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FEAR MAKES A COMEBACK

And so it continues. After 13 months of largely feeling that the worst of the financial crisis was behind us, the S&P reached a cycle high of 1217 on April 23rd. We have been consistent in our belief that investors should be "bullish until the bill comes due." Of course the tab can arrive in the form of deflation and a run on U.S. Treasuries just as easily as in the form of inflation and the concomitant rise in long-term interest rates. The developments in Greece and their aftermath appeared to convince investors worldwide that its private sector debt problems had only been transferred to the public sector. **Simply put, the bill in the 2nd quarter came due in Athens, not in Washington, as we had expected.** The U.S. and its reserve currency status makes it special of course, and it is still difficult for many equity investors to understand why the people are willing to pay an almost infinite multiple on cash and 34x earnings on the 10-year, and yet still seem unwilling to pay up for large-cap high quality stocks loaded with cash and thus totally un-reliant upon the credit markets. (We prefer large and mid-cap names over small-caps in periods of economic and market dislocation).

Ironically, the problem for large American companies, at least at the moment, isn't the economy or even liquidity. Indeed, we believe pent-up demand for capex and still remaining fiscal stimulus in the U.S. make a double-dip unlikely. In addition, the Fed's Flow of Funds analysis tells us that U.S. non-financial corporations have more cash as a percentage of assets than ever before. Our current crisis, it appears, is simply one of confidence. We suspect that few companies are comfortable taking undue risks in an environment in which a small number of policymakers in Washington, Brussels, and Beijing, rather than normal cyclical forces, are dictating the future character of the global economy. This might not be so bad if at least some modicum of altruism or competence on the part of the political class were evident. March's passage of a comprehensive, yet largely politically unpopular health care bill, the failed attempts to contain BP's oil spill, at times almost tribal contentiousness of European economic policymakers, and, most recently, the wrangling over a 1,900 page financial reform bill, haven't helped in this regard. There appears to be a fear that if you make money, you could become a political target – together, the Financials, Energy, and Healthcare sectors comprise 40% of the S&P 500 which have been in front of Congress recently. Responding to this sclerosis and venality, the common stock investor appears to have all but given up – there have been net outflows from equity market mutual funds despite the 83% increase in the S&P from the March 9, 2009 low to the April 23, 2010 high. Two fifty percent declines in stocks in the past decade, serial misdeeds on the part of Wall Street, and, finally, the May 6th "Flash Crash" may have convinced the few remaining die-hards that the dice are stacked against them. This circumstance doesn't necessarily need to be permanent, but it seems unlikely to be resolved until the "rules of the game" become clear. With the 2-year note at 62 basis points and the 10-year Treasury yielding 2.95%, it wouldn't be hyperbole to suggest that the private sector has gone to the mattresses. The widening spread between Euribor and Libor might also indicate that the ECB's game of chicken with fiscal policymakers on the Continent might be getting dangerously close to a policy mistake. Discretion may be the better part of valor for equities until greater clarity on European monetary policy, or the American political landscape, becomes evident.

QUARTERLY STATISTICS

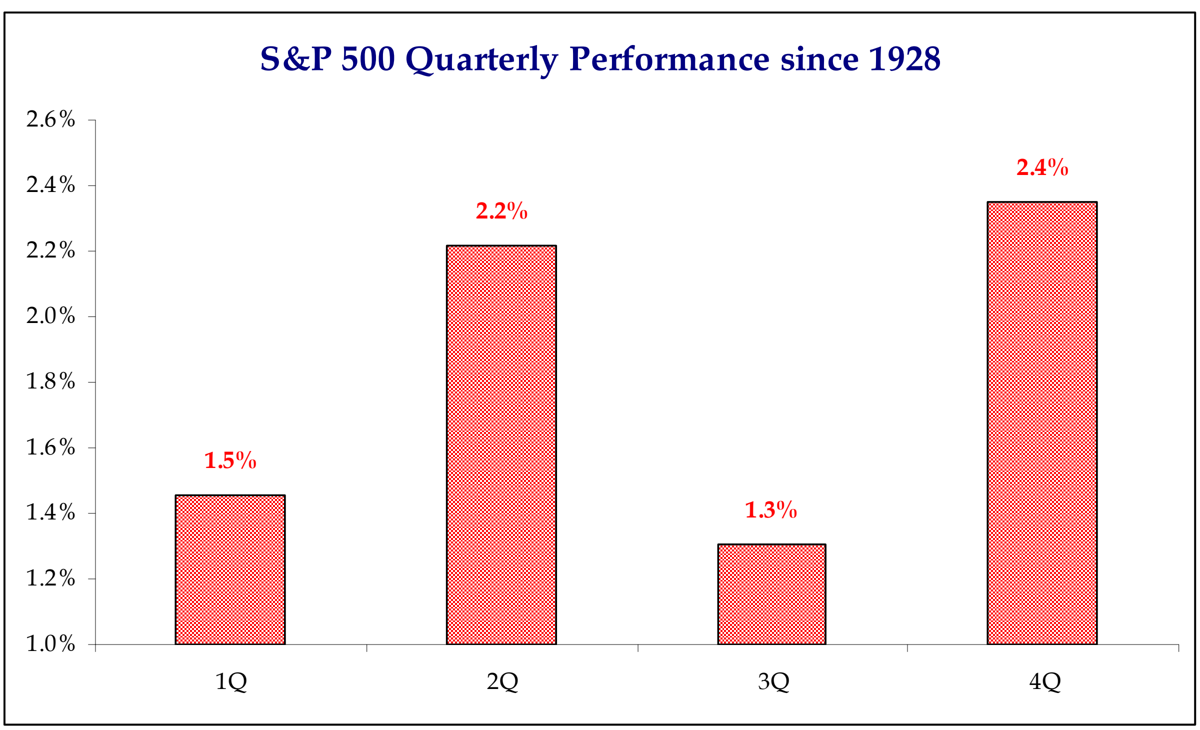
Leading US Indices (Total Return)	1Q '09	2Q '09	3Q '09	4Q '09	2009	1Q '10	2Q '10
S&P 600 Small-Cap	-16.8%	21.1%	18.7%	5.1%	25.6%	8.6%	-8.7%
Russell 2000	-16.3%	21.2%	20.5%	5.2%	28.8%	9.7%	-9.0%
Dow Jones Industrials, Adj for Div	-12.4%	11.9%	15.7%	8.1%	22.6%	4.8%	-9.4%
S&P 400 Mid-Cap	-8.7%	18.7%	20.0%	5.6%	37.4%	9.1%	-9.6%
Nasdaq	-4.5%	20.9%	16.0%	8.2%	46.7%	6.5%	-10.8%
S&P/Citigroup Growth	-6.2%	14.6%	13.6%	7.8%	31.6%	3.7%	-11.3%
Dow Jones Wilshire 5000	-10.7%	16.2%	16.1%	5.5%	27.1%	5.8%	-11.4%
S&P 500 Adj for Div	**-10.9%**	**16.0%**	**15.6%**	**6.0%**	**26.4%**	**5.4%**	-11.5%
S&P/Citigroup Value	-16.1%	17.5%	17.9%	4.2%	21.2%	7.1%	-11.6%

S&P 500 Sectors (Total Return)	1Q '09	2Q '09	3Q '09	4Q '09	2009	1Q '10	2Q '10
Utilities	-10.8%	10.2%	6.2%	7.3%	11.9%	-3.5%	-3.7%
Telecom	-7.1%	3.4%	5.6%	7.4%	8.9%	-4.3%	-4.2%
Staples	-10.5%	9.8%	11.4%	5.0%	14.9%	5.8%	-8.1%
Discretionary	-8.1%	18.1%	19.3%	9.1%	41.3%	10.4%	-10.9%
S&P 500 Adj for Div	**-10.9%**	**16.0%**	**15.6%**	**6.0%**	**26.4%**	**5.4%**	-11.5%
Health Care	-8.0%	8.9%	9.5%	9.1%	19.7%	3.4%	-11.8%
Technology	4.3%	19.7%	17.0%	10.7%	61.7%	1.9%	-12.2%
Industrials	-20.9%	18.9%	22.0%	5.4%	20.9%	13.1%	-12.3%
Energy	-11.6%	10.7%	10.1%	5.6%	13.8%	0.6%	-12.7%
Financials	-28.8%	35.7%	25.5%	-3.3%	17.2%	11.1%	-13.3%
Materials	-2.0%	16.3%	21.5%	7.4%	48.6%	2.9%	-15.3%

US Yields **	2Q '09	3Q '09	4Q '09	1Q '10	2Q '10	Y/Y Chg (bps)
Fed Funds Target Rate	0.125	0.125	0.125	0.125	0.125	0.0
3-Month T-Bill	0.18	0.11	0.10	0.13	0.16	-1.5
30-Year Bond	4.30	4.04	4.60	4.65	3.85	-45.4
2-Year Note	1.12	0.96	1.14	1.02	0.62	-49.9
10-Year Bond	3.52	3.31	3.84	3.83	2.95	-56.8
5-Year Note	2.56	2.32	2.69	2.56	1.79	-76.3

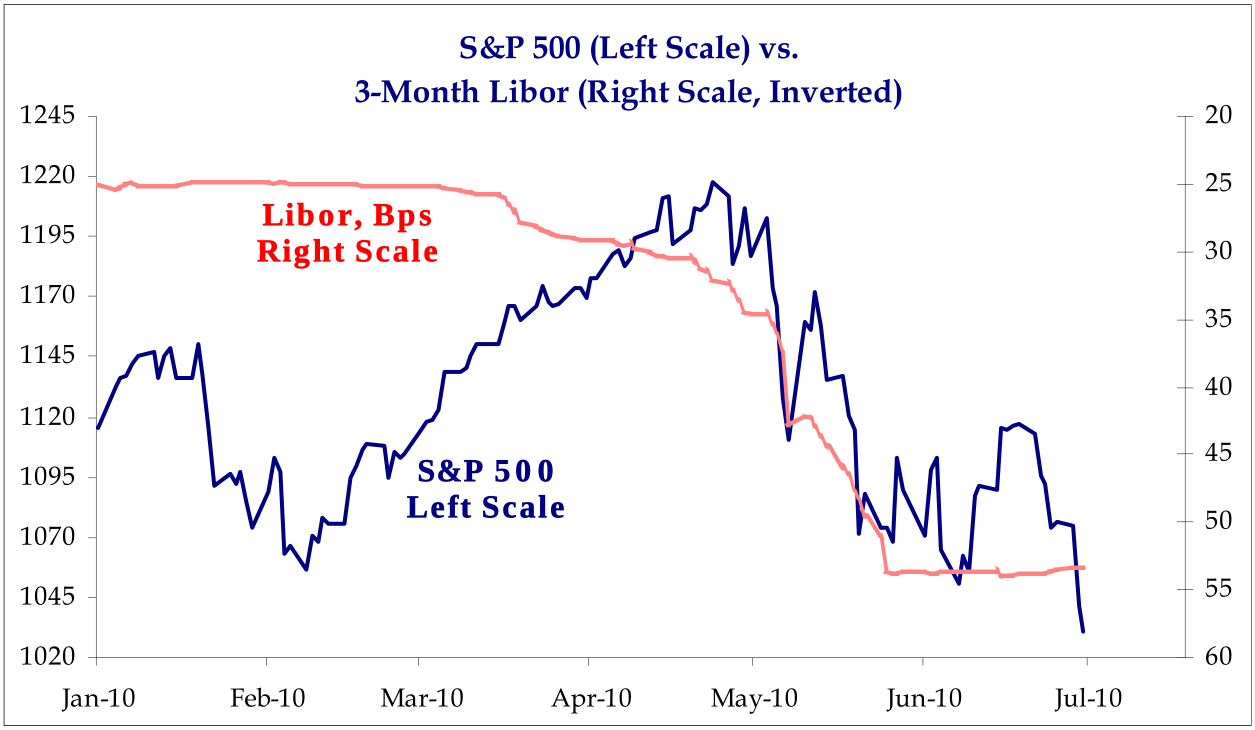
International Indices (Price Chg)	1Q '09	2Q '09	3Q '09	4Q '09	2009	1Q '10	2Q '10
DAX - Germany	-15.1%	17.7%	18.0%	5.0%	23.8%	3.3%	-3.1%
Hang Seng - Hong Kong	-5.6%	35.4%	14.0%	4.4%	52.0%	-2.9%	-5.2%
S&P/TSX - Canada	-3.0%	19.0%	9.8%	3.1%	30.7%	2.5%	-6.2%
Bolsa- Mexico	-12.3%	24.2%	20.0%	9.9%	43.5%	3.6%	-6.3%
Swiss Market Index	-11.0%	9.7%	17.0%	3.5%	18.3%	5.0%	-10.8%
CAC 40 - France	-12.8%	11.9%	20.9%	3.7%	22.3%	1.0%	-13.4%
Bovespa - Brazil	9.2%	25.8%	19.5%	11.5%	82.7%	2.6%	-13.4%
FTSE 100 - UK	-11.5%	8.2%	20.8%	5.4%	22.1%	4.9%	-13.4%
IBEX -Spain	-15.0%	25.2%	20.1%	1.6%	29.8%	-9.0%	-14.8%
Nikkei 225 - Japan	-8.5%	22.8%	1.8%	4.1%	19.0%	5.2%	-15.4%
Shanghai A Shares - China	30.3%	24.7%	-6.1%	17.9%	79.8%	-5.2%	-22.9%

TAKING A LOOK AT SEASONALS

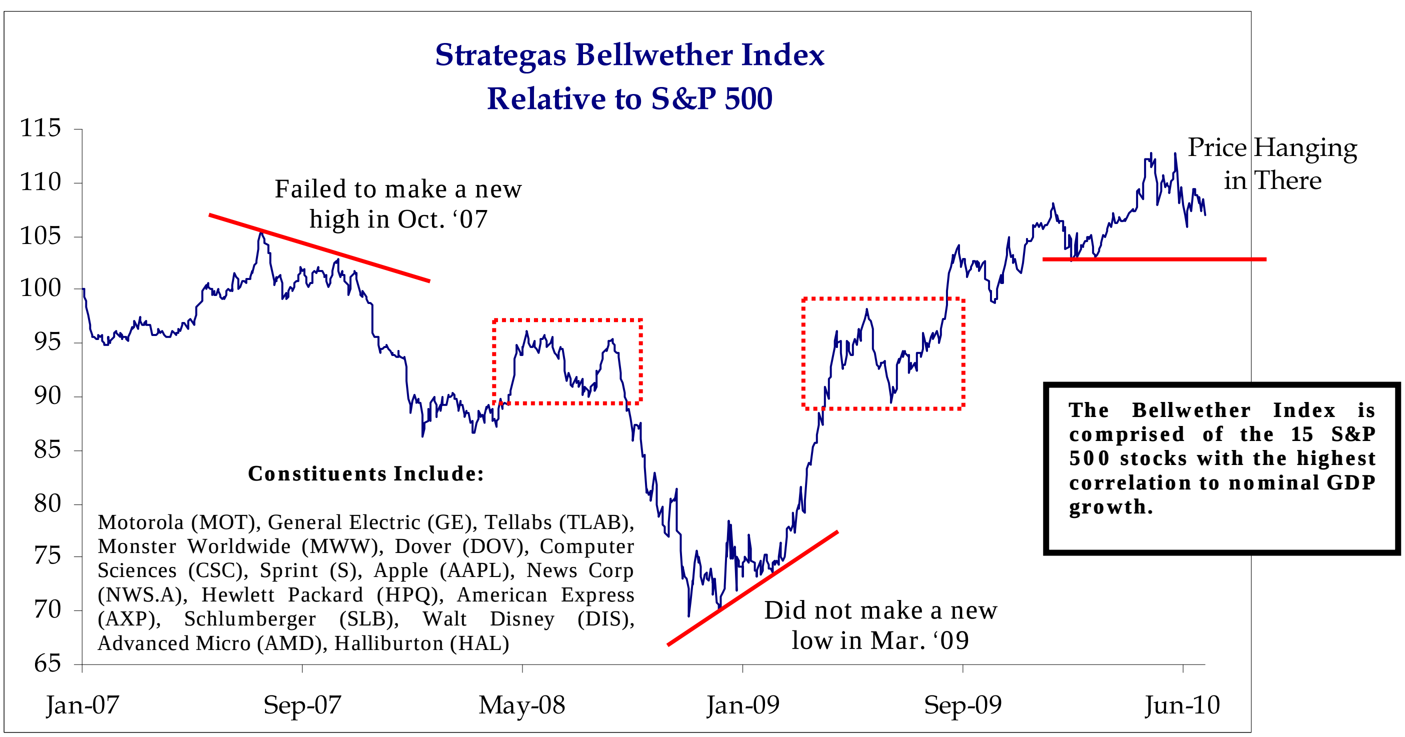


KEY MARKET MONITORS:

