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ECONOMIC UPDATE -- RECOVERY CONTINUING

While the economic data we have parsed since our October client letter showed signs of improving consumer sentiment and final demand -- reliable signals of expansion -- last week's surprisingly weak US November employment index underscored the uneven and fragile character of this recovery more than a year after the economy began to recover. For some analysts, the employment numbers called into question the durability of the recovery. In our view, investors would do well to recall that earlier this year we had another surprising slowing in US employment growth which was accompanied by a steady stream of *disappointing* economic indicators. The broad economic indicators soon reversed direction followed, shortly thereafter, by the employment figures which tend to lag the economic data. Our Economic Model, a copy of which is enclosed, captured the slowing trend and its reversal.

More recently, the weak November employment reading stood in stark contrast with a largely consistent pattern of *positive* data points and observations, which include the following:

- The four-week moving average for initial jobless claims, which foreshadows the monthly employment numbers, fell to 427,000 over the month of November, the lowest level in more than two years, and the employment reading from the November non-manufacturing Institute for Supply Management (ISM) survey reached its highest level since the end of the recession. Companies now appear to be firing fewer workers as sales improve and expectations for growth brighten while hiring remains anemic.

- Consumer spending and household confidence appear to be picking up. Increases in goods consumption during the three months through October rose to a 7.6% annualized rate. November readings from auto and chain store sales were also firm. And consumer confidence figures continue to rebound, albeit from previously very depressed levels.

- Capacity utilization in 55 US industries has been rising for a year indicating the expansion is durable.

- The current path of US GDP recovery is much more normal than is being portrayed by the media who appear to be more focused upon headline grabbing unemployment figures and depressing housing statistics. In fact, the economy is largely retracing the moderate recovery paths which followed the more recent 1990 and 2001 recessions. Although both of these recoveries were weak by post-WWII standards, the pace of the current recovery is not at all unusual.

- Home sales appear to be lifting from very depressed levels, judging by the latest readings of mortgage purchase applications and pending home sales.

- Anecdotal evidence gathered recently by the Federal Reserve's regional banks for its forthcoming FOMC meeting "points to slightly firmer growth" this fall.

- Soon to be released October trade data will shed important light on economic performance as we anticipate further signs that the mid-year surge in imports is dwindling.

- The November Global Purchasing Managers Index (PMI) survey showed a rise in its new orders index for the second consecutive month following this summer's slowdown.

So, while the November employment report was weak, it is at odds with other forward-looking US data which are signaling expansion. The employment numbers are, therefore, not a reason to conclude the year-old reacceleration in global recovery will fail. Indeed, it is also worth noting that our Economic Model resumed its upward slope a quarter ago, portending a continuation of improving business.

FINANCIAL MARKET CONDITIONS

Looking ahead, financial market conditions, which, in our view, precipitated the 2008-2009 recession, are now supportive of the strengthening expansion we forecast for 2011 and beyond. With the Fed Funds rate effectively at zero, the cost of borrowing has never been lower. We expect Fed-administered short-term rates will remain unchanged at least through next year and probably well into 2012. Long-term interest rates will also remain low by historical standards despite their recent spike in reaction to the Federal Reserve's QE2 decision and the administration's proposed tax compromise.

Inflation overall remains low by most measures. In fact, data shows that for the last year inflation has run well below the Fed target of about 2.0%, with core CPI at 0.6%, headline CPI at 1.0% and the personal consumption expenditures deflator (PCE) at 1.3%.

Thus, inflation remains muted despite a surge in commodity prices, and the potential for inflationary pressures in some developing economies which bears watching.

Corporate borrowing costs have rarely been lower. A combination of low Treasury yields and tight credit spreads have encouraged companies to refinance and extend existing debt maturities, issue new bonds, and lower overall borrowing costs. US investment-grade bond issuance this year has exceeded $800-billion.

Company balance sheets are bullet-proof. The cash/asset ratio for the S&P 500 (ex-financials) stands at an all-time high of 10.8%. Non-financial S&P 500 firms hold more than $1.0-trillion in aggregate cash balances, equal to roughly 10% of their equity capitalization. Despite these high cash balances and a now well-functioning credit market, managements are reluctant to boost capital expenditures significantly given large excess capacity. Given these huge cash balances, Wall Street forecasts now show common stock buybacks could rise 25% in 2011 to more than $340-billion and dividends could increase by 11% to $270-billion in 2011, providing an underpinning to stock valuations.

FORECAST

We forecast US GDP growth will accelerate from its current rate of about 2.5% to 3.5%-4.0% by the end of 2012 with growth next year approaching 3.0%. Outside the US, GDP growth is likely to grow at 4.5% next year and 4.75% in 2012 led by growth of 6.0%-8.0%+ in the emerging markets. Core inflation will remain low, averaging about 1.0% in both years as low operating rates and elevated unemployment, which has been about 9.6% this year, will remain high, averaging 9.0% in 2011 and fall to 8.5% in 2011. The private sector has created 1.1-million jobs this year with gains reported every month. Although job growth of 100,000 per month is an economic plus, it is insufficient to significantly lower the unemployment rate given the number of new entrants into the workforce.

