

INVESTMENT OUTLOOK

June 30, 2009

The broader market moved higher in the second quarter as valuations and sentiment recovered from a scenario which discounted the likelihood of a depression. Year to date, the S&P 500 index is up only slightly through the end of June, having recovered a bit more in the second quarter than it lost in the first. The volatility index, or VIX, declined to levels that were prevalent prior to the collapse of Lehman last fall, as credit availability continued to improve and investors grew more confident about the economy.

During the quarter we reduced the allocation to consumer staples, materials and utilities as we adopted a more cyclical stance in the portfolio, which came about through significantly increased allocations to energy and technology. We also scaled back our hedges during the quarter, although towards the end of June we began to increase them again.

The additions to energy were primarily in the domestic unconventional natural gas sector. As gas has reached record low relative prices notwithstanding its superior carbon footprint, reduced drilling activity along with considerable gas-for-coal substitution could be paving the way for a resurgence in natural gas usage and prices. Recognizing the volatility inherent in short-term energy prices, we hedged some of this risk by adding a small position in an ultrashort oil and gas ETF.

Our work on the changing behavior of the consumer and the likely duration of that change has increased our conviction that consumer spending trends will continue to be profoundly affected for some time to come. Our view is unchanged that the economy will experience below-trend growth for the intermediate term, but we have changed our view somewhat on the shape of the recovery, to a square root “√” shape from an L-shape. This implies that while many of the economic indicators may well bounce back significantly from their lows, the below-trend growth aspect will persist after the bounce for reasons that are painfully obvious (housing, unemployment, under-utilization of manufacturing capacity, etc.). As a result we are re-evaluating the sensitivity of our holdings, as well as possible additions to the portfolio, to various economic indicators.

It is important to note that much of the spending associated with the administration’s fiscal stimulus program has yet to flow through to the economy and hence may still provide a significant boost to equities. We continue to be impressed at the cost-cutting measures taken by many corporations to right-size their expense structures as they adjust to a slower growth regime. Although we expect sub-par growth rates to persist for some time, companies overall are doing a good job in mitigating the impact of a challenged revenue environment and this will no doubt help to protect corporate earnings.

317 Madison Avenue, Suite 1004 New York, NY 10017

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On the fixed income side of the ledger, the yield curve steepened considerably during the second quarter, as the 10 year–3 month Treasury spread widened from 245 basis points to 333 basis points. Most of this spread widening took place in April and May. A steeper yield curve has historically been the precursor to economic growth, but it also means higher borrowing costs compared to the first quarter. Higher interest rates for individuals and corporate borrowers are a key risk to the economy’s recovery.

Mortgage rates are attractive from an absolute standpoint, but they are higher than the sub-5% rates of March and April. Home affordability is still quite high relative to the last few years, but tighter credit standards have significantly reduced the number of eligible borrowers. Investors are concerned that higher mortgage rates may reduce home buying activity and push out an eventual housing recovery.

Many believe that large waves of government spending such as we have seen and are likely to see more of, “crowd out” other borrowers by pushing interest rates up. Bond investors are justifiably concerned about the enormous spending program that this administration is apparently about to embark upon, and the equally enormous amount of new debt that will have to be issued to pay for it.

Another issue faced by the Fed is the risk of devaluing the dollar. As the Fed tries to keep rates low by buying back (monetizing) debt with newly printed dollars, the supply of dollars increases which, all else being equal, should push the dollar lower versus other currencies. While we recognize crowding out as a risk to an economic recovery, we believe the rise in yields to their current level is more a reflection of normalization of the credit environment from its near-collapse last fall.

Whichever future path the Fed follows, we feel strongly that persistently high unemployment accompanied by anemic consumer spending (as consumers rebuild their broken balance sheets and come to grips with massive wealth destruction) are fundamentally changing the way that consumers live their lives, and what they perceive as ‘normal’. This, plus a financial system that will operate with significantly less leverage going forward are the structural reasons for our longer term thesis of below trend economic growth.

The Roosevelt Investment Group, Inc.

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