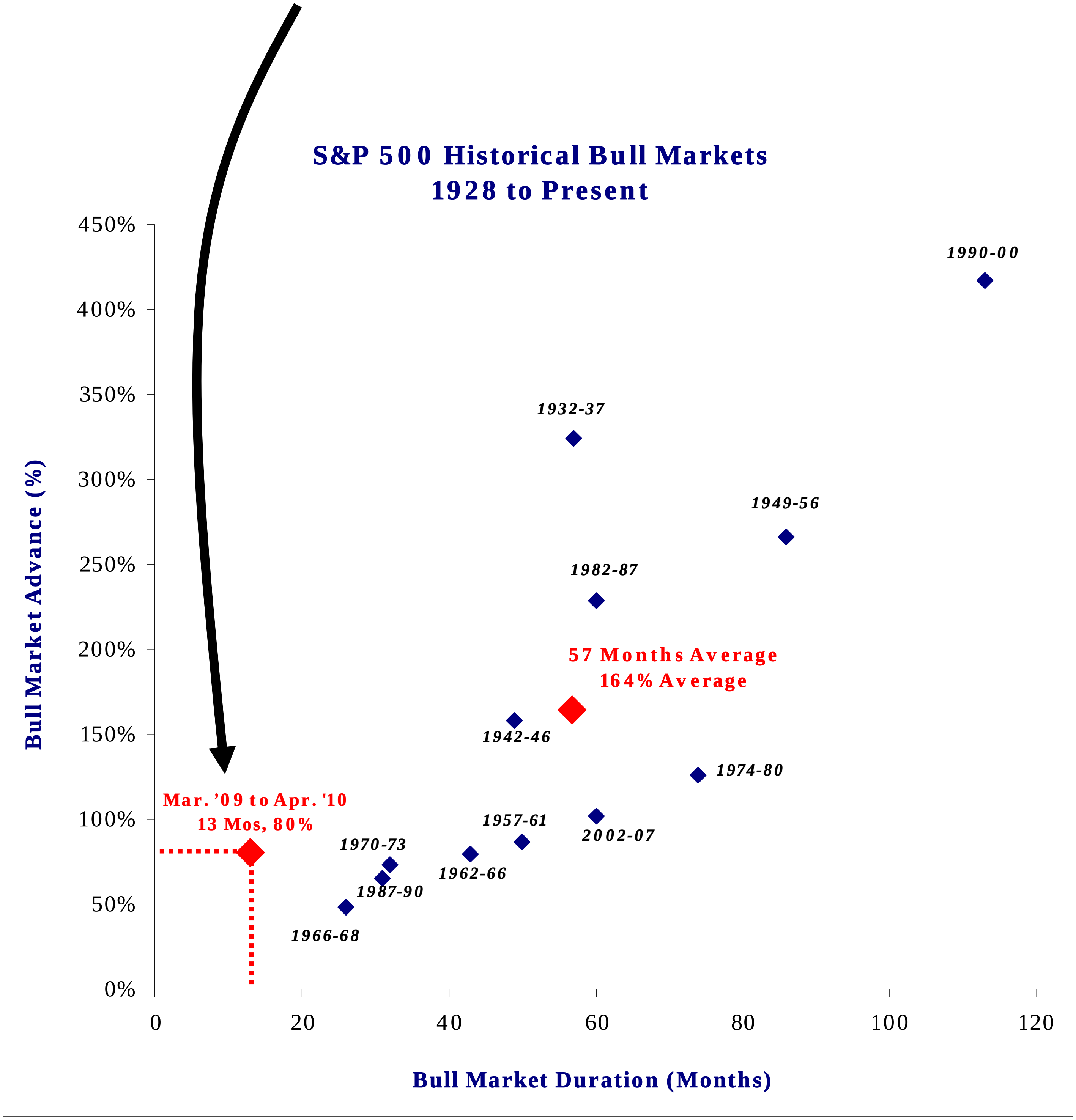
1) LIBOR MOVING SIDEWAYS AT AN ELEVATED LEVEL



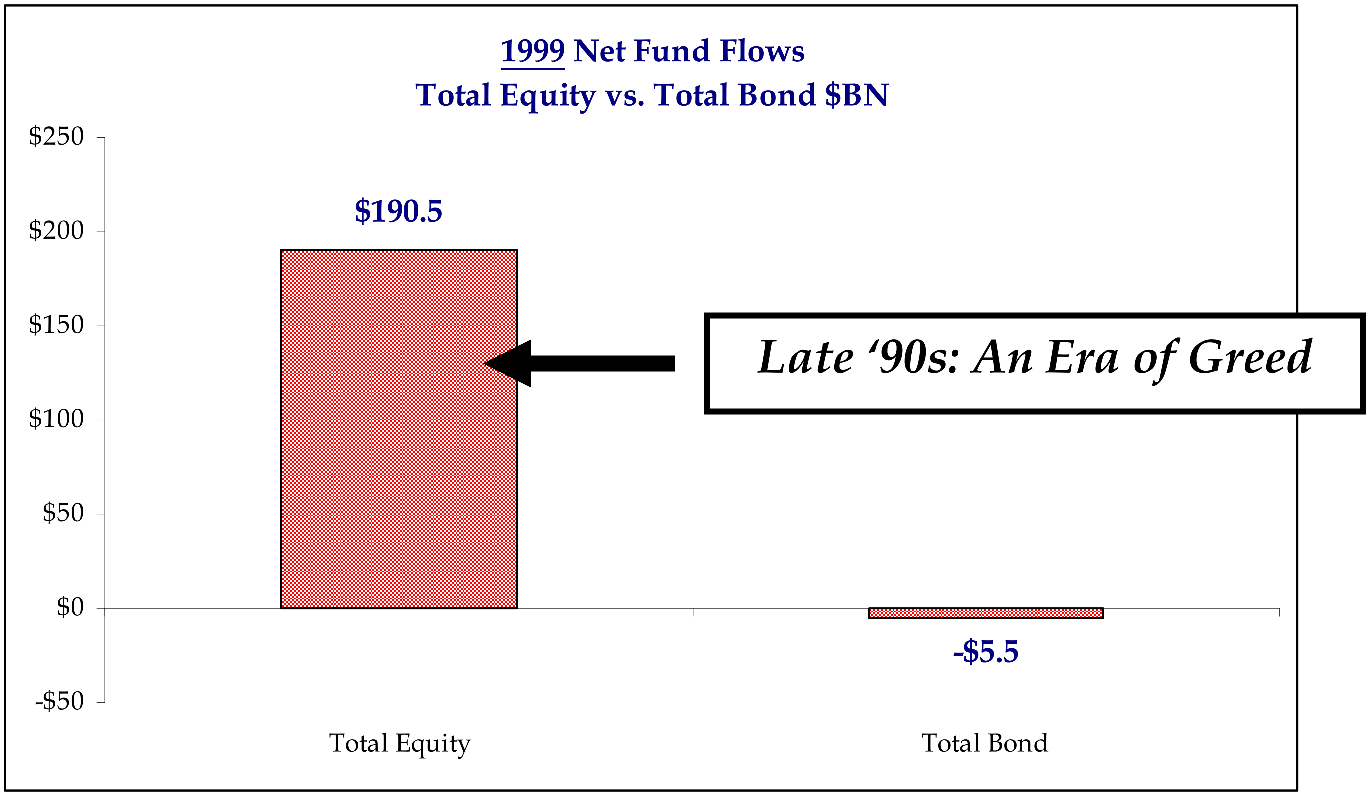
2) PROPRIETARY BELLWETHER INDEX HOLDING UP

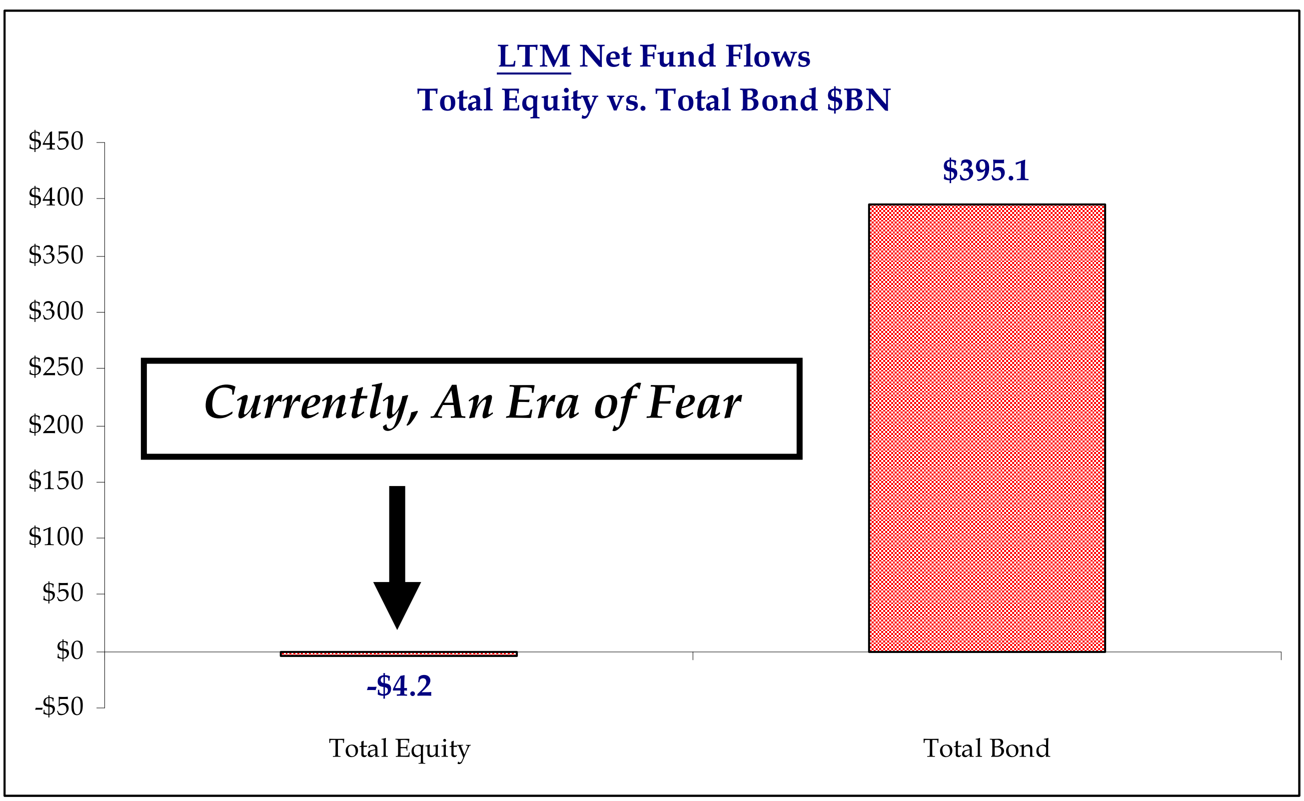


IF THE APRIL 2010 HIGH MARKED THE TOP, THIS WAS THE SHORTEST BULL MARKET IN HISTORY



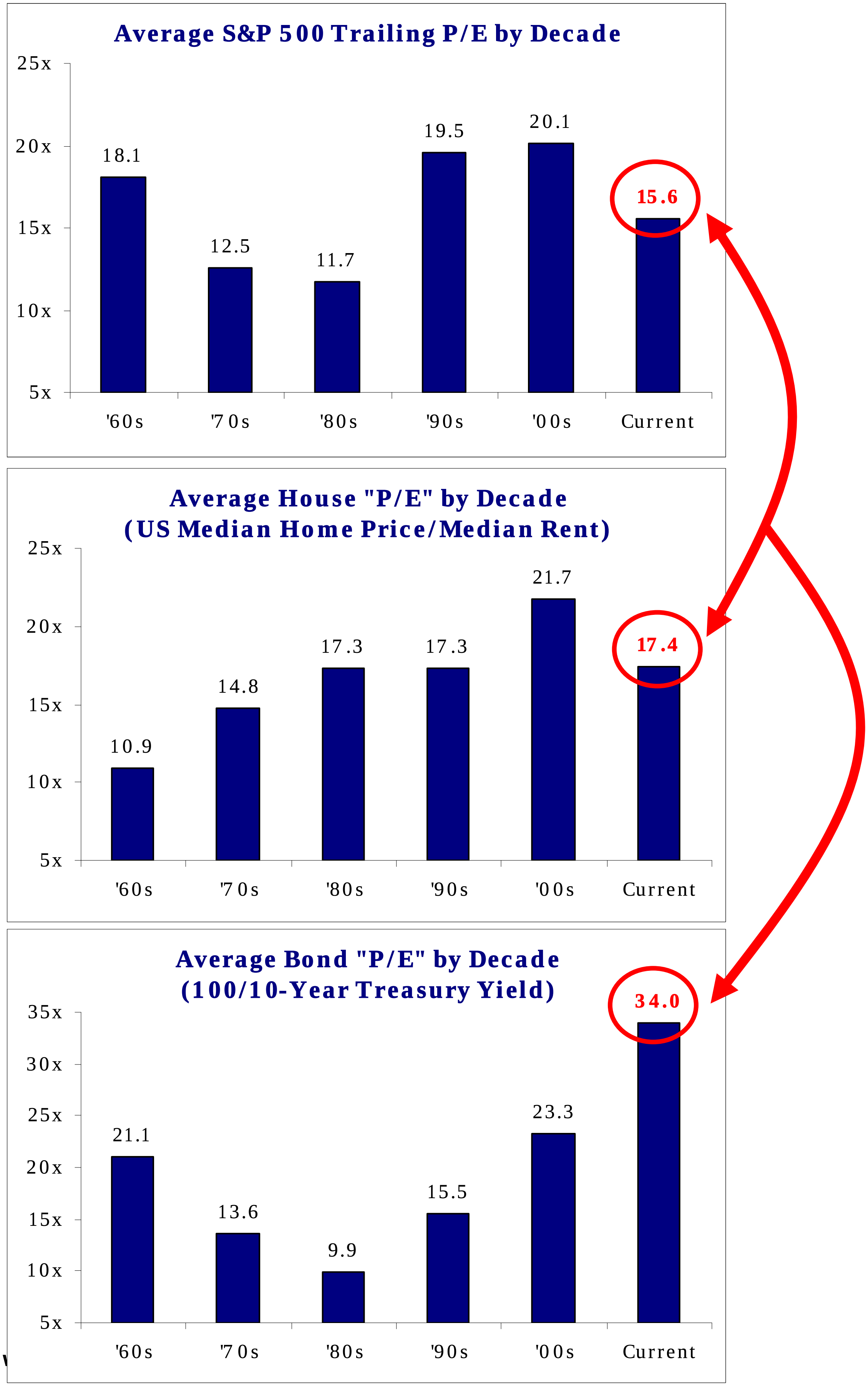
THE "BUBBLE" IS LIKELY IN BONDS, NOT STOCKS



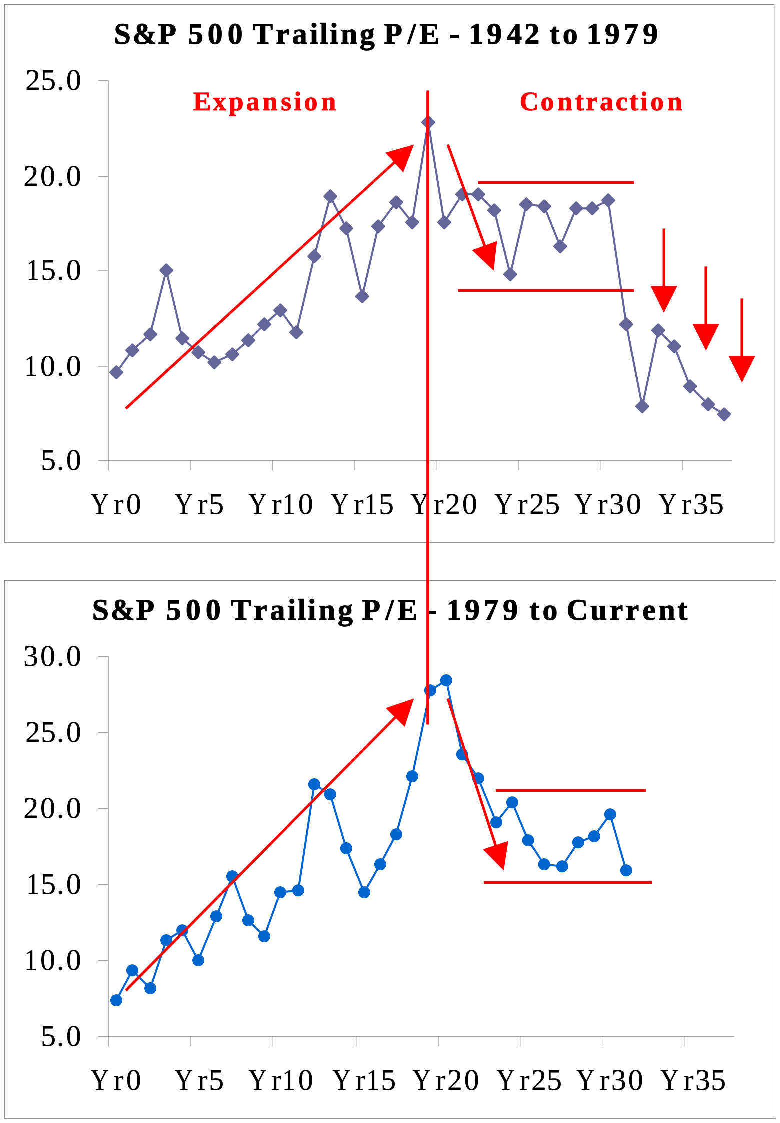


LTM Data through May 2010

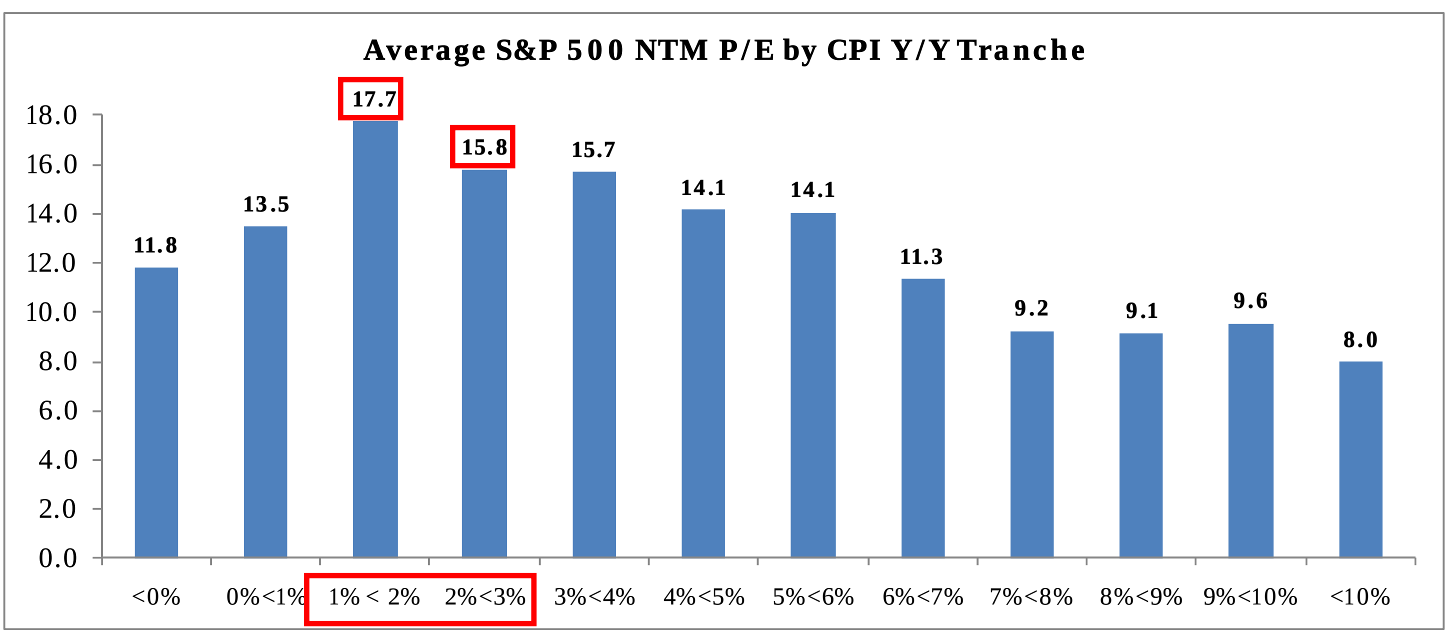
IF YOU HATED THEM AT 3.70, YOU REALLY HATE THEM AT 2.94… DEBT IS GETTING PRETTY EXPENSIVE



