

EQUITY INVESTMENT OUTLOOK

May 7, 2010

As the first quarter earnings reporting season winds down, corporations have for the most part confirmed the economic recovery and powerful earnings growth potential which we have discussed in previous letters. As an added plus, many of the positive earnings surprises being reported are not being driven solely by cost cutting benefits, but from a resurgence in top line growth. Our prior concerns about the US remain, although a divergence between the two most frequently cited surveys on employment activity has us wondering if the hiring backdrop is stronger than it appears. For the first time in a long while, we heard companies discuss hiring activity on their conference calls, as manufacturing activity increases and idled capacity is restarted. This activity continues to be led by improving trends in the ISM surveys and the other data we monitor, such as durable goods orders and consumer spending.

We continue to believe that the recovery continues apace and may in fact even grow strongly from this point if supported by continued gains in job growth, capital spending and inventory replenishment. These positive data are reflected in our portfolio via overweights in technology and industrials. On the other hand, continued regulatory uncertainty in both the financial and healthcare sectors combined with the related difficulty in assessing normalized earnings power indicate to us that our underweights in these areas continue to be warranted.

An emerging threat to the continued recovery of our economy and the market recently intensified, and that is the instability relating to the European Monetary Union, or EMU. The EMU concept has been formally in place since early 2001, and coincidentally Greece was the last of the initial 12 founding members to join the union, which has since grown. The various political, philosophical and economic benefits of the EMU have long been debated, but the basic concepts upon which it is based are now being questioned by the accelerating sovereign debt crisis.

To date, this crisis has revolved around Greece, and its fiscal problems that have spun out of control. From the beginnings of the EMU through mid-2007, government bond rates across member countries were essentially in-line, regardless of the level of indebtedness of the individual member. Near the stock market's peak in the fourth quarter of 2007, spreads began to widen ever so slightly, and with the development of the financial crisis throughout 2008 and into 2009, they continued to widen. As the global recession has led to lower tax revenues combined with the spending from stimulus programs and other liquidity-fostering efforts, fiscal budgets have deteriorated. Countries such as Greece, which were not in such good shape to begin with, have

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become focal points for the so-called bond vigilante mechanism of the capital markets. This phenomenon tends to force governments to get their fiscal houses in order if they wish to continue to access capital by selling bonds.

As a borrower's fiscal condition deteriorates relative to other countries, that borrower has higher interest rates imposed upon its debt as the risk of default rises. At this point in the crisis, the market rates on Greek debt have grown so high that a default was becoming a likely scenario, thus necessitating the involvement of both the European Central bank and the International Monetary Fund (IMF). Most concerning is that even after those entities put together a \$150 billion rescue package, global markets fell on concerns that the rescue package would not be sufficient, and also that the other troubled EMU countries (Portugal, Spain, Ireland) might require some sort of bailout as well.

In response to these events of early May, our markets have witnessed a flight from risk, as investors seek the safer haven of bonds and cash, and reduce their exposure to equities. The US dollar has also broken out to new highs and the Euro currency has broken to new lows. This is happening despite the backdrop of very strong US economic data and corporate earnings which have grown an incredible 85% over last year's depressed figures for the S&P 500 index members.

We see a wide range of possible scenarios in projecting the ultimate impact of the developments in Europe, but it appears that our markets may be in for a bit of a rough spell while that crisis works its way to a conclusion. Therefore we are increasing the risk tool exposure in our portfolio, via the use of short ETFs and zero coupon bonds. This shift reflects our view of the moderate increase in probability of a negative scenario involving sovereign debt. These hedges still remain well below prior peak weightings because in our view the odds of a successful resolution of the issue are still reasonable. However, should the situation continue to deteriorate, we are poised to increase the hedges as necessary.

The Roosevelt Investment Group, Inc.

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