Investment Update
Second Quarter, 2010

Economic Developments

Through the end of March, the domestic economy continued to recover, and final real GDP growth of 2.7% was reported for the quarter. As expected, the pace of recovery had cooled somewhat from the very strong growth seen at the end of 2009, but at the end of the first quarter, the odds of the economy falling back into recession seemed to be fading. Credit markets were continuing to heal and global growth was rebounding on the backs of strong growth in the developing markets and recoveries in the U.S., Europe and Japan.

However, starting with the downgrading of Greek government debt to junk status in late April, worries about the near-term outlook multiplied rapidly. Investors reacted by selling the riskier asset classes and seeking safer havens. Since the Greek downgrade, most equity markets have fallen 10-15% and bonds have rallied strongly (prices have risen/yields have fallen) -- for example, two-year Treasury note yields have dropped from 1.1% to 0.6%, a historic low. Big-picture economic concerns focus on three main areas:

1) China's slowing growth, and the possibility that recent attempts to deflate its real estate bubble may go too far. If these efforts slow overall growth too much, one of the world's key sources of economic momentum could fade. This is certainly a near-term risk, but the Chinese authorities have a very good track record in matters of economic policy. Policymakers intend to redirect resources from speculative investment in property into improving the supply of public and low-cost housing so that the net effect on demand for global commodities will probably not be very large. Acting now is probably better than waiting until China's rapidly aging demographics burst the property bubble more dramatically. In addition, the recent decision to permit some yuan appreciation, which will tend to benefit Chinese consumers by making imports more affordable while also blunting international criticisms of China's currency policy, is a good example of policymakers' flexibility and pragmatism.

2) Europe's sovereign debt problems, and the implications for Euro-land growth. Years of excessive public-sector borrowing and budget deficits have come to a head in Greece, Spain, Portugal, Italy, and Ireland. The immediate impacts have been to trigger fears of another global credit crunch and to weaken the euro. Longer-term impacts will be felt as governments across the Continent adopt some combination of budget austerity, tax increases, and initiatives to revive economic growth in order to bring budget deficits under control. Early indications are that the worst fears of much higher taxes are probably not going to materialize, and so far we have not seen signs that tightening credit, currency turmoil and public protests against austerity measures have materially affected economic growth or business conditions. On the whole, European banks have needed relatively little of the emergency short-term funding that the European Central Bank has made available. One positive effect of the weaker euro is likely to be that Europe's exports become more competitive globally.

3) Softening U.S. economic indicators, which have revived fears of a double-dip recession. The weak recovery in private employment may have stalled. However, because corporate profits are rebounding, productivity is still improving, and temporary employment is still rising, we still expect hiring to continue to improve gradually. Employers are still struggling with a great deal of regulatory and economic uncertainty that affects their willingness to hire, and greater clarity (for example, the recent Obama administration decision to dramatically reduce the scope of intended carbon cap-and-trade legislation) is helpful. Rising real wages (a result of improving productivity) means that those consumers who are employed can continue to spend and save. Home sales have predictably weakened following the expiration of the mortgage tax credit, but with mortgage rates again at historically low levels and home prices no longer falling, a slow housing recovery will probably still be visible once the tax-credit

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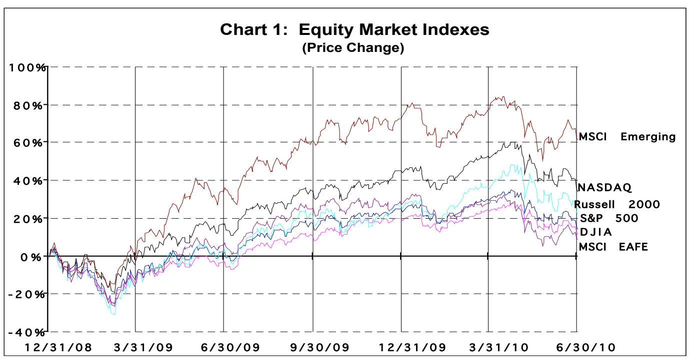
distortions have worked through the system. The manufacturing sector is still expanding, though the most recent June readings of manufacturing data do indicate that the sector is not expanding as rapidly as it had been. This is also true in China and in Europe, but that in and of itself should not be alarming – the recoveries in the manufacturing sectors have been so rapid and sharp that they had to eventually slow, and "slowing" is different from and better than "contracting." Similarly the U.S. service sector, which represents a much larger share of the overall economy than manufacturing, has slowed, but the June data to be released in July will still likely show continuing expansion.

We are reasonably optimistic that these current concerns will prove to be overdone, but some time will have to pass before it is clear how each problem is being resolved. In the meantime, since investors are still quite skittish after the experience of the 2007-2009 bear market, we can expect markets to continue to be unusually volatile in reaction to new data. An interesting longer-term question is whether Russia will be admitted to the World Trade Organization, and what the effects of its membership might be. China's admittance to the WTO in 2001 arguably ignited a significant acceleration of global economic growth.

Equity Markets

Beginning in late April, stock markets have sold off on incrementally negative economic news, although analysts' estimates for company earnings this year and next have not changed much. Current consensus estimates for the S&P 500 put 2010 and 2011 earnings at $79.50 and $92.20 respectively, compared to the recent high of $88.17 in 2006 and low of $65.27 in 2009. If these estimates are close to being accurate, then stock valuations look reasonably cheap at 12.9 and 11.2 times forward earnings. Admittedly that is a big "if" in the current environment, but we can count on an ongoing focus on cost controls to help achieve those estimates, plus some revenue growth is likely, which will also help. On the negative side, the euro's recent weakness will be a headwind this reporting season for companies with significant business in Europe.



Companies will begin to report quarterly earnings next week, and another round of generally strong results should help to offset investors' macroeconomic concerns. However, as long as fears of a potential double-dip recession are in the air, it is quite possible that even unequivocally good second quarter results will not be enough to rally stock prices in the short run.

Fixed Income Markets

Interest rates have fallen again, and while this has meant very good returns for bond investors, rates are so low now that going forward, it difficult to justify longer-term bonds except as a hedge against potential future deflation. While deflation is a risk, we think that eventual inflation and higher interest rates are more likely. Short-term bonds bought at these historically low yields do not offer much in the way of current income, but if interest rates eventually rise, they will protect principal better than longer maturities. For higher tax bracket investors, municipal bonds offer slightly more attractive after-tax yields than U.S. Treasuries and government agency bonds. Potentially higher future income tax rates add to municipals' current appeal, but this must be balanced against the increased credit risks posed by state and local budgets that are under strain. Diversification beyond municipals into corporate and government bonds is worth considering.

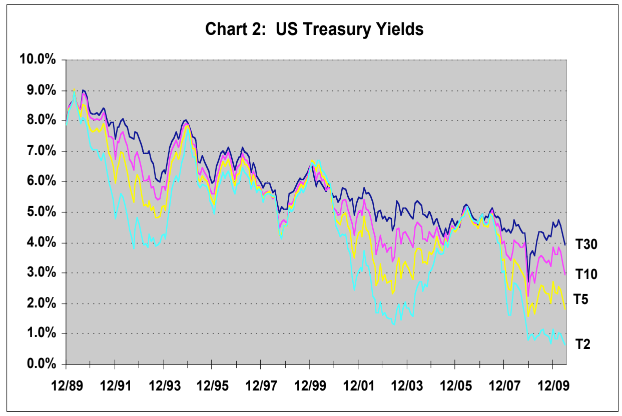


Chart 2: US Treasury Yields

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