EARNINGS MULTIPLES REMAIN IN CONTRACTION PHASE

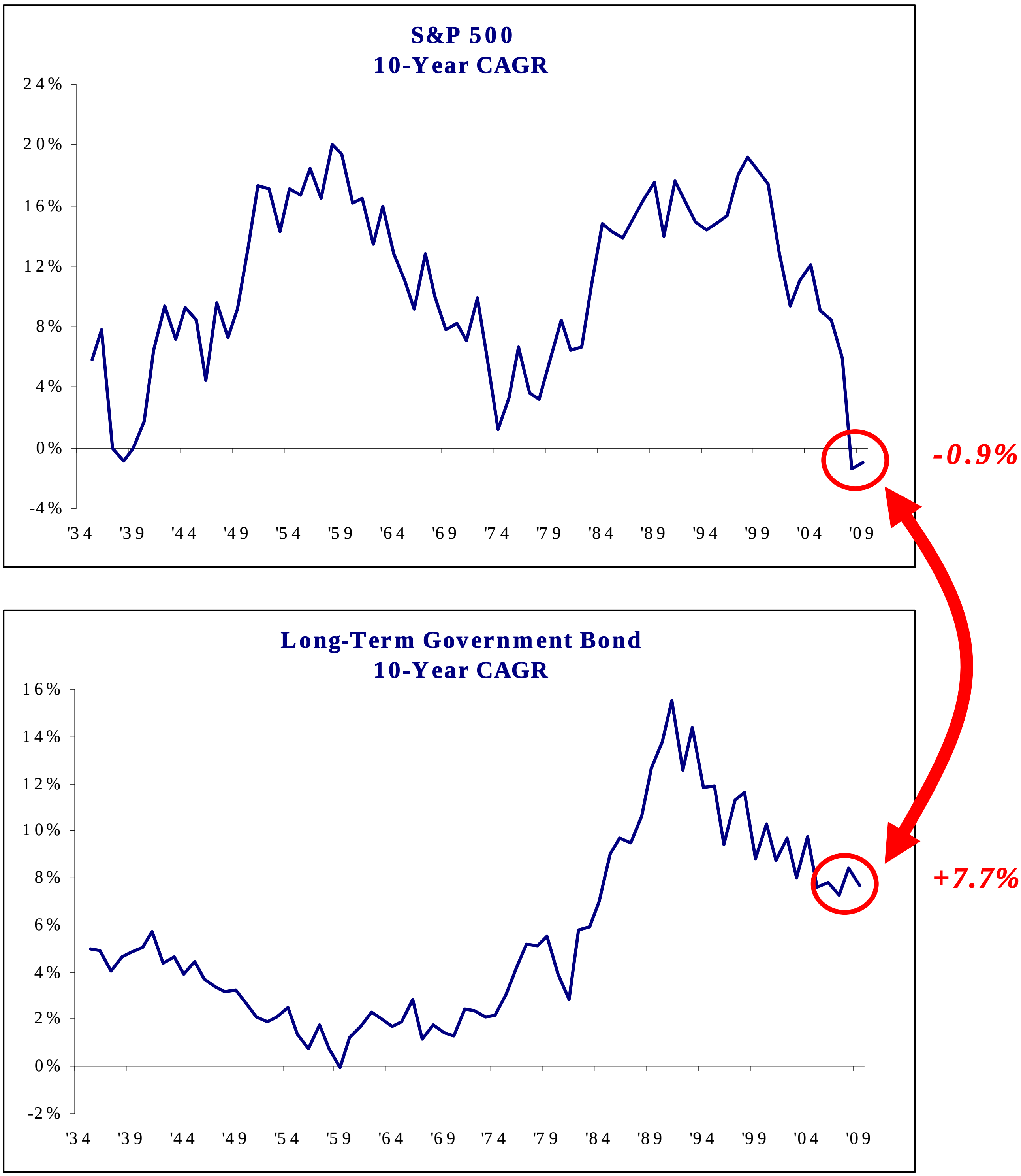


In the modern financial era (post-WWII), equity market multiples have moved in near 40-year cycles – roughly a 20-year expansion phase, followed by an equally long contraction phase. The two phases, however, are distinctly different. Expansion is best described as linearly upward sloping, and the fundamental backdrop is highlighted by easier regulation, lower taxes, lower interest rates, and lower inflation. Secular multiple contraction is a whole different animal. Falling earnings, higher Index turnover, and the reversal of the 4 tailwinds of expansion – taxes, regulation, interest rates, and inflation – leading first to a period of sideways multiples and then, if unaddressed, a sharp move lower.



ROLLING 10-YEAR RETURNS: STOCKS VS. BONDS

Admittedly, "we're due" arguments are not among the most intellectually robust, especially for investors with shorter-term time horizons. Still, there's only been one other time in the past 70 years in which the 10-year CAGR in the S&P has been as low as it is right now.



CONTRARIANS NOTE: DECADE RETURNS

By Asset Class,

	1970s	1980s	1990s	2000s
Long-Term Government	5.5	12.6	8.8	7.7
Long-Term Corporate	6.2	13.0	8.4	7.6
Small-Cap Stocks	11.5	15.8	15.1	6.3
Intermediate-Term Government	7.0	11.9	7.2	6.2
Treasury Bills	6.3	8.9	4.9	2.8
Inflation	7.4	5.1	2.9	2.5
Large-Cap Stocks	**5.9**	**17.5**	**18.2**	**-0.9**

Style,

	1970s	1980s	1990s	2000s
Small-Cap Value	15.0	21.1	14.5	10.6
Large-Cap Value	12.2	20.2	13.9	0.3
Small-Cap Growth	5.8	10.8	15.0	-1.1
Large-Cap Growth	**3.4**	**15.8**	**19.9**	**-1.8**

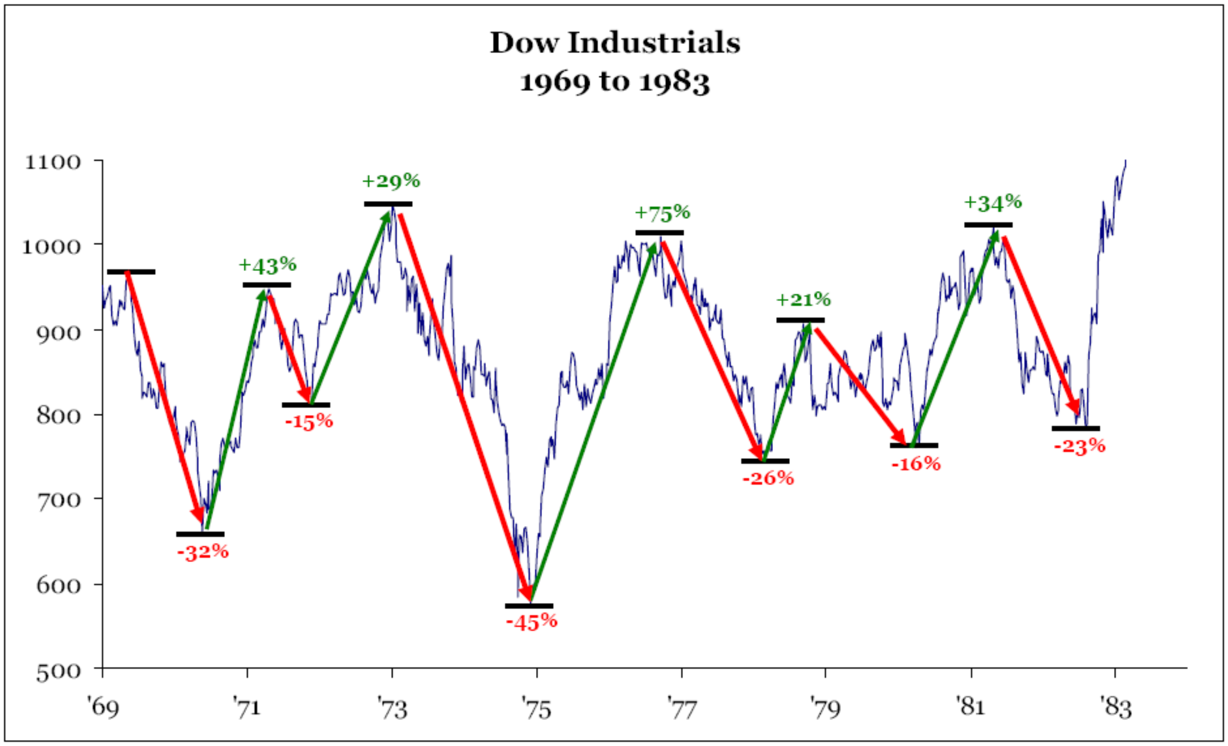
And Region

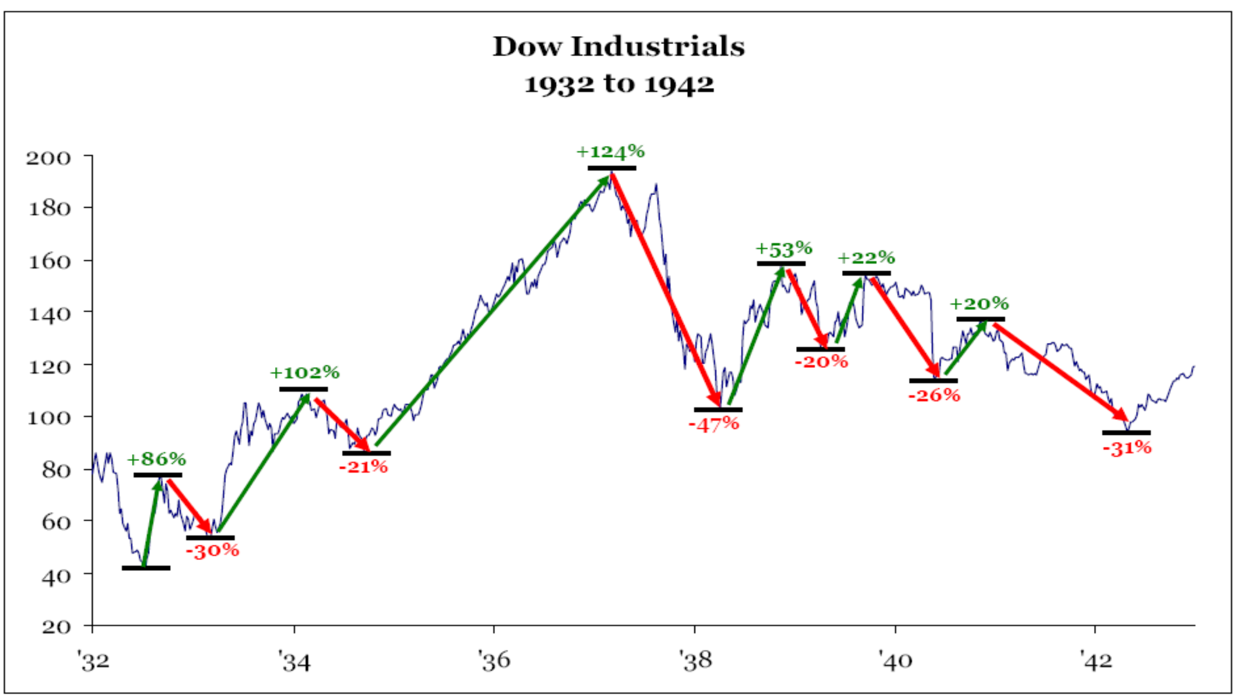
	1970s	1980s	1990s	2000s
Canada	11.0	11.6	9.9	9.2
Europe	8.6	18.5	14.5	2.4
EAFE (Europe, Australia, Far East)	10.1	22.8	7.3	1.6
World	7.0	19.9	12.0	0.2
Pacific	14.8	26.4	0.5	-0.3
United States	**5.9**	**17.5**	**18.2**	**-0.9**

Source: Ibbotson, Data through 12/31/2009.

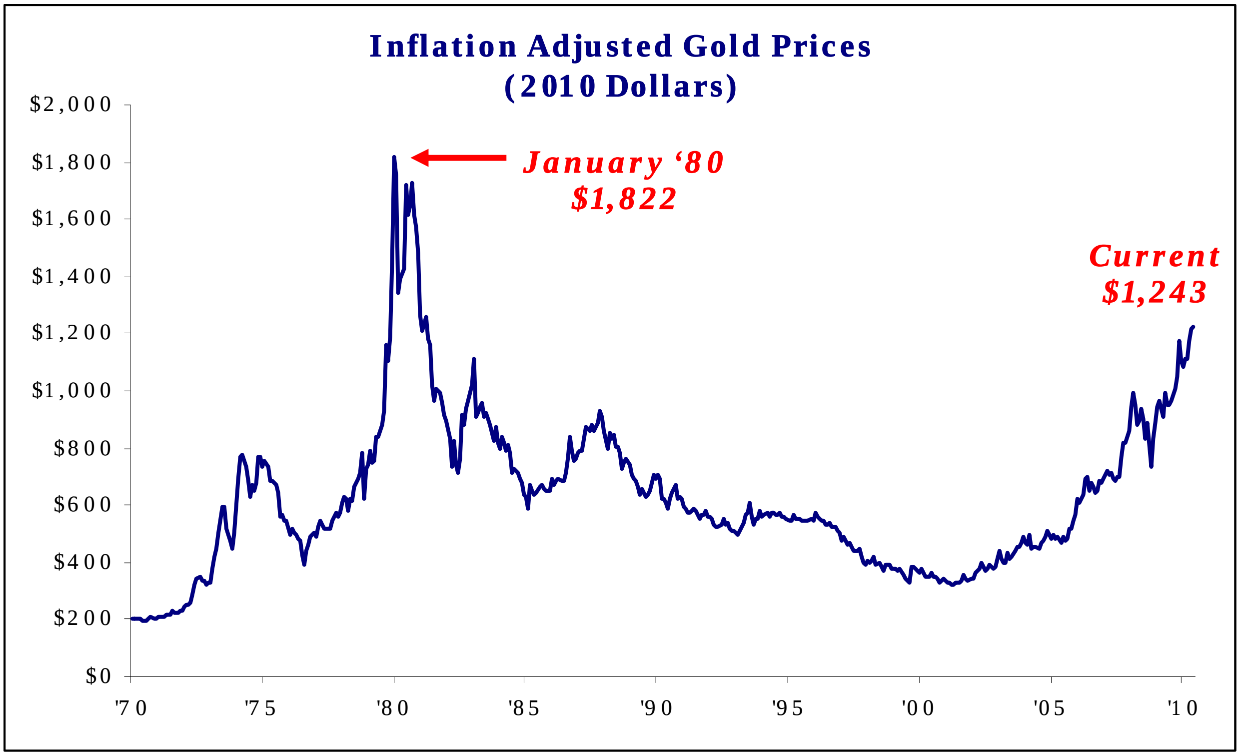
1930s OR 1970s, DEFLATION OR INFLATION, RANGEBOUND MARKETS PROLIFERATE

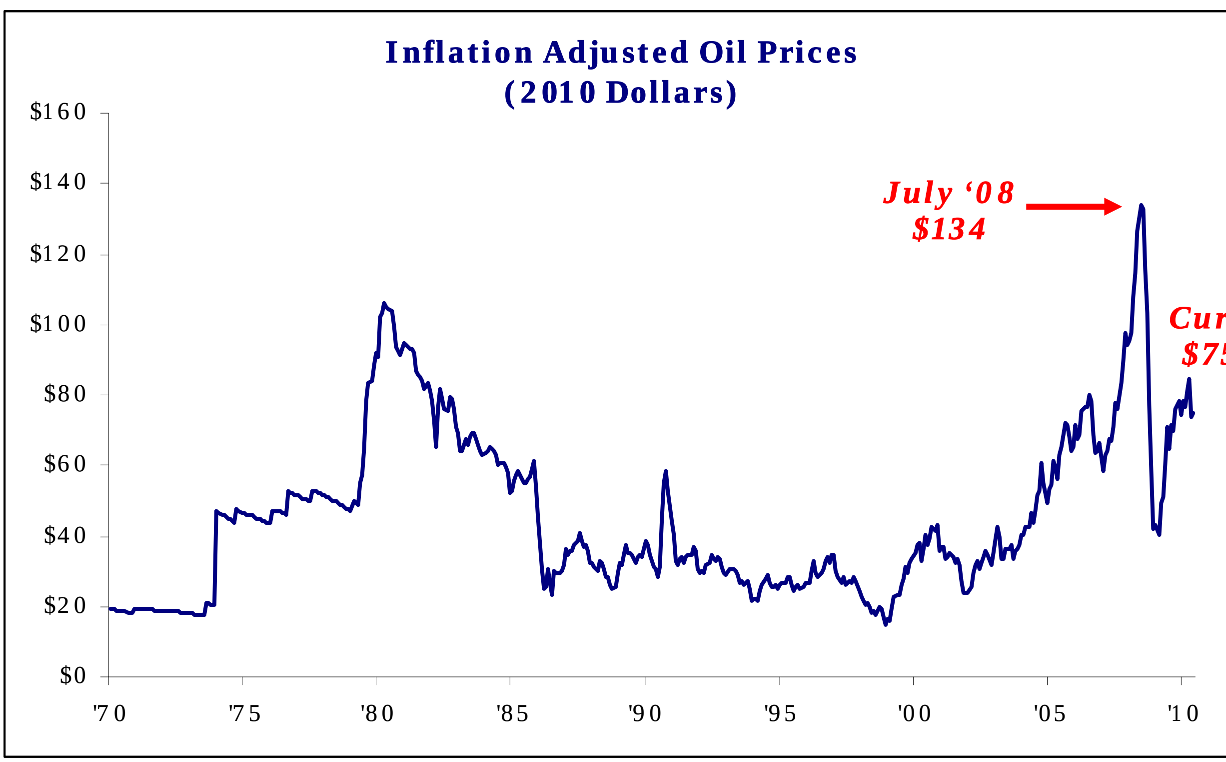
Given the market volatility over the last several weeks, a client encouraged us to republish a series of chart we first highlighted earlier in the year. The top chart may ultimately be the most instructive – **while the Dow Industrials made its final low in late 1974, there were declines of -26%, -16%, and -23% (and rallies of +21% and +34%) before new highs were finally made in '82.**





