

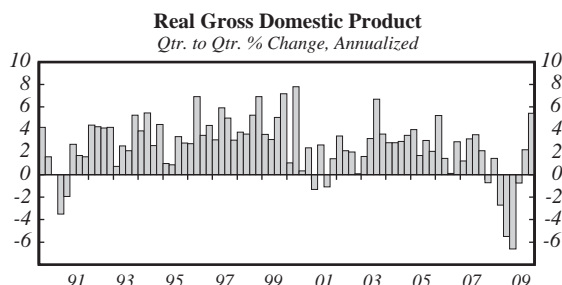
WENTWORTH, HAUSER AND VIOLICH

REVIEW AND OUTLOOK - SPRING 2010

Economy recovering from worst recession in 60 years.

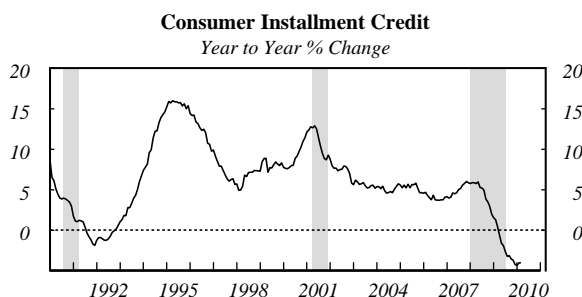
The economic recovery that began in the summer of 2009 remains in place and will continue throughout 2010. The National Bureau of Economic Research, the official arbiter of the inflection points in business cycles, determined that the recession in the United States began in December 2007. The NBER has yet to announce when it ended. However, most economists postulate that it ended in June or July of 2009 when many of the indicators of economic activity turned up. If this is confirmed by the NBER, the recession will have lasted 19 months, the longest and most severe downturn in business activity since the 1930s.

Many headwinds will constrain recovery in period ahead.



Real Gross Domestic Product (GDP), the total output of goods and services within the United States adjusted for inflation, advanced 2.2 percent in the third quarter of 2009 followed by an increase of 5.6 percent in the fourth quarter. However, the underlying economy is not as robust as the headline GDP number. In the fourth quarter, inventory investment added 3.8 percentage points to GDP, and with other adjustments, real final sales grew at an annual rate of only 1.6 percent. Estimates for the first quarter of 2010 are for GDP to have grown at an annual rate of about 3 percent. Estimates for the full year project the economy to grow at an annual rate of 3 percent as well.

The consumer is deleveraging.



Consumers are deleveraging by voluntarily paying off revolving (credit card) and non-revolving (auto) debt and involuntarily through home mortgage foreclosures. Since peaking in January 2009, consumer credit has declined \$115.8 billion or over 4 percent. Consumer saving has jumped to about 3.5 percent of personal income compared to a negative rate at the post-recession peak of the cycle. Thus consumer spending has been restrained. In addition to consumers paying off debt, banks have tightened their lending standards in response to the financial market collapse making loans more difficult to obtain for businesses. Other constraints to economic expansion are the housing market which remains depressed and high unemployment. Over 8 million jobs have been lost since the recession began and this has impaired the growth of personal income, the underpinning of consumer spending. Given the excess capacity of residential and commercial real estate, construction spending continues to contract. For the latest reported period, total construction spending declined at an annual rate of 22.1 percent despite an increase in infrastructure spending as part of the February 2009 \$787 billion stimulus legislation. Finally, the unprecedented level of government intrusion into the private sector has created uncertainty on the part of business and individual investors as to future liabilities regarding fees, taxes, health care, personal property rights and the rule of law.

Housing and construction remain weak.

The manufacturing sector is leading the recovery.

On a more positive note, the manufacturing sector of the economy is expanding at a healthy pace and the labor markets appear to be stabilizing. In March the ISM Manufacturing Index registered its highest level since 2004. After experiencing its worst performance in decades, the auto industry appears to have turned around as pent-up demand and sales incentives have lifted motor vehicle sales above their recession trough. Exports are contributing to the growth of the economy. After

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In the post-World War II period, economic recoveries following recessions have tended to mirror the depth of the downturn. That is, the steeper the recession the stronger the upturn and vice versa. That pattern has not occurred in this recovery. Indeed, this recovery has been quite tepid. Personal consumption expenditures, that represent about 70 percent of GDP, advanced at an annual rate of only 2.2 percent in the second half of 2009 compared to the 10-year average annual rate of 3.1 percent.



declining at an annualized rate of 33.8 percent between July 2008 and April 2009, exports have increased at an annualized rate of 23.7 percent over the past nine months. The ISM Non-Manufacturing Survey, representing the services, construction and government sectors, expanded in March at its fastest pace since May 2006 indicating a moderate upturn is in place in this aggregate.

The labor markets have stabilized.

