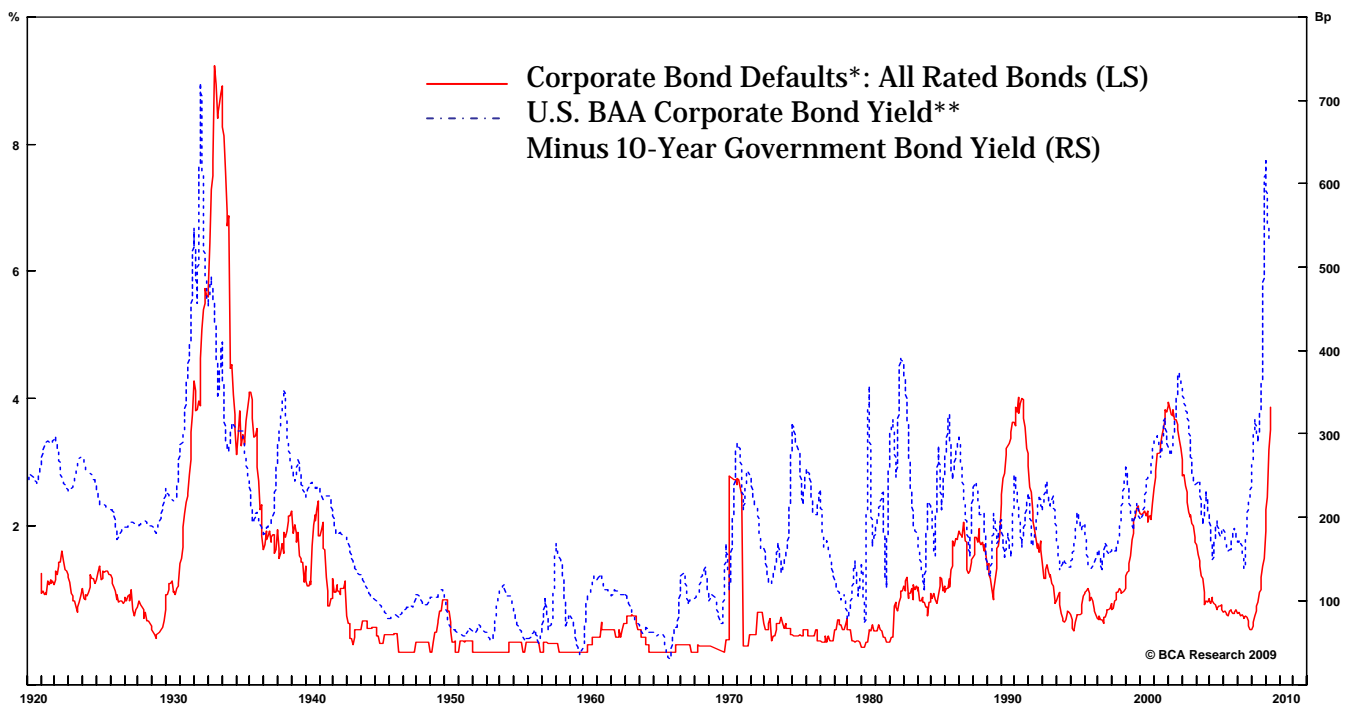


Economic & Market Commentary

The U.S. stock market rebounded sharply in the second quarter and is now up slightly for the year as measured by the S&P500. The economic freefall in 2008's fourth and 2009's first quarters appears to have morphed into a more modest rate of contraction in the second quarter. Markets appeared to be preparing for the worst in early March as concerns about the solvency of major financial institutions abounded. As the graph below shows, the spread of BAA (lowest quality investment grade) rated bonds over U.S. Treasuries approached the levels last seen in the "Great Depression" of the 1930s.