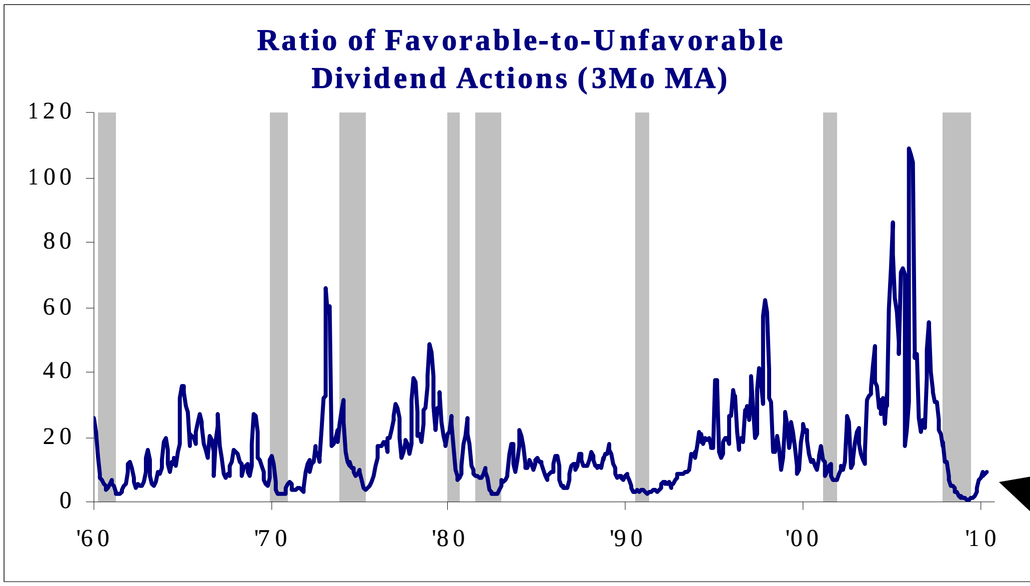
TAKING A LOOK AT GOLD & OIL IN INFLATION-ADJUSTED TERMS

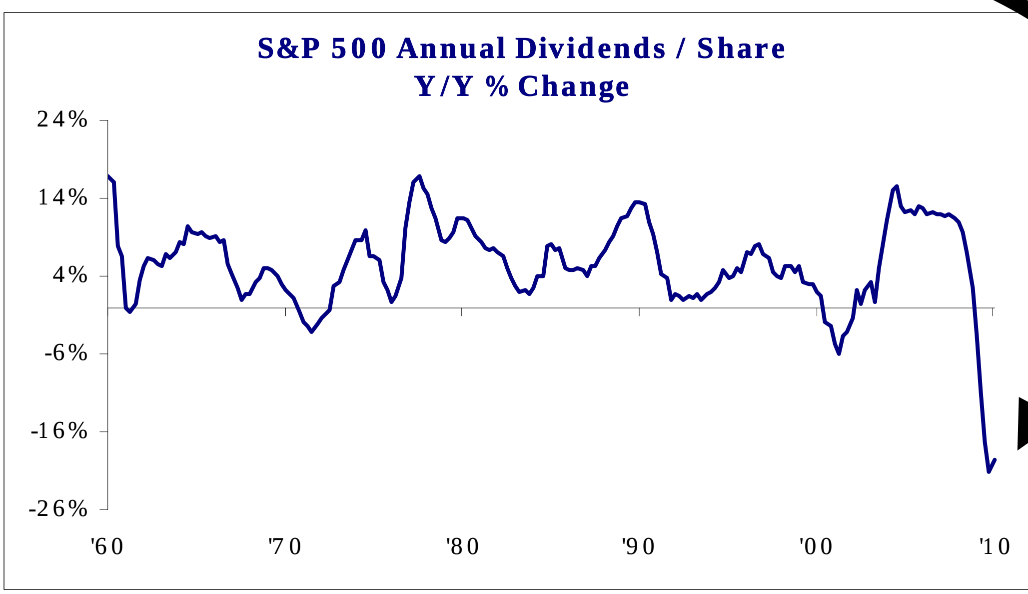


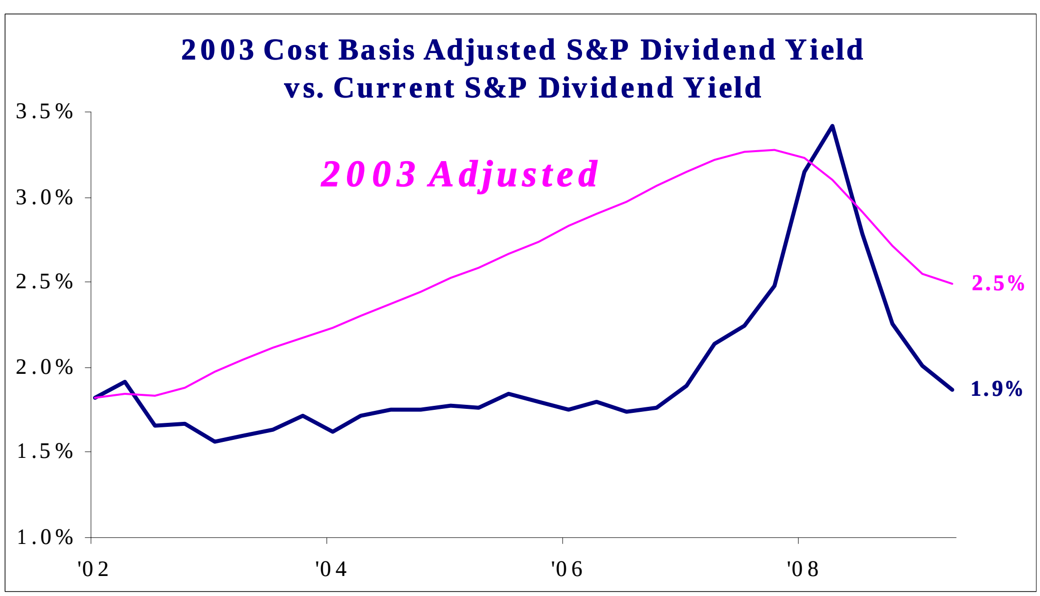


Monthly Closing Values Used

WITH 2003 TAX CUTS SUNSETTING, ONE WONDERS THE FATE OF HARD-FOUGHT RESPECT FOR DIVIDENDS



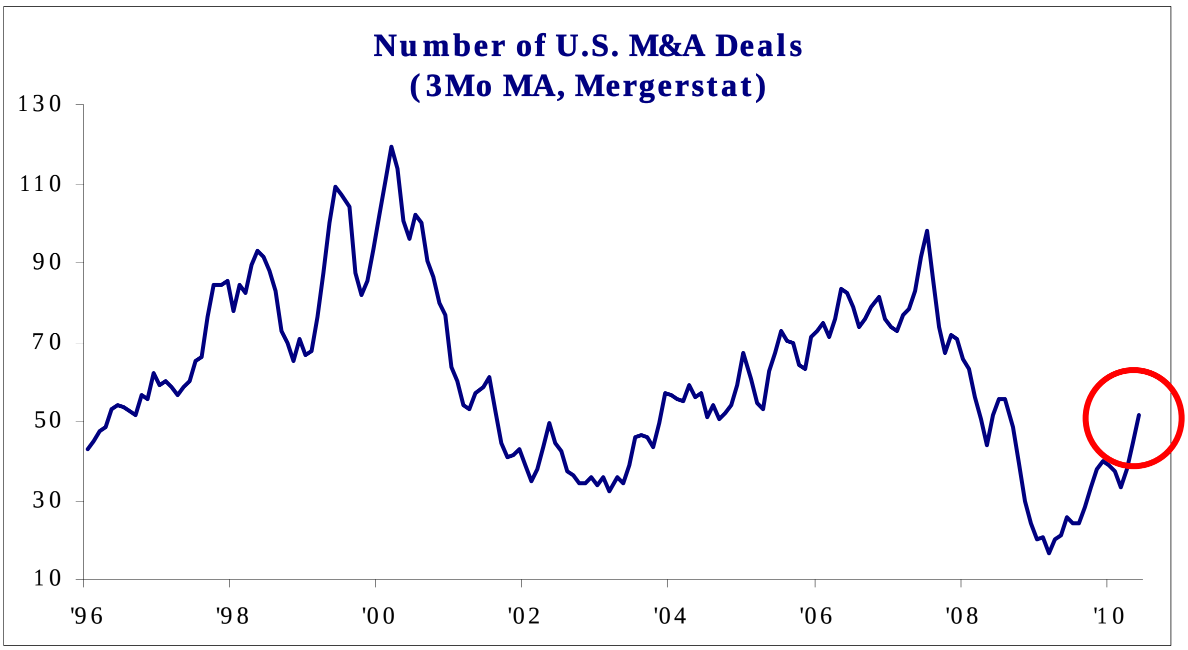


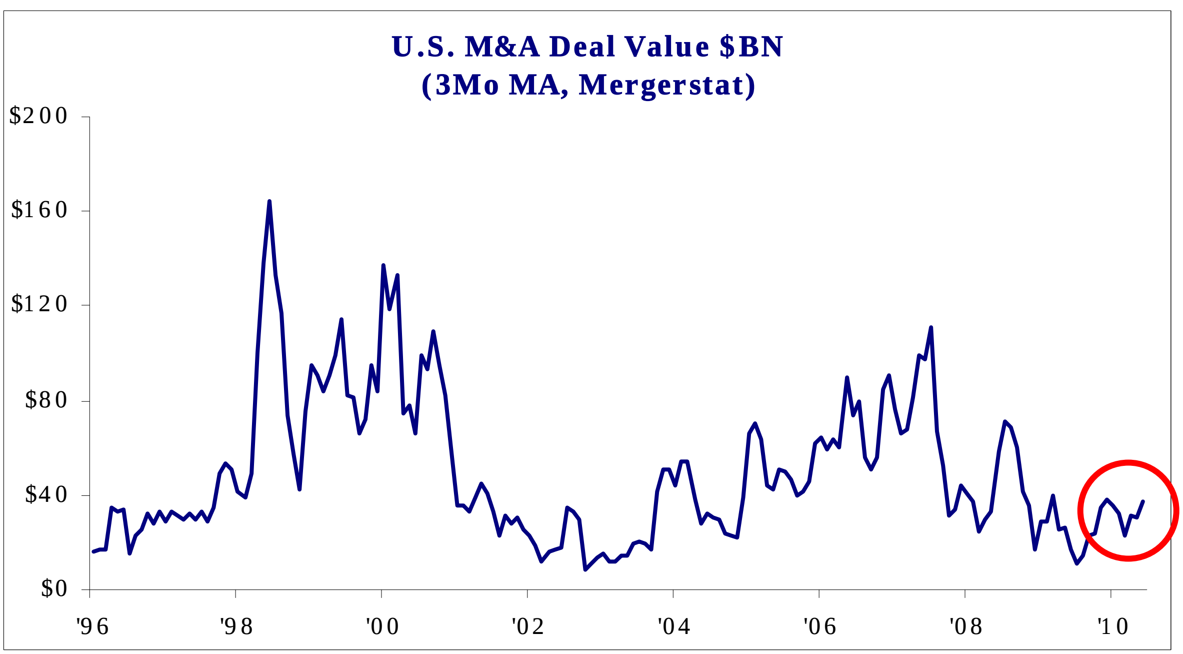


Data through May, June update available in coming days.

SEEK M&A TARGETS AND POTENTIAL SPECIAL DIVIDENDS IN ANTICIPATION OF HIGHER TAXES

A virtually inevitable increase in tax rates on dividends and capital gains in 2011 is likely, in our view, to pull economic activity, particularly M&A and special dividends, into 2010, enhancing returns for holders of companies with perhaps too much cash. M&A could be attractive for companies when the prospects for secular growth, at least in the U.S., appear dim. Valuations are low enough today for many deals to be accretive for the acquirer. One could also argue that companies have a fiduciary duty to consider paying out special dividends given the risk that the dividend tax rate is poised to nearly triple.



