



MARKET COMMENTARY

January 18, 2011

In our view the second round of the Fed's quantitative easing program has so far been a success, having boosted stock prices significantly since the program was first announced. Economic data from the past quarter indicate an accelerating but still uneven economy, with jobs growth a persistent sore spot in an otherwise improving environment. We believe that "don't fight the Fed" continues to be a good strategy and have positioned the portfolio accordingly as we enter 2011.

Auld Lang Syne

This well-known New Year's refrain, written over two centuries ago by Scottish poet Robert Burns and set to the tune of a traditional folk song, exhorts listeners to remember old friends and days gone by. As we at Roosevelt Investments take the opportunity to thank our clients and friends for their continued support, we also vividly recall the time roughly two years ago when it appeared that the world as we knew it was slipping over the precipice. While we are thankfully in a much improved economic climate, the Fed has once again embarked upon an effort to boost asset prices through another round of quantitative easing, or QE2. QE2 has been underway for two months now and comments from the mid-December Fed meeting (released to the public in early January) indicate that there are no plans to stop or slow the pace of easing based upon current economic conditions, since unemployment is still elevated and core inflation measures are benign. The Fed also repeated its pledge to keep the Fed Funds rate low for an extended period.

Not only do we think that the Fed's QE2 program will be carried out in full, but given the still-elevated unemployment rate we believe that the odds may even favor the announcement of a QE3 program later this year. Though we all like instant gratification, it's important to keep in mind that monetary stimulus programs like QE2 tend to work with a lag of roughly six to nine months, and thus it may be well into 2011 before we see employment metrics improve. However, the capital markets have already responded favorably. From the day that QE2 was first disclosed by the Fed in late August, the S&P 500 index is up nearly 20% and the 10-year Treasury yield has increased by nearly 1%. Based on our analysis of this yield change in the context of Treasury Inflation-Protected Securities (TIPS bonds), we find that 40% of the change was due to increased inflation expectations and the remainder was due to other factors such as an improved outlook for economic growth and selling pressure related to outflows from bond funds. While an increase in rates is not normally viewed as a good thing for the economy, in this case it's worth keeping in mind that one of the Fed's

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317 Madison Avenue, Suite 1004 New York, NY 10017

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goals with QE2 was to boost prices of risky assets (i.e. everything other than government bonds), and the absolute level of rates is still low. At this juncture, we view the increase in interest rates as a function of normalization in corporate growth rather than anything with negative implications for equity valuations. Today's steep yield curve presages a positive spread environment for banks and is generally constructive for the economy.

As investors await the beginning of fourth quarter earnings season, recently released data indicates that there is reason for optimism. The late summer 'soft patch' has clearly ended, and the odds of a double dip recession now appear remote. Retail sales have been strong for the last two months, reflecting the best holiday season in five years, and many consumers have started to spend again. Auto sales have been robust, with Ford and GM reporting double digit sales growth supported by lean inventories, which bodes well for the entire automobile supply chain. Industrial production has accelerated over the period, likely as a response to increased consumer spending and growing capital expenditures by many businesses. Capacity utilization, while still providing enough slack to ease inflationary concerns, is at its highest level in over two years. Perhaps as a result, commercial and industrial loans at large banks are starting to grow again after declining 25% over the past 18 months. News on employment has been uneven. Although weekly claims are showing improvement, the decline in the unemployment rate appears to be the result of technical factors rather than an improved outlook. Lastly, indicators such as the Purchasing Managers Index (PMI) and the Institute for Supply Management (ISM) point towards stronger growth in the economy, and November's trade deficit shrank as exports rose and imports fell.

Although we are pleased that there is an abundance of good news, a few challenges remain. We are still concerned about the ultimate resolution of the sovereign debt crisis in Europe. It is unclear how the numerous countries facing fiscal challenges will solve the serious difficulties on the horizon, although Germany's Prime Minister recently stated she will do whatever is needed to support the Euro. Another significant issue facing global investors is the food-related commodity price surge, which has moved the prices of certain foodstuffs near levels that in the past have caused civil unrest in emerging markets. Inflation in the US is still at a low level, but weekly average gasoline prices at the pump have moved up above \$3. Grain and sugar prices have also moved higher, pressuring margins of food companies. While many of the food-related price swings can be traced at least partially to La Niña-related weather factors that have affected supply, a reacceleration of global growth is driving increased demand, and elevated prices act like a tax on the consumer and on corporations, reducing discretionary

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income and earnings, respectively. If central banks find it necessary to raise interest rates in an attempt to ward off inflation, this would create a more challenging economic environment.

