ALTMAN INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS ... OCTOBER, 2009

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"THE ECONOMIC PANIC THAT SPILLED INTO THE MARKET IS OVER. MONEY IS FLOWING AGAIN AND AVAILABLE; YET CONSUMER BEHAVIOR HAS CHANGED MATERIALLY.THE THINGS THAT HAVE MADE AMERICA WHAT IT IS WILL REASSERT THEMSEVES OVER TIME"

Warren E. Buffet (November 16, 2009)

THE U.S. ECONOMY

General Observations

The Financial markets continue to rise on ever higher prices, as the fourth quarter gets underway. The stock and bond markets continue to climb "a wall of worries" on concerns over unemployment, weak consumption, an unwinding residential housing and commercial bubble, dollar weakness, and a huge national deficit of approximately $1.5 trillion on an estimated $14.2 Trillion GDP in 2008 (or as high as 10.0% of GDP) . This is twice the level of historic recessionary troughs as the real GDP is running at an annual rate of -2.3% year-over-year through the third quarter. According to the Center on Budget and Policy Priorities, the "fiscal gap" (the amount of deficit reduction needed to stabilize the debt-to-GDP ratio at today's level) is 4.7% of GDP over the longer term. In other words policy makers would need to enact both a combination of spending cuts and revenue increases each year ($665 billion in 2009) to keep the long term level of debt from exceeding its 2009 level of 54% of GDP. However, the lack of confidence in Washington leadership in areas of healthcare reform, a national energy policy, and bank regulatory reform all have added to great uncertainty; yet the markets are propelled higher. You might ask, how can this be? The gravity of the situation necessitated drastic corrective action. In retrospect, when the Federal Reserve Chairman Bernanke announced expanding the definition of Quantitative Easing to include purchases of U.S. Treasuries, he unleashed a monetary and fiscal accommodation unlike anything we have ever seen since the U.S. expansionary policies during World War II.

Just as the system appeared broken in the spring of 2009, we were faced with a choice: either the U.S. Fed, with the support of Congress, will act to stop the hemorrhaging, or the system as we know it will fail. Since our financial problems were man-made they will also require man-made solutions. It takes an optimist who is consistent with a value philosophy to stay the course and continue to step up to the plate taking advantage of investment opportunities as they present themselves. We were given the rare "value" opportunity to increase our investments at wholesale prices. As difficult and unexpected as the 2008-09 decline turned out to be, we maintained our resolve, remained fully invested and have been selectively rotating our investment portfolios as we move through the bottoming process. If any investor had doubts before this crisis began that emotions can play a significant role in potentially damaging long term performance results, we have been humbly reminded of this fact. The challenge of building a long term investment program is to first recognize that we still retain those qualities of fear and greed and everything else that is human and then to learn how to steer clear of irrational behavior when it comes to managing our financial future.

Great bull markets that last several years are not usually followed by great bear markets - but rather by great sideways markets. The Dow soared 645% from April 1942 to January 1966. It then was range bound until November 1982, and then soared 1,041% during the last great bull market, which ended on January 14, 2000 when the Dow rose to a new high of 11,722.98. It has been moving sideways since then with extreme volatility around 10,000. Indeed, as of October 19th the Dow closed at 10,092 up 54.15% from the March 9 low of 6,547. It remains 28.75% below the October 9th, 2007 record high of 14,164.53. In other words, even if it rallies 40.4% from current levels, technically speaking, it would still be range bound, unless it breaks out to new record highs. Of course, a move from the March 9 low to the previous record high would put the 116% gain in the history books as the best recovery from a bear market ever.

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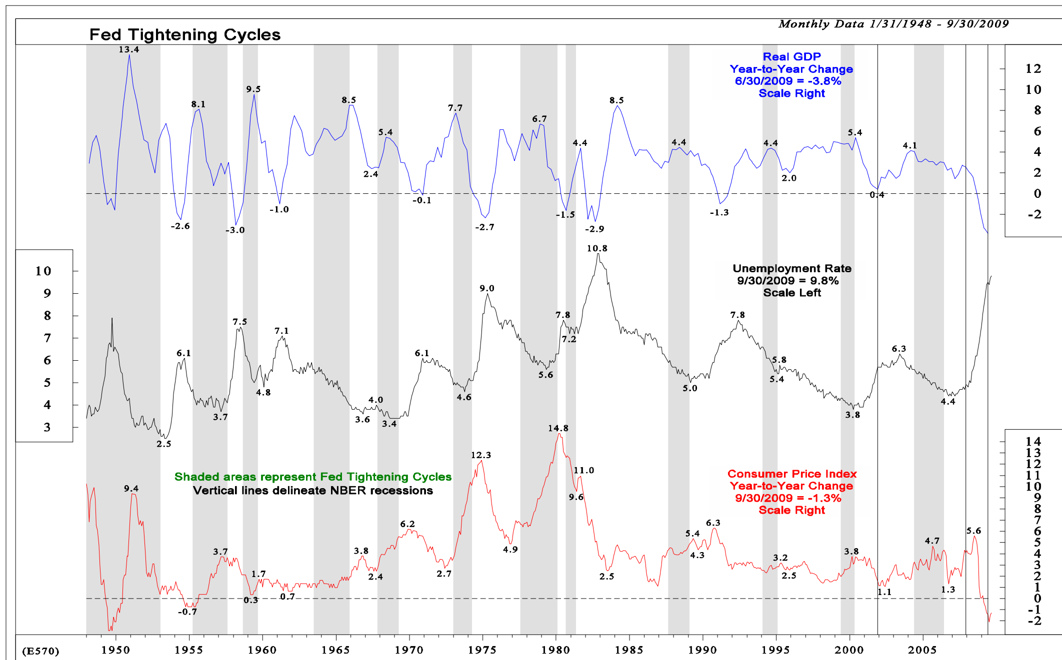
Can we do it? Can we revisit the record high, or even exceed it before the next bear market? Yes we believe we can! But in order to move higher, we need to implore this Congress as well as those new entrants in 2010 elections to seriously address the systemic risks inherent in our financial system making substantial headway with sound solutions. Despite our political problems, American businesses have probably never been more productive and more competitive than they are today. And they most certainly have the potential to be extremely profitable as their revenues recover.

The Economic Outlook – The Global Recovery and its Ramifications

The Department of Commerce announced the growth of real GDP for the third quarter up 3.5%, beating the consensus of economists of 3.2%. The magnitude of this improvement is significant from the recessionary trough experienced in the first half of the year, when real GDP declined by 6.4% in the first quarter and 0.7% in the second quarter. Most economic indicators are now recording sequential improvement, but levels of activity remain significantly below year-ago results. In September the leading indicators rose 1% and have increased for six months in a row for a gain of 5.7%. This represents an annualized rate of 11.8%.

EXHIBIT I



Source : Ned Davis Research 1/31/1948 - 09/30/2009

Existing home sales increased 9.4% in September to a rate of 5.57 million, with the average sale price at $174,900, down 8.5% from year-ago levels. Sales have increased 24% from the January bottom spurred by the tax credit of up to $8,000 for first-time homebuyers. This will expire at the end of November, with the possibility of an extension by Congress. Inventories of homes at 3.6 million are down to a 7.8 months supply at current sales rates. Many housing analysts, however, are concerned that with a high unemployment rate of 9.8% in September, against a background of high foreclosure rates, housing growth will again decline when the government stimulus plan expires. This happened in September to auto sales, which declined significantly when the Cash for Clunkers program ended. Ben Bernanke, Chairman of the Federal Reserve, has issued a number of warnings regarding the danger to the economy of reducing stimulus programs too early when the economic recovery is still fragile. This happened during the Great Depression in 1937-1938 when the economy faltered a second time as stimulus was prematurely withdrawn.