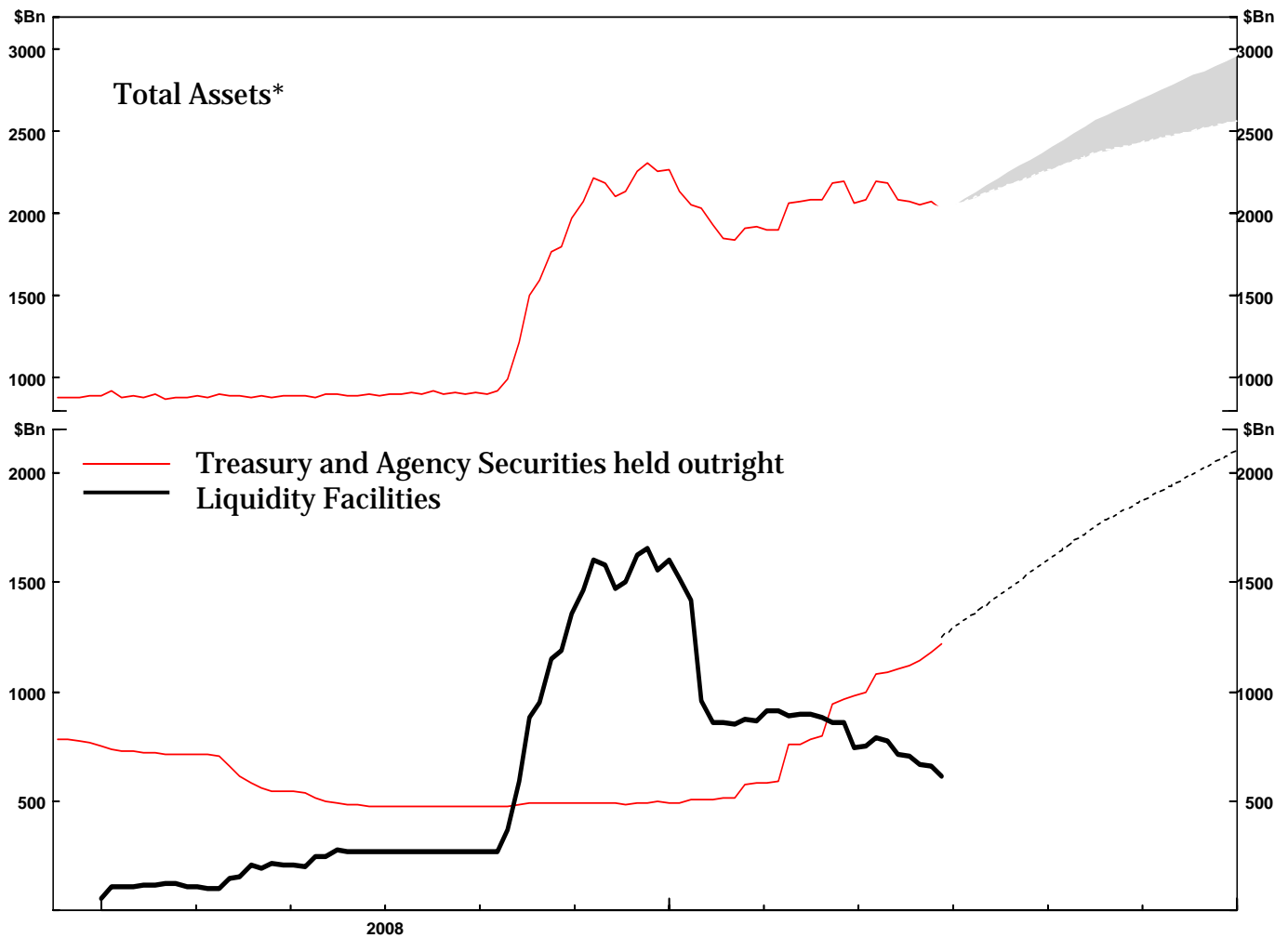
* Includes U.S. and non U.S. bonds. Source: Moody's Investors Service.

** Source: Moody's Investors Service

During this current financial crisis, Bear Stearns, Lehman, and Merrill Lynch ceased to exist as independent entities either through bankruptcy or desperation shotgun acquisitions. Fannie Mae, Freddie Mac, and AIG's need for additional capital required U.S. government guarantees and significant ownership. In addition, the almost unthinkable occurred; both Bank of America and Citigroup were faced with insolvency and were forced to accept capital and loan loss guarantees in order to survive as independent, ongoing entities. While their independence was compromised by the large stakes taken by the federal government, their status as ongoing entities survived.

