Capital Markets Overview:
What to look for in today's investment environment

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Main Themes for 2011

1. QE2: Driving Asset Inflation and a Migration from Bonds to Stocks and Commodities
2. GDP Growth: Sustainable but Subdued
3. Significant Headwinds and Risks Remain
4. Recommendations

QE2 and its Effect on Asset Prices

- What is Quantitative Easing:
  - Unconventional monetary policy used by central banks when conventional policy is ineffective
  - Central bank credits its own account with money it creates electronically
  - Central bank buys government debt and other financial assets with newly created money: increases money supply and excess reserves
- Affect on Asset Prices:
  - Decreased supply of US Government bonds, lower than normal yields
  - Investors seek higher returns in more risky asset classes such as stocks and commodities, increasing asset prices
  - Decreases value of currency relative to other currencies

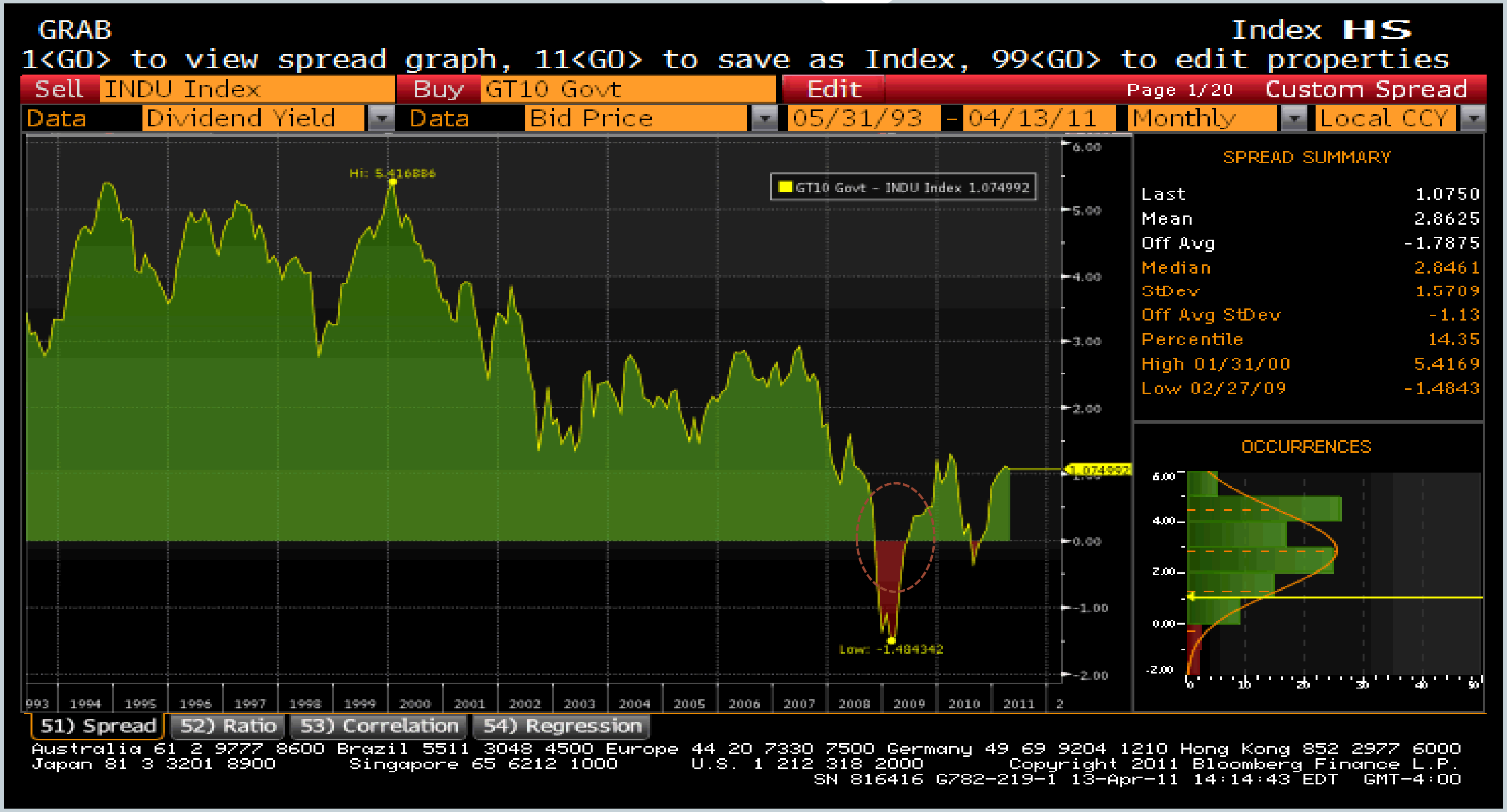
US Budget Deficit as a % of GDP

Ten Year Treasury Yields:

