

INVESTMENT OUTLOOK

March 31, 2009

At the end of the fourth quarter when we wrote our last client letter, we reflected upon the opportunity presented by the economic crisis, and stated our belief that much of the bad news was already reflected in security prices. Over the ensuing three months, the S&P 500 index edged down from the 900 level to below 700 before rebounding back above 800 in the second half of March. In our view the market's drop during the quarter had two proximate causes; the first was a sharp drop in economic activity during January and February, and the second was the Obama administration's lack of clarity on progress toward resolving the banking industry's problems and a very ambitious budget proposal that led to concerns about future deficits and higher taxes.

In our view, helping to spur the market's rebound were remarks by the CEOs of several large banks about their profitability in the first two months of 2009. The market was also helped by reassuring words from regulatory officials regarding changes in mark-to-market rules that have hurt the banking industry. A discussion of the possible reinstatement of the 'uptick rule' also boosted investor sentiment. These events, on top of an oversold market and some investor-friendly language from President Obama, seem to have set the bulls running again. Now we will see whether the market's recent advance is sustainable.

As the administration embarks upon its progressive agenda, there is a new appreciation that it must walk a fine line between populist rhetoric and functioning capital markets. For the market to continue to edge higher, the administration will need to back away from anti-Wall Street sound bites and policies which are openly hostile to capital investment. In addition to the uptick rule and mark-to-market rule changes, other catalysts exerting upward pressure on the market include lower mortgage rates, improved housing affordability, and a modest improvement in spreads. The Federal Reserve's policy of buying long-dated Treasuries, and the recently announced public-private investment program are big doses of medicine that should help to re-inflate the values of loans held on bank balance sheets. Investors generally perceive that the risk of a full-blown depression has diminished, although it appears to be broadly understood that the recession we are experiencing is severe.

The sheer magnitude of the fiscal and monetary policies that have been announced may be an overlooked catalyst for the economy and the market. Historically there has typically been a six to twelve month lag between the start of stimulus programs and their impact upon the economy. Therefore the market is probably already starting to discount some positive influence of the

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stimulus. Corporate earnings in 2009 are unlikely to provide much of a catalyst, since investors widely regard the whole year as a mulligan and are largely focused on 2010. However, if corporate management teams were to provide the slightest improvement in their 2009 outlook compared to the near absence of activity in the January/February timeframe, it would certainly provide more fundamental fuel for the rally.

On the other hand, if the Treasury or the Fed were to backtrack from their recent capital-friendly policies and instead move further in the direction of nationalizing banks it would be a clear negative. First quarter earnings reports are also a key near-term barometer, and should they contain worse news than anticipated, this would clearly derail the rally. Another item to watch is the progress through Congress of card-check legislation that if passed would make it much easier to unionize a workplace. This is a clear negative across the economy because it would lead to higher labor costs and more restrictive rules for employers. In a related move, FedEx has threatened to delay delivery of jets it ordered from Boeing should the legislation be passed.

Interest rates have edged up slightly during the quarter, and the yield curve has also steepened. The short end of the yield curve rose by 13 basis points during the quarter, while the long end was nearly 100 basis points higher. A steeper yield curve is positive for the economy overall, and especially for financial institutions because it boosts their net interest margins.

Given the massive fiscal and monetary stimulus programs and aggressive budget proposal put forward by the administration, it should be no surprise that inflation concerns are growing among investors. However, efforts to re-inflate depressed asset prices are clearly a part of the Fed's plan, and for now the deflationary impact of the recession is trumping other inflationary pressures. Chairman Bernanke's recent announcement about buying hundreds of billions of dollars in long-term Treasury bonds and mortgage-backed securities triggered a decline in the value of the dollar as well as an increase in the price of gold. This aggressive action helped show investors that the Fed is very serious about providing all manner of stimulus to the economy, but we will need to keep an eye on the value of the dollar vs. other currencies.

Three months into the year, our thoughts regarding the market and the economy have shifted slightly. There are some very important takeaways from the combined recent actions of the Treasury department and the Federal Reserve. Despite a number of false starts with respect to plans to help speed the banking sector's recovery, it seems much clearer now that the administration is serious about doing what it takes to help banks while at the same time avoiding nationalization if at all possible. These actions have led us to conclude that a higher weighting in financials is a good idea, and so we are much closer to market weight today. In the same vein,

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we have reduced the amount of our ETF hedges and incrementally increased the macroeconomic sensitivity of the portfolio with the addition of GE.

Our thematic work this quarter directed us to AT&T, Dominion Resources, National Fuel Gas and Aqua America (dividend tilt), Potash Corp., an increase in our gold position (inflation hedges), as well as Tyco (security), Wal-Mart, Teva, Perrigo (flight to value), and Washington Post (education, via its Kaplan subsidiary). We added Cerner based upon our work on the government's initiatives in the healthcare IT industry. During the quarter we sold most of our fourth quarter basket of undervalued stocks (RCL, ANF, MGM), and sold some more defensive stocks on earnings disappointments (GIS, HPQ, COST).

While a number of positives have developed, the most probable outcome we envision is a protracted and painful recovery with structurally higher unemployment. We are currently studying the likely investment consequences of this type of recovery, and believe that it will have long-lasting ramifications for consumer behavior with respect to spending/saving patterns, security needs, employment trends, and the possibility of extended families living together under one roof. As well, we are evaluating the beneficiaries and losers in the likely re-regulation of our economy and the winners under the new stimulus program. This work will help guide our investments over the coming periods.

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