

INVESTMENT UPDATE

Making accurate assessments of what the future may hold for our clients is perhaps our biggest challenge. And while history can be helpful in forming an outlook, we've learned over the years that the truth lies somewhere between "history always repeats itself" and "it's different this time." Clearly, fundamental laws of economics don't change—the law of supply and demand, for instance, will always apply—but economic cycles (and the capital markets' reaction) never resolve themselves in exactly the same way.

This will surely be the case when the fog clears from the present economic recession. The current debate seems to be polarized between those who believe that the downturn portends an end to free market capitalism, with years of economic malaise, and others who remain sanguine,

believing that we'll soon be back on the Yellow Brick Road to prosperity. The markets have reflected this bifurcation of opinion, as we've moved from the widest risk margins (as measured by

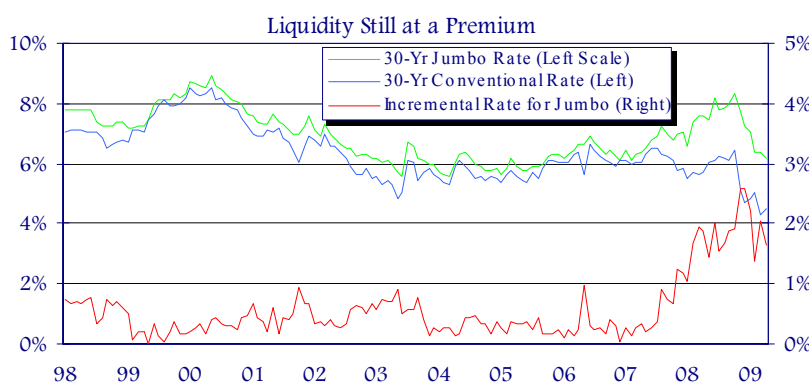
corporate and mortgage bond yield spreads over Treasuries) since the Great Depression a few weeks ago, to a stock market that has risen by 30% since mid-March.

If we believe that the markets are inherently good forecasters of future economic conditions, the recent swing to the positive implies that we'll soon be out of the weeds. After all, we've seen a remarkable recovery in risky assets and a sell-off in Treasuries in the past two months. In fact, it's not too much of a stretch to say that the markets, after pricing themselves for a doomsday scenario, now appear to be getting a little ahead of themselves in predicting a quick return to strong economic growth. This optimism is most obvious in certain sectors of the stock market, where prices have shot up despite earnings projections that still look pretty dismal.

More specifically, the S&P 500, which traded at a 20+ year low of 10 times earnings in the first quarter, has

bounced and is now priced at approximately 15 times next years' expected earnings. While a P/E of 15 is still on the low side of "historically normal," if earnings disappoint in the next few quarters, the prices currently being paid for stocks may turn out to be too expensive. And it's not just corporate earnings projections that may prove to be too optimistic; improved asset pricing for most types of risky assets is now implying a big upswing in the global economy.

Yet the fact is, despite the markets' move to the manic side of the equation, we are still in the midst of a very deep recession, and it's likely that economic growth will remain depressed for the foreseeable future. Let's look at the underlying conditions.



First and foremost, while the credit crunch has been eased, it has not been solved. As a proxy for the degree of pain that creditworthy households are facing, we can look at the difference between conventional and jumbo mortgage rates.

Recall that jumbos are prime mortgages whose principal balance exceeds the maximum size to qualify for one of the Government's mortgage programs. After averaging 0.4% for the decade from 1998-2007, the incremental borrowing costs for jumbo mortgages increased sixfold in 2008, reaching a high of 2.6% more than a conventional 30-year mortgage by year-end. While all mortgage rates have fallen as a result of economic weakness and from the Fed and Treasury's buying programs, jumbo rates have been stickier, and are still 1.7% higher than those for conventional mortgages. The reason is clear: newly-minted conventional mortgage loans can be securitized (by Fannie, Freddie or Ginnie), while the securitization market for jumbo loans is moribund. If new jumbos cannot be packaged or securitized, they must be held as raw loans by the banks that originated them.

This is exactly what the newspapers refer to when they talk about the collapse of the "shadow banking system."