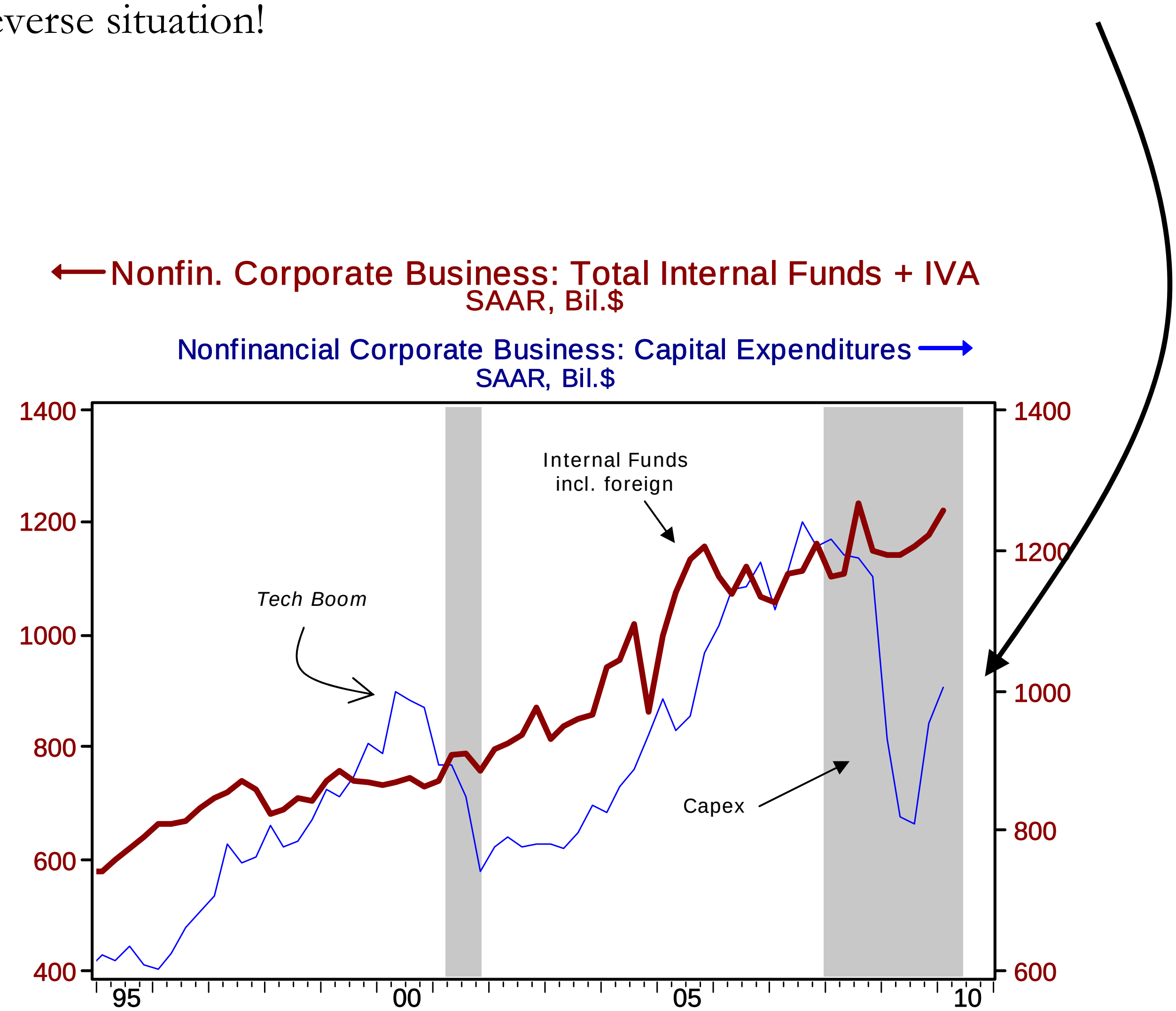


LOCOMOTIVES FOR THE BUSINESS CYCLE

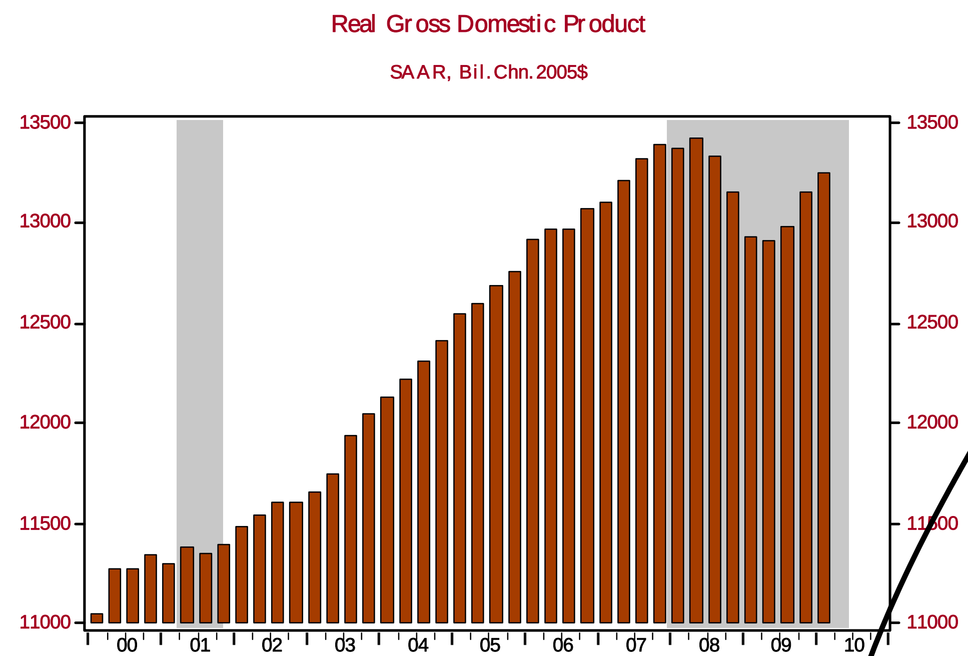
1) HOUSING (IN NEUTRAL WITH POLICY HELP).
2) CONSUMER DURABLES (IN NEUTRAL WITH POLICY HELP).
3) CAPEX (MOVING FORWARD).

PLENTY OF CORPORATE SAVING (PROFITS) AS FUEL NOW.

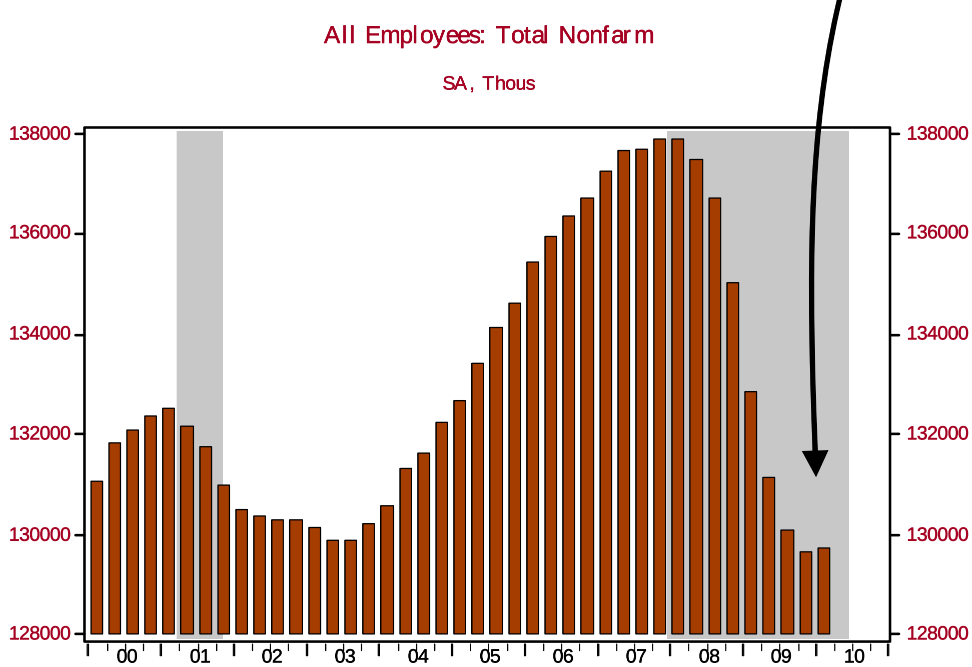
In addition to govt stimulus, nonfinancial corporations appear to have a substantial ability to spend – corporate cash flows have fallen slightly, but capex has been cut much more dramatically. The story in the late 1990s was the large "financing gap" as there was a tech capex boom – we're now in the reverse situation!



CONFIDENCE IN THE RECOVERY COMES FROM A FOCUS ON "GROSS" DOMESTIC PRODUCT & EMPLOYMENT.
(This still leaves the next Expansion as an Open Question)



U.S. real GDP started to recover in 2009, driven by productivity, as employment remained restrained. Over the past several months, employment has started to recover as well – it is employment that provides the income that supports the 71% of the U.S. economy which is consumer spending.

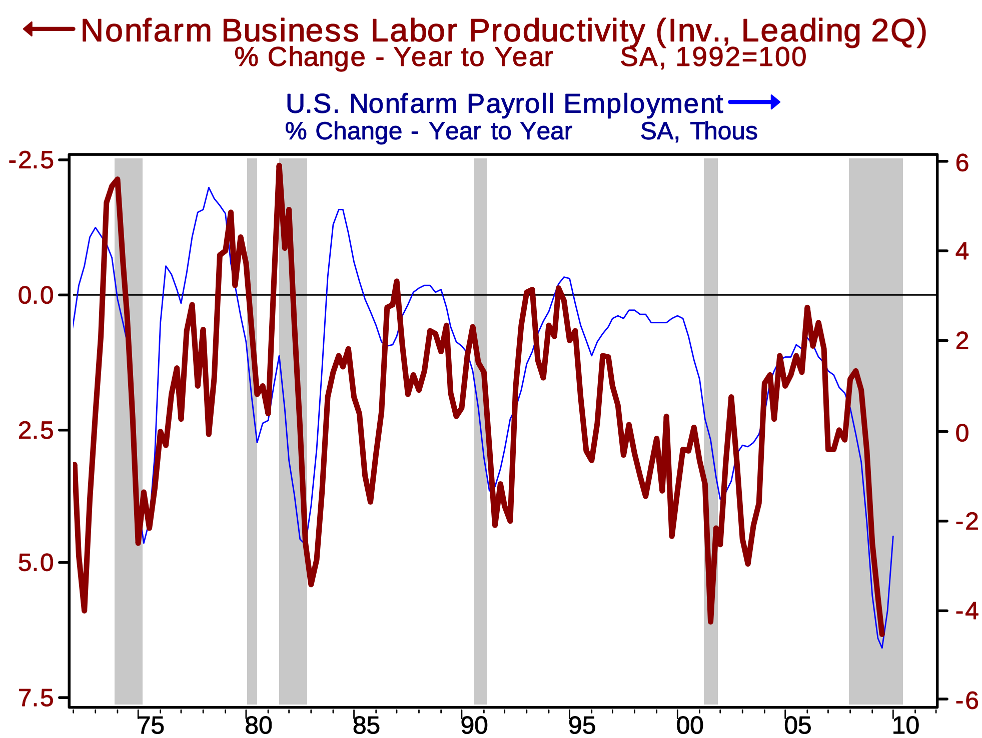


"Replacement" hiring and capital spending are key reasons for no double dip in the near-term.

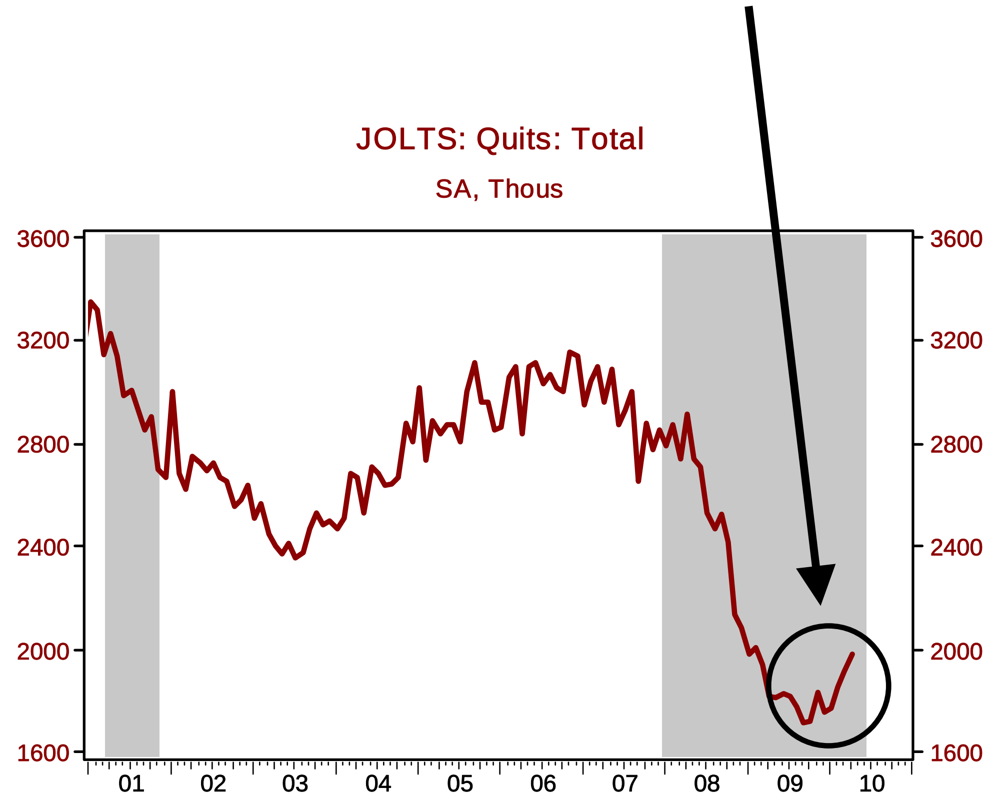
SIZABLE PRODUCTIVITY GAINS SUGGEST EMPLOYMENT SHOULD BE GETTING BETTER

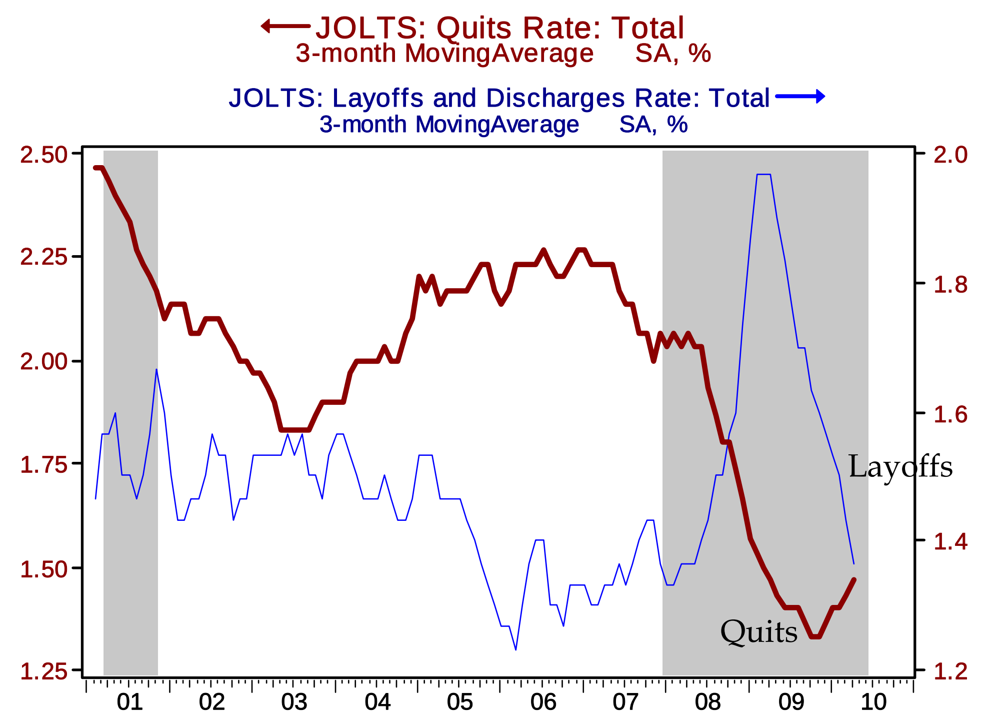
Employment Growth Following + 7.8% Labor Productivity Growth Q/Q AR

	1Q after	2Q after	3Q after
4Q '47	1.3	0.9	4.3
3Q '50	6.7	7.0	3.2
3Q '51	1.2	2.4	0.6
4Q '52	3.7	1.3	-0.2
3Q '58	4.6	7.0	6.1
1Q '60	1.0	-2.0	-2.3
2Q '61	3.58	3.3	3
3Q '63	2.6	2.9	2.6
1Q '68	3.6	3.7	4.0
1Q '71	1.91	1.44	2.43
1Q '73	3.67	2.4	3.84
2Q '78	4.2	4.2	3.6
2Q '83	4.2	5.7	5.4
2Q '00	0.76	0.82	0.56
1Q '02	-0.4	-0.3	0.1
3Q '03	0.96	1.17	2.23
Average	**2.7**	**2.6**	**2.5**



EMPLOYMENT DYNAMICS SHIFTING



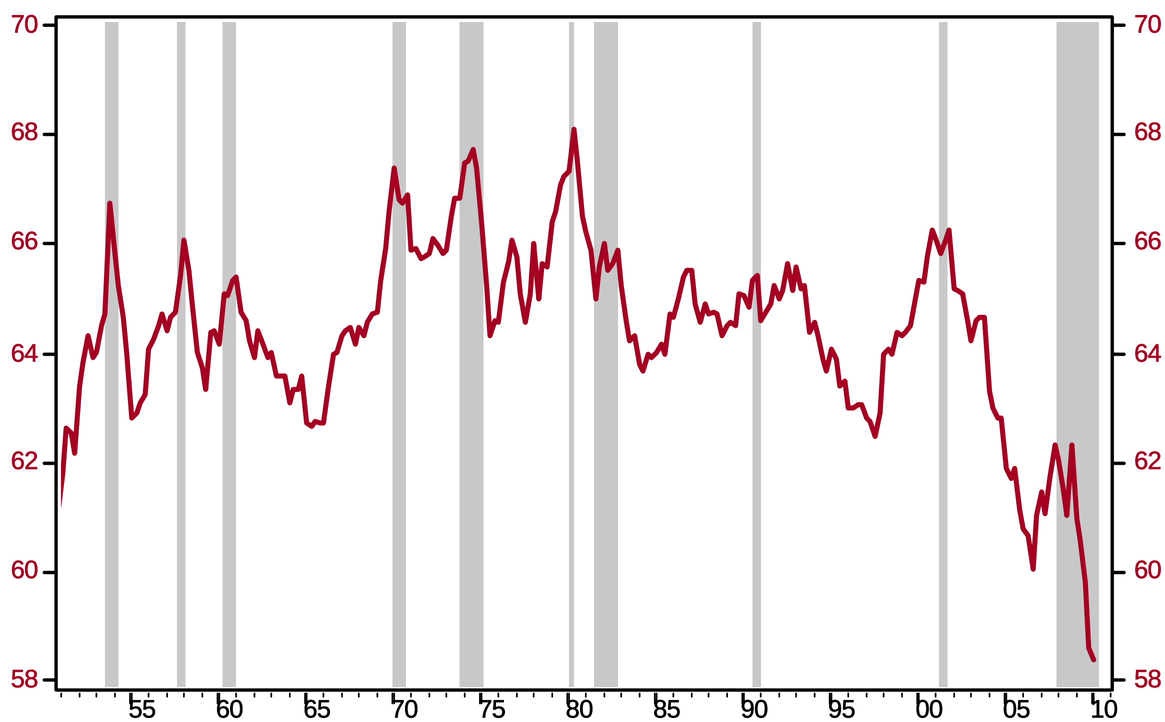


LABOR'S SHARE OF INCOME ANOTHER NEW LOW

(THE ECONOMY SHOULD NOW – IN RECOVERY– TURN THE LIQUIDITY THE FED HAS GENERATED INTO INCOME)

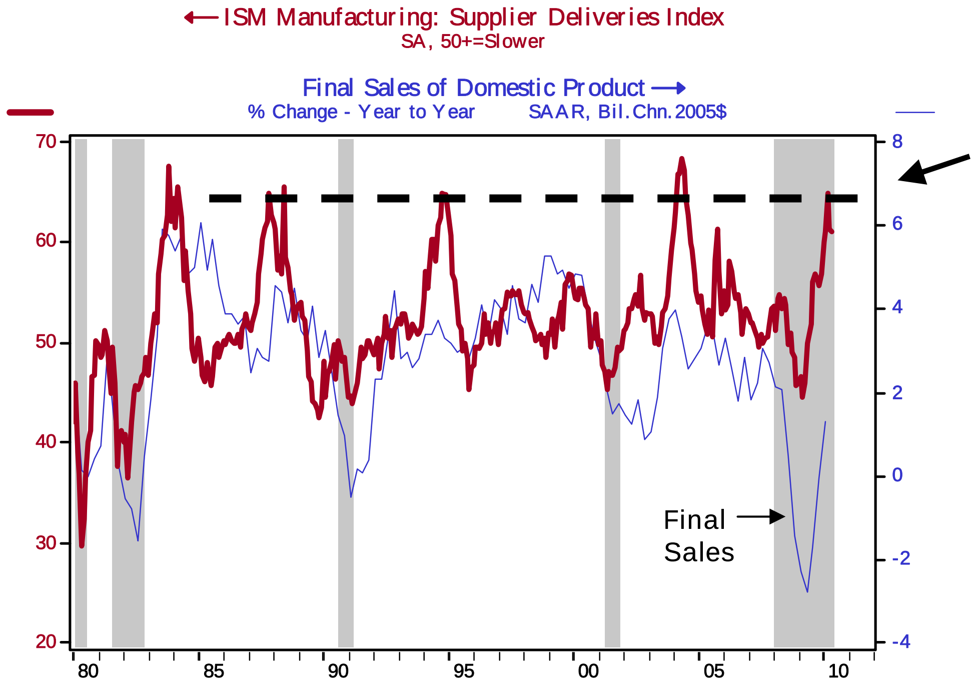
Corporate compensation again grew more slowly than corporate GDP in 1Q, **again causing the labor share of GDP to fall to a new low**. Cost-cutting has been the story, but economies cannot cost cut their way to growth overall (one company's costs are another's revenues). We believe the economy should move back to a period of labor income generation now – which is essentially a positive employment story.

