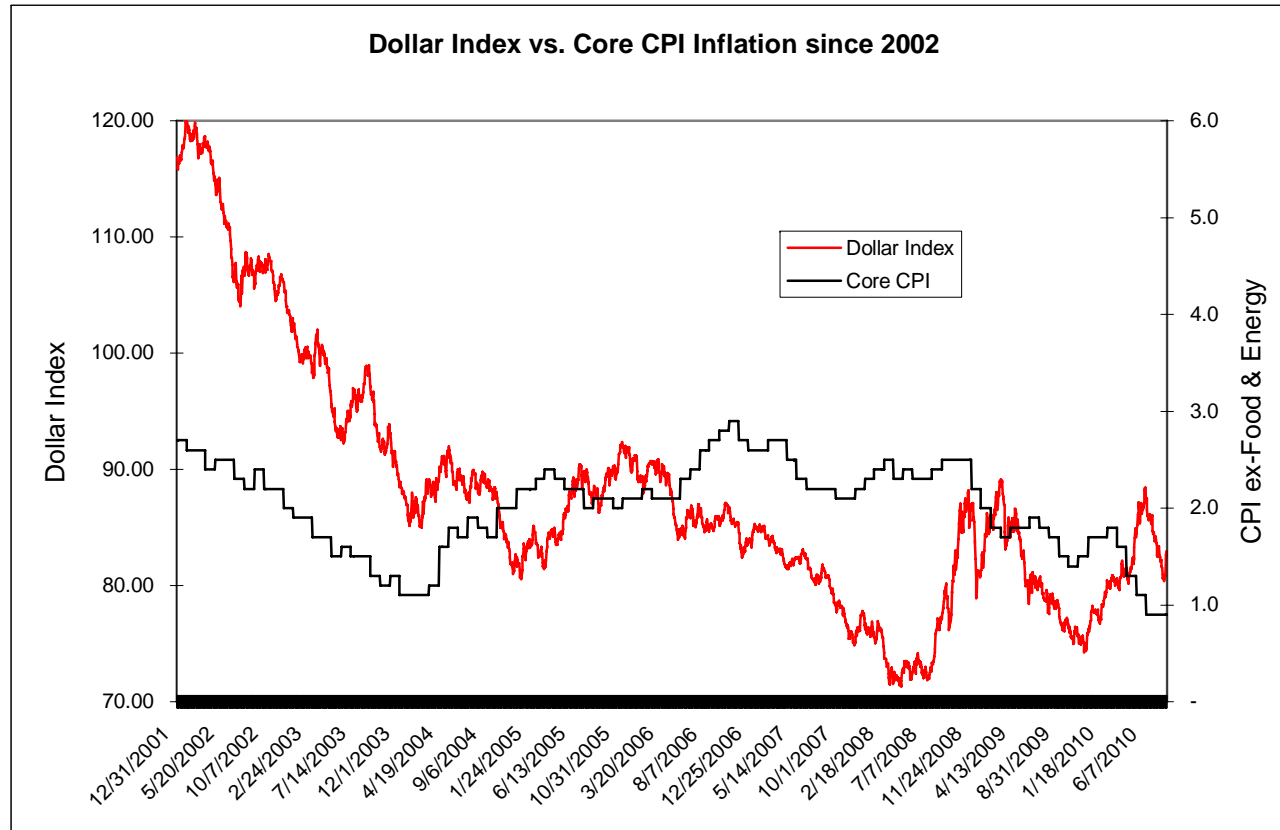


The chart above compares the performance of the spot price of Gold against the Dollar Index. As the Dollar has plunged in relative value since 2002, gold has appreciated sharply. This is a powerful inverse correlation, and it has been stable over the period represented by the chart. The performance of gold is signaling that further quantitative easing is necessary, and as a consequence, the Dollar should continue to weaken.

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DOLLAR WEAKNESS = INFLATION? NOT NECESSARILY.