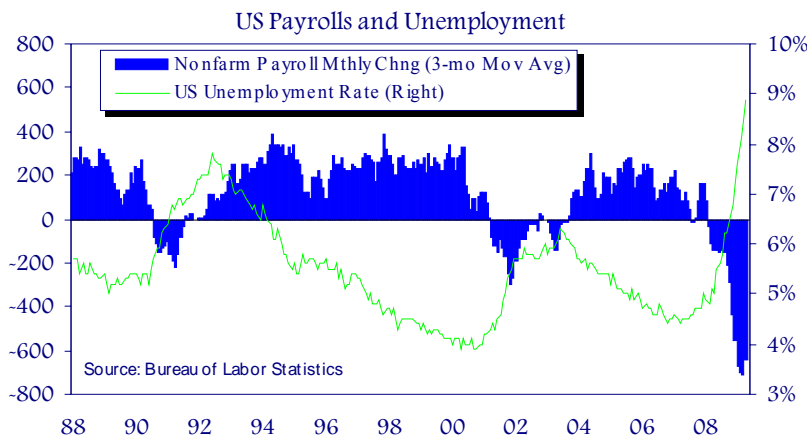
Over the past two decades, the securitization market provided reduced rates for borrowers and enhanced liquidity for lenders; for most of that time, the system functioned beautifully, allowing banks to package mortgage loans (as well as other receivables) and resell them as securities to investors looking for a little more yield than an Agency-backed mortgage bond. This allowed banks to pick and choose which loans they wanted to keep on their books and which they chose to off-load. The massive expansion of the securitized markets led to a virtual doubling of the global banking system.

But the success of the securitized markets also sowed the seeds of their disaster, as ever-riskier loans were originated and off-loaded by those with no “skin in the game.” Investors (and the ratings agencies) failed to do their homework to ensure that they knew what was packaged into many of these bonds. A whole industry (SIVs, structured investment vehicles) sprang up to borrow money and channel capital into the creation and distribution of high-risk MBS, over-expanding the definition of who could be considered “creditworthy,” inflating already-high home prices, and producing a whole new class of low-quality mortgage loans. With the excessive degree of leverage inherent in the system, even a small crack in asset prices would have crippled this model; when these impaired borrowers began to default in numbers, the entire system collapsed.

While we are well-advanced in the Great Unwinding of this highly levered mess, the after-effects will last for years. Some of the largest US banks have seen their capital wiped out and are now vassals of the state; the weakest will be repaying their debts to Uncle Sam (and, rightfully, bowing to his will) for months, if not years. Even those banks that aren’t loaded down with government debt are justifiably reluctant to lend funds in this environment; in some cases this is an appropriate response—borrowers, as a whole, are far less creditworthy in this weakened economy and lenders are rightfully wary. But as we saw in the chart on page one, even creditworthy buyers, pledging collateral, are paying excessive premiums for credit.

Over the past few decades, the US consumer has led the way in pulling us out of our periodic economic recessions. But after years of running up debt, excessive spending and little (if any) savings, consumer balance sheets are in shambles. As we’ve seen, unless you qualify for a Government-backed loan, credit is extremely difficult to obtain, even if you wanted to borrow. And by most measures, consumers are in their bunkers, concerned about their jobs, their homes and their investments. Thrift is back in style, with the US savings rate rapidly moving into positive territory after hitting a low of -2.7% in 2005. Our “consumption culture” appears to be changing into one more focused on personal fiscal responsibility.

This new thrifty lifestyle is consistent with the bleak outlook for the US labor market. Since the official beginning of the US recession sixteen months ago, the



US has lost more than 5.5 million jobs; last month, payrolls fell by another 540,000 as the unemployment rate soared to 8.9%. As the chart on this page shows, these numbers are worse than anything we’ve seen in decades; every indication is that we’re still many

months away from touching bottom.

To be fair, employment statistics are the classic trailing economic indicator, and will be among the last to show improvement. Overall, our assessment of the economy is one that’s “still declining, but at a slower rate.”

There are reasons to be optimistic, but the markets are looking for more improvement than the US economy may be able to muster for a while. That 540,000 job loss figure was a huge improvement from the average of 700,000 over the previous four months, but we are still losing jobs and that means even lower aggregate demand for goods and services for the next few months. Those expecting a “V” shaped recovery (i.e., a quick snap-back) will be disappointed, as the lone source of job growth right now is in the public sector. Likewise, government stimulus programs, while helpful, cannot offset the dearth of corporate investment and consumer spending.

The recovery will come, but fitfully and over a protracted time frame.