U.S. Corporate Compensation % Corporate GDP



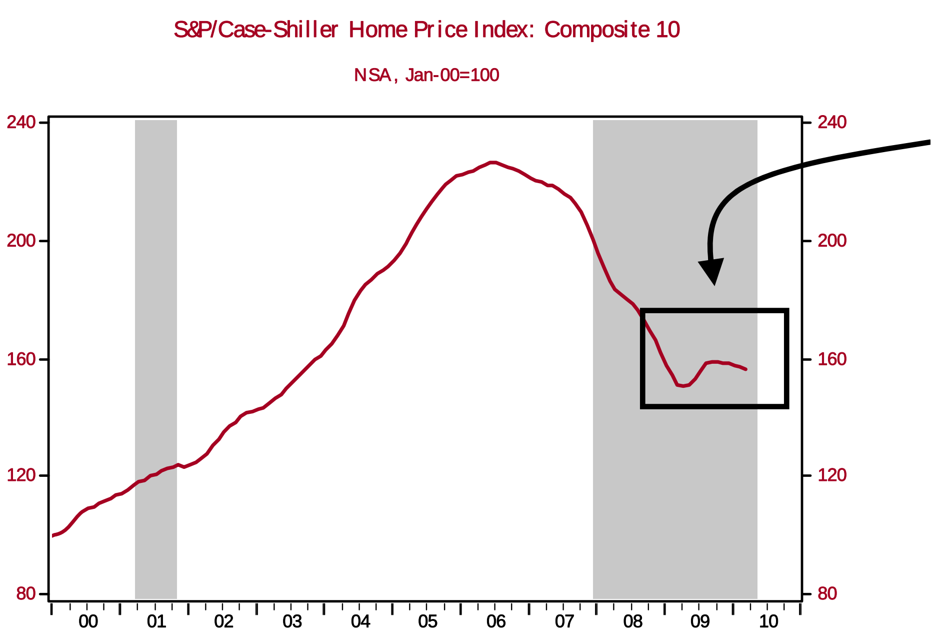
A rebound in the labor share of GDP – from this depressed level – is what should drive the economy from here.

SLOWDOWN IN SUPPLIER DELIVERIES ARGUES FOR A SUSTAINABLE ECONOMIC RECOVERY.



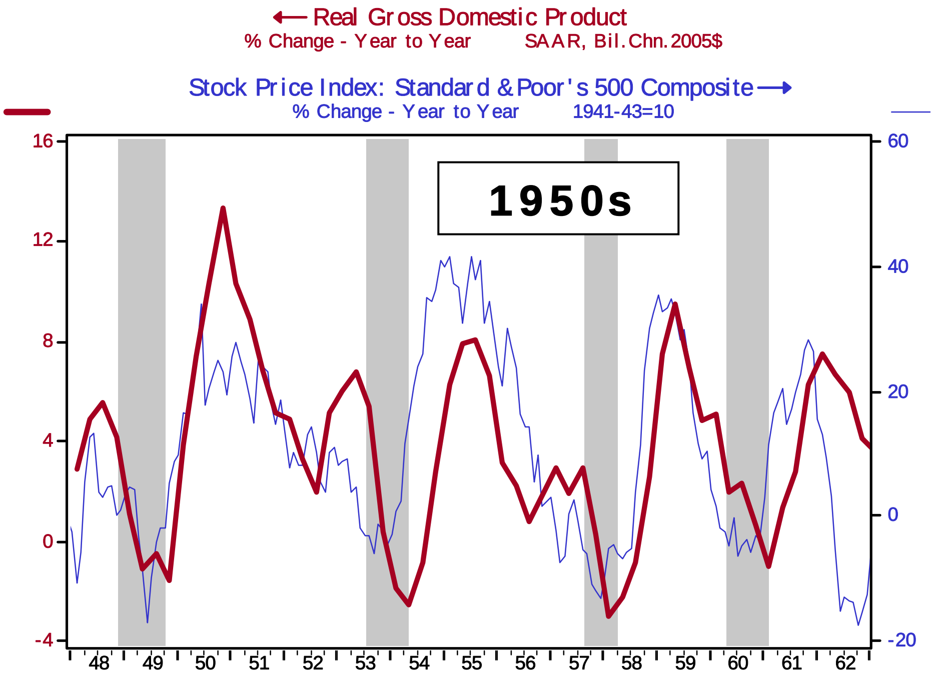
When we've seen the PMI measure of supplier deliveries show the pace of deliveries slow down this much, we have generally been in a period of sustainable domestic growth. We believe that is the base case this time as well – backlogs should result in more activity.

"L" SHAPED BOTTOM IN HOUSING, "U" SHAPED BOTTOM IN CONSUMER SPENDING, "V" SHAPED BOTTOM IN MFG.

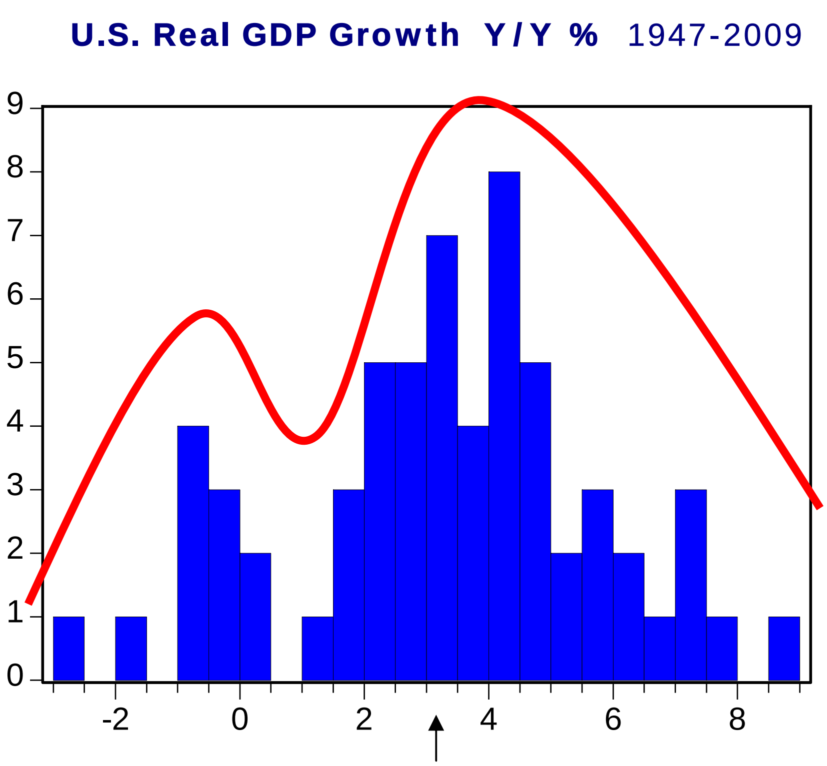


Housing is continuing to show an "L"-shaped bottom in the U.S. data, though the recent weakness in the timely mtg apps for purchase data is notable. As we move past the expiration of the housing tax credit, housing appears to be taking 2 steps forward and 1 step back.

DEVELOPING QUESTION GOING FORWARD IS PROBABLY WHETHER WE WILL NOW SEE "SHORT" U.S. EXPANSIONS (LIKE THE 1950s).



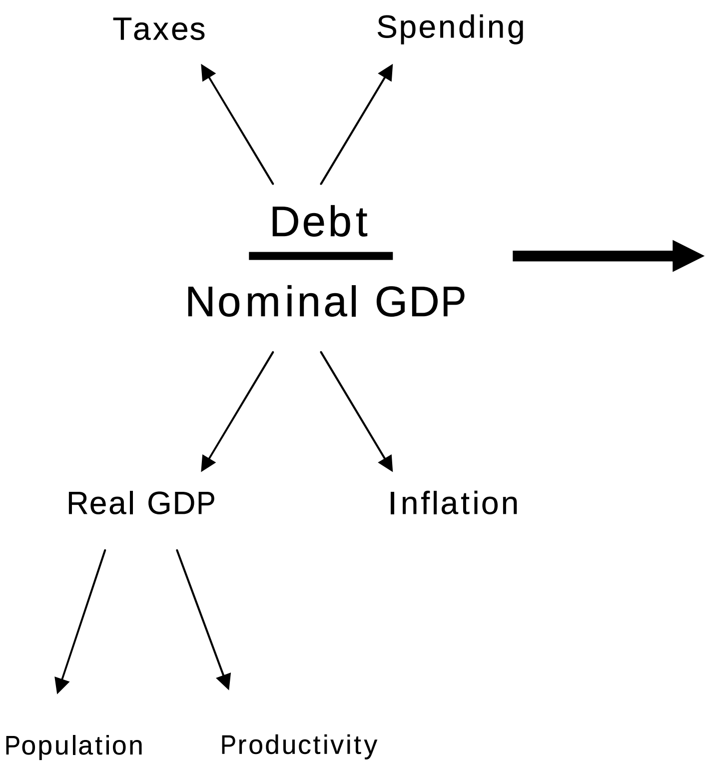
Since we are seeing a cyclical recovery, the developing question going forward will likely turn from *recession* to *recovery* to *expansion.* There are historical periods in which recessions were much more common (eg, the 1950s). Our concern is that if we see a slower trend growth rate in the U.S. economy, we will be perpetually closer to the recession condition of negative growth.



Slower trend growth would push this "hump" in the distribution to the left in the next expansion.

Historically, the U.S. economy has tended to either be expanding around potential growth (3%), or in a recession (-1%). **<u>A "flat" economy has generally been unstable</u>**. If potential growth in the next expansion will be slower (as we believe), we will be starting out closer to the "flat" economy – it may therefore be harder for economic growth to slow without tipping into recession ("mid-cycle slowdowns" could become more rare).

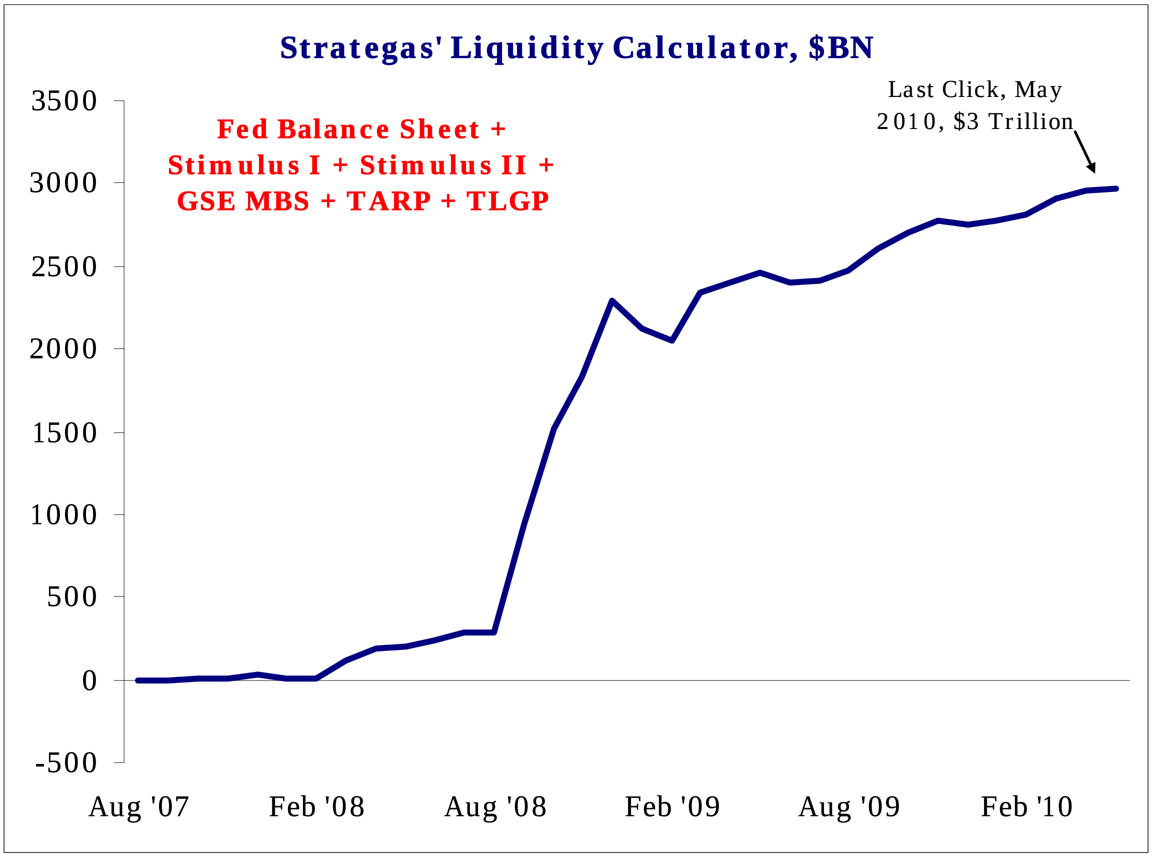
U.S. DEBT/GDP MUST GO SIDEWAYS AS A DEFINITION OF FISCAL SUSTAINABILITY

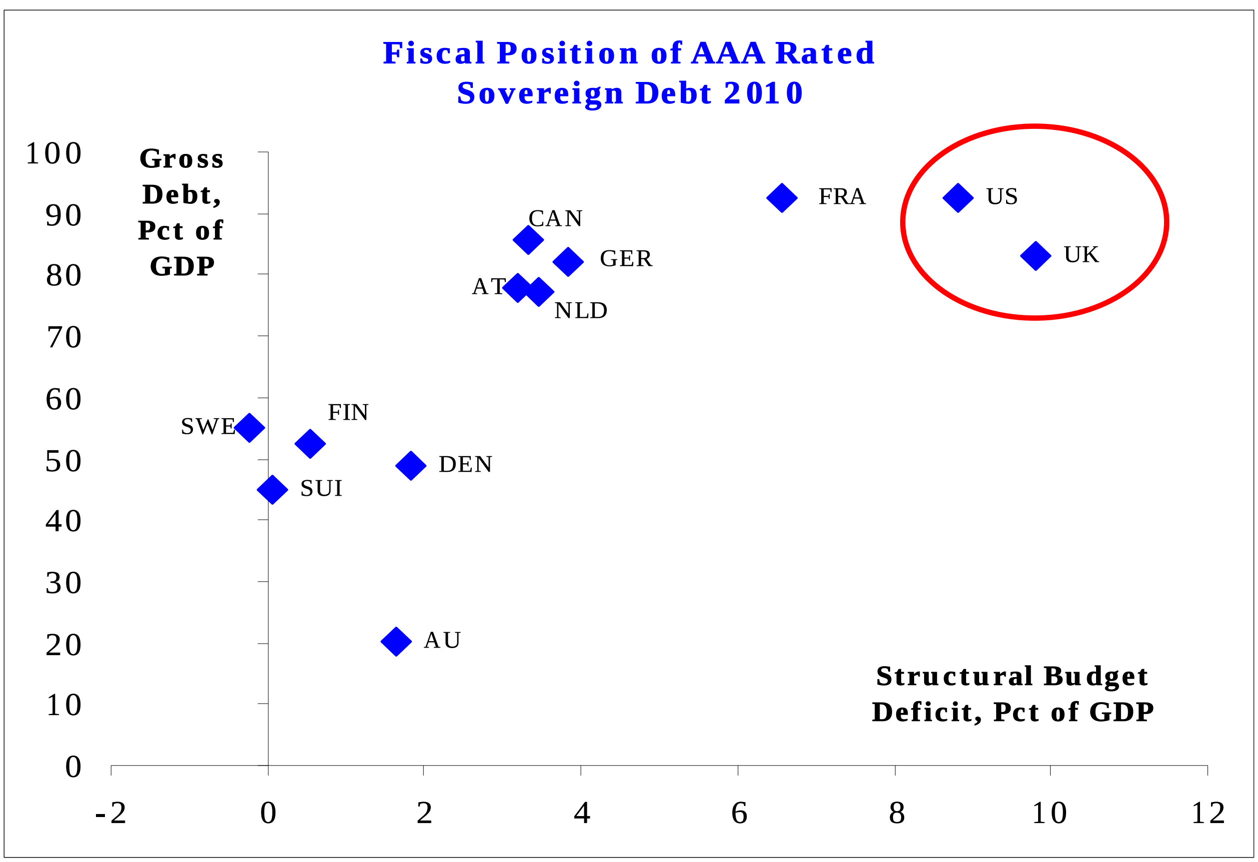


This ratio needs to go sideways long-term as a <u>definition of fiscal sustainability</u> (otherwise, interest costs would eventually consume the entire federal budget).