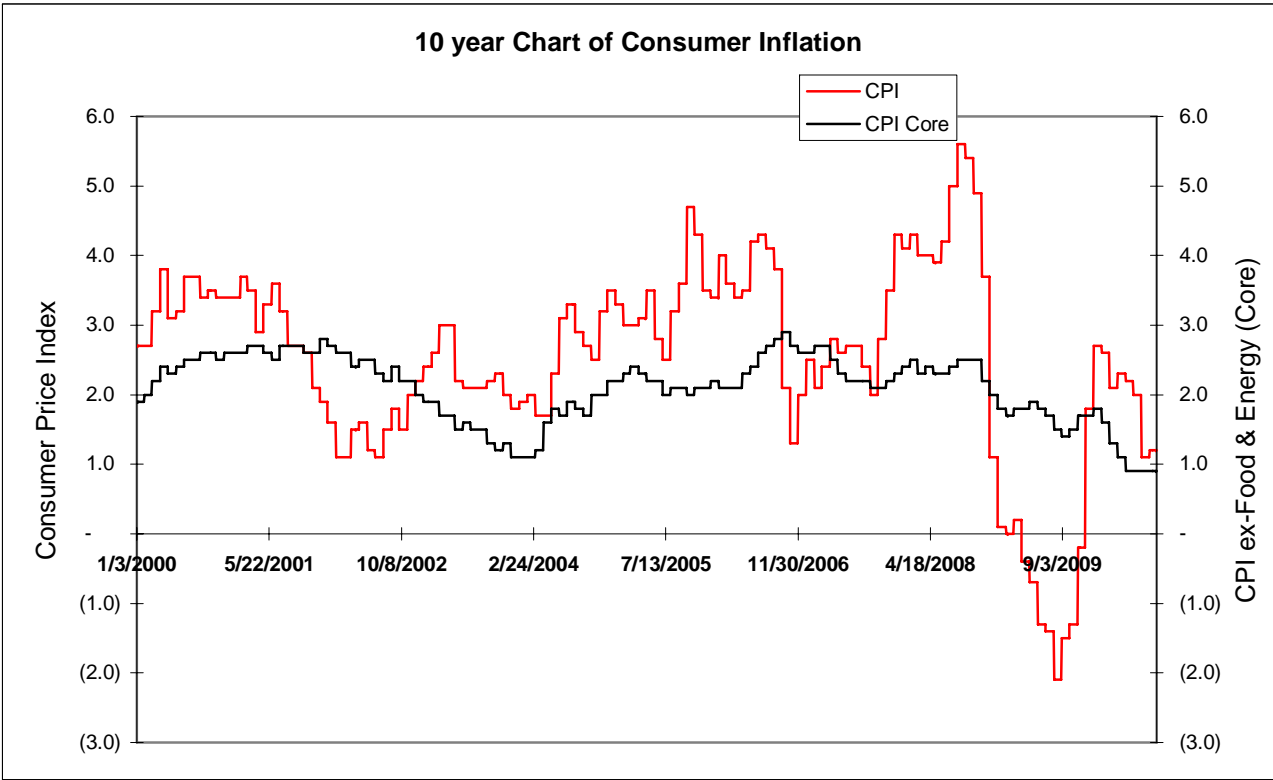


Do currency devaluations invariably lead to inflation? The chart above demonstrates that, despite a 40% decline in the value of the Dollar index since 2002, core consumer inflation (ex-food & energy) has remained quite stable.