With unemployment unacceptably high and inflation remaining well below the Federal Reserve's 2.0% target, the Fed Funds rate will remain unchanged through next year and well into 2012. The Fed's quantitative easing program will remain in place for an extended period with the initial $600-billion possibly increased to as much as $1.0-trillion depending upon whether the economy is able to gain more traction than is currently forecast. Yields on 10-year US Treasury notes will gradually rise to 3.50% by the end of next year and approach 4.0% in 2012.

The likely extension of the current tax rate regime for two years will be a near term positive for consumer spending, which represents over two-thirds of GDP, and for the economy as a whole. Longer term, the huge US fiscal imbalance eventually must be addressed as the federal debt has risen to 93% of GDP and next year's federal budget deficit will total $1.3-trillion -- 11% of GDP.

FIXED INCOME INVESTMENT POLICY

The length of laddered bond portfolios under our management has generally been reduced over the past quarter with average durations now below 3.0. During this time, the proceeds of maturing bonds and cash flow have been invested in investment grade corporate issues maturing in 1-3 years. Legacy holdings of longer-term tax-exempt bonds have been reduced or eliminated in favor of short-term taxables. Aside from Treasury Inflation Protected Securities (TIPS), US Treasury bonds were sold earlier in favor of corporates. We plan to allow portfolio durations to remain at their current levels -- below the relevant benchmark.

EQUITY INVESTMENT POLICY

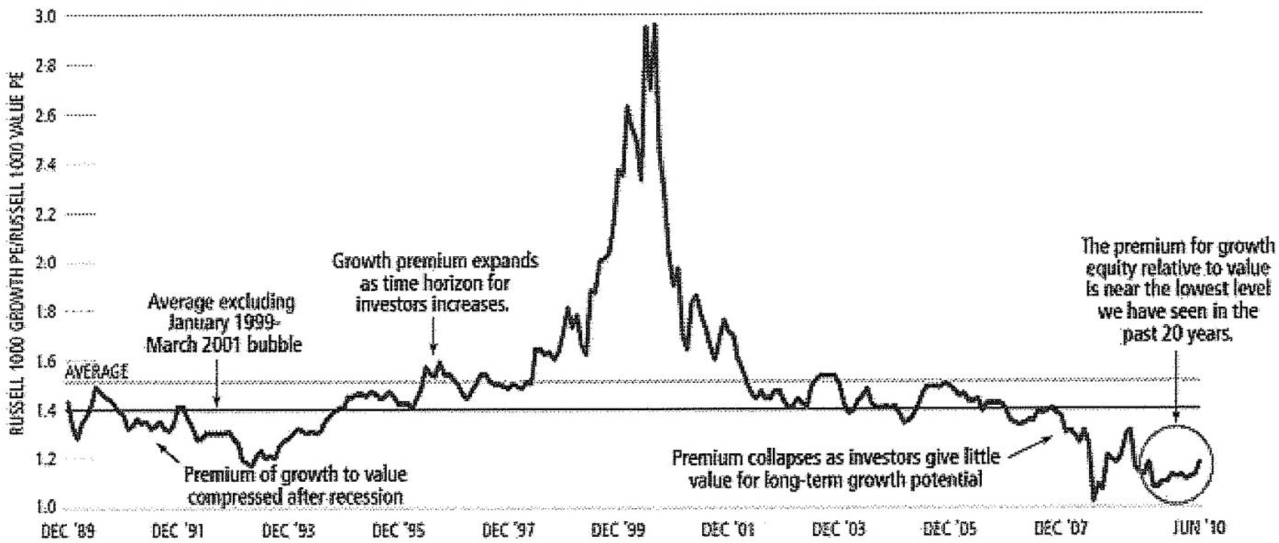
Overall, we continue to view stocks as more attractive than bonds or cash. We expect S&P 500 operating earnings to rise by 11.0% from $85.00 this year to about $95.00 per share in 2011, and then increase further to $105 per share in 2012. With US equities selling at only 12.8 times 2011 forecast earnings, we view stocks to be attractively priced despite the US stock market's 22% rebound from its July 1st low. Other metrics of equity valuation we monitor confirm their statistical attractiveness. Abroad, market valuations of stocks domiciled in emerging markets, which are expected to grow more rapidly than those in developed areas, remain extremely attractive. Accordingly, investments in emerging markets have been increased in client's portfolios while US-based multi-national companies exposed to emerging markets continue to represent substantial core holdings.

Domestically, financials, technology, diversified industrials, and energy -- all well represented in client's portfolios -- will account for over half of S&P 500 earnings next year and, as we see it, translate into relative outperformance compared with other sectors. We remain fully invested in equities despite the likelihood of a meaningful correction along the way.

