

# INVESTMENT STRATEGY OUTLOOK



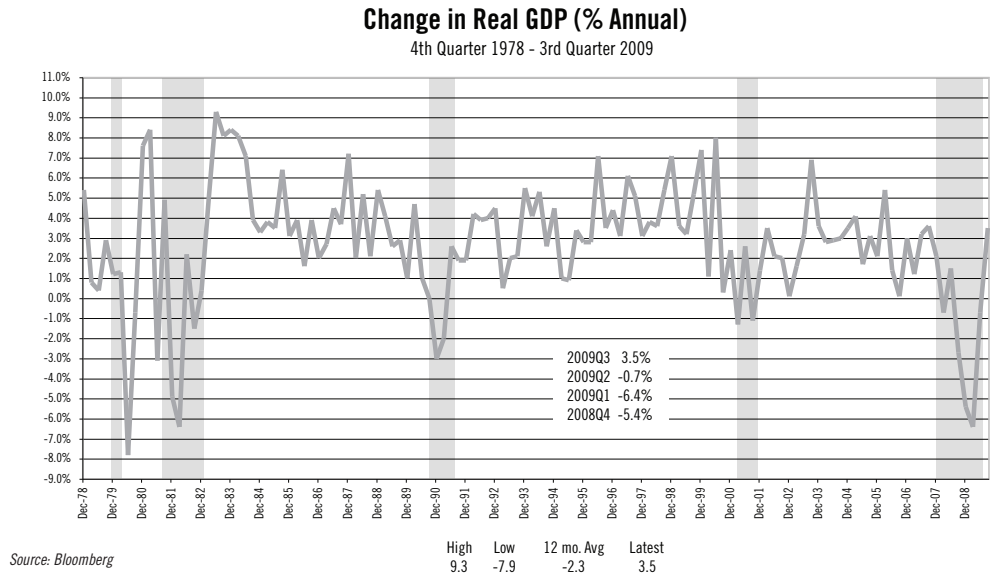
## The Economy:

### First Positive Quarter Since Mid-2008

The U.S. economy is expanding again, according to an early estimate of third quarter real GDP (inflation adjusted economic output). The 3.5% increase followed four quarters of declines and likely marked the end of the deepest recession since the 1930's. Real consumer spending grew 3.4%, the largest increase since the first quarter of 2007. Business spending on equipment and software edged up 1.1% after falling steeply for a year and a half, and business spending on structures slowed its decline to 9.0% from 17.3% and 43.6% declines in the two prior quarters. Federal government spending went up 7.9% and is on course to maintain that growth into early 2010 since approximately half of the stimulus package has yet to be spent.

The stage is set for further growth the rest of this year and into 2010. Because of the severity of the recession, we expect the economy to rebound sharply at first. The deep cuts in output, inventory and jobs during the downturn mean big percentage increases can be posted while the levels of those important economic factors remain well below the peaks of the boom. The fiscal and monetary stimulus which is occurring simultaneously in both developed and developing economies is self-reinforcing.

We look for subsequent growth below historical averages for the U.S. economy as households reduce debt loads, financial institutions repair damaged balance sheets, the commercial real estate market



Source: Bloomberg

slowly retrenches and consumer confidence wavers. The "reverse wealth effect" may last a long time as households and businesses rationalize the losses incurred in real estate and securities markets. Once the lagged effects of the fiscal stimulus run out in 2010, private sector economic activity will have to kick in if the recovery is to be sustainable. Employment will be one of the last areas to improve and will be critical to creating a healthy economic climate again.

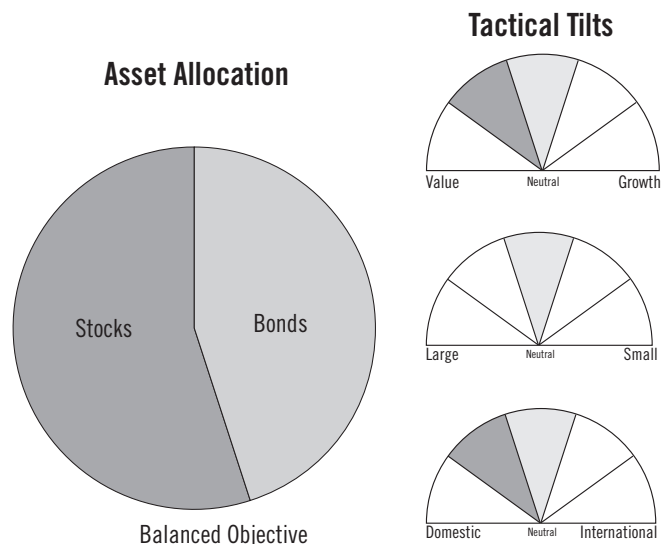
Inflation expectations appear under control so far, but starting in the current quarter, year-over-year price indexes in the U.S. will inevitably rise, reflecting the bottoming in oil prices last year. At some point concerns about the ballooning federal debt, dollar weakness and the Federal Reserve's ability to deftly shrink its balance sheet and unwind its monetary stimulus programs will reignite the inflation debate, even if the economy has not fully recovered. ▲

## Asset Allocation:

### No Change in Strategy

Our recommended asset allocation targets remain the same as last month. The Russell 1000 index declined 2.2% and the Barclays Aggregate Bond index increased 0.5% for the month. Stocks have outperformed bonds six of the past eight months. Our slight tilt toward stocks across the majority of our strategies continues to add to performance relative to our neutral asset allocation targets. We remain overweight equities by 5% in most of our objectives. An increase in expected future profits, albeit from very low levels, outweighs concerns of a market that has run too far too quickly. We will be watching closely as to whether these expected profits materialize.