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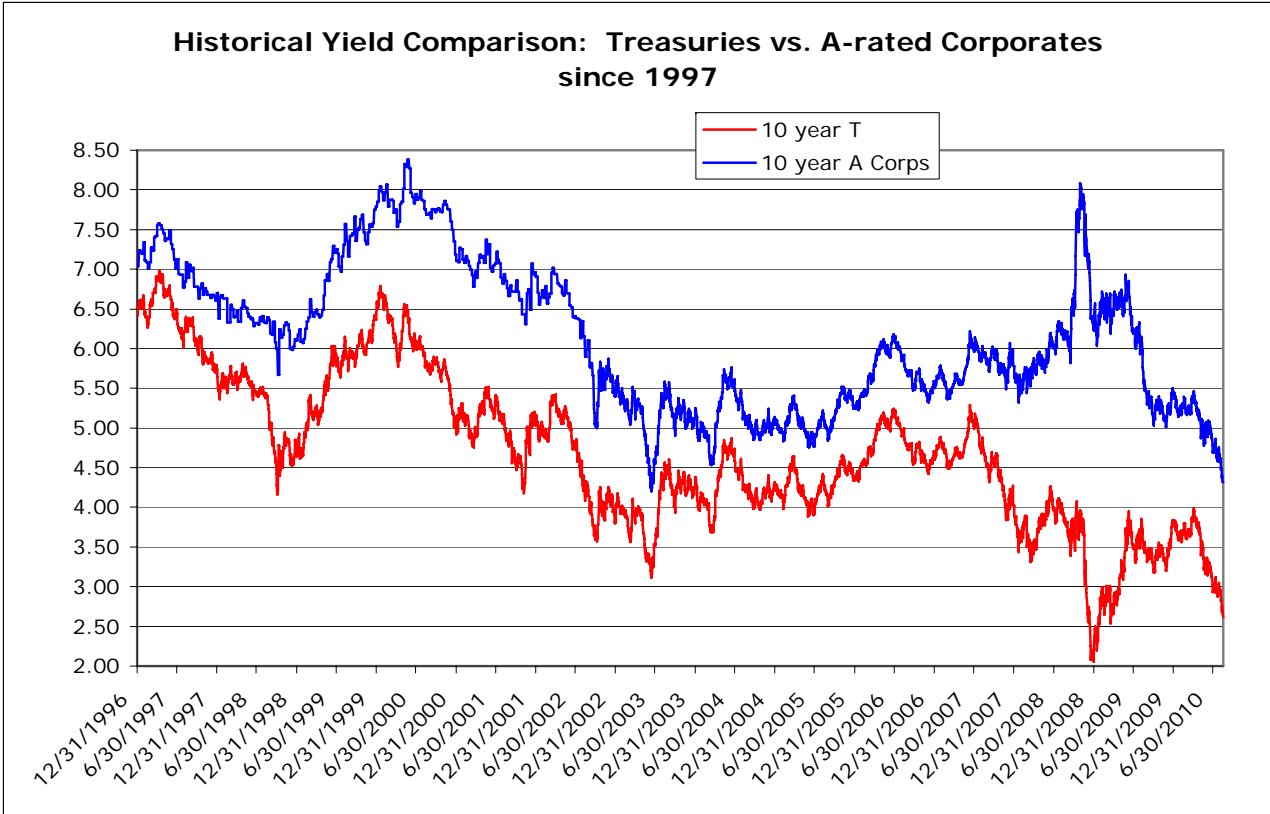
CORE INFLATION V. HEADLINE INFLATION



The obvious criticism of the previous chart is the exclusion of the more volatile food and energy components of the CPI index. As discussed previously, commodities prices tend to self correct over time. The chart above demonstrates that overall consumer inflation since 2000, including food and energy, has likewise remained relatively stable if one considers the average over the period.

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YIELDS ON BONDS CONTINUE TO DECLINE



The chart above tracks the decline in yields for 10 year Treasuries and 10 year A-rated Corporate bonds since 1997. Note the tremendous opportunity that existed during Fall 2008 (the height of the Crisis) to purchase A-rated Corporate bonds.

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WHAT TO DO?

Deflation	Volatility	Inflation
Treasury bonds.	Protective instruments.	TIPs.
High quality corporate bonds.	Greater diversification.	Commodities.
Defensive, dividend paying stocks.	Tactical, opportunistic trading strategies.	Non-Dollar exposure.
Cash.		Real Estate.
		Global infrastructure.

The table above identifies sectors and asset classes that should fare better, on a relative basis, during periods of deflation and periods of inflation. The center column refers to portfolio adjustments that should be considered during periods of heightened volatility. Interestingly, common stocks are not found in the chart above, with the exception of the subset of “defensive, dividend paying stocks” under Deflation. Broadly speaking, common stocks tend to fare poorly when economic conditions are at either extreme – i.e., extreme deflation or extreme inflation. Common stocks tend to perform well during periods of **beneficial disinflation** or moderate consumer inflation.

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