The desire to end federal spending programs emanates from the fears generated by the large fiscal deficits. The federal budget deficit for the 2009 fiscal year ending in September was $1.42 trillion, or 10% of GDP, compared to $455 billion in fiscal 2008. Federal revenues fell to $2.1 trillion, a decline of 16.6% due to the recession. Government spending jumped to $3.52 trillion, a gain of 18.2%. The huge increase in government borrowing has been offset by a large fall in borrowing by businesses and consumers in a recessionary environment. As a result, net interest payments fell by $10 billion in fiscal 2009. Looking ahead however, it is doubtful that interest rates will remain low on government bonds as the economy recovers against the background of a weaker dollar. There are increasing worries about the value of the national debt unless future deficits are brought under control. As the economy recovers, the level of taxation will most likely increase but Congress will still have to exert some discipline overspending levels if the deficit is to be meaningfully reduced. This could best be done by capping spending, rather than increasing taxation, which would put the recovery at risk. The current health care proposals (entitlements) are just one example that poses risks to the idea of long-term government spending being brought under control.

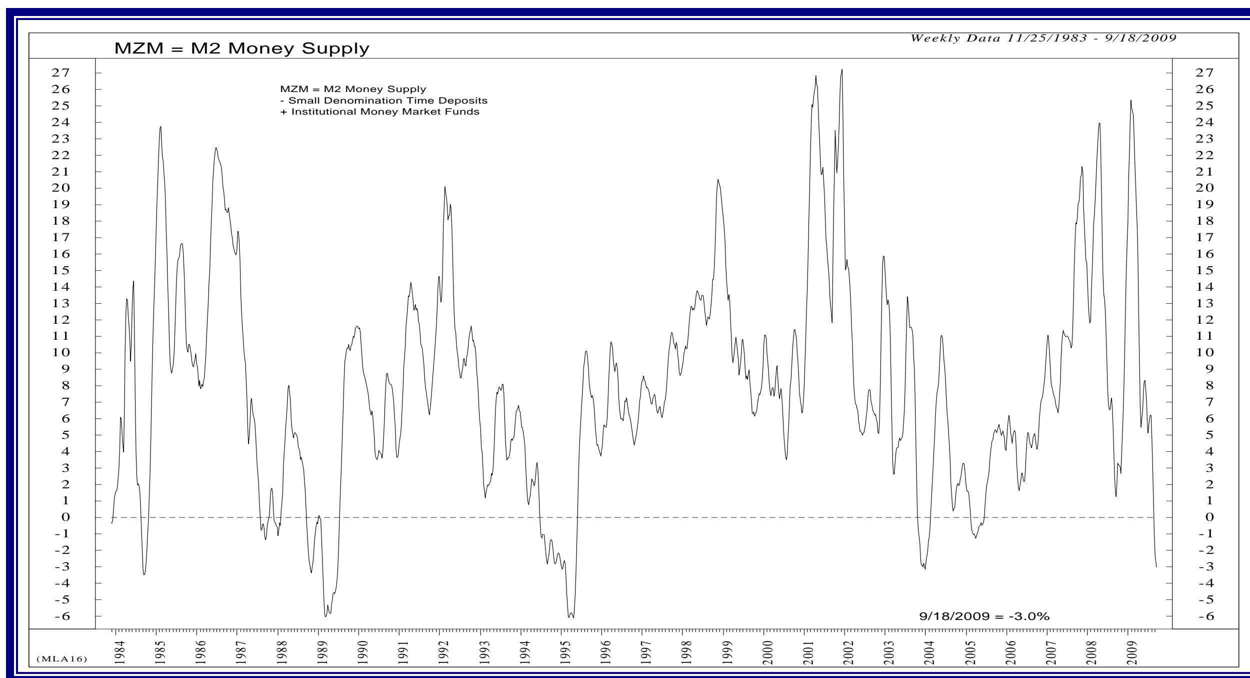
Consumers are presently deleveraging from historically high levels of debt, against a backdrop of high unemployment. Potentially higher taxation runs the risk of further weakening the recovery and prolonging recessionary conditions. It is for the above structural reasons that we are projecting only modest growth for the U.S. economy in 2010. Fortunately the global economy, particularly in Asia, could experience significantly higher growth next year, which will aid the U.S. Primarily because of the recession, the economy is undergoing modest deflation as measured by the CPI and the PPI. In September the CPI rose 0.2% but is down 1.3% over the past year. Excluding food and energy however, core consumer prices also rose 0.2% but have increased 1.5% in the past year. Producer prices fell 0.6% in September and are down 4.8% versus year-ago levels. The core index is up 1.8% over the past year. One must add however, that the costs of education, health care, state and local taxation, as well as tolls on bridges, roads and tunnels are in an inflationary pattern in contrast to the overall indices mentioned above. If the dollar remains in a downward spiral, imported goods and services (14% of GDP) will also rise. With most economic statistics modestly improving (corporate profits, housing, industrial production, leading indicators, productivity, and retailing), we believe that real GDP, after falling approximately 2% in 2009, will recover by 3.0-3.5% in 2010 with corporate profits advancing 12% against a background of 2.5% inflation.

THE ECONOMIC DATA

- **The Third quarter Gross Domestic Production (GDP) rose at a 3.5% rate, above the consensus 3.2%.** The deflator rose at a 0.8% rate, below the consensus 1.4%. As expected the biggest single contribution to growth came from consumption, which rose at a 3.4% rate, adding 2.4% to GDP growth. We believe that about a third of the rise in consumption was due to the Clunker program. Fixed investment rose 2.3%, with residential construction up a huge 23% as builders sought to meet demand for first-time buyer homes spurred by the tax credit. Corporate capital expenditures rose 1.1% but non-residential construction was down 9%. Net foreign trade subtracted 0.5%, partly because the Clunker program demand was met from higher auto imports, and inventories added 0.9% to growth. Government spending climbed 2.3%. In short, a decent quarter, thanks in part to significant stimulus. We are expecting a much weaker fourth quarter.

- **The September Producer Price Index (PPI) fell 0.6%, below the consensus forecast of no change.** The core dipped 0.1%, also below consensus +0.1%. The consensus forecast for the headline always looked a bit pessimistic to us, given the drop in energy prices between the August and September survey dates, but the decline was even bigger than we hoped. The core dip was a pleasant surprise too, thanks to a broad-based 0.1% dip in capital equipment prices - including a hefty 1.4% drop in light truck prices - and softness in several consumer goods prices, including furniture, detergents and sporting goods. More broadly the downward trend in core PPI is following the plunge in core materials prices in the second half of last year, and it has a good deal further to run. We expect negative year-over-year rates by next spring.

EXHIBIT II



Source: Ned Davis Research

❖ **The September CPI rose 0.2%, as expected, but the core rose 0.2% too, a tenth more than the consensus.** The core overshoot was due to two components, used autos (+1.6%) and lodging away from home (+1.5%), which together contributed half the 0.16% increase. Lodging costs are hugely volatile month-to-month but year-over-year rate is -6.9%. We are not worried about the September month-to-month jump. Used cars are different; September jump follows 1.9% in August. CPI used auto prices lag auction prices, which plunged after Lehman but have since rebounded strongly. The good news is that the CPI measure has now mostly adjusted to auction prices. Elsewhere, both primary and owner-equivalent rents are down 0.1% and there are no clear signs that the downward pressure is easing. The other components of the CPI appeared stable. This isn't a "bad" core CPI; just noise. Disinflation continues.