Note:

- There seems to be a disconnect here, because of QE2
- The Federal Reserve has purchased most new Treasury supply

Ten Year Yields vs. Div. Yield of DJIA



1. Negative is a sign of cheap equities
2. Spread is still 1.5 standard deviations below mean
3. Rates need to rise or stocks need to rally or both to revert to mean

S&P 500 Performance: 2010

- Since rumors of QE2 the S&P has returned approximately 23%

GDP Growth: Modest but Sustainable

- Retail Sales
- Return of US Manufacturing
- Health of Corporate Balance Sheets

GDP Growth Sustainable: What are the Drivers

GDP Growth is Driven by Three Main Categories:

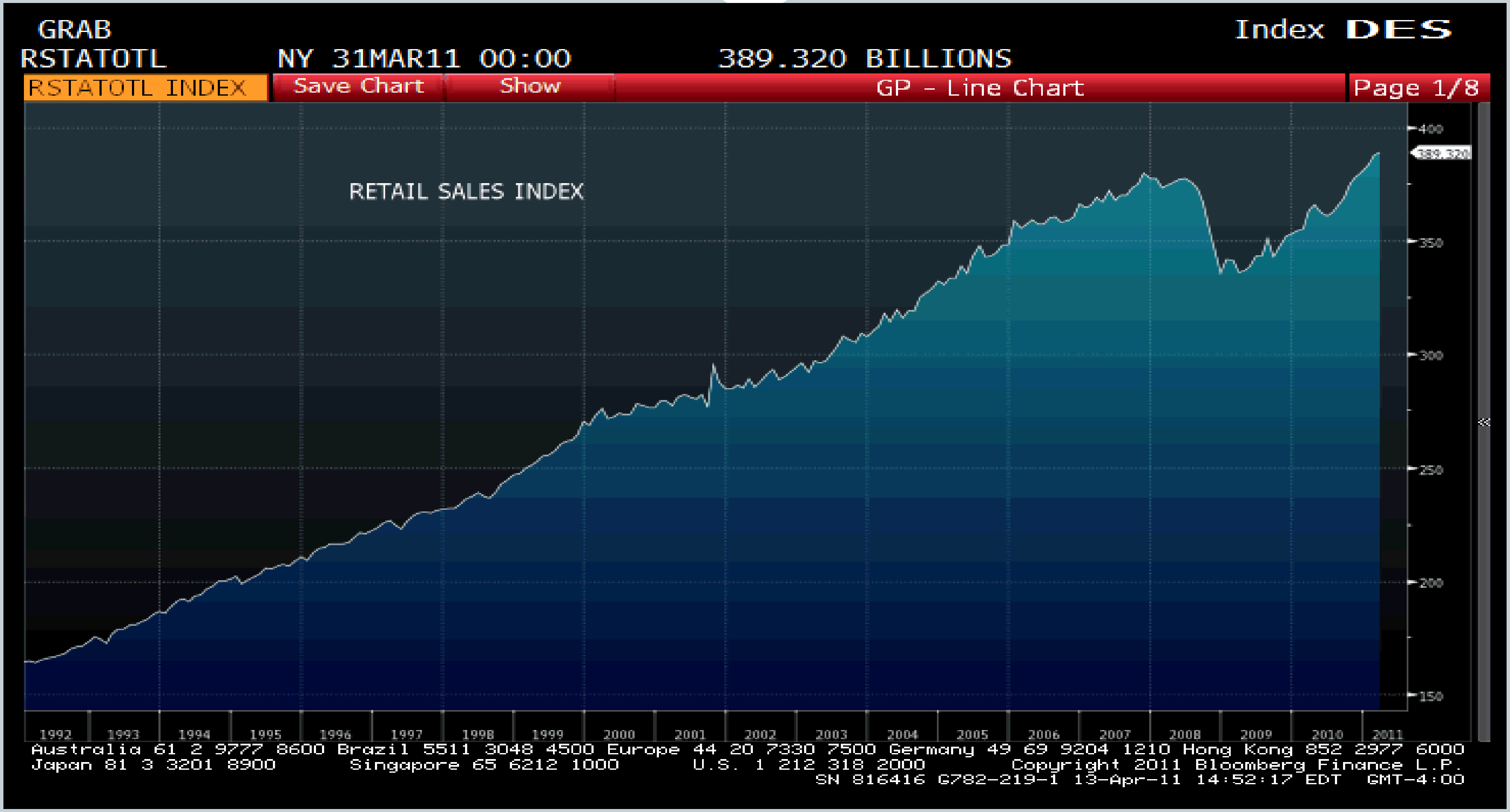
- Personal Consumption (70%)
  - Services (42%)
    - Real Estate (10%)
    - Health Care (12%)
    - Other (20%)
  - Products (28%)
    - Non-Durable Goods (20%)
    - Durable Goods (8%)

