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ECONOMIC UPDATE -- RECOVERY UNDERWAY

Unprecedented global fiscal stimulus and dramatically improved financial market conditions have paved the way for the nascent expansion now underway. Many analysts believe the recovery will be held back by the unwinding of the credit bubble which is expected to create headwinds against a more robust US recovery. Others are more optimistic, citing recently released data showing improved consumer confidence as well as new momentum in a number of key industries.

On the one hand, industrial production, durable goods orders, and other forward looking indices of manufacturing have turned up as businesses move to replenish badly depleted inventories. Measures of housing activity from mortgage applications to sales of existing homes to new residential construction have been improving for months, and consumer spending has stabilized following its freefall last winter. Consumer confidence indexes are spiking higher, some of which have returned to levels unseen since late 2007. On the other hand, anecdotal evidence gathered in conversations with clients, industry contracts, and our outside consultants, points to a moderate expansion as consumer spending, which now accounts for about 65% of economic activity in the US, is seen as remaining under pressure. Households, chastened by the events of the past year, continue to deleverage their balance sheets and add to savings in the aftermath of the worst recession since the 1930's, dampening outlays. On balance, as we view the outlook, important restraints to a recovery in consumer and business outlays -- high borrowing costs and diminished availability of credit -- will recede next year, and, as this occurs, the expansion will gain momentum and durability. Stay tuned!!

As for corporate profits, in retrospect, businesses preemptively cut costs early in the recession fearing a deeper and more prolonged decline in activity than actually took place. As a result, profits have held up better than expected during the downturn and now will rebound more sharply than is currently forecast as the expansion gains traction and revenues, now stagnant, begin to expand. In fact, recently released figures show that corporate profits recovered sharply last quarter, rising at the most rapid rate in four years.

FORECAST

Looking ahead, we see the economy recovering moderately for the next two to three quarters, first propelled by inventory restocking, fiscal stimulus, monetary ease, export

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growth, and a rebound in housing activity. Then, as employment growth resumes next spring, and credit availability improves, consumer spending will begin to show more sustained growth underpinning an extension of the recovery. Overall, GDP growth will approach the 3.50% trend rate this quarter and remain between 2.75% and 3.50% for the following two quarters. Operating earnings of the S&P 500 are likely to rise to about $75 per share in 2010, implying a current P/E of less than 14x next years' earnings with the S&P now at 1040.

The relatively moderate pace of economic recovery means, in our view, that *deflationary pressures* will persist and slow the normalization of monetary policy. The Fed will defer rate increases well into 2010 as policy makers give greater weight to high levels of unemployment, excess capacity, and low inflation expectations than to longer-term inflationary worries. Inflation, now running at about a 1.50% rate, will fall in the near term to 1.00% as high unemployment and the overhang of unused capacity in manufacturing and housing dampen price pressures. Medium-term bond yields are, therefore, unlikely to move beyond a range of 3.00%-4.00% as measured by the yield on the benchmark 10-year US Treasury bond for the foreseeable future.

Against this backdrop of improving financial markets, better business conditions, low inflation, recovering profits and benign interest rates, we continue to remain fully invested in equities within client's portfolio guidelines. In our view, equities -- domestic as well as foreign -- while volatile over shorter periods of time, and, from time-to-time may become "overbought", will generate returns over the next 18 to 24 months which justify their added risk when compared with expected returns from cash equivalents and bonds. Intermediate-term, high-quality corporate bonds, which we purchased aggressively last fall and winter, continue to offer more attractive return prospects than US treasuries for fixed income investors. And, longer term, US Treasury Inflation Protected Securities (TIPS) warrant inclusion in all balanced portfolios as an insurance policy against the risk of a weaker dollar and higher inflation in 2012 and beyond.

Clearly, while investors can expect corrections of bond and stock market excesses along the way, their focus should remain on the benefits we forecast to corporate profits and stock prices of the gradual improvement in the global economy.

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