❖ **September durable goods orders rose 1.0%, in line with the consensus forecast.** Orders ex-transport were a touch stronger than expected, rising 0.9% against a consensus of 0.7%, but this overshoot was more than offset by a 0.4% downward revision to August. Moreover, half the headline increase in September orders was in defense, where a 10% rise in capital goods orders led the way. Core civilian capital goods orders, ex-aircraft, rose 2.0%, reversing the declines in the previous two months. As far as we can tell the trend in core capital goods orders is about flat, following a brief rebound as the post-Lehman panic faded. But the level of orders is some 21% off its pre-Lehman peak, and with capacity utilization still extraordinarily low gives us pause to expect a sustained near-term uptrend. In short, industrial orders are stable but very low.

❖ **Jobless claims fell to 530,000 from 531,000 above the consensus forecast of 525,000.** Although the downward trend in claims continues, the weekly numbers are very volatile. Even the often quoted four-week moving average is far too erratic to make any reasonable judgments. We prefer to use the eight-week moving average as a better lead indicator, which dropped this week to 537,000 the lowest since January. We expect claims to continue falling through the fourth quarter, but likely at a slower pace than in the past couple of months, simply because we think the pace of economic growth will be slower than in the recent third quarter. The level of claims remains consistent with substantial declines in payrolls. If history is any proxy, we would expect that claims would need to get down to about 375,000 before we can be confident payrolls will stop falling. This is not necessarily a foregone conclusion.

- ❖ **New home sales fell 3.6% to 402,000, below the consensus 440,000.** August sales were revised down a bit. This dip in sales almost certainly reflects the impending expiration of the first-time buyer tax credit on November 30. New home sales are captured at the point of contract signing, not closing, so sales are trailing off now as people start to run out of time to close sales before the deadline. We had anticipated the September numbers would hold up before the October drop but the hit had come a bit sooner. Despite the dip in sales, the months' supply was steady at 7.5, as absolute inventory fell 10,000 to 251,000, a 27-year low. We think the fundamentals are now supportive of the market, but the tax credit story is now the key element. We are expecting October sales to be down again; and November will most certainly depend on whether the credit is extended.

- ❖ **Case-Shiller home prices fell 11.3% in the year-to-August, better than the consensus, -11.9%, and up from -13.3% in the year-to-September.** This is the smallest year-over-year drop since January 2008. On a seasonally adjusted basis, prices rose 1.0%, following a 1.2% July gain and a 0.9% rise in June. That means prices rose at a 6.7% annualized rate in the three months to August, compared to the previous three months. As recently as April, prices were down at a 20.8% rate on this basis. The turnaround is partly a reflection of the rise in home sales, which is in turn partly due to the tax credit, and a substantial drop in inventory. The tax credit seems likely to be extended but we worry about a large wall of supply overhanging the markets next spring from both private sellers and foreclosures. However, for now these numbers are a welcome positive surprise.

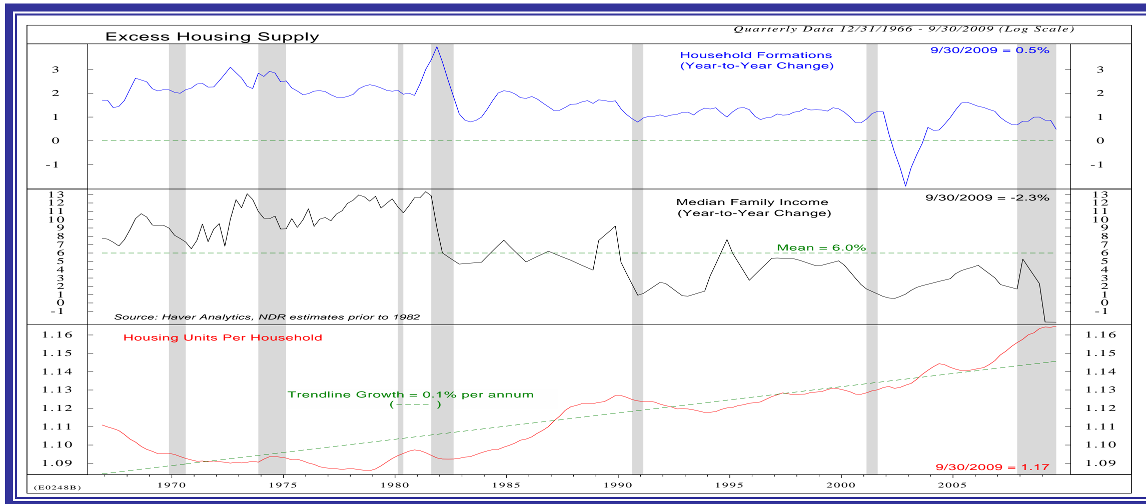
- ❖ **October consumer confidence fell to 47.7 from 53.4, well below the consensus, 53.5.** Both the current conditions and outlook indexes fell, but the latter dropped much more, to 65.7 from 73.7. This is disappointing news because the outlook index is a near-term leading indicator of consumers' spending - current conditions just moves in line with unemployment - and at this level it is consistent with broadly flat real spending. And that assumes people will be able to spend in line with the confidence numbers as they have before; it takes no account of the idea that the tightness of credit will mean weaker spending at every level of confidence than in the past. Usually, rising stock prices boost expectations; the lack of response this time around is of some concern.

- ❖ **The September index of leading indicators (LEI) rose 1.0%, above the consensus forecast, 0.8%, and the sixth straight gain.** The net revision to prior data was zero. The LEI has rebounded very sharply from its post-Lehman plunge and now seems to signal massively strong GDP growth. According to High Frequency Economics, Ltd., one of our economic research sources, they are far from convinced that these recent figures will prove correct. The LEI, in their view, overweights the importance of the yield curve - which has contributed more than two thirds of the cumulative gain over the past six months - and ISM delivery times, which have also jumped sharply. There's no question that most leading indicators of GDP growth are now rising, but HFE points out that the key number in their estimation still points to recession - the NFIB index of smaller company activity – which is not part of the LEI.

- ❖ **September housing starts rose 0.5% to 590,000 from 587,000, below the consensus, 610,000.** Building permits declined 1.2% to 573K, also below the consensus, 595K. Starts were depressed by a 15.2% drop in the wildly volatile multi-family component; single family starts rose 3.9%, reversing most of the August dip. More broadly, single family starts appear to be leveling off after a run of big gains stretching back to April. The rebound following the post-Lehman panic seems to be over, and uncertainty over the extension - or not - of the first-time buyer tax credit is making builders understandably nervous about the near-term outlook. Permits were weaker than starts, suggesting the latter will dip in October. We remain optimistic for 2010 but the next couple of months will be tricky.

- o **September existing home sales rose 9.4% to 5.57M, above the consensus forecast, 5.35M.** The pending home sales index clearly warned of a big rise in sales; the consensus forecast always looked too low. In the event sales did not rise quite as far as pending sales implies that tighter appraisal standards were preventing some portion of pending sales from closing. Still, the trend in sales has clearly risen in recent months, but we have no way of knowing exactly how many of these sales have been driven by the tax credit and, hence, how far sales will drop if it is allowed to expire on November 30. Our view is that near-record affordability and falling inventory - down sharply again in September - is pulling people into the market, not just the tax credit.