- Business Investment and Manufacturing (16%)
  - Manufacturing (12%)
  - Software and Business Equipment (4%)

- Government Spending (20%)
  - State and local Government (12%)
  - Federal Government (8%)

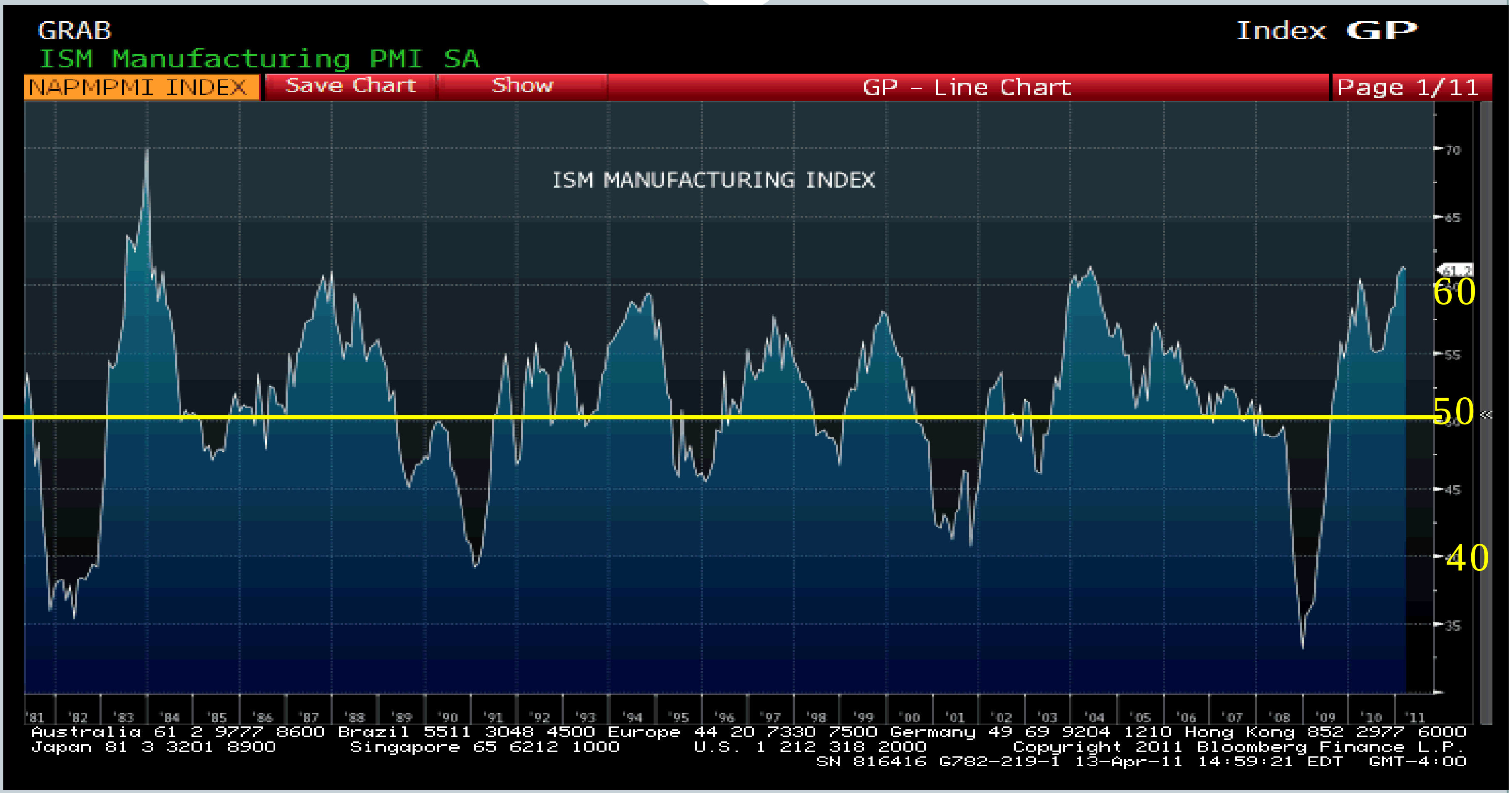
Note: The percentages don't total exactly to 100%, because of calculations made to net out exports from imports, and from changes in inventory.