The labor markets typically lag an upturn in the economy following a recession. The unemployment rate peaked at 10.1 percent in October and has held steady at 9.7 percent for the past two months. In March non-farm payrolls rose by 162,000, the first meaningful increase in employment since 2007. With both the manufacturing and non-manufacturing sectors in expansion, the decline in employment has troughed. There are, however, considerable challenges to the labor markets in the period ahead.



There are two surveys for reporting conditions within the jobs market. The non-farm payroll survey reports the monthly payroll jobs gained or lost by canvassing about 400,000 establishments. This survey does not include agricultural employees, the self-employed, sole proprietorships and workers in private households. The household survey of about 60,000 households provides estimates on civilian employment, the labor force, the unemployment

Unemployment likely to remain high for an extended period.

rate, labor force participation rate and employment-population rate. The labor force is made up of those that are employed and those that are looking for a job. A person who stops looking for a job is no longer counted as part of the labor force. The long-term unemployed are those that have been looking for a job for six months or longer. Sifting through all these statistics reveals that 15 million people are unemployed and looking for a job, 5.7 million people want a job but are not looking for one, 9.1 million people are working part-time but want to work full-time and 6.5 million people are considered long-term unemployed. The long-term unemployed number has more than doubled in the past year. The so called U-6 unemployment rate, the unemployed and part-time employed, is 16 percent. The employment situation from this perspective is the worst since the 1930s.

The dynamics of the labor market are also impacted by population growth, immigration, retiring baby boomers, obsolete skills and changes in productivity. Additionally, government incentives for employers to hire through tax credits or not hire because of mandated costs together with the perverse non-incentive of the unemployed to find a job because of extended unemployment benefit payments impact the labor markets. Non-farm payrolls need to grow about 125,000 per month to keep pace with population growth and keep the unemployment rate unchanged. In conclusion, while the labor markets will improve in the period ahead, it will be several years before the United States returns to an unemployment rate of 5.5 percent, the average rate of the past ten years.

The global economy is recovering.

The global economy is also recovering from the economic downturn. Manufacturing activity accelerated in March in China, Great Britain, and the Euro zone. Japan reported fourth quarter annualized growth of 4.6 percent and in March the government raised its assessment of the economy for the first time in eight months. The recovery in the global economy is driven by monetary and fiscal policy stimulus, stabilized financial sectors, increased internal demand and a resumption in production and trade. World trade declined 12.3 percent in 2009 according to the International Monetary Fund (IMF) which forecasts world trade to grow 5.8 percent in 2010 and 6.3 percent in 2011. Asian emerging and developing economies will lead the global recovery followed by emerging and developing economies in the Middle East, Africa and South America. The advanced economies of the United States, Great Britain, Europe and Japan will lag and their recoveries will be subpar by past standards. The IMF is projecting the global economy to grow 3.9 percent in 2010 and 4.3 percent in 2011. The emerging and developing economies are projected to grow 6.0 and 6.3 percent respectively in 2010 and 2011. While the near-term outlook for the United States economy appears favorable, the longer-term prospects are problematic because of the large increase in government

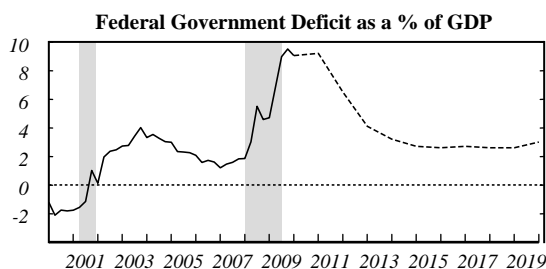
Emerging and developing economies will lead the developed economies.

Longer-term the U.S. faces several challenges.

spending, expansion of entitlement programs, large federal budget deficits and unfunded future liabilities. Additionally, the increased share of the economy controlled by the federal government will crowd out the private sector and have adverse consequences for longer-term growth. Finally, the enormous expansion in the Federal Reserve's balance sheet has inflationary implications of unprecedented proportions.

Federal budget deficits, increased debt and higher taxes will dampen economic growth.

In fiscal year 2009, ended in September, the federal budget deficit jumped to \$1.4 trillion from \$459 billion in fiscal 2008. The deficit is forecast to be \$1.6 trillion for fiscal 2010 and \$1.4 trillion for fiscal 2011. The Congressional Budget Office (CBO) in March estimated that deficits between 2011 and 2020 would total more than \$9.7 trillion. Total outstanding federal debt as of this writing is \$12.8 trillion and based upon CBO estimates will jump to over \$22.5 trillion in ten years. The federal government debt is growing at about \$4.5 billion a day. These estimates do not include the two newly enacted entitlement programs of health care and student loans. The first full decade of health care legislation will cost about \$2.4 trillion.