As for the balance between *growth* and *value* shares in clients' equity portfolios, investments remain tilted toward *growth*. The chart below shows the premium for *growth* stocks relative to *value* shares is near the lowest level we have seen in two decades.

FIGURE 2. LITTLE PREMIUM FOR GROWTH

RUSSELL 1000® GROWTH INDEX P/E RELATIVE TO RUSSELL 1000® VALUE INDEX P/E, DECEMBER 1989–JUNE 2010



Source: FactSet and Cap IQ

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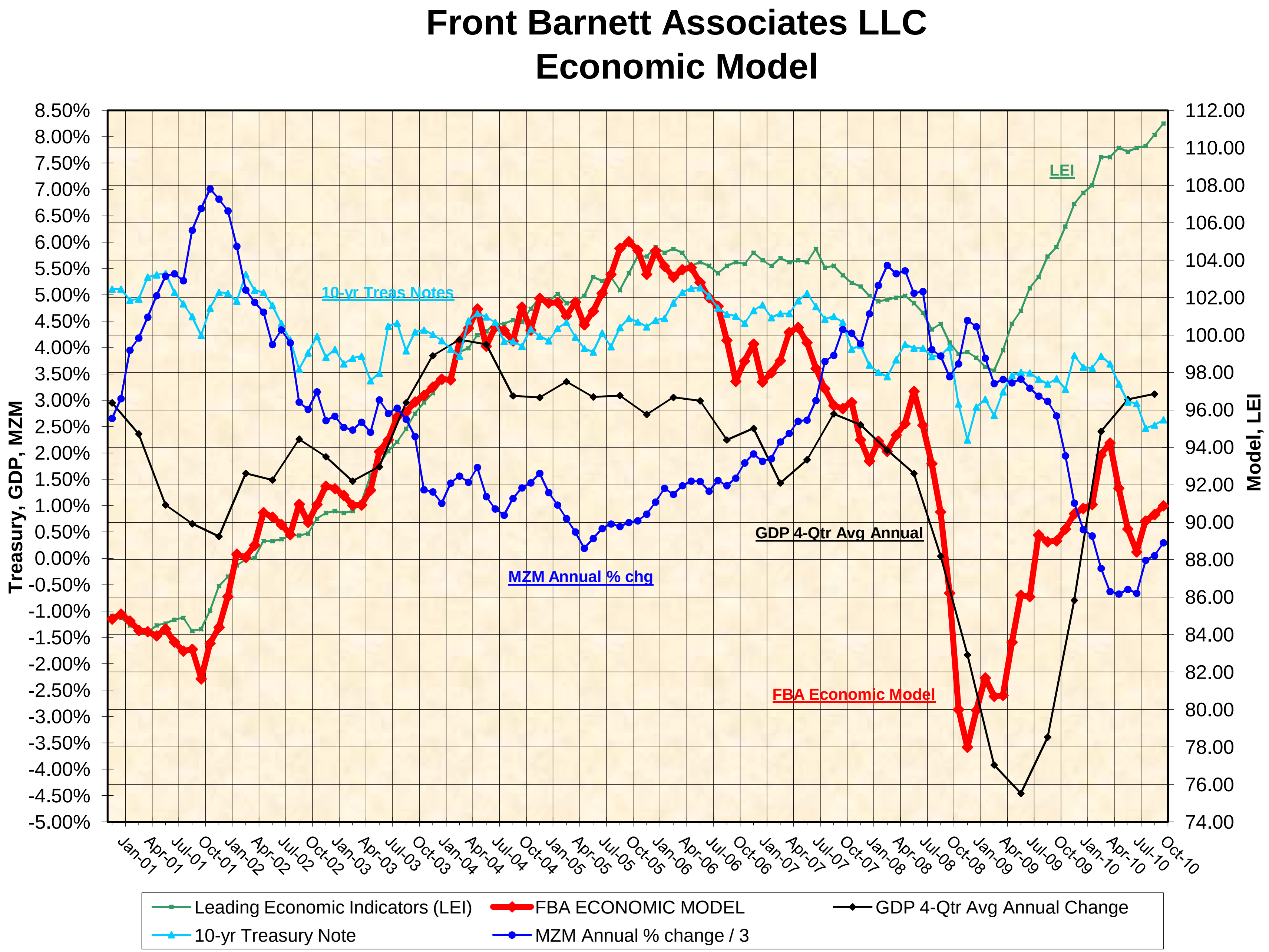
In closing, we extend Season's greetings and warmest best wishes for happy and healthy holidays to our clients and associates whose valued friendship and support over the past sixteen years has been an important element in our firm's success.

To help those many families in need during these trying times, we have again made a contribution to the Chicago Food Depository in lieu of sending holiday greeting cards.

MBF



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