Consumption: US Retail Sales



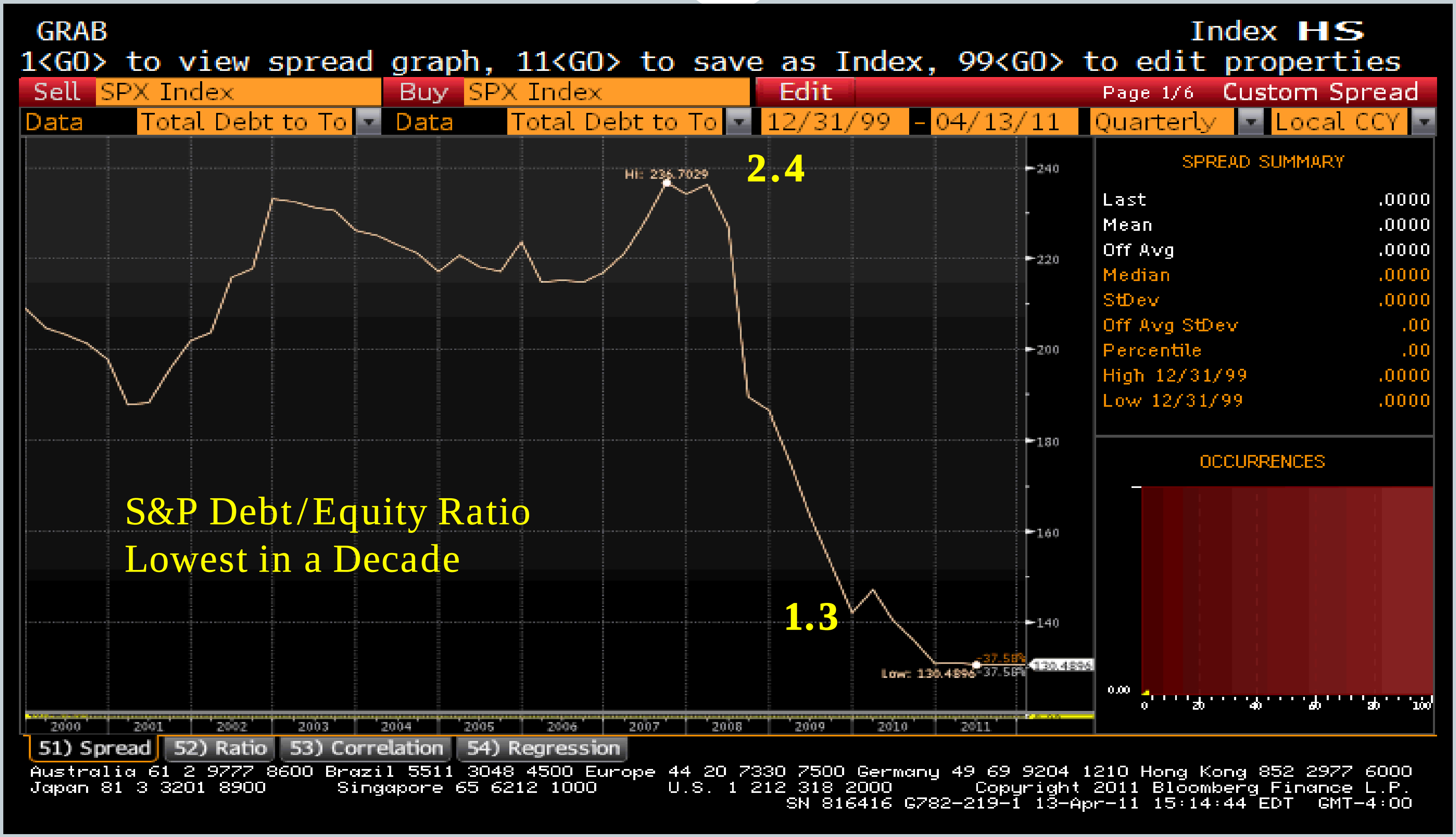
- Consumer spending back to 2007 levels

ISM Manufacturing



- Readings above 50 indicate expansion