EXHIBIT III



Source: Ned Davis Research

- **The ISM non-manufacturing index rose to 50.9 from 48.4, above the consensus 50.0.** The index is a bit higher than we expected but it does not change the fundamental story, which is that the headline index is not - as far as we can tell - a leading indicator of anything much and is mostly a lagging indicator of retail sales. The jump in auto sales thanks to the Clunker program may account for some of the rise in the index in the past couple of months, though we can't tell for sure. If it did, the index will likely dip next month. Note too that behind the big rise in the headline index, the employment number continues to creep up at a painfully slow pace, the Index rising to 44.3 from 43.5. That's consistent with payrolls falling by about 200,000 per month. Better, but still terrible.

- **The Michigan consumer sentiment index for October slipped to 69.4 from 73.5, below the consensus 73.3.** This is quite a hefty drop but it follows an even bigger gain in September so the two months in tandem were a bit better than the previous two months. Still, given the surge in stock prices over the summer, the improvement is very modest. Moreover, almost all the October dip is in the outlook index, which is a leading indicator of real consumption and which fell to 67.6 from 73.5. If sustained at that level, it would be consistent with real spending growth of only about 1.5% year-over-year, but we think even that will be a struggle in an intensely credit-constrained environment. In short there is nothing here to suggest consumption - 89% of private GDP – will accelerate in the usual cyclical way anytime soon.

- **September industrial production rose 0.7%, well above the consensus 0.2%. Capacity use rose to 70.5% from an upwardly-revised 69.9%, also well above consensus, 69.8%.** This is impossible to square with the ISM, hours and employment data but such divergences are not unknown. The details show manufacturing up 0.9%, the third straight big gain, and led again by autos, up 8.1%. This is surely a bout of inventory replenishment after some popular models sold out before the Clunker program ended in August. Manufacturing ex-autos was up 0.5% too but we think a good part of this is auto-related (some components which go into autos are not made only for autos so they count as ex-auto production). With ex-auto inventory still huge, sustained production growth is unlikely. But for now the numbers look good.

- **The August trade deficit improved to $30.7B from $31.9B, below the consensus $33.0B.** This is a pleasant surprise. We were very worried about a further sharp rise in auto imports as demand soared under the Clunker program, but the data show an increase of only $1.2B - compared to July's $2.3B - which was mostly offset by a drop in oil imports. Excluding oil and aircraft from the numbers, the good news is that exports continue to recover, up 1.6% in August - the fourth straight gain - and up nearly 20% annualized in the three months to August compared to the previous three months. They are still very depressed but moving in the right direction. The core deficit was little changed at $15.7B - half its August 2008 level - and it will fall further as the auto import boost fades in Q4.

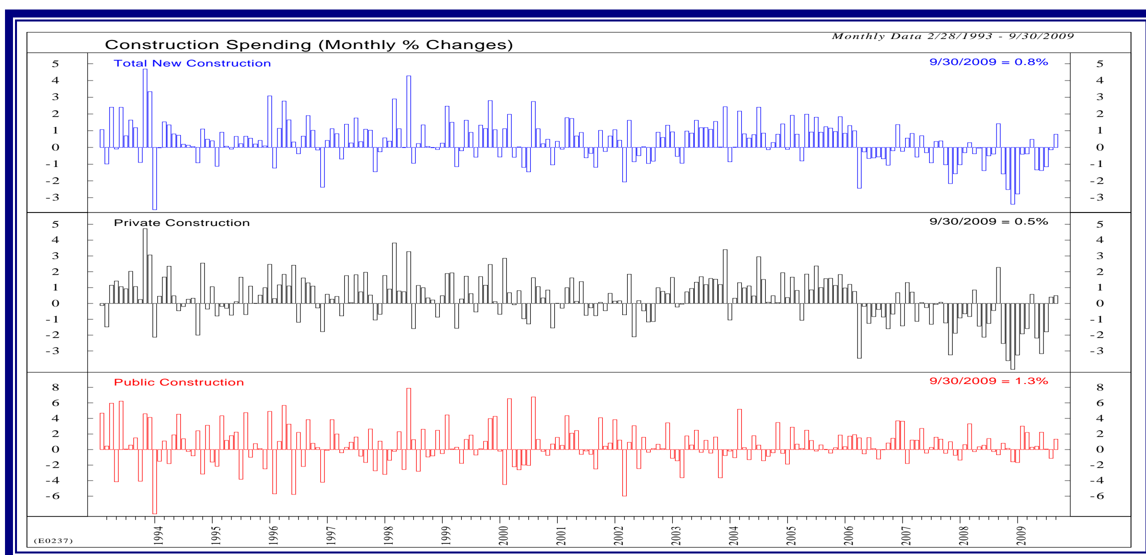
❖ **The Philly Fed index slipped to 11.5 from 14.1, very close to the consensus 12.0.** This is disappointing in the wake of the huge uplift in the Empire State index reported earlier this morning. The Philly survey has a much longer track record and is less volatile, so we are inclined to think this survey has more to say about the overall picture. Behind the headline sentiment index new orders rose, albeit modestly, to 6.2 from 3.3. Shipments dipped to 3.3 from 8.2, but employment climbed to a 13-month high of -6.8. Inventories plunged to -31.8 from -18.1, the lowest in six months. Overall, it seems as if the survey is consistent with a modest further dip in the national ISM, but we need to see the Chicago and Milwaukee PMIs before we finalize our view.

❖ **The FOMC has extended their purchases of mortgage securities into 2010**, after the policy helped lower mortgage rates for the important 2009 home-selling season. The housing problem is being dealt with slowly, and policymakers appear happy with a "flat" housing sales and price profile. Housing in our view should be forming the biggest "V" of all time, given the exceptionally low interest-rate profile, and the degree of the downturn in a tax-advantaged asset class. Flat housing data, while not optimal, appears to be good enough. However, the consequence is that an elevated level of mortgage debt will remain on consumer balance sheets - still roughly 100% of disposable income.

❖ **Residential Construction Spending rebounds as overall construction spending rose 0.8% in September**, contrary to the consensus for a slight 0.1% decline. It was only the second increase in the past 12 months, and the most in a year. But August's spending was downwardly revised to a loss of -0.1% from +0.8%, so results were essentially in line. Private spending increased 0.5%, as a 3.9% jump in residential construction spending (the most since July 2003) more than offset a 1.8% drop in nonresidential (its sixth consecutive decline). Residential spending has rebounded 7.9% in the past two months, second only to December 1993. Public spending rose 1.3%, helped by federal stimulus funds.

On a year-over-year basis, overall construction spending has fallen 13%, the largest year-over year drop since March 1991. Nonresidential spending is 15.4% below its year-ago level, the most since December 2002. But the rate of decline in residential spending has stabilized around -27%.

