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THE ECONOMIC OUTLOOK -- STRAWS-IN-THE-WIND

It has become commonplace for commentators to characterize the current economic downturn as the most severe since the Great Depression of the 1930's. While there are a number of similarities both in the run-up to the current malaise and its evolution when compared with the events of 80+ years ago, this crisis is moving along more rapidly and the nation's fiscal policy response has been both rapid and far more forceful than in the earlier period. The similarities include:

- A preceding period of excessive debt;
- Subsequent massive asset deflation;
- Corresponding trauma in banking and financial systems, and;
- A resulting economic downturn that spread quickly and powerfully across the rest of the world.

Despite these similarities, we are neither in nor are we headed for a depression. There are many fundamental differences between the 1929-1932 period and today. These differences, which are often overlooked and/or misunderstood, are as follows:

Condition	**Great Depression (Early Years: 1929-1932)**	**Today**
Economic Contraction	25% Unemployment	8.1% Unemployment
Banks	Hundreds of failures No deposit insurance	Fewer than 50 failures Increased limits on deposit insurance
Monetary Policy	Decreased money supply	Massive liquidity injections; rate cuts; quantitative easing
Federal Government Policy	Small steps, raised taxes, tariffs	Massive economic stimulus and recapitalization of financial system
Global Response	"Beggar thy neighbor" policies raised tariffs and destroyed world trade	"Rush to rescue" policies to aid banking systems

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With massive fiscal and monetary stimulus in place or on the way, the outlook for a recovery from this downturn will depend importantly upon whether governments manage to stabilize the banking sector. If this is achieved in the first half of this year, as we expect, we believe signs of an economic recovery will emerge later this year, and a rebound will become evident in early 2010. Indeed, despite grim data released last week showing an increase in the unemployment rate to 8.1%, and a preponderance of negative economic news showing the economy is still sliding, a small but growing number of hopeful indicators have begun to sprout pointing to a *slowing in the rate* of the business decline, a prerequisite to the eventual upswing. These straws-in-the-wind, signaling a possible bottom to the economic slide, are:

- Consumers, who account for better than two-thirds of GDP, continue to cut back on spending, but not as steeply as late last year. In fact, retail sales actually rose in both January and February, following declines in each of the prior six months. However, with consumer confidence at a generational low, the recovery in outlays is likely to be slow and uneven.

- Home construction, probably aided by unseasonably warm weather, jumped 22% in February from the previous month following seven consecutive declines. Apartment construction soared 82% while single-family home-building edged up. The number of building permits also rose, a promising sign for future construction activity. The downside to these reports is that a rebound in home construction will only add to the glut of unsold homes, particularly new homes at higher prices -- an especially tough sell in the currently depressed market.

- Many retailers have reduced inventories on their shelves to the point that any further pickup in consumer outlays will force them to restock.

- Prices for a broad range of industrial commodities have been rising for weeks, evidence manufacturers, who had kept raw material inventories lean through most of late last year, have resumed buying.

- Oil prices are up close to 25% over the past four weeks, a sign demand may be firming.

- Shipping rates, sensitive to the volume of goods moving worldwide, have risen 140% this year according to a recent reading of the Baltic Dry Index, our favorite measure of future global business activity.

- Industrial production in February fell by the smallest amount since November, declining 1.4% from the previous month, possibly setting the stage for a rebound, at least in manufacturing, by this summer as production, inventories, and final demand come into better balance.

- Several major bank CEOs have in recent days commented that their businesses were profitable in the first months of this year. This, coupled with firm retail sales in February and better than anticipated industrial production, has buoyed the stock market -- a leading economic indicator -- which, in earlier cycles, has turned up 6-8 months ahead of the emergence of a business recovery.

- The price of gold fell sharply in recent weeks to about $900/oz as investors may have found the safe haven appeal of gold to be less compelling.

- In the major global markets, separate surveys of manufacturers' purchasing managers all inched up early this year suggesting for the first time in months the contraction in manufacturing could be slowing.

- And, interestingly, US port shipment levels have plunged along with global trade. However, early signals suggest that the declines may be bottoming out. Day-shift employment levels at west coast seaports in March are running only slightly below the pace of last year.