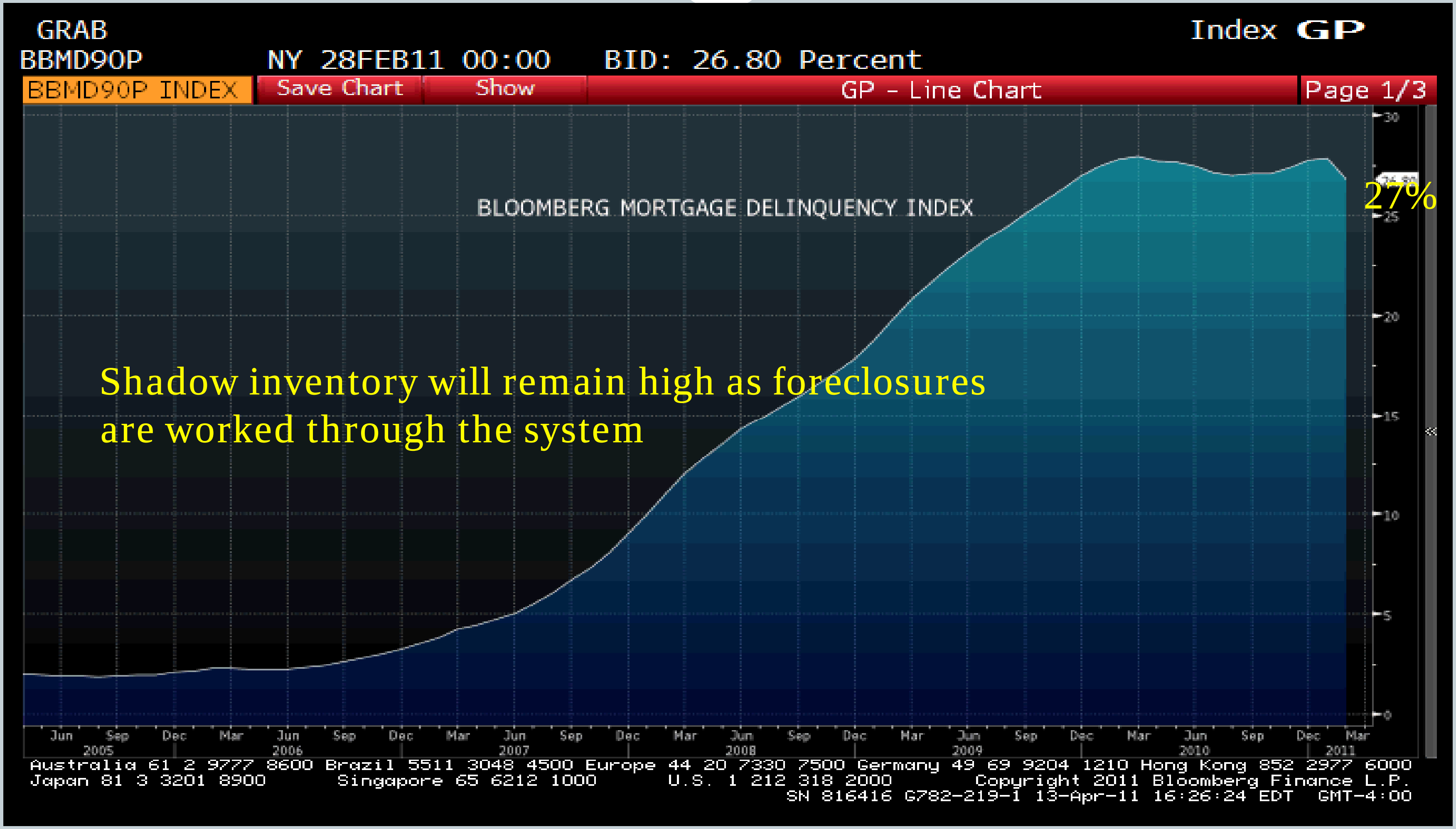
Health of Corporate Balance Sheets



Headwinds and Risks

1. Residential real estate will remain a drag on the economy