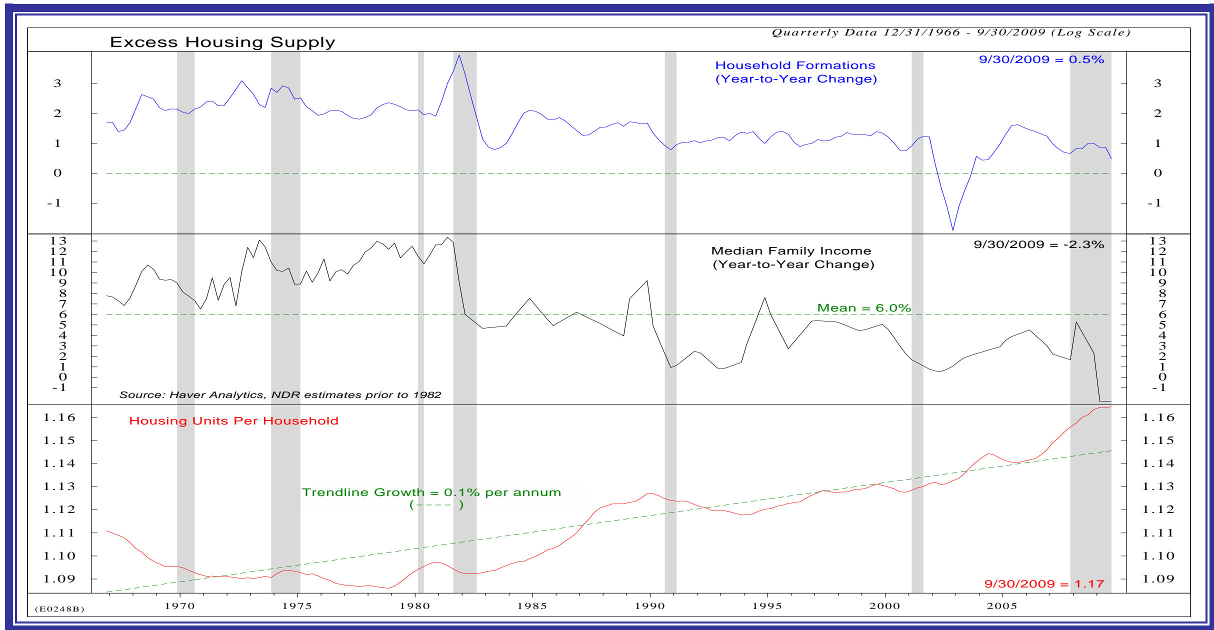
EXHIBIT IV



Source: Ned Davis Research

- **Pending home sales continued their upward momentum in September, rising 6.1% to its highest level since December 2006.** It was its eighth straight increase, the longest positive streak since records began in 2001. Expectations were for +0.7%. Three of the four regions posted sizable gains, led by a 10.2% jump in the West. From a year ago, sales are up a record 21.2%. According to the NAR, an estimated 3.0 million renters are financially qualified to purchase a median-priced home, representing sizable pent-up housing demand. But the fragile recovery in sales may face headwinds ahead, as the first-time homebuyer tax credit approaches its November 30 deadline and more foreclosures continue to enter the pipeline.

EXHIBIT V

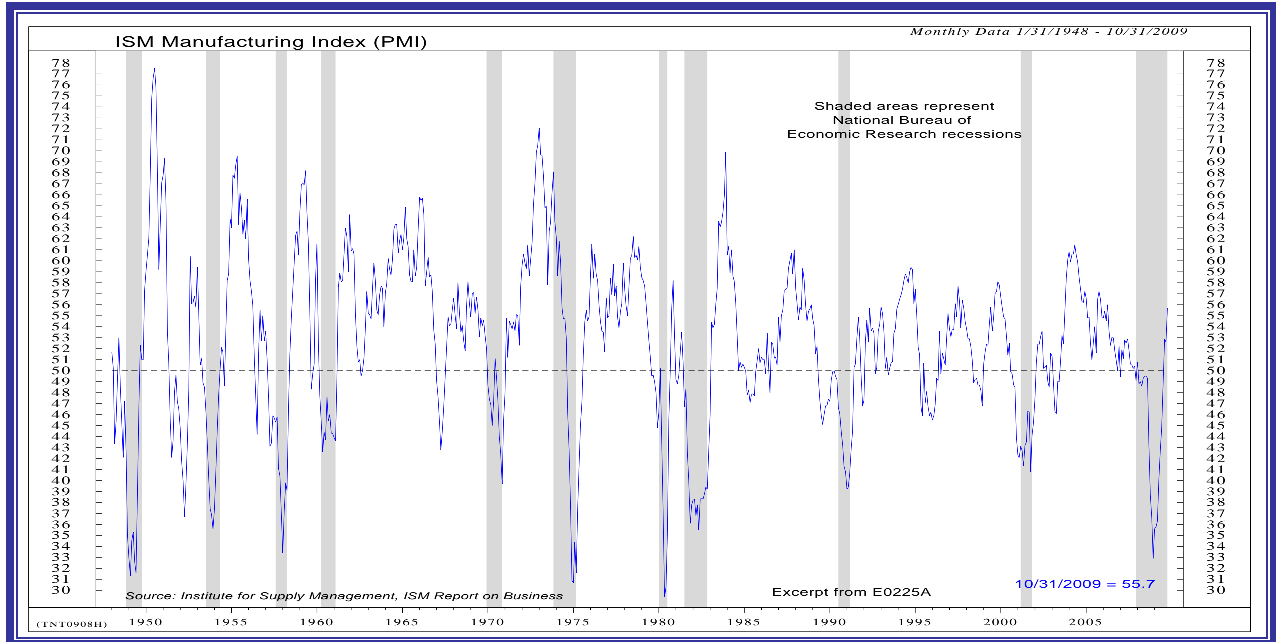


Source: Ned Davis Research

- **The ISM Composite Index rose 3.1 points to 55.7 in October**, indicating acceleration in manufacturing activity See **Exhibit VI** on page 9. Economists expected a more moderate gain of 0.7 points to 53.3. It was the highest reading since April 2006, generating an expansion signal for manufacturing production. The gain was led by a 7.6 point jump in production, the most since August 2003, to 63.3, its highest level since July 2004. Surprisingly, the employment index rose 6.9 points, its first month of growth after 14 straight negative readings. This suggests we may have seen the worst of the declines in manufacturing employment. But new orders grew at a slower rate, falling 2.3 points to 58.5. 13 of the 18 industries in the survey, or 72%, reported growth, same as last month, which was the highest share since February 2007. According to the ISM, the latest PMI corresponds to 4.5% annualized GDP growth, consistent with our analysis.

  Inventories fell at a slower pace, gaining 4.4 points to 46.9. It was its fourth straight improvement, the longest positive streak since April 2002. Customer inventories edged down 0.5 points to 38.5, its lowest reading since July 2004, indicating respondents believed customer inventories are too low. The prices index was little changed at 65.0. Eleven commodities rose in price, while one fell. Lead times for MRO supplies and production materials slipped further, with the latter falling to 41 days, it's shortest since September 2001.

EXHIBIT VI



Source: Ned Davis Research

❖ **We expect flat growth in the current quarter with positive growth in the fourth quarter for an overall decline for the year of about 2.0%.** This sequential improvement is occurring because of expansionary monetary policy against the background of the Federal Reserve maintaining a Federal funds rate at 0-0.25%. In addition, the fiscal stimulus of $787 billion should impact the economy in the fourth quarter of 2009 and carry throughout 2010. See **Exhibit II** MZM monetary growth.

❖ **As a lag indicator, we would expect unemployment to continue to rise north of 10% before we see most economic statistics confirming the recession's end.** We still conclude that because of the deleveraging of balance sheets, the current recovery will most likely be relatively weak by historical standards. This is especially true, since consumption, still 70% of the U.S. economy, will continue to be restrained as memories of the painful lessons of the recent past persist. The consumer savings rate has risen impressively in response to the recent crisis and compares to negative rates before the recession began. The contraction of debt among households and non-financial corporations reported a decline in the second quarter - the first such event since the early 1950's. The drop in the budget deficit projected by the Center on Budget and Policy Priorities is still projected at $350 billion in 2010-11 timeframe. These deleveraging secular forces are projected to slow the U.S. economic recovery by as much as a full 10% of GDP growth in the next ensuing year.