Among Stocks, we continue to tilt our portfolios slightly toward U.S. stocks over International stocks. Within the domestic market, we favor stocks with Value characteristics over Growth, and remain neutral within our Small-Cap and Large-Cap tactical weightings. Our recommendations will continue to reflect our judgments regarding the investments that offer good return prospects. ▲



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## Stocks:

### Quarterly Earnings Exceed Expectations

October saw some weakness as the S&P 500 pulled back about 2% on the month with Financials, Materials and Industrials showing the most weakness. Energy was the relative winner in the month. Investors have become skeptical of the recovery even as earnings reports for the third quarter have been mostly positive.

Market uncertainty can be gauged using the VIX volatility index, also known as the "Fear Index". Declines in the VIX imply that investors are more optimistic regarding stocks while increases indicate more pessimism. The VIX is down about 50% since early March but leveled off in October. The VIX tends to follow liquidity and the Fed is doing all it can to support credit. That said, bank balance sheets still concern investors and with Financial Service stocks up over 135% since the March low many are taking profits now. The argument

Index	October Total Return	1 Year Total Return	3 Year Total Return*	5 Year Total Return*
S&P 500	-1.86	9.80	-7.02	0.33
S&P 500 Citigroup Value	-3.62	2.99	-10.18	-0.76
S&P 500 Citigroup Growth	-0.24	16.35	-3.95	1.32
Russell 2000	-6.79	6.43	-8.51	0.62
Russell 1000 Value	-3.06	4.79	-9.78	-0.01
Russell 1000 Growth	-1.35	17.48	-4.06	1.36
Russell 1000	-2.21	11.21	-6.83	0.74
NASDAQ Composite	-3.61	20.09	-3.90	1.54
Dow Jones Industrials	0.14	7.72	-4.40	1.95
International-EAFE	-1.24	27.97	-4.82	5.56

\*Annualized

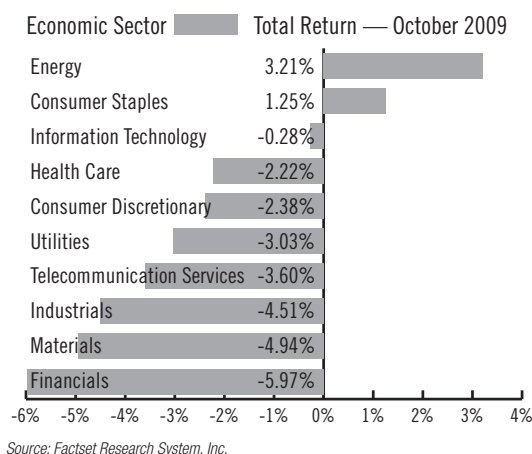
Source: Bloomberg

for continued recovery depends on improving conditions at banks.

With respect to corporate earnings, third quarter results have been positive so far. Nearly 80% of companies that have reported have posted higher earnings than Wall Street expectations.

Most companies are posting revenue and earnings declines relative to this time last year but many are also posting gains relative to last quarter. The improvements in earnings are mostly driven by cost cutting. There has also been an increasing number of companies showing revenue gains over the prior quarter. We are hearing more management teams indicating that the worst has passed and the outlook for business is improving. If more companies develop this positive outlook, cost cutting will abate. Over time, the labor market should see some improvement as optimism among employers leads to opportunities for employees. At this time, the companies with the most optimistic outlooks tend to have the most foreign exposure. ▲

### S&P 500 Performance by Sector



## Bonds:

### Treasury Yield Curve Continues to Steepen

During October, fixed income investors turned cautious as the economy exhibited strong quarterly growth and the outlook for sustainable growth improved. Third quarter real GDP grew at 3.5%, the first positive quarter of growth in the economy since the second quarter of 2008. In addition, inventory rebuilding and fiscal stimulus is expected to be sufficiently strong to boost growth over the next few quarters. Adding to the cautious tone for investors is the forecast for large U. S. budget deficits and its implications for Treasury debt issuance. While market sentiment has turned more cautious, there are still record amounts of liquidity available from investors and the Federal Reserve is expected to target short-term interest rates at zero for the foreseeable future. In the short run, Treasury yields should remain in their recent ranges even as corporate spreads tighten further. Next year, we expect yields to move higher as the federal deficit remains problematic and the Federal Reserve unwinds their quantitative easing programs.

The slope of the Treasury curve steepened sharply as two-year Treasury yields declined 6 basis points to 0.90% and ten-year Treasury yields increased 9 basis points to 3.39%. This resulted in an increase in the slope of the yield curve to 249 basis points from 235 basis points. We remain cautious on the outlook for Treasury yields as the pace of the economic recovery quickens and the need to finance the federal deficit grows.

We remain with our strategy to overweight investment grade corporate bonds and a market weight in agency quality mortgage securities. These sectors outperformed Treasuries and continue to offer better relative value. In portfolios subject to the federal income tax, high quality municipal bonds remain attractive. ▲

### Basis Point Change in Yield