With these moves, the government has assured the markets that systemically important financial institutions would not be allowed to fail. The worst of the financial institution crisis now seemed behind us and the markets breathed a sigh of relief and rallied.

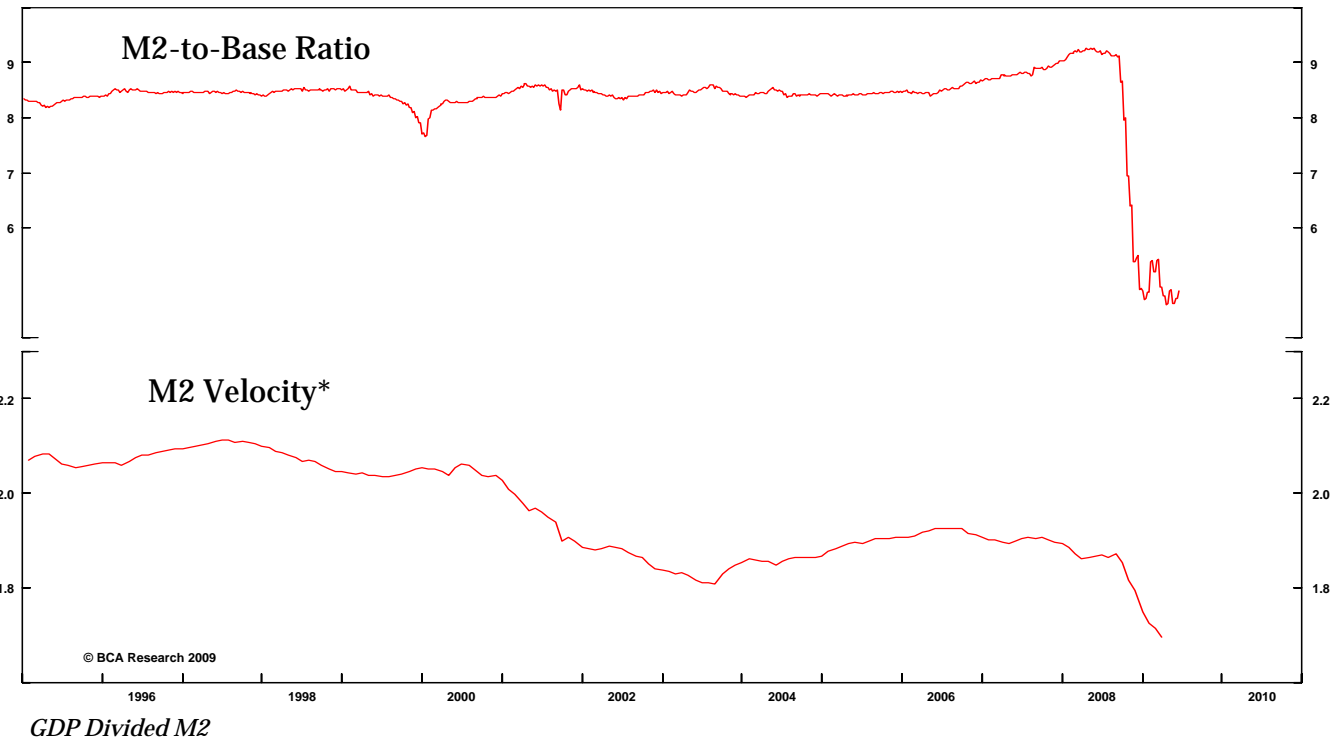
The unprecedented moves on both the fiscal and monetary front dramatically reduced the possibility of a meltdown of the financial system and the domino collapse of financial institutions. This quite clearly is a good thing.