From a longer term perspective, we are also cognizant that the Fed's easing programs may create asset price bubbles. It is unprecedented that the Fed Funds rate has essentially averaged zero for the past two years. In our view the most likely candidates for such bubbles include commodities and emerging markets, and we will be actively on the lookout for warning signs in this regard. For now, we see strong fundamental underpinnings to support our exposure in both of these areas, which generally have attractive risk/reward ratios. Ultimately the risk posed by unsustainable Federal, state, and local entitlements is also an enormous issue that will have to be dealt with. The full extent of spending cuts relating to these budget deficits will act as a headwind to our economy. As a country we will be facing the same issues as many countries in Europe if we do not proactively deal with these challenges; otherwise the capital markets will force a solution, just as is occurring in Greece and Ireland today and perhaps in Portugal and Spain tomorrow.

The broader market represented by the S&P 500 index had a total return of 15% in 2010, but it was a choppy year marked by concerns about China, the sovereign debt crisis in Europe, and fears of a slowing US economy in the third quarter. After peaking in May, the volatility index subsequently declined, and fell further after QE2 was discussed and then implemented. We used the phrase "two steps forward, two steps back" to describe the back and forth movement of the stock market over the summer months. Through the first eight months of the year, the market was down nearly 5%.

The Fed held its annual Jackson Hole offsite summit meeting in late August, and Chairman Bernanke spoke for the first time about his plans to conduct a second quantitative easing program (thereafter known as QE2). One of the program's goals was to encourage investors to buy risky assets, including stocks. While we believed QE2 might help the market, at the same time we had grown incrementally more bearish about the market due to the slowing economy and added some ETF hedges to adjust for the risks we saw. The market looked past these risks and delivered strong returns in early September, but that created a drag in relative performance from our hedges. On the back of some very strong stock-specific performance through the end of November, we made up for the lost ground and more, and finished that month ahead of the benchmark.

For most of the year we have had a significant underweight in the financial sector due to the unfavorable regulatory climate, the mortgage foreclosure problems, and the related uncertainty

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regarding what normalized earnings power for the banks will ultimately turn out to be. One impact of QE2 has been to steepen the interest rate yield curve, creating a much more favorable spread environment for the banks, and with a boost in long rates that took place in early December, the banks began to outperform. In addition to QE2, bank stocks have been supported by the Fed's signals that dividend increases will be permitted, potential new capital rules will not be as onerous as originally believed, and some M&A activity. We performed a quantitative study and identified a pattern by which certain bank stocks tend to outperform on days which the Fed is conducting its easing program. After some analytical work confirming that some of these stocks were attractive fundamentally, we added several financial services stocks to dramatically reduce our underweight and better position the portfolio to benefit from the Fed's quantitative easing program. The All-Cap Core portfolio ended the year slightly trailing the broader market, partly as a result of the strong performance of financial stocks in December.

In closing, we believe the market is starting off in 2011 on solid footing. Economic data has largely been positive, the Fed's QE2 program is supportive of equities, inflation risks overall appear low in the US, recent tax stimulus will act as a tailwind, and the administration's move toward the political center should also help dampen the risk of anti-business, anti-growth policies. Historically, the third year of a president's term has also been auspicious for the stock market, as thoughts about re-election strategy tend to color fiscal policy in a favorable way. Lastly, while mutual fund flows have been heavily skewed towards bonds at the expense of US equity funds over recent years, the last few weeks of 2010 appear to show an inflection in that pattern. If this data continues to show a shift in investor preference for equities, a significant amount of cash could come into the market and further support equity prices. We acknowledge the risk factors on the horizon but on balance find the current market environment very favorable for equities.

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