Taking a simple look at the U.S. debt situation, any interest rate much above 7% reaches the 100% of GDP "danger" level pretty quickly, and anything above a 4% interest rate eventually trends in that direction. **<u>Basically, we cannot pay more in interest than trend nominal growth.</u>**

LIQUIDITY STILL PUMPING, BUT DEFICIT BECOMING A LARGER PART OF THE STORY MOVING FORWARD

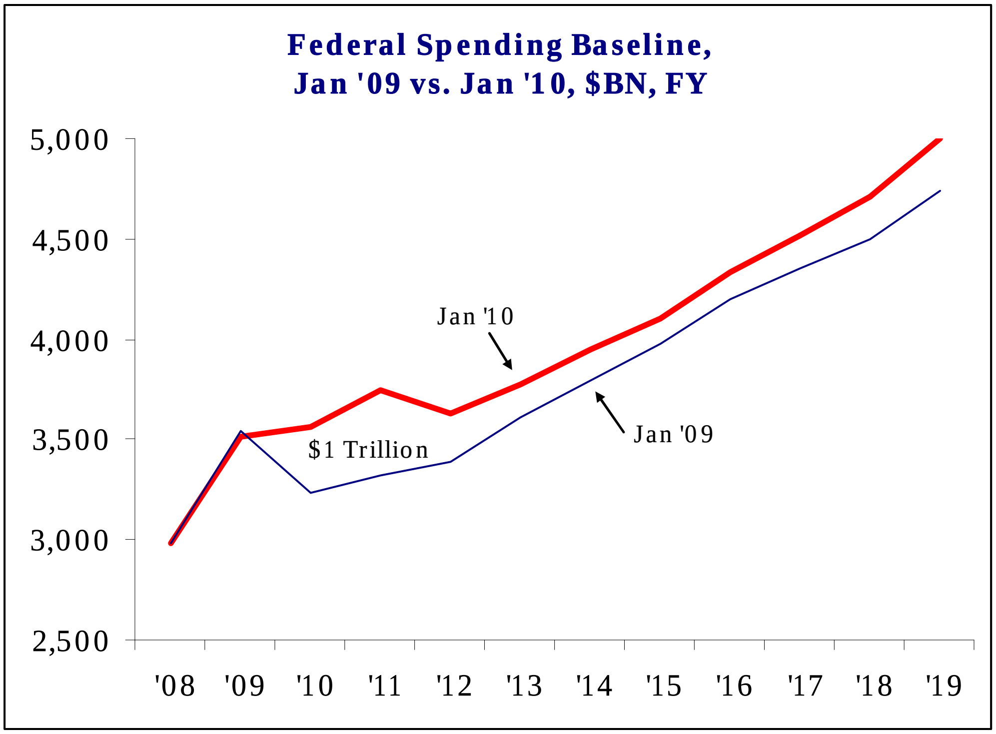


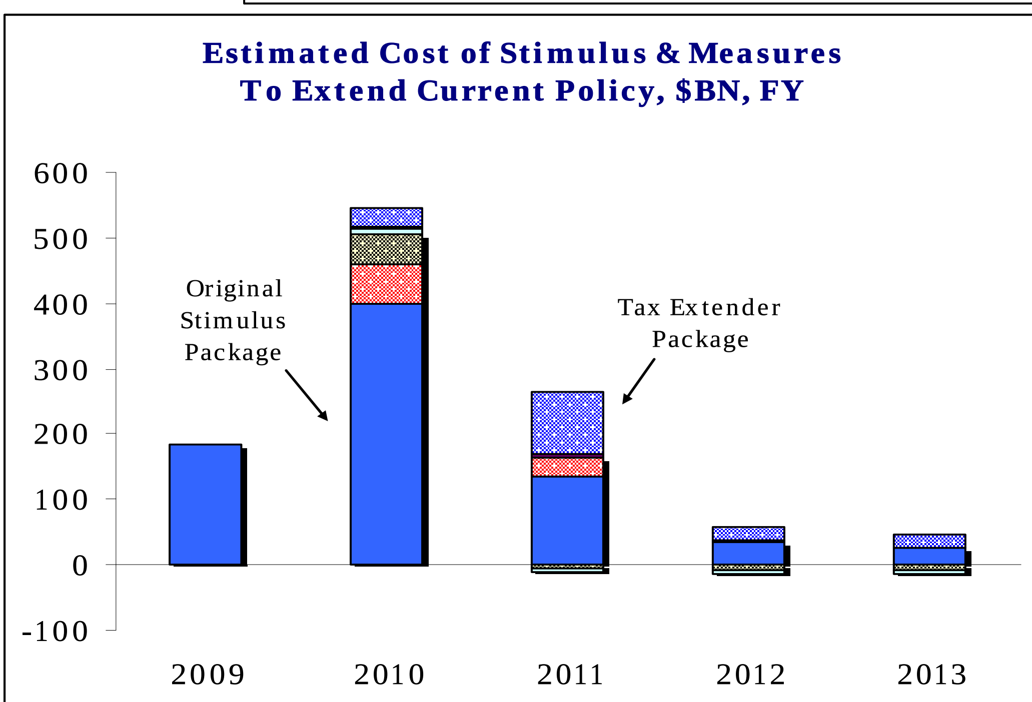


HALF OF THE STIMULUS HAS BEEN SPENT, BUT INCREMENTAL SPEND IS DECLINING

Allocation of First Stimulus Package, $BN

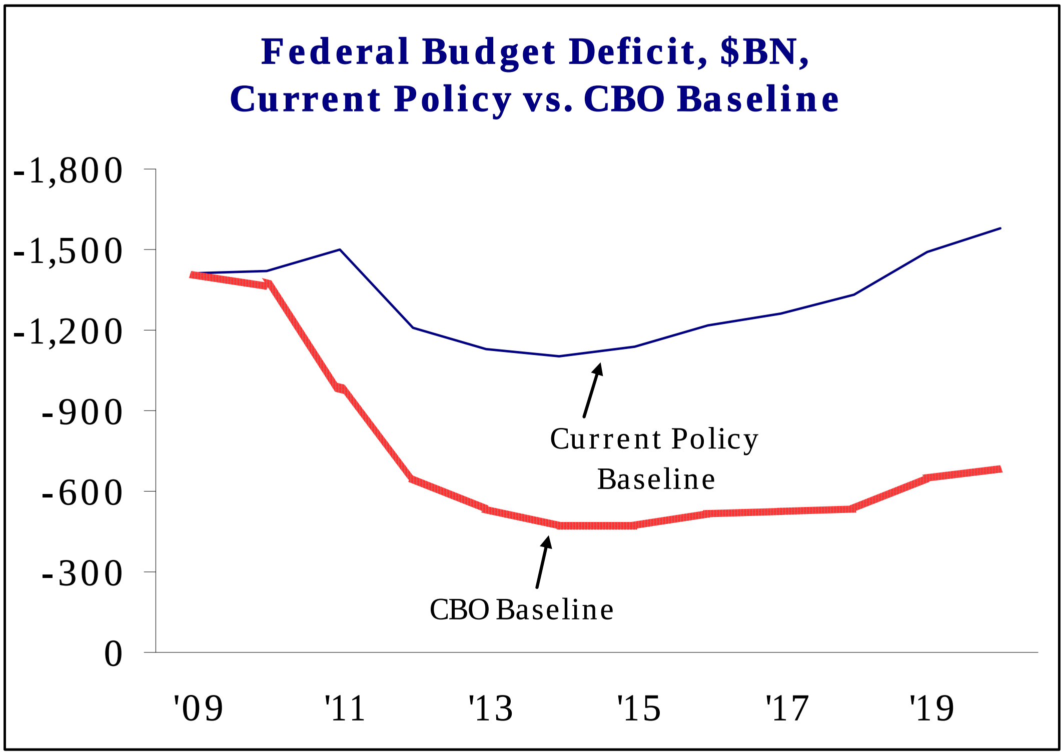
Category	Allocated	Available	Spent	% Spent
Spending	$626.00		$247.15	39.5%
Tax Cuts	$236.00		$209.50	82.4%
Total	**$862.00**		**$456.65**	**52.9%**

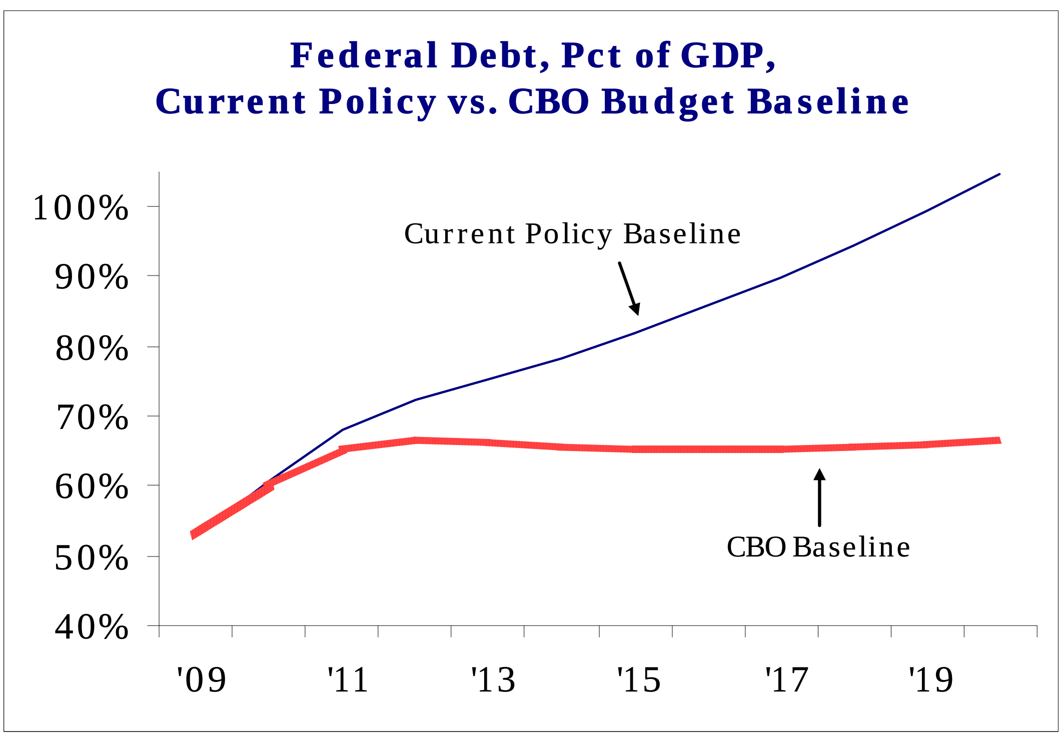




Extension of current policy has resulted in initial stimulus spending moving from $400bn to $550bn for FY '10 and nearly doubling FY '11 spending.

U.S. FISCAL POLICY IS ALREADY TIGHTENING: TEMPORARY EXTENSIONS OF *CURRENT* POLICY REQUIRES PERMANENT TAX INCREASES

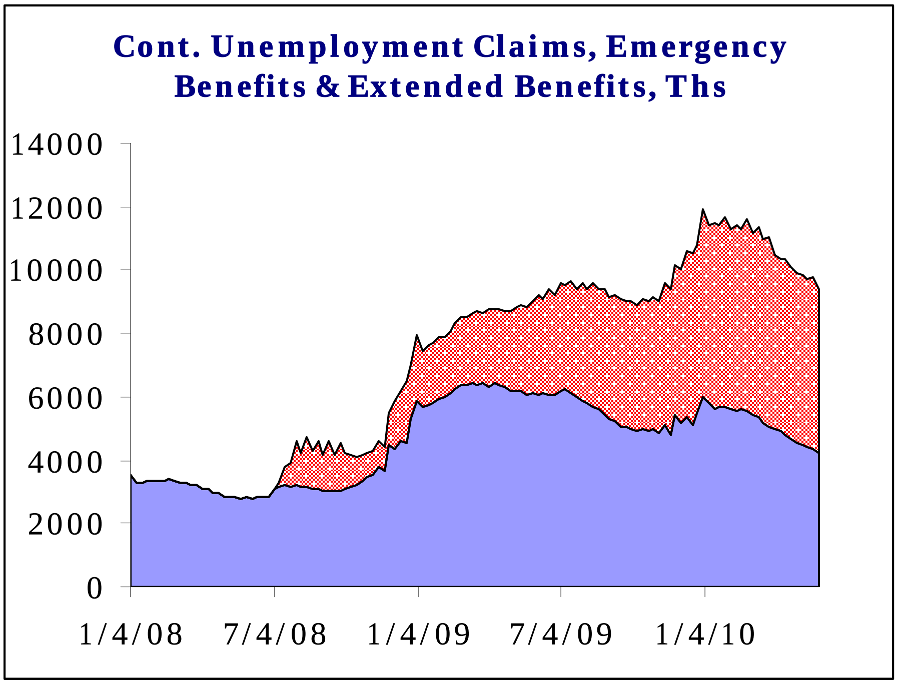


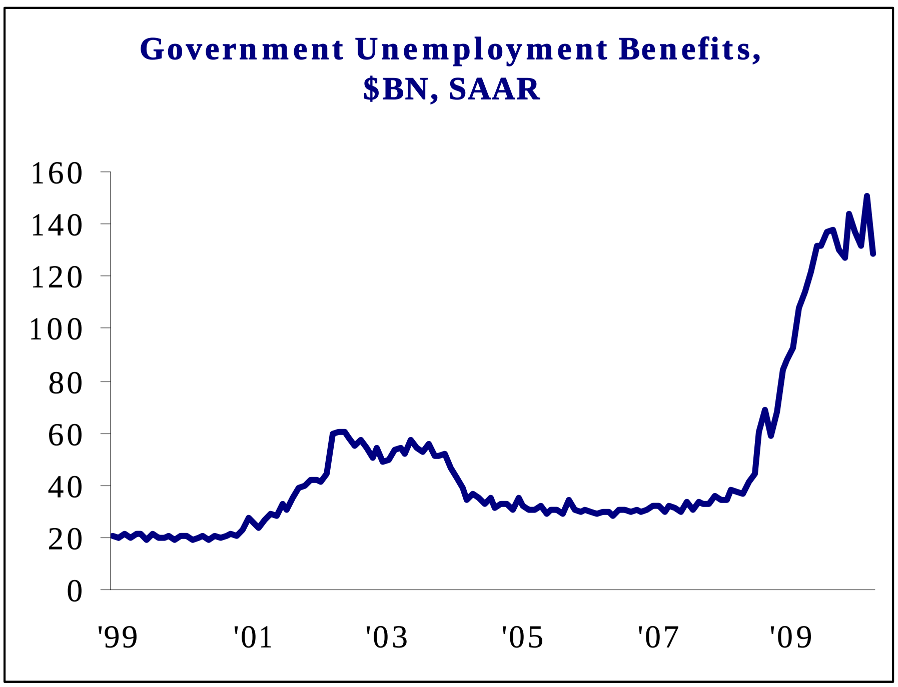


WITH CONGRESS LACKING ACTION ON UI BENEFITS, LABOR DEPT SAYS 1.2MM BENEFITS HAVE BEEN DROPPED

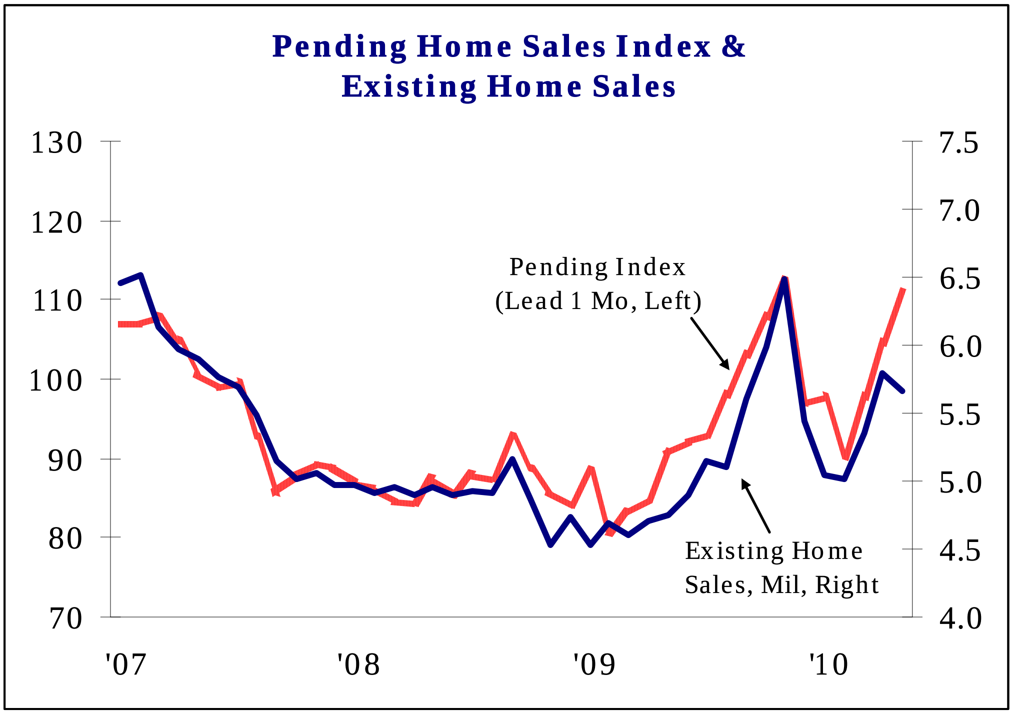
Cumulative Number of Claimants Impacted by a Delay in Extending EUC and 100% Federal Share of EB