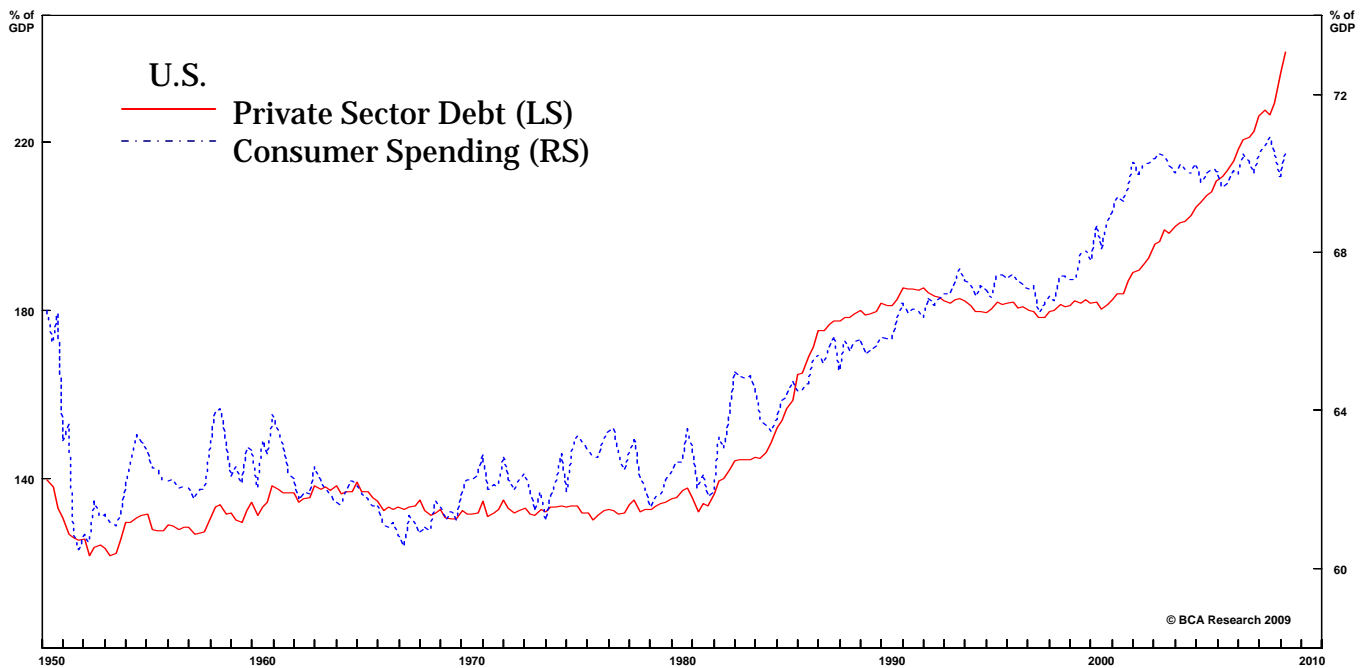
*Shaded Region denotes likely range; Based on expected runoff in Liquidity facilities

**Dashed line indicates Fed's Announced purchase plans

The Federal Reserve's (Fed) expansion of its balance sheet through loans to banks and purchase of debt instruments has assured the solvency of the largest financial institutions. Unfortunately, the massive increase in the monetary base is not spurring economic activity and private sector loan expansion.