2. Unemployment is coming down, but slowly
3. Consumers may continue to deleverage
4. Geo-Political risks

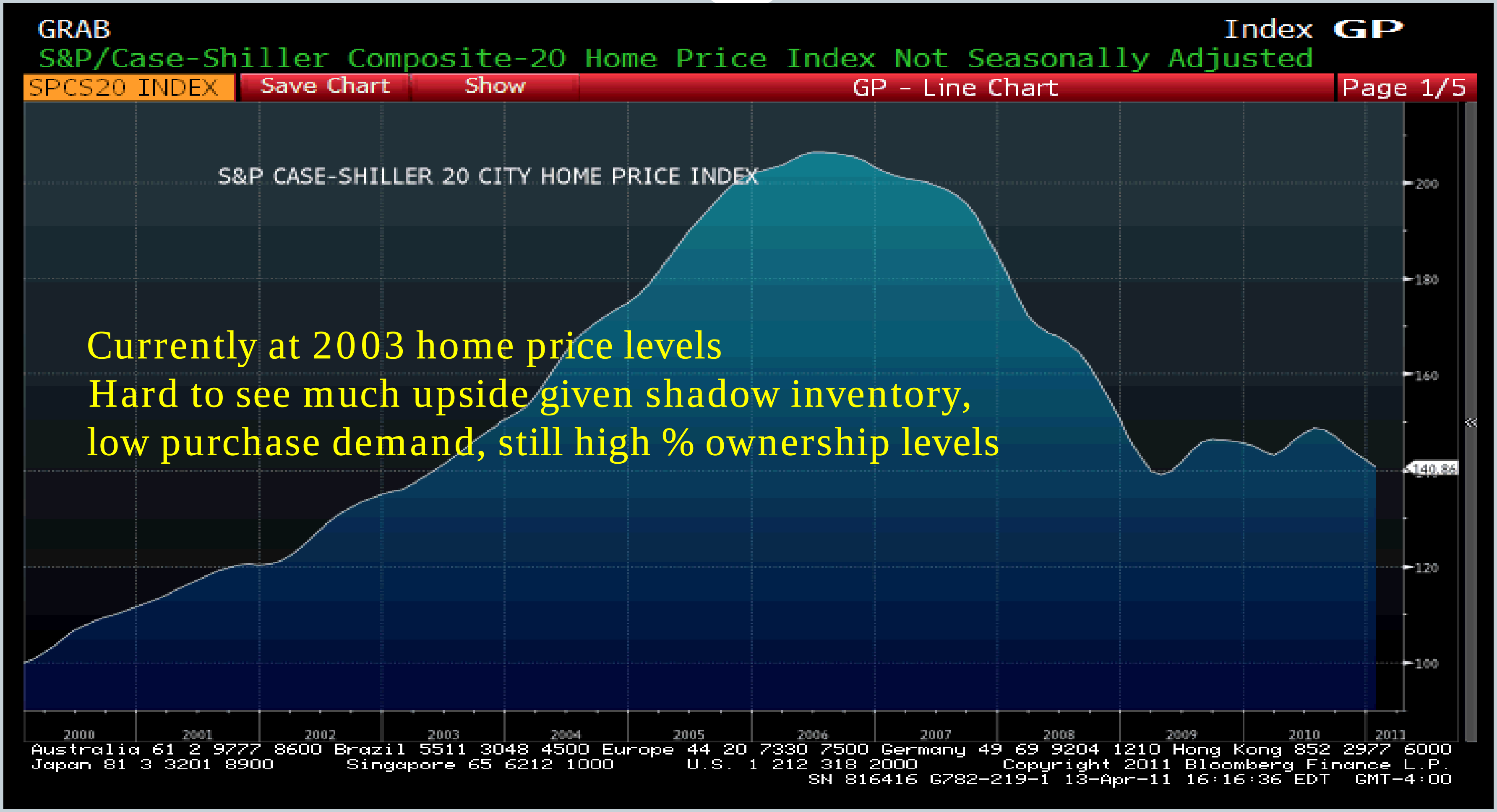
Real Estate: Delinquencies and Foreclosures