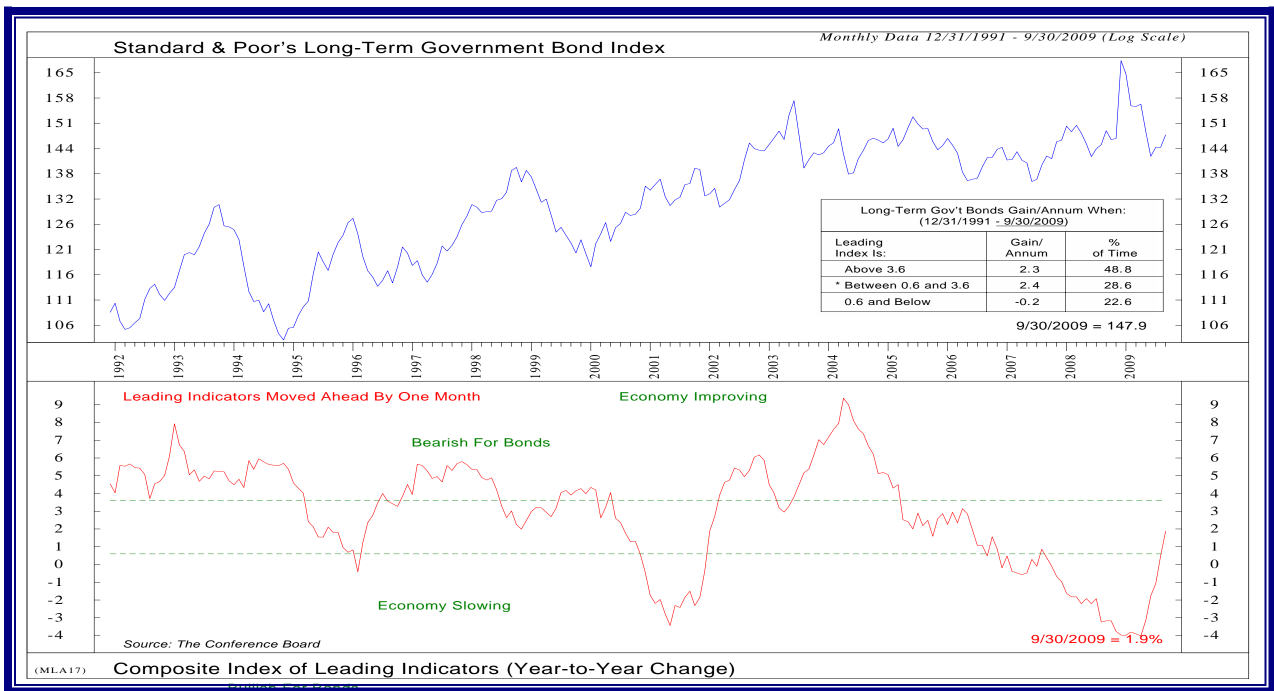
❖ **While fears of inflation have surfaced associated with the enormous monetary response,** a case can be made for modest deflation as well with current pressure on the consumer price index and the Producer Price Index (PPI) which are down over the past year. In addition, estimates of asset wealth have been removed from consumer balance sheets by the drop in both stock prices and houses. Additionally market analysts have concluded that the recent increase in corporate business profitability was primarily due to operating margin improvement through cost cutting and modest improvement in the top line growth in the most recent quarter.

❖ **While investors have begun to modify their recession forecasts of a recovery in 2010,** our earlier expectation of an economic turnaround resulting in a positive 1% GDP growth for 2009 and corporate profits of 5.0% may be a bit too optimistic. However, we are still quite encouraged that the leading indicators have begun to reinforce our positive stance on equity participation through the spring of 2009, as GDP forecasts for 2010 get revised upward.

An Update on the U.S. Fixed Income Markets

- The U.S. economy appears to be gaining traction evidenced by the third quarter positive GDP growth exceeding estimates and likely to continue in the ensuing quarters. Although the Treasury has ended the "Cash for Clunkers" program, we don't expect the government supported money market fund guarantees and other support programs will be pulled from the system. Although Bernanke continues to validate the need for government intervention on October 8th the Federal Reserve recognizes that "when the economic outlook has improved sufficiently, we will be prepared to tighten the stance on monetary policy and eventually return our balance sheet to a more normal stance". He did recognize that although "the government programs appear to be having their intended effect"; there is still evidence that the economy remains fragile with consumers burdened by underwater mortgages and high unemployment. The FOMC is maintaining the targeted federal funds rate at close to zero, where it is likely to remain for the foreseeable future.

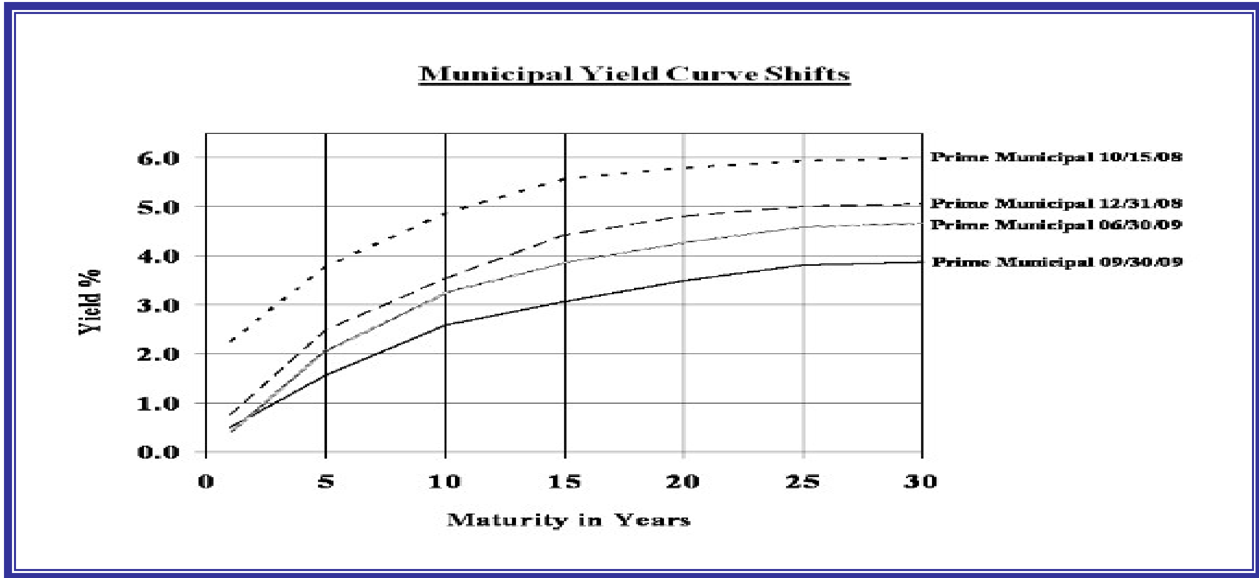
EXHIBIT VII



Source: Ned Davis Research

- **Investors have been coaxed back into the stock market as money market funds** and other short term instruments yield close to nothing. Bond investors have also been encouraged to move out along the yield curve in search of return in the fixed income markets. Municipal bond funds have enjoyed strong inflows in recent months that have buoyed the long end of the market while individual buyers have focused their purchases on intermediate maturity bonds. As demand has been building, the supply of tax-exempt paper has been restricted by a growing segment of issuers opting to market new offerings in the taxable and tax exempt Build America Bonds. The exhibit below shows the prime tax-exempt municipal yield curve has shifted sharply lower over the course of the year in reaction to the demand/supply imbalance.