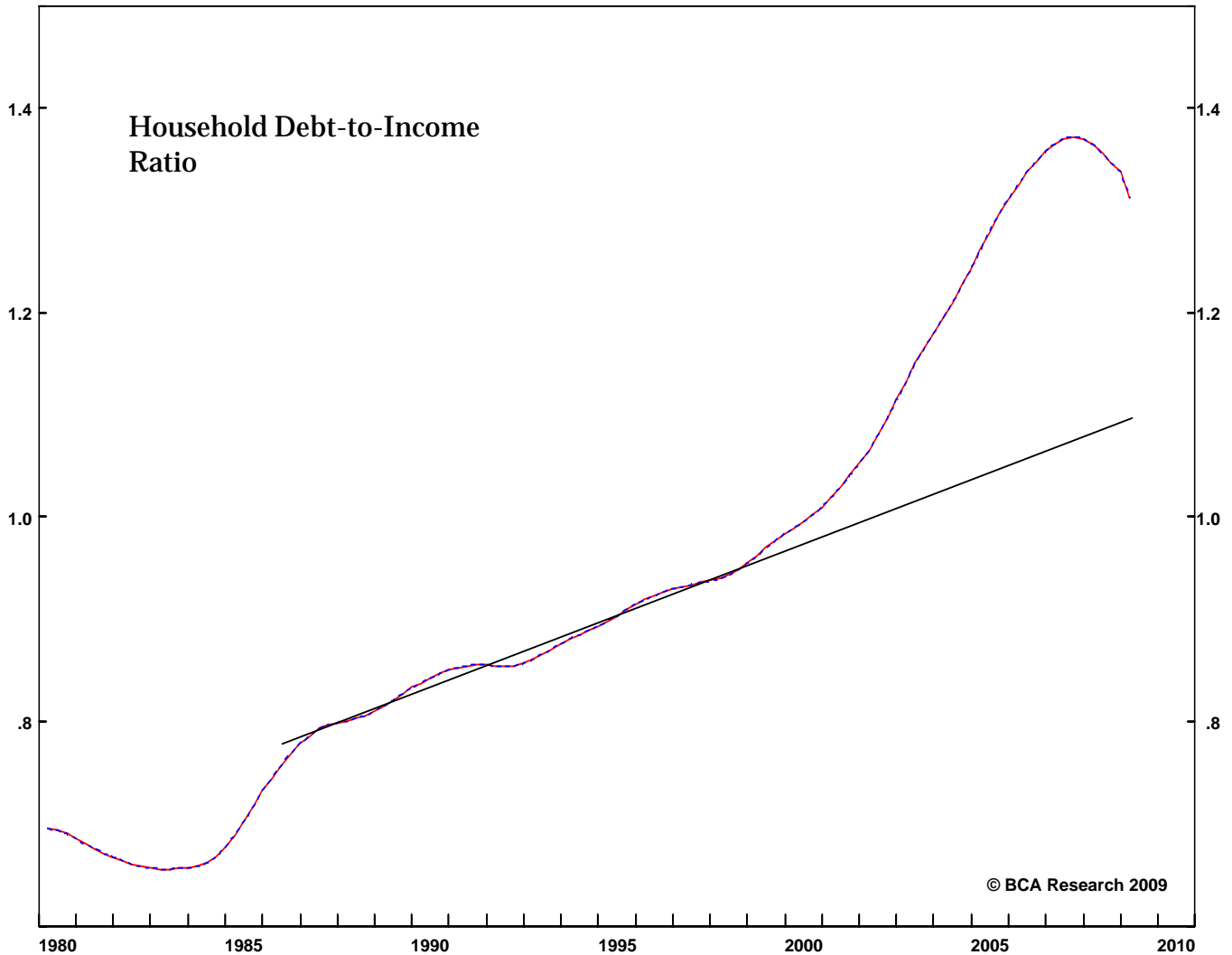


The Fed's efforts are helping the financial institutions, but so far have had limited positive impact on the real economy; thus, we remain concerned about the consumer and his debt load.