So, while on the surface the outlook for the economy remains decidedly downbeat and the timing of a turnaround is unclear, there is enough evidence for us to conclude the rate of decline is diminishing -- the first steps toward stability.

FINANCIAL SYSTEM RECOVERY

In addition to the above-noted straws-in-the-wind, the fragile financial system appears to be regaining it's footing. A key barometer for financial sector health -- the London Interbank Offered Rate (LIBOR) -- soared to 4.18% on October 10 after Lehman Brothers filed for bankruptcy as banks ceased lending to each other. The three-month LIBOR rate has since declined to 1.29% from that peak. Also, in US financial markets, issuance of highly-rated corporate bonds rose sharply in January exceeding $100-billion of new offerings signaling a return to a more normal market. Globally, companies have sold in excess of $300-billion of investment-grade corporate bonds this year. Short-term corporate credit markets have shown signs of improvement. Interest rates on short-term commercial-paper financing agreements have come down and firms have become less reliant on a special Federal Reserve facility serving commercial-paper borrowers. And, of particular interest is the Federal Reserve's

recently released quarterly Survey of Terms of Business Lending (STLB) which shows that, contrary to heated rhetoric and claims banks are not lending to businesses, Commercial and Industrial loans (C&I) made by banks during the week of February 2-6 show solid growth at record low interest rates. During the survey period, banks extended $95.6-billion in credit to business firms, an increase of 13% from the same period last year. Moreover, much of the recent decline in rates has been passed through to bank customers: the average rate for C&I loans for the current quarter has been 2.34%, the lowest since the inception of the series in 1997. It is also not the case, as some have charged, that these loans are being made only to customers with existing lines of credit: 77% of the loans were made under prior commitment, down from the prior quarter and well below the recent peak of 84.7% reached in 2006. In short, the hard data lend little support to those who scapegoat the banks by accusing them of choking off credit to businesses.

Underwriting the eventual business recovery, under the heading of *quantitative easing* (Q/E), the Fed has promised to employ all tools available to it including the unprecedented purchase this year of up to $1.2-trillion of mortgage backed government agency securities in order to provide support to mortgage lending and the housing market. The Fed will also purchase up to $300-billion of longer term US Treasury securities over the next six months. And, the Fed has launched the Term Asset-Backed Securities Loan Facility (TALF) to facilitate the extension of credit to households and small businesses as well as pledging to keep interest rates low for an extended period to assure the economic recovery is well supported. These steps, along with soon-to-be-announced comprehensive measures to rid bank balance sheets of toxic assets, are, in our view, game changers intended to reverse the corrosive liquidity crunch which has plagued the economy since the credit shock of last September/October, and to promote bank lending.

Still, while the economy may be bottoming out in terms of its *rate of decline*, most forecasts, including our own, see business contracting at a steep 5.0% annualized rate this quarter following a 6.2% decline in the last quarter of 2008. With inventory liquidation largely completed and consumer spending picking up, we expect the economy to continue to shrink next quarter, albeit at a more moderate 2.0% to 2.5% rate. Thereafter, the enormous fiscal stimulus being applied coupled with the Fed’s highly accommodative monetary policy, should begin to kick-in with the economy showing flat-line performance in the third quarter. The fourth quarter is expected to produce a modest up-tick in activity -- but well below trend-line growth of 3%. We believe unemployment, a lagging indicator, will continue to rise well into next year eventually peaking at a rate near 10%. All in all, then, we expect signs of recovery later this year to give way to a modest but sustainable advance in 2010.

INFLATION

Some bond investors are growing fearful the government's massive fiscal stimulus and heavily accommodative monetary policy, will soon foster excess demand, raising fears of rising inflation. We view these concerns as largely overblown for a number of reasons:

- The current global downdraft in demand, which is likely to persist at least into next year, has produced vast over capacity at all levels of business. In the US, factories and mines are producing at only 70.9% of capacity -- a rate 10 percentage points below the 1972 to 2008 average. Given this surplus, corporations currently have no pricing power and this situation is unlikely to change soon.

- The massive amount of dollars the Fed is creating is largely a substitute for a portion of the collapse in asset values (i.e. housing prices and common stock values). It is not creating new demand.