EXHIBIT VIII



Source: Bloomberg and Altman Investment Management Research

Fixed income markets largely held onto gains that began in March. Some corporate bond spread retracement has occurred over the past month since the credit rally peaked in early August. Cash and derivative indexes in formerly-troubled areas such as asset backed securities and financial company bonds, however, have narrowed, and TALF (Term Asset-Backed Loan Facility) is helping to jumpstart issuance of commercial mortgage-backed debt for the first time in this cycle

Meanwhile, 10-year government benchmarks continue to trade in a fairly predictable range, with Treasuries around 3.25% to 4.0% and bound about 3.25% to 3.5%. This is due in no small part to muted inflation pressures. Indeed, contrary to some investor concerns, consumer price pressures in the developed world are virtually non-existent. For instance, deflationary forces are still a concern in Japan, while the personal consumption expenditure index (also known as the PCE deflator, the Fed's favorite inflation gauge) and CPI have steadily declined over the last five months.

While the labor market continues to be weak (U.S. unemployment has moved to 9.8%, and job openings are at a 9-year low), there are encouraging signs. For instance, the pace of layoffs has diminished greatly. Additionally, pundits calling this a "jobless" recovery are forgetting that hiring typically lags other economic indicators as companies are reluctant to expand workforces before solid signs of sustainable momentum become more apparent. Combined with outsized fund flows being directed into the capital markets by the private sector, interest rates are poised to remain low.

Intermediate bond returns in the third quarter continued higher by 2.94%. A breakdown by sector shows corporate securities rose 6.9%, mortgage securities rose 2.4% and government debt increased the least at 1.60%.

HIGH GRADE CORPORATES AND PREFERREDS

The corporate sector finally took a break from an impressive six month rally. With the exception of lower real yields precipitated by the decline in U.S. Treasury rates spreads are largely unchanged. Corporate bonds outperformed the broad market by 79 basis points during the last month of the quarter. The gains were once again fueled by the BBB sector, boosting year-to-date total returns above 13%.

We find there is still plenty of value in high grade corporates, and high quality debt such as asset backed bonds continues to provide better value than Treasuries. While many investors seem determined to stay hunkered down in short duration securities, most fixed income portfolios could benefit from extending maturities given steep yield curves and adding

callable positions. While the market has healed quite a bit this year, there is still value in preferreds. We favor cumulative trust (or enhanced trust) preferreds in the in the cable, utility, REIT sectors and the systemically sensitive sector of the U.S. banking industry.

MUNICIPALS

We suspect that the municipal market is close to its near-term bottom, after a fairly impressive correction, but as noted in the previous section, the direction and magnitude of flows into bond funds is likely to play a key role going forward. The municipal market has started to become inherently thinner and more volatile, as dealers reduce their willingness to take on secondary blocks and unsold balances approaching year-end, after and extremely profitable first nine months of the year. The outlook for the economy and thereby for Treasury yields will also play a key role, we believe. Projections as to the strength of the U.S. economy going into 2010 vary widely, with a few high-profile observers beginning to suggest that unemployment may peak as early as the first quarter of 2010. If the economy remains soft, even if no longer in recession, the treasury market might not come under much pressure for quite a while. In our view, a key factor for long-term treasury yields is competition from other users of credit--corporations, consumers and homebuyers.

On the other hand, investors with cash to put to work may find that some extremely attractive offerings become available over the next two months or so, both in the primary and secondary market, as dealers pull in their horns and allow prices to drift lower. In the new issue market, investors should be on the lookout for issues that are "priced to sell".

Near term we anticipate continued volatility, but do not expect a dramatic surge in rates. Inflation is not an immediate concern as the economy grapples with high unemployment, limited, if any, pay increases, underwater residential mortgages and trouble in the commercial real estate market, and tepid consumer demand. At the same time we continue to see investors demanding an increase in yield, prompting them to extend duration along the yield curve coincident with market selloffs. The expectation of higher tax rates is also encouraging investors to consider the tax-exempt income alternative.

Despite our overall confidence in the fiscal integrity of municipal governments, we continue to emphasize that credit standards not be sacrificed in fixed income portfolios. Some investors have pursued yield in recent months by purchasing lower quality securities which caused spreads between AAA and single A credits to narrow by some 40 basis points. Spreads to BBB and high yield credits contracted more significantly. We strongly believe that lowering credit standards in the current environment is inappropriate. Spreads could easily widen again (perhaps even significantly) as budgetary challenges persist. We prefer to seek added returns through the use of securities with either unique structures as well as more active management strategies, without altering credit standards.

The recent backup in rates caused the tax-exempt market to cheapen relative to Treasuries. The table below indicates the ratio of ten year prime municipal yields compared to the ten year Treasury rates since last fall. The current 95% spread level falls in the "more normal" 85% to 95% range that prevailed during most of the decade. Prior to last year's market disruption, when investors fled to safe haven Treasury securities as bond insurers stumbled, credit default swaps and various mortgage backed instruments unraveled. This all occurred as the auction rate programs froze and several major financial institutions failed.

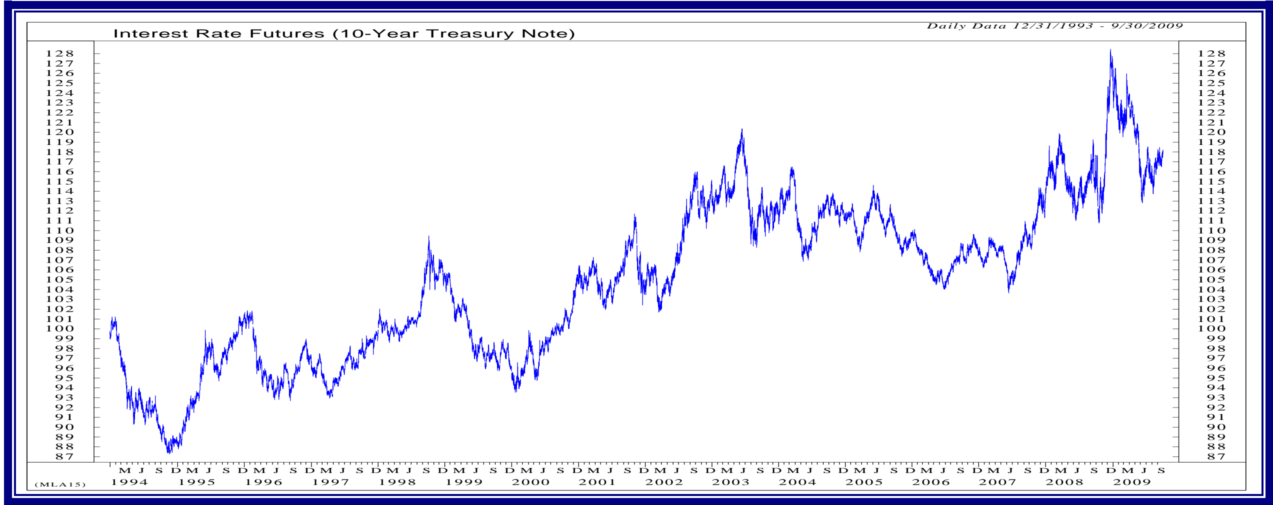
EXHIBIT IX

	Current	30-Sep-09	30-Jun-09	12-31--08	10/30/2008
10 Year Muni *	3.76%	3.28%	4.08%	3.67%	4.75%
10 Year Treasury	3.39%	3.31%	3.53%	2.25%	3.98%
Ratio	110%	79%	92%	157%	119%

Source: Bloomberg and Altman Investment Management, LLC
** Merrill Lynch Global Index- Investment Grade*

Our longer term view is cautious in certain sectors as the massive government deficits need to be financed and Treasury auction demand could ultimately be met with reduced demand from both domestic and foreign investors. On the near term basis continued dollar weakness and moderately higher inflation appear possible as the economy regains its footing. Any evidence of such developments in our estimate would not cause a material yield change on the long end of the curve to justify portfolio duration extension.

