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ECONOMIC UPDATE -- BOTTOMING

While some economists' claims the "Great Recession" has ended may turn out to have been a bit premature, there is gathering evidence the economy has, indeed, bottomed and that GDP figures for the current quarter will be positive for the first time since the end of 2007. Most importantly, the Bureau of Labor Statistics July employment report, issued last Friday, showed employers eliminated 247,000 jobs, clearly a large number by the standards of an ordinary recession, but the smallest monthly total since last August. Further, the report indicated the unemployment rate actually fell to 9.4% from 9.5% in June -- the first decline in this measure since April 2008. Friday's report also noted the average work week expanded to 33.1 hours in July from 33 hours the prior month, that hours worked by production workers increased to 39.8 from 39.5 hours, while overtime held at 2.9 hours, bringing average weekly earnings up to $614.34 from $611.49. These figures indicate that while employers are no longer in a panic to reduce payrolls, having cut 6.7-million jobs since the recession began in December 2007, there remains a lack of sufficient momentum in the economy to convince companies of the need to add to staffs.

Coming just a week after the government announced another significant improvement -- that the overall economy contracted at a rate of only 1% in the spring quarter, vastly better than the prior two quarters -- the two reports have convinced many forecasters the economy has past the low point for this cycle and will soon begin to grow again. These figures support our long-held expectation of an upturn following mid-year, despite further job losses. Recall the economy lost 265,000 jobs in the first month of the recovery in 2001 and 226,000 jobs in the first month of the 1991 rebound. Even with the encouraging employment report, consumer spending, which accounts for 70% of the economy, will recover only slowly as households, concerned about job security and chastened by the experience of the past year, save more and continue to deleverage their balance sheets. The backdrop of falling housing prices, stagnant wages and climbing unemployment will keep consumer spending increases in check.

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OTHER SIGNS OF BOTTOMING

Other indications, culled from recently released economic data, lend credence to our view the economy has bottomed.

- *Initial Jobless Claims*: The number of Americans filing claims for jobless benefits in the week ended August 1 fell by 38,000 to 550,000 -- the fifth consecutive week of fewer than 600,000 claims.

- Employers in the US for the second straight month announced fewer *job cuts* than a year earlier, according to a Challenger, Gray & Christmas report, marking the first consecutive year-on-year drops since late 2007. Planned firings fell 5.7% to 97,373 from 103,312 in July 2008 after 0.9% year-over-year drop in June. The pace of layoffs is clearly slowing.

- *Factory orders* rose for the third consecutive month in June as demand increased for goods such as metals and construction. Excluding demand for transportation equipment like cars and aircraft, which tend to be volatile, orders rose 2.3% indicating the factory slump is easing. A record-breaking drawdown of inventories, amounting to a $141.1-billion annual rate in the second quarter -- the most ever -- is setting the stage for future growth. Lean inventories, signs business investment may turn up, improving demand from overseas and the federal "cash for clunkers" program have caused manufacturers' customers to grow more comfortable with the level of their stockpiles – provide the foundation for an increase in orders and production. Interestingly, at the current sales pace, it would take only 1.26 months for distributors of durable goods to deplete their inventories, the lowest level since last October.

- *The Institute for Supply Management's (ISM)* factory gage, a reliable leading indicator, rose to an 11-month high of 48.9 in July. While remaining below the break-even point of 50, this indicator has now risen above 44, below which conditions are likely recessionary.

- The July *ISM* service industries survey showed non-manufacturing companies, which account for almost 90% of GDP, remained below breakeven at 46.4 but well ahead of its 43.9 six-month average. Monthly readings between 37.4 and 40.8 were common earlier this year.

Figures from the housing and mortgage markets, where many forecasters believe an improvement is a necessary prelude to a broader economic recovery, have been improving for months:

- Near record low interest rates are allowing homeowners to refinance out of adjustable-rate mortgages and reduce their monthly payments. The average rate on a 30-year fixed rate mortgage fell to 5.17% last week from 5.36% a week earlier. The rate reached a record low of 4.61% in late March after the Federal Reserve announced it would buy treasury and mortgage-backed securities in a bid to drive down mortgage rates.