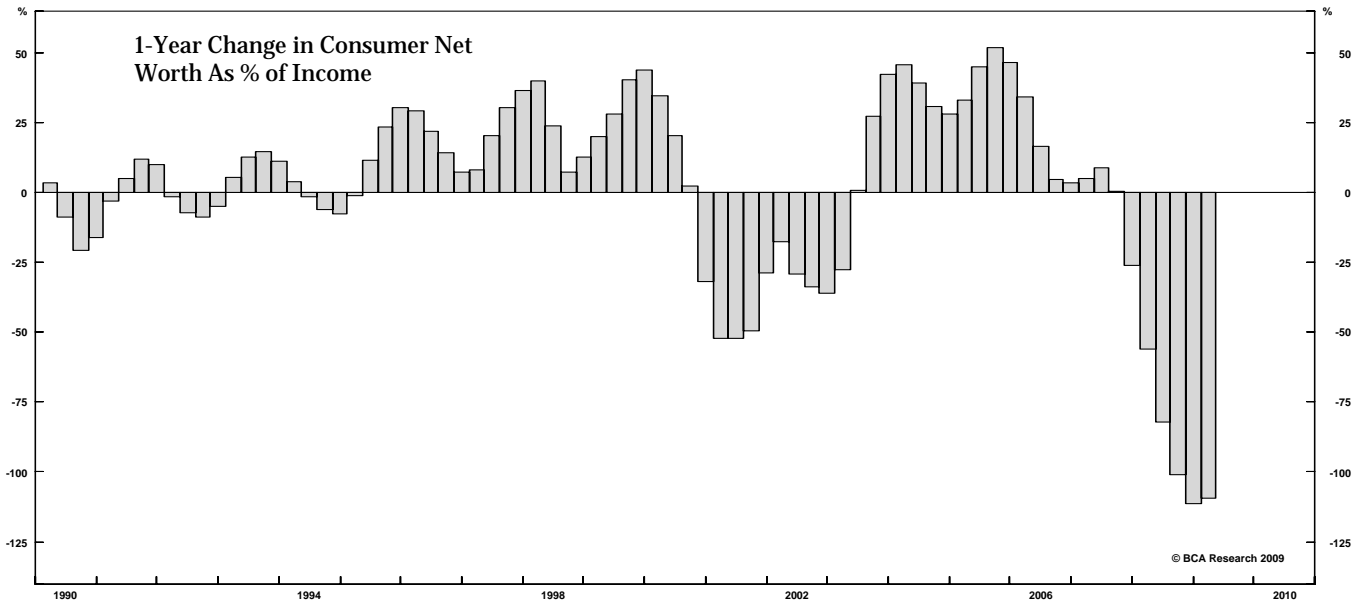


*Excludes financial sector debt. Source: Flow of Funds.

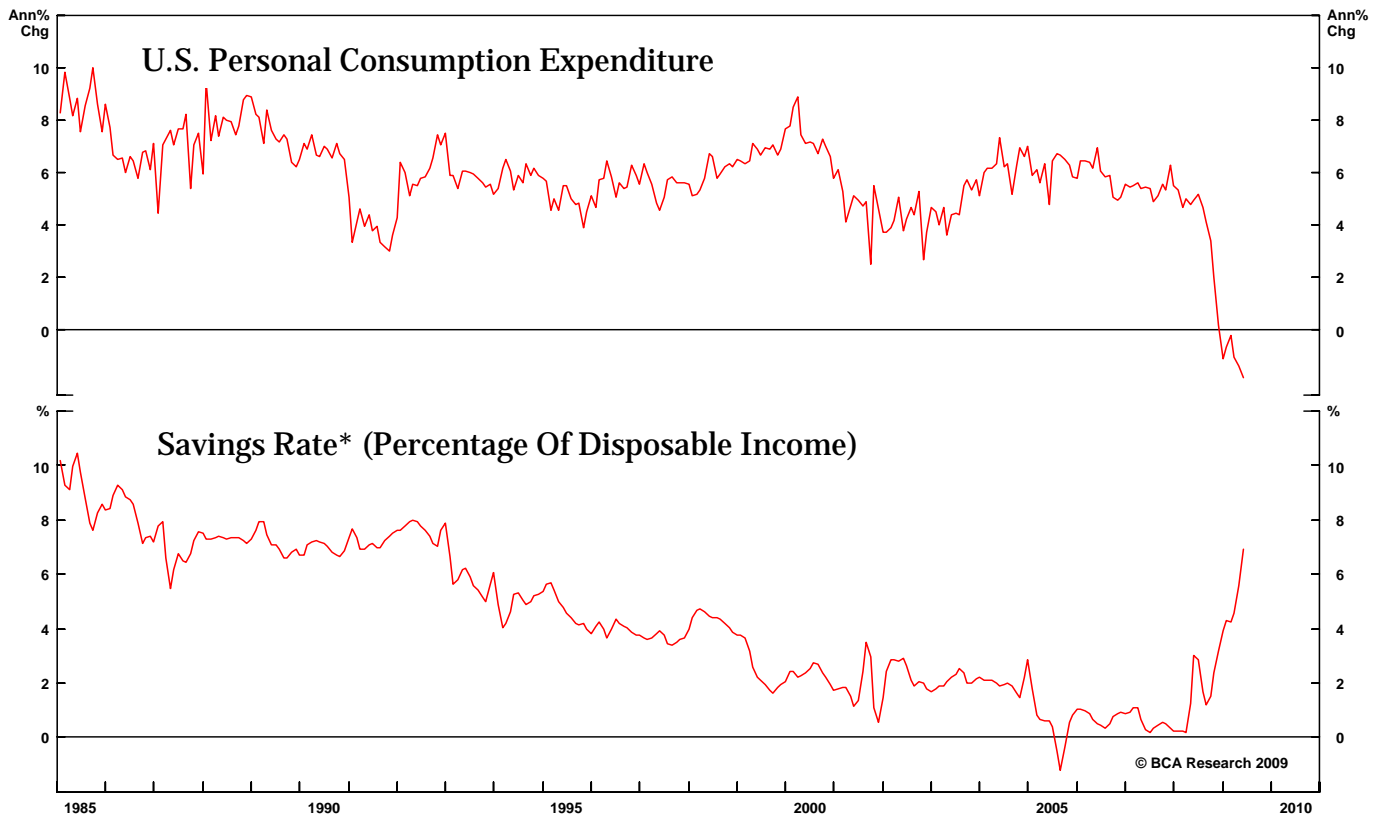
As shown on the previous chart, private sector debt has expanded dramatically as a percentage of GDP and has allowed consumption to expand its importance in the economy as well. Private sector debt and consumption as a percent of GDP have been tightly correlated, and we would argue this relationship was causal as greater debt provided the means for excess consumption.



