



ECONOMIC AND INVESTMENT FORECAST

August 13, 2009

It has become increasingly evident that the U.S. economy is gradually improving, albeit at a slow and uneven pace. Recent improvement in new and existing home sales, better than expected durable goods orders, higher prices for basic materials, and the strong bear market stock rally seem to have convinced consumers that there is a light at the end of the tunnel. Consumer sentiment now stands at a 15 month high. However, the economy is still weak from the effects of deleveraging, wealth destruction, credit tightening and increasing unemployment. Industrial capacity utilization dropped to a record low of 65% in May. Unemployment, a lagging indicator, will likely peak at approximately 10% before beginning to decline in the first half of 2010. Although there is now adequate liquidity in our economic system, restricted credit is still a problem. Car Allowance Rebate System (Cash for Clunkers) has been successful in stimulating new auto sales and will positively impact 3rd quarter retail sales and GDP. However, U.S. consumers have recently increased their savings rate, which essentially takes money out of the system and slows the recovery. Some economists think the savings rate will reach 10% to 11%. Nevertheless, we still anticipate that the recession will end in the second half of this year. With respect to inflation, the Fed recently commented “substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time.” Therefore, we do not expect any short-term interest rate hikes in the near term.

The stock market, which was substantially underpriced in early March due to panic selling and fear of an economic depression, has rallied strongly. The S&P 500 Index is up 13.2% year to date and is up an impressive 48.7% from March 9th. Although we believe that the stock market is now due for a pause, we still expect some modest gains in the remainder of the year. There are issues, however, that can derail the economic and stock market recovery: higher state and federal income taxes, higher payroll taxes, increased regulation and the enormous budget deficit. Corporate earnings have been unexpectedly strong this past quarter as productivity has increased with workforce reductions. It is unlikely that there will be further cost reductions, and prospects for top line revenue increases are limited. This being said, cash has begun to leave its low yielding safe haven and enter the market. The cash level is still abnormally high at about 40% of the S&P 500 market value, which likely means the market has further to rise.

The strongest economic growth will likely take place outside the U.S. as well as outside developed countries, as the emerging countries expand their economies. The U.S. GDP is now only 23% of the global GDP, and the U.S. accounts for only 36% of world stock value. Although we believe that the U.S. economy will grow modestly in 2010, some emerging economies are expected to grow 2-3 times faster than the U.S. We see opportunity in these emerging markets as well as investments that benefit from expanding economies and inflation, such as energy, gold, and real estate.