- The housing market is showing signs of having turned the corner -- sooner than many had expected. Combined sales of new and existing homes climbed to a 5.27-million unit annual pace in June, the highest level since October. The number of contracts to buy previously owned homes rose in June for a fifth straight month. And recent surveys of housing activity in the hardest hit markets (i.e. Nevada, Arizona, California, and Florida) have shown notable improvement in the past two months.

THE OUTLOOK

In summary, then, unprecedented inventory liquidation in the second quarter implies a big future boost to production as firms bring production into closer alignment with expected demand. Judging from the sharp pickup in the July ISM factory index this process appears to have begun. The boost to the economy later this year from the government's unprecedented fiscal stimulus now looks larger than earlier anticipated due in part to a slower-than-expected take-up of the spending provisions in the fiscal package in early 2009 and the huge success of the "cash for clunkers" program. Residential investment appears to be turning up earlier and more sharply than previously forecast. And, business conditions abroad, particularly in southeast Asia, have rebounded quickly underpinning a

pick-up in global trade. These factors point to second-half GDP growth in the 2.5% to 3.0% range -- above our earlier forecast of 2.0%+.

Unless consumer spending expands more quickly than we now forecast or, in the unlikely event a second stimulus package is enacted, we see below trend growth in the first half of 2010 as consumers will remain under significant financial pressure. The personal savings rate now stands at 4.6%, well below the 6% to 10% range that prevailed prior to the equity, housing, and credit bubbles of the 1990's and the 2000's. Sluggish growth in household income -- partly resulting from a sharp slowdown in hourly wage growth -- will make increased saving without significant constraints on consumption difficult. While homebuilding has probably bottomed, and the downturn in capital spending is slowing, a vigorous rebound in those sectors is not expected for some time, largely because the overhang of unused capacity in both housing and business remain formidable.

We still see unemployment drifting up toward 10%+ by mid-2010. While inflation remains a major long-term threat to economic stability, the enormous slack in both the labor and product markets is likely to keep inflation well contained through 2010 and beyond. Over the past year, the year-over-year rate of core inflation has slowed to about 1.5%. We expect further deceleration to a rate of 1.0% or less by year-end 2010. Finally, with unemployment unacceptably high and inflation moderating further, we expect Fed officials to maintain the Fed funds rate in the current 0% to 0.25 % range for several additional quarters.

FINANCIAL MARKET CONDITIONS AND BOND STRATEGY

Financial market conditions continue to show signs of improvement, reflecting a combination of Federal Reserve policy actions, measures taken by other government agencies and the improved economic outlook. That said, financial markets and financial institutions remain under some stress. Depressed asset prices and tight credit conditions, particularly for small businesses, continue to act as restraints on economic activity.

Among the markets where functioning has returned to normal pre-Lehman levels are those for *short-term* funding, including the interbank lending markets (LIBOR) and the commercial paper market, where risk spreads have narrowed considerably and lending is taking place at longer maturities. Also encouraging is that the private sector's reliance on the Fed's programs has declined markedly as market stresses have eased. Some of these programs will not be renewed when they expire

later this year. The issuance of asset-backed securities backed by credit card, auto, and student loans has picked up and asset backed securities rates have declined.

In markets for *long-term* credit, bond issuance by non-financial firms has been very strong and spreads between US Treasury yields and rates paid by corporate borrowers have continued to narrow, but still remain wide by historical standards. We have used this period of renewed corporate issuance to shift the mix of bonds held in clients' fixed income accounts from about 80% US Treasuries and 20% corporates and cash equivalents a year ago to 80% high grade medium term corporates and 20% US Treasuries and cash equivalents currently. Inflation Protected Treasury bonds (TIPS) now represent a significant portion of clients' US Treasury holdings.