With the consumer stretched from a financial standpoint, we expect consumption to contract. On a cyclical basis, higher unemployment, less available credit, and lower wealth will force the consumer to spend less over the near term. Unemployment hit 9.5% in June and is poised to surge past 10% over the next few months. Including the marginally attached, unemployment has already reached 16.5%. Marginally attached workers are either working part-time or in jobs below their normal compensation and skill set.



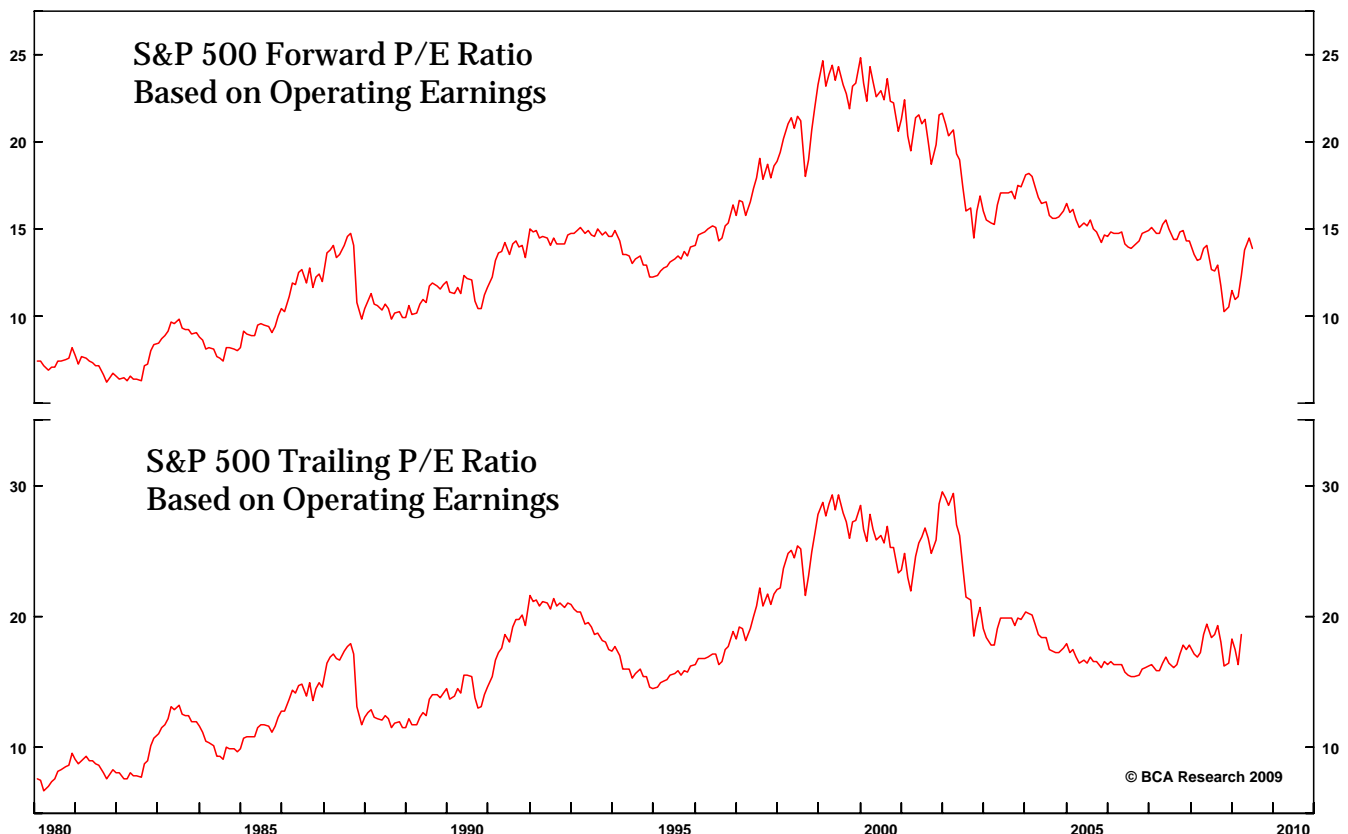
As the chart above shows, the loss of consumer wealth has been severe and should cause a continuing readjustment in spending and savings patterns. Moreover, tightening lending standards and a more cautious consumer should force spending down and savings up.



*Shown smoothed except for latest datapoint.
Source: Bureau of Economic Analysis.

In our view, the crisis that started with the financial institutions as the center has moved to the consumer as the biggest problem. We believe it is unrealistic to expect a strong consumer spending recovery in the face of higher unemployment, lower wealth, and a tight borrowing environment. While the recession has accelerated the decline in consumption and an increase in savings, we believe this is a secular change that will evolve over a 5-10 year period. The increase in private sector debt and consumption took five decades to reach its bubble peak; hence, we expect the unwind to take years as well. This recession is thus different from the ones of the past 60 years because its end will not come as the result of a sharp increase in spending on consumer discretionary items like houses, cars, clothes, and electronics that need incremental debt to finance a surge. Retailers, restaurants, and discretionary consumer services face a difficult environment that will require retrenchment and fewer employees. We expect a negative feedback loop to exacerbate the problem.

With this in mind, we are hopeful that the economic contraction might stop during the fourth quarter, and a muted recovery will unfold in 2010. However, given the unprecedented nature of the great debt unwind and consumer spending shift, we think the risk to this forecast is to the downside.



Similar to the BAA/Treasury yield spread (see first chart), the stock market was preparing for the worst in early March and has since posted a strong recovery. Valuations as measured by price/earnings ratios are no longer near the fifteen year lows and are now at the upper half of their thirty year range. We believe that the market is discounting a strong economic recovery in 2010 which, in our view, is a low probability event. A muted recovery would most likely result in the stock indices being near the high end of their trading ranges for the next year. The unpredictable nature of the debt unwind and its impact on consumption and thus the broad economy, makes the possibility of further economic contraction into 2010 an event that investors should consider when evaluating risk and reward. At the current price of stocks, the possible risks outweigh the limited possibility of near term rewards in our opinion; therefore, we continue to urge a conservative posture towards the broad U.S. stock market. However, we continue to look for and own well-financed companies with good growth prospects that are selling below our estimate of their fair value.