EXHIBIT X

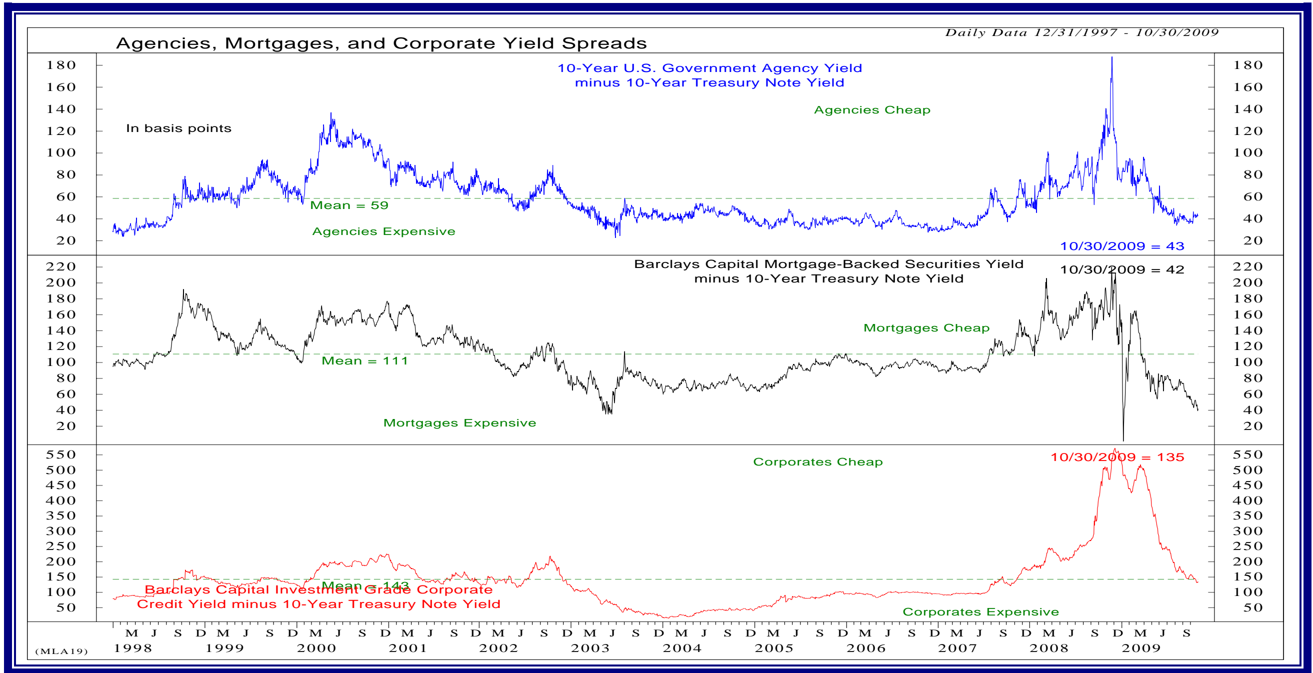


Source: Ned Davis Research

AGENCIES

- ❖ Relative to U.S. Treasuries, 5-7 year callable securities appear to be neutral versus the bullets. Supranational issuers also provide modest yield pick-up over Treasuries due to their similar government sponsorship. See the graph in Exhibit XI illustrating the magnitude of the rally since the fourth quarter of 2008 and the beginning of this year.

EXHIBIT XI



Source: Ned Davis Research

Our Bullish Outlook on the Financial Markets Continues

- ❖ **The S&P 500 stock index as of October 16th (1087) has advanced 62.95% from its intra-day low of 666 on March 9.** It has risen 1.9% over the last four weeks and 18.0% over the last year (10-16-09). Positives have included expansive monetary policy, better than expected earnings, and a belief by investors that sales will pick up as the economy continues to recover. As the credit crisis has subsided, corporate bond issuance was $488 billion in the first half of 2009 compared to $141 billion in the second half of 2008. Also corporations were net issuers of stock for the first time in seven years such that their financial condition has improved significantly. Most importantly, non-financial companies in the second quarter had approximately $150 billion of surplus cash flow relative to their capital spending. The above statistics combined with the sequential improvement in the economy give fundamental support to the stock market rally. At its current price, the S&P sells at 14.49 times our estimate of $75 per share for 2010. This is not an unreasonable multiple given the exceptionally low interest rate environment.

- ❖ **Nevertheless, given our slow-growth GDP recovery estimate of 2.5% in 2010** amid the concerns regarding employment growth, the costs of an additional entitlement program in health care, and the cost of two wars, a fiscal deficit at 10% of GDP and worries about Iran's nuclear program, it would not be unexpected if the stock market experienced either some near-term volatility or temporary correction (5-7%).

- ❖ **Fixed income markets have been exceptionally stable over the past month** with 10-year Treasury bonds at 3.4%, long-term high quality corporate bonds yielding 6.2%, long-term municipal bonds yielding 4.6% and 30-year mortgage bonds at 5.5%. With Federal Reserve monetary policy still maintaining federal funds at 0-25%, 3-month Treasury bills yield 0.8%. With the exception of municipal bonds and some corporate bonds, we remain skeptical about investing in government debt with interest rates close to 50-year lows, as the federal debt accelerates against the backdrop of the weak U.S. dollar. The dollar index against the Euro has fallen 2.1% during the month of September and declined over 11.1% over the past year (10-16-09). Commodities, as measured by the CRB index (276) are up 5.1% over the past month and yet still flat from a year ago. Gold ($1047 per ounce) has risen 5.9% over the past month and is up 25.3% over the past year. The reason for gold's advance is fear of future currency depreciation in the face of huge fiscal deficits and the dollar's weakness. The savings rate has recently fallen to 3% from a near-term high of 6% and the trade deficit appears to be on the rise again. However, the Baltic Dry Index (2728), a measure of raw material shipping costs, has risen 12.9% over the past month, suggesting that global trade is strengthening from very weak levels. See **EXHIBIT XII** This particular statistic lends more credence to the global recovery. At present, we are getting somewhat more cautious with regard to equities, after the major rally since March.

EXHIBIT XII

Baltic Dry Index

Source: Bloomberg

- **Overall, we believe that commodities will continue to rise based on the global recovery.** The S&P 500 has had a strong rally in September and at 1057 sells at 16.2.1 times our $65 earnings per share estimate and at 14.1 times our $75 per share estimate for 2010. Our view is that earnings will gain 12.0% in 2010 with real GDP growing by 3-3.5%. The above multiples appear reasonable and we would therefore continue to maintain an asset allocation of 65% in equities, 20% bonds (corporate and municipal), 5% gold and 10% cash.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.