MARKET PERSPECTIVES

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Brief Reflections:

As the second quarter earnings calendar draws to a close, 70% of S&P 500 companies have continued to positively surprise consensus estimates by as much as an aggregate 9%. Our investment portfolio earnings continued to exceed the market results, with over 76% of our companies beating street estimates in bottom line earnings by an aggregate 13% through the month end. These positive results were muted by the market participants weaker than expected top line (sales) growth. Tepid forecasts given by corporate management during quarterly releases were shrugged off during July, as investor concerns about the sustainability of US economic growth into the second half of the year dissipated. During the second quarter, fears of a potential double dip recession overshadowed 2010 forecasts of $78 in earnings power for the S&P 500 and $90-95 expectations for 2011. This in turn put pressure on market valuations during the quarter, contracting the market price-earnings multiples from the high of 16 times earnings to the July lows of 13 times - setting the stage for a strong rally in July.

As headline news overseas fades, the Federal Reserve Chairman Bernanke in his recent semi annual testimony on Capital Hill struck a cautious tone on the current economic recovery. He indicated that rising demand from households and businesses should help sustain growth as the boost from the rebound in inventories fades, and that the economy should continue to expand at a "moderate pace." He also cited notable headwinds in the near term, including the housing market, given the large foreclosure pipeline, and the commercial real estate sector. Furthermore, he noted that the recovery in the labor market has been sluggish and that "significant time" will be needed to restore the 8.5 million jobs lost over the recession. He again highlighted the high level of long-term unemployed, and the possible lasting ramifications on employment and earnings prospects. Bernanke did note that domestic financial conditions have improved substantially since the recession, despite "somewhat less supportive of growth in recent months."

As we focus on the rest of the year, the recent U.S. GDP release suggests that domestic growth could weaken to a 2.5% annualized pace, as the inventory rebound, housing recovery, and federal stimulus begin to diminish. Although we do not expect a double-dip recession, we recognize that the potential for higher taxes in 2011 will become a contentious debate leading into the November elections. We expect Real Personal Consumption Expenditures to remain subdued below historical levels, due in part to sluggish wage growth, deleveraging, and demographics. Equipment and software spending, which has been robust, should continue to recover, albeit more slowly compared to past cycles. We anticipate spending on nonresidential structures to remain muted through the rest of the year, and on balance the government sector's contribution to growth to wane.

We continue to see a period of low inflation this year due to plenty of slack in the domestic and global economies. A surplus of labor and capacity continues to hold the inflation rate down as a result of lower wage growth and price competition. Excess housing units has placed downward pressure on rents and slower debt growth coupled with private sector deleveraging. We still hold to the basic tenet that core inflation is still biased higher in the longer term. However, we believe Federal Reserve policy will likely be on hold well into next year, if not all of 2011, as the unemployment rate says stubbornly high. In summary, we remain optimistic concerning market participation, as corporations have adjusted to the new global growth dynamics, interest rates remain low, inflation is under control and equities offer exceptional value.