- This recession, which has already run 15 months, is likely to be unusually long and deep. Unlike most cycle-related recessions, growth in demand during the recovery will be moderate by historical standards as consumers, fearful of adding to debt and reluctant to spend, increase their savings rate.

- The Fed can eventually absorb excess demand, should it need to, by selling assets it has purchased in exchange for dollars. And the Fed can mop-up excess reserves by increasing its fed funds rate from its current all-time record low.

- There is still risk of *deflation* as the course of the current recession plays itself out. The Japanese experience of curbing deflation once it starts is worth noting.

- Money supply growth is cited as a key reason for worrying about inflation. However, growth in the money supply by itself cannot be inflationary if the *velocity* of money is collapsing as it has because banks, up until recently, have not been lending for growth-oriented activities.

An additional concern for some is that, in the long run, US Treasury's borrowing costs will rise. Indeed, our *long-term* inflation forecast includes such an outcome with the 10-year US Treasury yield rising to 4.5%+ three to four years from now. This forecast has led us to avoid overpriced, longer dated US Treasury bonds preferring

instead intermediate term municipals and high quality corporate bonds where appropriate for clients.

FIXED INCOME POLICY

Intermediate-term, high-grade corporate and tax-exempt bonds remain uniquely attractive when compared with US Treasury obligations which we view as overvalued. Accordingly, we have continued to add to client's bond positions using the proceeds of sales of US Treasury bonds and funds which have been parked in money market or other short-term instruments.

Purchases for low tax bracket clients of Aa and A rated industrial and financial obligations maturing in four to seven years were implemented broadly. As a result, yields on the fixed income portion of portfolios have been increased sharply and durations extended.

In portfolios managed for high tax bracket individuals, we continue to find high quality, general obligation tax exempts with maturities of up to eight years attractive as tax-exempt bond yields exceed by a wide margin on an after-tax basis those available from US Treasuries. This is a rare occurrence of which we have been taking full advantage using the proceeds of the sale of short-term Treasuries and cash equivalent investments.

Finally, we continue to allocate a portion of client's fixed income portfolios to US Treasury Inflation Protected Securities (TIPS). These offer both higher yields than straight treasury bonds as well as inflation protection in the event inflation escalates.

THE STOCK MARKET

The financial panic and subsequent collapse of the global economy following the Lehman bankruptcy, which caught central banks and governments by surprise, have created a bleak landscape for equity investors. Pessimism abounds. S&P profits are forecast to decline this year to about $48.00 per share -- down roughly 50% from levels forecast a year ago. The market consensus now is that the US economy and that of Europe and the major emerging markets will continue to slide at least through year-end. More worrying, President Obama has presented what many investors consider to be a populist redistribution tax scheme, increasing the tax rates on capital gains and dividends, raising taxes on small businesses, and taxing the accumulated foreign earnings of US corporations. Despite this gloomy backdrop, stocks have retraced about 50% of their precipitous drop of earlier this year as investors seem to be rejecting the doomsday scenario of depression and deflation -- of the Dow Jones

hitting 5000 and the S&P falling to 500 -- as farfetched. In fact, markets may have already begun a major rally, in anticipation the US economy may soon show signs of recovery given:

- unprecedented fiscal and monetary stimulus;
- terrible news which may already be priced into the markets;
- stocks are cheap in absolute terms as well as versus inflation, recovery earnings, and interest rates, and;
- the dividend yield on US stocks is higher than the interest rate on US government bonds;

Clearly, sentiment remains incredibly depressed, below that of 1974 when the outlook was grim indeed. That year, we had just lost the Vietnam War and nearly impeached a president who subsequently resigned in disgrace. We suffered high and rising inflation, and our cities were on fire. Today, the value of money market funds plus short-term US Treasuries are equivalent to 90% of the total capitalization of US stocks -- a record -- and a reminder of how bearish sentiment continues to be.

History suggests that when we recover from this severe recession and the bear market ends, the return on the S&P in the first year will be strong. In the post World War II period, equity investors have recovered 30% of their bear market losses in just the first forty days of a new bull market. While we are unable to pinpoint the timing of the economic recovery, and know enough to avoid attempting to call a stock market bottom, we are maintaining clients stock positions in anticipation of an improving equity market and above-trend returns over the next several years as returns from equity investments revert to their long-term mean of 8%.

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