

EQUITY INVESTMENT OUTLOOK

June 8, 2010

Despite what was a very volatile month for equities and the worst May for the Dow in 70 years, our base case outlook for the US economy remains unchanged. While the May employment report (published by the Labor department in early June) was a disappointment, employment data still indicate an economy growing at roughly a 3% clip. Our view is that the economic recovery continues, supported by a wide variety of data which encompass housing, employment, auto sales, durable goods orders, healthy inventory levels, hotel occupancy rates, railcar loadings and construction activity. Given this unchanged positive outlook, why did the stock market come under so much pressure in May? We will cover this question in detail over the remainder of this month's letter.

The emerging threat to our continued recovery that we mentioned in last month's letter (the Eurozone crisis) has continued to expand. In early June, government officials in Hungary commented that its fiscal situation was as serious as that of Greece. Credit spreads have widened to near record levels not only for Greek debt but also for almost all countries whose fiscal situation is considered to be out of balance. While the IMF and the European central bank structured the foundations of a very large (\$1 trillion) rescue plan in April and May, the precise mechanisms by which it will be utilized remain somewhat opaque. This lack of transparency combined with questions of political will and the difficulty of getting consensus from the various Eurozone authorities have unnerved investors. It remains unknown how much of a bailout will be required and whether the funds being directed towards the problem will be enough. Some investors believe that a restructuring or default of Greek sovereign debt will be necessary. The longer the European authorities dither about their ultimate policy towards Greece and the other troubled countries, the more expensive the solution is likely to be.

Fiscally-challenged European governments have announced major austerity budgets, some of which have been met by strikes by labor unions and pensioners, among others. The impact of these budgets is likely to mean lower demand for goods and services in the affected countries and seems likely to create deflationary pressure that could last for years. The most recent set of data from Europe indicate that the odds of a slip back into recession have increased. As one might expect given the widespread fiscal tightening, consumer confidence is slipping and purchasing manager index figures have also turned down. As Germany and France are the economic engines of Europe, these two countries probably have the most to lose in terms of economic trade with their neighbors, while the US should be impacted to a much lesser degree.

317 Madison Avenue, Suite 1004 New York, NY 10017

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To date, the sovereign debt crisis has remained largely a European problem, and the effects are not impacting all countries in the region. Management of several large US companies who sell products in Europe recently indicated that their European business remains quite strong, although it is possible that any reduction in demand will not be felt for months. Germany recently reported strong economic data buttressed by lower interest rates and a weaker Euro relative to the other major global currencies. The lower Euro exchange rate should provide a tailwind to exporters in Europe as well as countries that could benefit from increased visits by tourists outside the Eurozone.

A source of greater concern is the potentially significant linkages between large financial institutions in Europe and those in the US. Over the past 12 months, major financial institutions in the US have significantly reduced the leverage on their balance sheets and shored up their equity capital, but inter-bank borrowing spreads, particularly in Europe, have begun to widen again. Credit spreads in the US are also widening, an indication that fears of counterparty credit quality issues have re-emerged and are spreading.

If Europe were all that investors had to be concerned with, we believe that May would probably have been an easier month for the stock market. But many other fears emerged or intensified during the month. Internationally, fears of an economic slowdown in China and its impact on the rest of the world, an increasingly strained relationship between North and South Korea, and a variety of events in the Middle East all conspired to create uncertainty. Domestically, the May 6 “flash crash”, the Gulf of Mexico oil spill and related regulatory pressure on the entire energy sector, continuing uncertainty over the details of US financial services legislation, and troubling fiscal deficits in many states and municipalities added fuel to the fire. This litany of reasons for investors to feel insecure could be seen in the heightened volatility levels indicated by the VIX index, which has returned to levels experienced during the liquidity crisis of late 2008/early 2009.

One positive outcome of this list of concerns is that interest rates are likely to remain lower for a longer period of time. Until very recently, investors had been on heightened “Fed watch” to try and discern when the Fed might deem it necessary to raise interest rates, but the deflationary effect of what’s happening in Europe and China will help keep the pressure off inflation and thus rates in the US. Flight to quality by global investors seeking the perceived safe haven of the US dollar have also sent Treasury yields to new lows in 2010. Since longer-dated Treasuries are typically used as benchmarks for mortgages and other loans, borrowing rates are now at levels which may spur a wave of refinancing or perhaps even new home purchases.

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Economic weakness in China is a new and important item on our list of threats to our base case scenario, but recently policymakers in China appear to have stepped back from prior aggressive actions to cool their economy and prevent a property bubble, perhaps because their previous efforts have been successful. This should help to ease one threat to the macroeconomic picture, although admittedly engineering a so-called soft landing in an economy as large as China can be a challenge.

What is clear is that the list of uncertainties about the geopolitical and macroeconomic picture has grown, and that this has led investors to reduce the level of perceived risky assets they hold, from stocks to bonds. As a result of this incremental shift towards greater uncertainty, we have taken the opportunity to increase our holdings of risk tools, which now include inverse ETFs, a gold mining ETF, zero coupon treasury bonds, and more cash than we might normally hold. We also incrementally trimmed some of our exposure to cyclical stocks.

If the European central banks are unable to bring their debt crisis to a swift resolution, either via some sort of controlled debt restructuring, quantitative easing, or other efforts, market volatility will likely remain elevated and so-called bond vigilantes may force the issue by refusing to subscribe to upcoming new sovereign debt issues which are needed to refinance maturing debt. Notably, Spain will seek to refinance about €25 billion of debt coming due in July. As well, inter-bank lending to financial institutions in Europe could continue to grow more costly and ultimately rise to a level where liquidity is frozen, much like what occurred in the US after Lehman Brothers collapsed. Credit spreads and volatility indicators are clear signposts in this regard that we will be monitoring on a regular basis. If, on the other hand, the central banks along with the IMF are able to bring about a resolution to the debt crisis, fear associated with all of the uncertainty should begin to subside and we would reduce our exposure to risk tools in the portfolio.

The Roosevelt Investment Group, Inc.

317 Madison Avenue, Suite 1004 New York, NY 10017

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