As noted above, mortgage rates and spreads were also reduced by the Federal Reserve's program of purchasing government agency debt and agency mortgage backed securities earlier this year. However, in recent weeks, yields on longer-dated US Treasury obligations have risen as concerns about large federal deficits and greater optimism about the economic outlook, have impacted bond prices. For example, the yield on the benchmark 10-year US Treasury bond has risen from 2.46% on March 20th to 3.77% currently -- a remarkable rise. We believe that while the back-up in yields on longer-term US Treasury bonds may continue for a while longer, inflation fears are overblown for the reasons cited earlier and that rates are not likely to experience a protracted nor substantial rise from current levels. We would view a temporary rise in rates on 10-year US Treasury bonds beyond 4.25% as a possible buying opportunity.

EQUITY STRATEGY

Global stock prices have experienced a breathtaking snapback from their early March lows when investors' fears of a financial meltdown and a deep and prolonged economic collapse peaked. For the year-to-date, gains are impressive.

Index	% Change through 8/10/09
S&P 500	+11.5
NASDAQ Composite	+26.3
S&P MidCap	+20.8
S&P SmallCap	+13.2
Russell Top 3000	+13.2
EAFE (Developed Markets)	+12.8
EEM (Emerging Markets)	+44.6

The calendar 2009 total return performance of equities in tax-free accounts under our supervision, as measured by our model account, remains well ahead of the benchmark S&P 500.

Looking back over this year, we are inclined to downplay the 50%+ rise in the market averages since their March lows. Much of the this bounce stemmed from a growing recognition the worst fears of panicked investors would not be realized. In fact, the rally of recent months merely returned the markets to levels that existed prior to the September 2008 Lehman Brothers bankruptcy, which unleashed the global financial system meltdown. At current levels, the S&P 500 remains 33% below its October 2007 highs and, in our view, stocks remain attractively valued at about 15 times expected 2010 earnings. That price/earnings multiple is only about average when viewed within the context of stock market history. However, when that ratio is adjusted for the current low level of inflation and the slack competition from the current low level of interest rates, the valuation of the stock market is cheaper than at any time since the 1950's according to the Fed Model.

Beyond favorable valuation, the *profit leverage* that corporations will experience as the economy revives and revenues turn up is underappreciated. Companies have cut inventories, payrolls and capital spending to the bone, in the expectation of a coming global depression. Wages have actually been cut in a number of industries for the first time since the 1930's and productivity has risen during the economic contraction. In fact, productivity of US workers grew in the second quarter at the fastest pace in almost six years as employers squeezed more out of their remaining staffs to bolster profits. Corporate profits are, therefore, poised to expand sharply even absent strong economic growth.

As noted in our June client letter, cash holdings amounted to about 95% of the value of US stocks at the end of March. Given the current low levels of inflation and interest rates, this ratio of cash to market capitalization could fall to 50% leaving nearly $5-trillion of cash currently sitting on the sidelines available for equity purchases.

With the foregoing factors in mind we maintain fully invested equity positions as we expect returns from equities over the next 12-18 months to outpace those of other asset classes in which we have traditionally invested. Clearly, stock market returns are not linear and periodic corrections are inevitable and should be expected.

Stock portfolios remain well diversified. Recent changes reflect our effort to better position clients' holding to participate in the economic recovery we expect. Principal sector concentrations currently are as follows.

Sector Concentrations %*		
	FBA Portfolio	**S&P 500**
Basic Industries & Transportation	**6.9**	**6.6**
Technology	**21.4**	**17.6**
Industrial Capital Goods	**11.5**	**8.0**
Discretionary Consumer Goods	**11.9**	**6.5**
Services & Media	**3.3**	**7.1**
Telecom Services	**3.5**	**3.2**
Consumer Staples	**9.4**	**10.0**
Healthcare	**10.9**	**13.2**
Energy	**7.4**	**12.4**
Financial	**11.8**	**12.1**
Utilities	**2.0**	**3.4**

*Excluding international investments

Significant positions in basic industries, technology, industrial capital goods, and discretionary consumer goods, which represent 51.7% of the FBA stock portfolio, reflect our optimism regarding the likelihood of improving business conditions and the profits of economically sensitive companies, leading to better than average market performance for these sectors as the recovery unfolds.

In addition, portfolios continue to have allocations of investments, through either exchange traded funds or mutual funds, in companies domiciled abroad in both developed countries and emerging markets in order to broaden diversification and gain exposure to economies viewed as likely to grow more rapidly than the US.

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