Real Estate: Purchase Demand is Low

Real Estate: % of homeownership still reverting to mean

Real Estate: Case-Shiller HPI



Unemployment

Consumers May Continue Shedding Debt

Consumers continue to shed debt
service from a peak of 14% to just under 12%
Pushes consumption out, but is more sustainable

Geo-Political Risks

- Unrest in the Middle East
- Peripheral European Debt Crises
- Currency War

Recommendations

- Keep talk of a “bond market bubble” in perspective
- Income is king in a low rate environment
- Position for higher rates

Bond Bubble in Perspective

- Worst calendar year return was in 1994
  - Federal reserve raised rates 250bps (2.50%)
  - Yield curve shifted up by about the same
  - Barclays Capital Aggregate Index return = -2.92%

- Worst 12 month trailing return was 3/79-3/80
  - Federal Reserve raised rates 1000bps (10%)
  - Yield curve shifted up about 400bps
  - Barclays Capital Aggregate Index return = -9.21%
- Worst 12 month trailing equity return = -68%

“Bond Bubble” in Perspective

	HORIZON ANALYSIS					
	Interest Rates Rise by 2.00% (200bps) Similar to 1994					
	3/31/2011	+1 year	+2 years	+3 years	+4 years	+5 years
Duration	3.58					
Yield Move	2.00					
Yield (%)	3.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Price Change (%)	0%	-7.16%	0	0	0	0
Total Return (%)		**-3.16%**	**5.00%**	**5.00%**	**5.00%**	**5.00%**
Cumulative Total Return (%)		**-3.16%**	**1.68%**	**6.77%**	**12.10%**	**17.71%**
Annualized Total Return (%)		**-3.16%**	**0.84%**	**2.26%**	**3.03%**	**3.54%**
	Interest Rates Rise by 4.00% (400bps) Similar to 1980					
	3/31/2011	+1 year	+2 years	+3 years	+4 years	+5 years
Duration	3.58					
Yield Move	4.00					
Yield (%)	3.00%	7.00%	7.00%	7.00%	7.00%	7.00%
Price Change (%)	0%	-14.32%	0	0	0	0
Total Return (%)		**-9.32%**	**7.00%**	**7.00%**	**7.00%**	**7.00%**
Cumulative Total Return (%)		**-9.32%**	**-2.97%**	**3.82%**	**11.09%**	**18.86%**
Annualized Total Return (%)		**-9.32%**	**-1.49%**	**1.27%**	**2.77%**	**3.77%**

“Bond Bubble” in Perspective

- Interest rates aren’t at “unprecedented” levels
  - 1933 – 1948 the Federal Reserve Discount Rate remained at or below 1%
- Interest rates don’t “have to” go dramatically higher in the near term
  - Japan 10yr yields have been below 2% since 1999

Income is King in a Low Rate Environment

- Underweight Treasuries
- Overweight corporate bonds and high yield
  - Default rates are at historic lows
  - Balance sheets are strong
- Overweight commercial mortgages
- Overweight asset backed securities
- Overweight GO and Essential Revenue Munis

Position for Higher Rates

- Run short duration relative to target or benchmark
  - We expect rates will move somewhat higher over the next 12-24 months as QE comes to an end
- Buy floating rate debt
  - All else equal, floating rate debt is not sensitive to the level of interest rates.

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