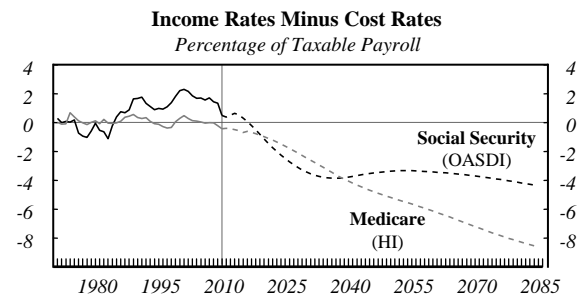


Federal spending has increased from its historic post-WWII range of 20-21 percent of GDP to a new baseline of 24-25 percent. Federal government spending currently represents about 27 percent of GDP. Revenues have averaged about 19 percent of GDP over the past 60 years. The recession caused tax revenues to fall to 16 percent of GDP, their lowest level in 61 years. Historically the federal government has run a deficit of about 2 percent of GDP which is

sustainable when GDP trend line growth is about 3.3 percent. Currently the deficit relative to GDP is about 11 percent. Interest on the federal debt is equal to about 13 percent of the deficit. By 2016 interest on the federal debt will take up 100 percent of the deficit.

Federal government debt will exceed 100 percent of GDP within ten years compared to 88 percent currently and 56 percent in 2007. Economists generally agree that 3 percent budget deficits and 60 percent debt to GDP are sustainable. Those are the criteria established by the Euro zone. The United States does not qualify for entry into the European Union.

Unfunded future government liabilities cannot be met under current policies.



The unfunded liabilities of Social Security, Medicare, Medicaid and other federal government employee pension programs together with the new health care entitlement are as high as \$75 trillion, an amount that exceeds total world GDP. The Medicare trust fund runs out in 2017 while the Social security trust fund runs out in 2037. This past year was the first time Social Security paid more in benefits than it received in payroll taxes and interest.

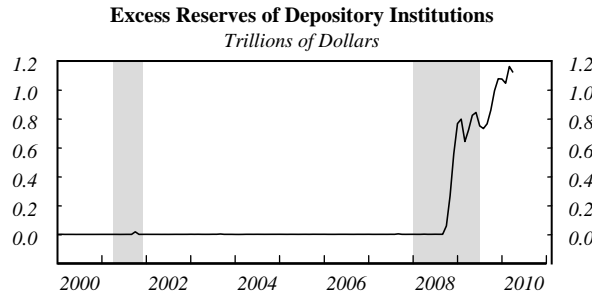
Past CBO estimates of the forward costs of current entitlement programs have understated the actual costs by a factor as large as 10. There are 78 million "baby boomers", those born between 1946 and 1964, that will be moving from work to retirement in the period ahead.

Additionally the various states are running unprecedented budget deficits. The new health care legislation places great burdens on the states as it expands Medicaid, the health care program for the poor that is shared by the federal government and the states. The recession and uncontrolled spending have created an estimated \$196 billion deficit for state governments in fiscal 2010 resulting in Moody's Investors Service lowering the credit rating of five states' bonds. State and local government debt is a record 20.7 percent of U.S. GDP.

There appears to be no political will to face these problems. Spending continues to grow. Tax increases are being budgeted, with taxes on individuals making more than \$200,000 and couples making more than \$250,000 for 2011, 2013 and beyond. However taxing this income group 100 percent would not

close the budget gap. The probabilities of a European style value-added tax are high. Uncontrolled spending, expanded entitlement programs, further government intrusion into the economy, increased regulation and higher taxes are not conducive to optimum economic growth. The results may well be the loss of the AAA rating for United States government obligations, a collapse of the dollar and runaway inflation.

Larger Fed excess reserves portend future inflationary pressures.



The Federal Reserve has helped to stem the financial crisis by injecting liquidity into the system, bringing the federal funds interest rate to near zero, establishing various credit facilities to lend or guarantee private sector debt and purchasing \$1.25 trillion of mortgage-backed securities. The result has been a massive expansion in the Fed's balance sheet and the creation of over \$1 trillion of excess bank reserves. Once borrowing

resumes, these reserves will be turned into loans and demand deposits, the money supply will balloon and, with a lag, higher inflation will follow. This dynamic will increase interest rates across the yield curve and drive bond prices down. This process will be exacerbated by the Fed's need to help the Treasury finance the large budget deficits mentioned above.

SUMMARY

Corporate profits are surging.



The United States and global economies will continue to recover throughout 2010. The U.S. economic expansion will be sluggish compared to the average of past post-WWII recoveries. Inflation will remain subdued in the near term keeping interest rates at levels that are conducive to economic growth. Corporate profits are benefitting from higher demand and improved productivity. Profits for the S & P 500 are increasing at a year-over-year

rate of about 37 percent. Corporate balance sheets are in good shape. Equities appear reasonably valued based on earnings estimates.

Longer-term the United States is operating at an unsustainable pace with higher spending, structural state and federal budget deficits, growing unfunded entitlement program liabilities, tax increases and an increased role of government in the private sector. These trends will dampen the economic potential of the country unless the executive and legislative branches of the government develop the political will to address the problems.

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