

ECONOMIC AND MARKET OUTLOOK THIRD QUARTER 2010

Rarely have so many events with serious financial consequences been concentrated in a single three month period. The second quarter of 2010 was such a period, and their onslaught became an emotional roller coaster for the stock market. Revelations of unsavory and profligate fiscal policies among certain southern European nations caused a very serious crisis for the entire euro zone and a threat to the solvency of European banks. The crisis was smoldering throughout 2009, but ignited in early 2010 when it was revealed that Greece had paid Goldman Sachs and other banks hundreds of millions of dollars in fees since 2001 for arranging transactions which hid the level of government borrowing. The April 27 downgrade of Greek national debt to junk bond status opened the door to fears of sovereign defaults in all countries with excessive debt. Stock markets throughout the world declined sharply, and a flight to quality ensued.

On April 20, 2010 an offshore drilling platform owned by Transocean and operated by British Petroleum exploded in the Gulf of Mexico 50 miles off the Louisiana coast. The tragedy cost the lives of eleven rig workers and caused the greatest environmental disaster in United States history. Efforts to slow and contain the leaking oil proved fruitless for over a month, and exposed the industry to criticism of its safety practices. The entire episode, which is ongoing as of this writing, has ignited a slew of government dictates with uncertain consequences for U.S. energy independence, national defense, regulatory environment, disaster response and a host of other considerations.

The second quarter also witnessed some of the softer economic data of the year in the United States. Coinciding with this news the Chinese government took steps to restrain bank lending in order to tame a speculative property sector, leading to prognostications that economic growth would slow sharply. Late in the quarter, China announced that it would adopt a flexible policy toward the yuan, a potentially bullish development for exporters to China. This announcement by the People's Bank of China was demoted in significance by most economists but if enacted holds positive implications for United States and European manufactures.

Volatility of the stock market rose sharply in the face of these events and reached its highest level in eighteen months at the end of May. Clearly, they will have ongoing influence on the world economy and domestic U.S. growth. Without downgrading their import we believe they do not signal a failed recovery for the U.S. The recovery will continue, although without the typical initial burst of growth normally seen when our economy emerges from a recessionary period. Rather, a moderate and steady pace of the expansion is likely. The durability of the expansion, however, could actually be lengthened by a moderate pace of growth. The fundamental reason for this assertion is the impressive and growing financial conservatism of the private sector. Corporations today are holding record levels of cash. This hoard is available for expansion, acquisitions, or other corporate intentions at some future time. In the current environment of political uncertainty and radical change, cash is valued for safety and

protection. Holding large cash positions also essentially deleverages corporate capital structures. Consumers, too, have a savings mentality. The savings rate is rising and consumer debt is slowly unwinding from the high levels of several years ago. The free-wheeling, speculative, and aggressive spending attitudes of 2007 and 2008 are over. The quality of balance sheets, both corporate and private, is rising steadily.

Boosted by exports to populous nations the manufacturing sector is powering the domestic recovery. Countries such as China, India, Brazil, Indonesia, and others were largely unaffected by the housing collapse and consequent near destruction of the financial markets. The rapid and continuing development of these countries will remain the driver of worldwide growth. Non defense durable good orders ex aircraft were up 2.1% in June, the third gain in four months, reaffirming that positive capital spending trends remain in place. A significant amount of “catch-up” corporate spending is a strong underpinning for continuation of business spending on machinery. Amid enormous policy uncertainty, spending on productivity enhancing technology and machinery will remain a favored intention of corporate managements.

Private sector job growth is the missing ingredient leading to a less expansive growth outlook. Still, lay offs have declined steadily as business recovered, and new job creation is crawling along. National policy emphasizes the growth of social programs with major but unknown additional costs and regulations. Other actions sew confusion or are viewed as hostile to corporate America. The Administration’s goal of doubling exports, a commendable path to high quality private sector job growth, is left to languish, while calls for higher tax revenue become increasingly strident. Solutions which have proven successful in past periods, such as permanent corporate or individual tax reductions, are far from the government’s mind set. It is not hard to see why confidence is lacking.

There is an unusual amount of uncertainty in this current environment. We believe it creates an opportunity to own very well managed established growth companies with fortress balance sheets, control over expenses, and a vision of the future which will carry them to greater success and higher valuations. We look for a sustainable recovery based on business spending and gradual improvements in employment and incomes. Corporate profits are growing and with strong emphasis on expense control, will continue to expand. Unlike Europe and most other industrial nations, the natural condition of the United States economy is growth, based on an entrepreneurial spirit which is willing to accept risk to achieve growth and its rewards. This indomitable spirit remains strong.

Investment Policy Committee
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June 25th, 2010

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