	Week Ending 5-Jun	Week Ending 12-Jun	Week Ending 19-Jun	Week Ending 26-Jun	Week Ending 3-Jul	Week Ending 10-Jul
US Total	**19,400**	**323,400**	**903,000**	**1,254,300**	**1,634,800**	**2,026,000**

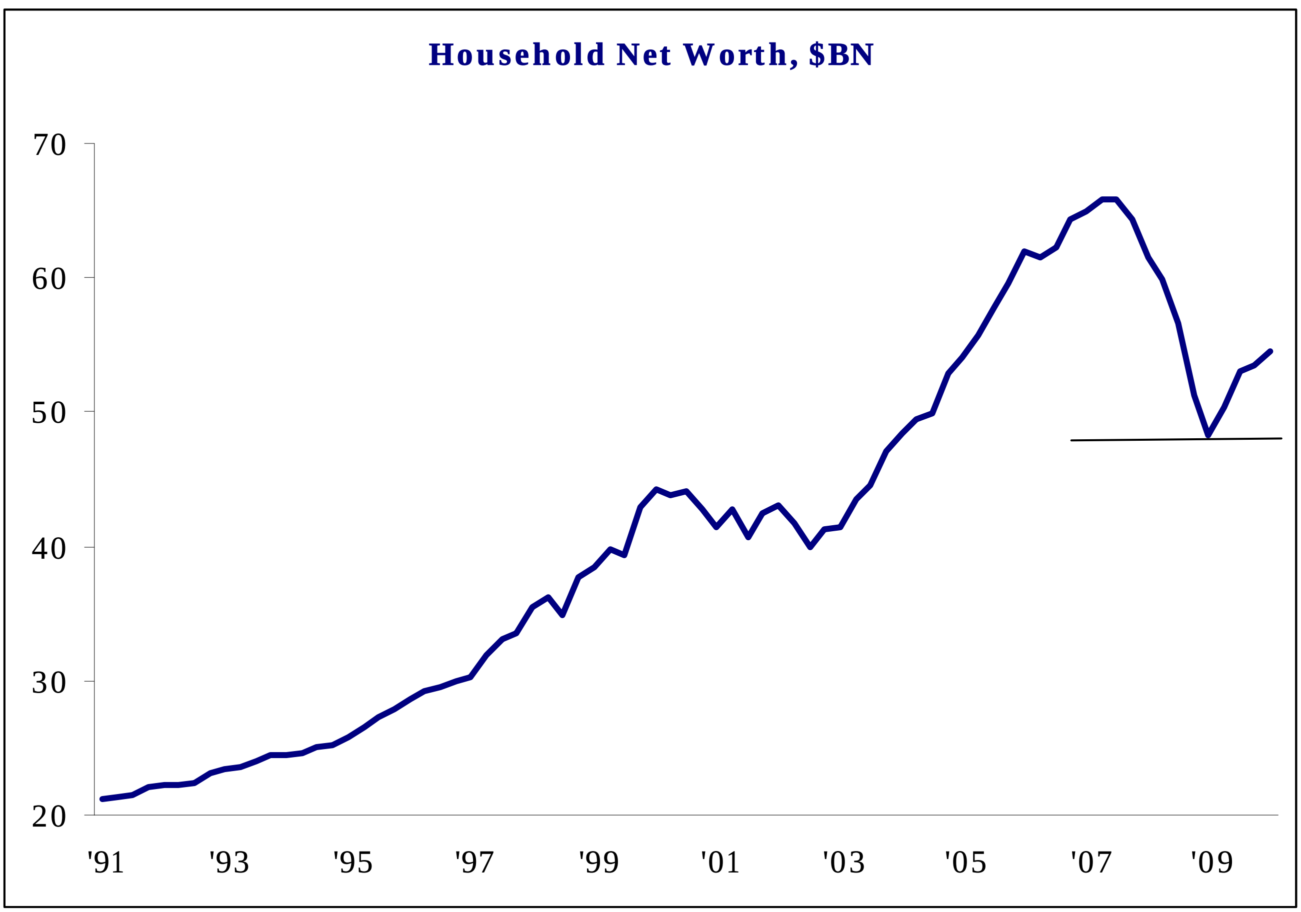




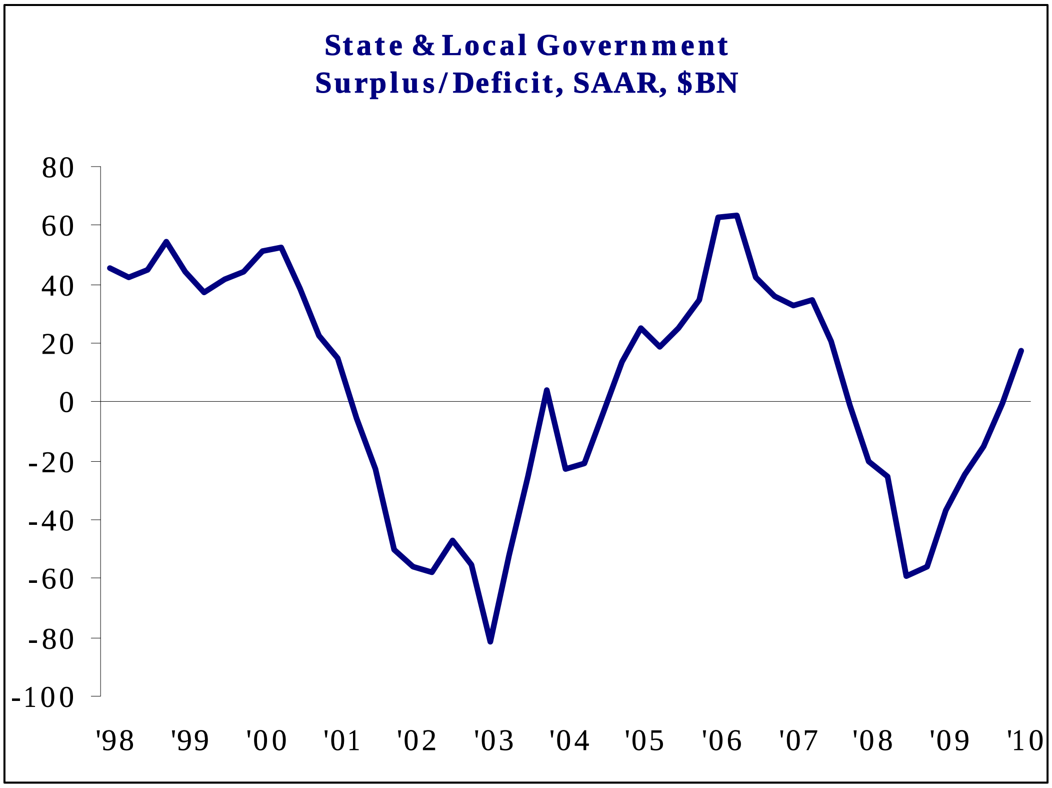
HOUSING IS A MAJOR CONCERN & REINSTATEMENT OF THE TAX CREDIT IS A POSSIBILITY IF ASSET VALUES FALL



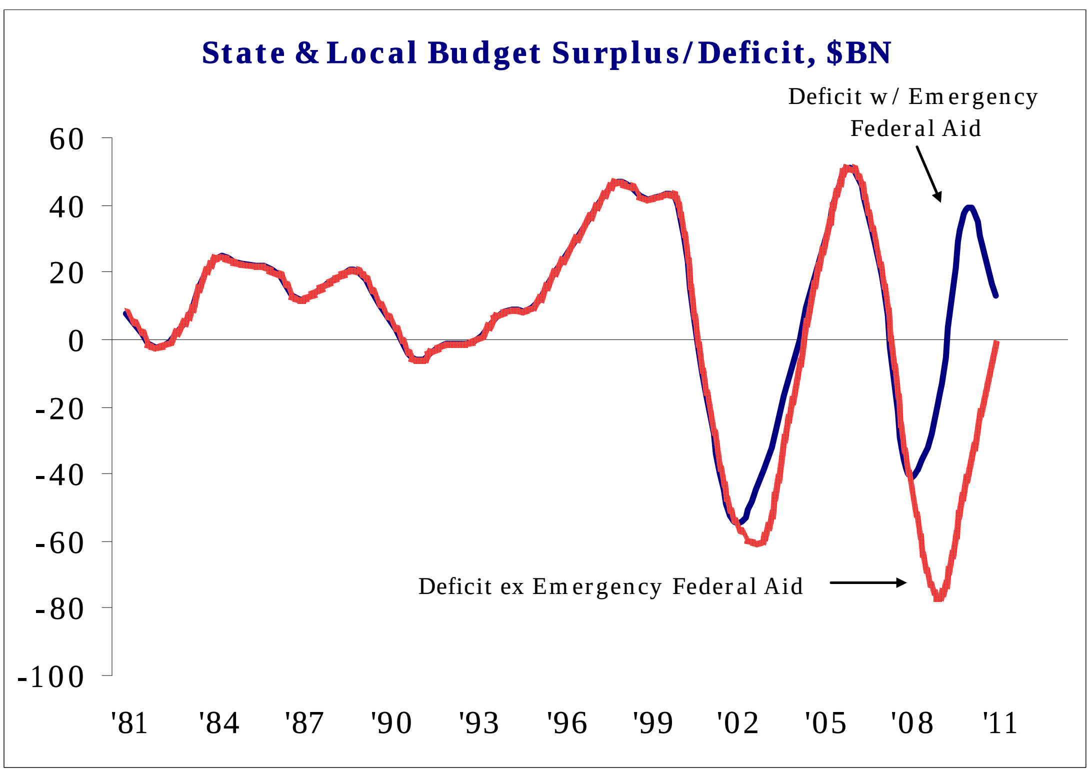
Recent data releases suggest the fundamentals of housing are weaker than policymakers initially anticipated. We are starting to hear calls for the housing tax credit to be reinstated.



STATE & LOCAL GOVERNMENTS ENTER SURPLUS IN 1Q, WILL EARN THROUGH EXPIRATION OF FEDERAL AID



State & local governments had a $17bn surplus SAAR in Q1, the first surplus since 2007 Q3 and the trend is improving. At times the budget fights in state capitols will appear that states are running out of money but these are political, not financial, issues.



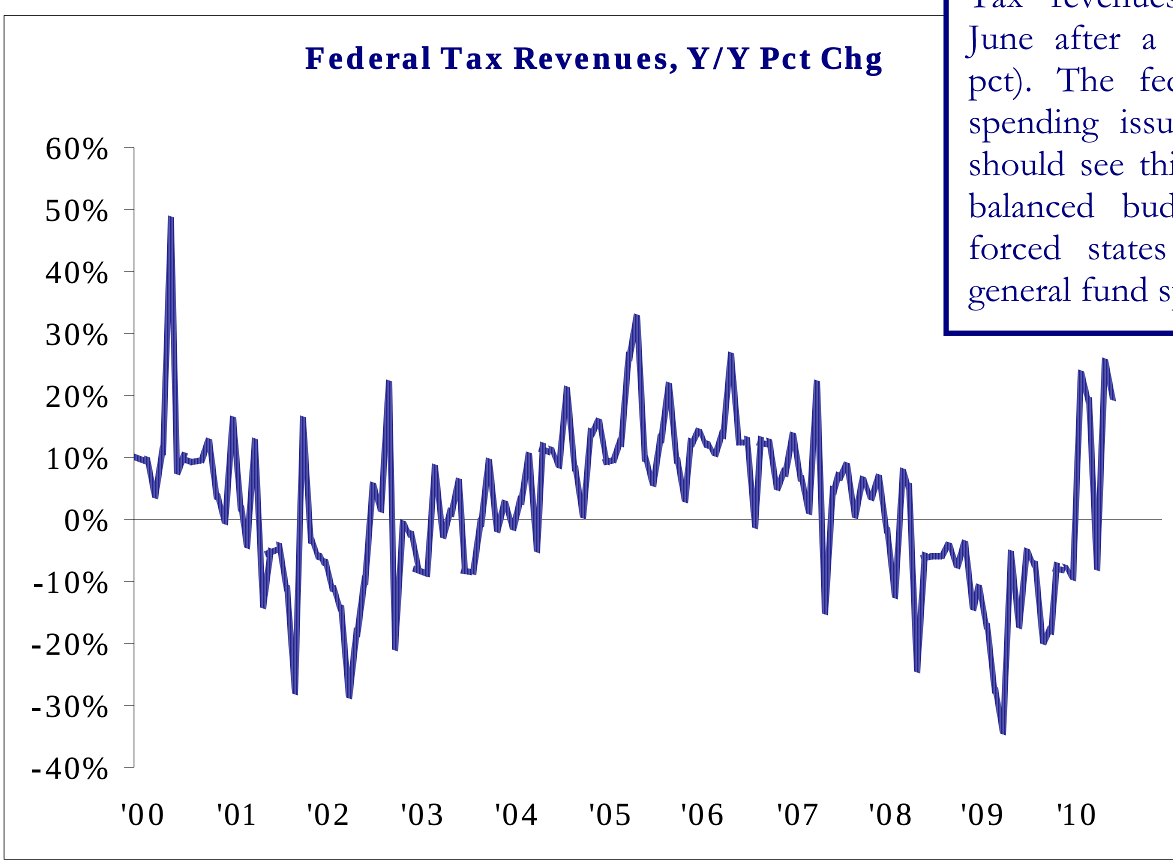
The question we have been asked the most in the past week is the impact the expiration federal aid will have on state & local budgets. Using conservative assumptions, state/local govts would be just about at surplus in CY '11 if they received no federal aid. We expect the governments to produce a $40bn surplus this CY.

ALMOST $50BN OF AID STILL LEFT FOR STATES & TAX REVENUES ARE SOARING

Major Federal Stimulus Provisions for State and Local Governments

Provision	Allocated ($BN)	Available ($BN)	Paid Out ($BN)	Paid Out (% Allocated)
FMAP (Federal Medicaid Assistance Participation)	$81.70	$65.11	$59.34	73%
State Fiscal Stabilization Fund (Mainly education, also public safety and other services)	$53.60	$44.52	$29.04	54%
Total	**$135.30**	**$109.63**	**$88.38**	**65%**

$47bn of discretionary aid still has yet to be spent.



Tax revenues are soaring in June after a stellar May (20+ pct). The federal govt has a spending issue, but the states should see this revenue gain as balanced budget requirements forced states to reduce their general fund spending.

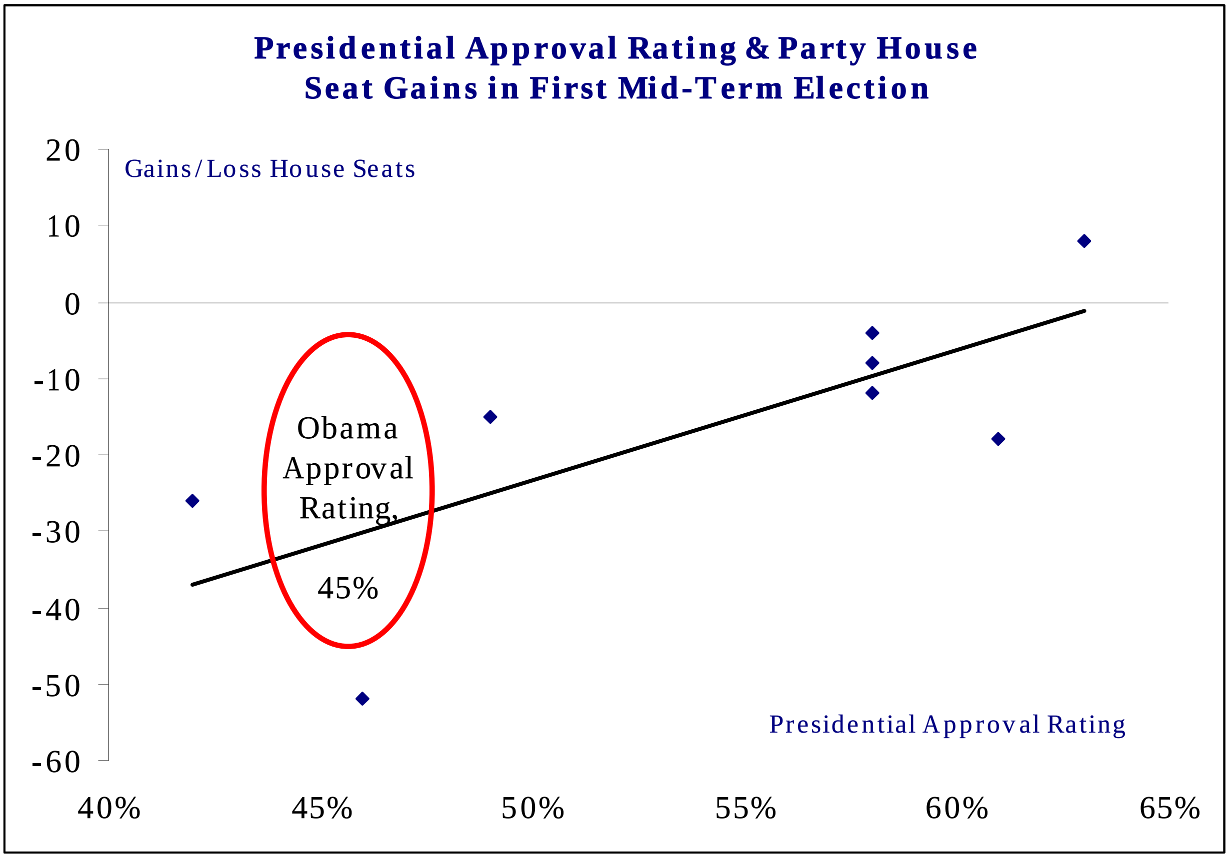
FIRST MID-TERM ELECTION IS NOT KIND TO NEW PRESIDENTS; PRESIDENTIAL APPROVAL RATINGS MATTER

Post-World War II First-Term, Midterm Elections

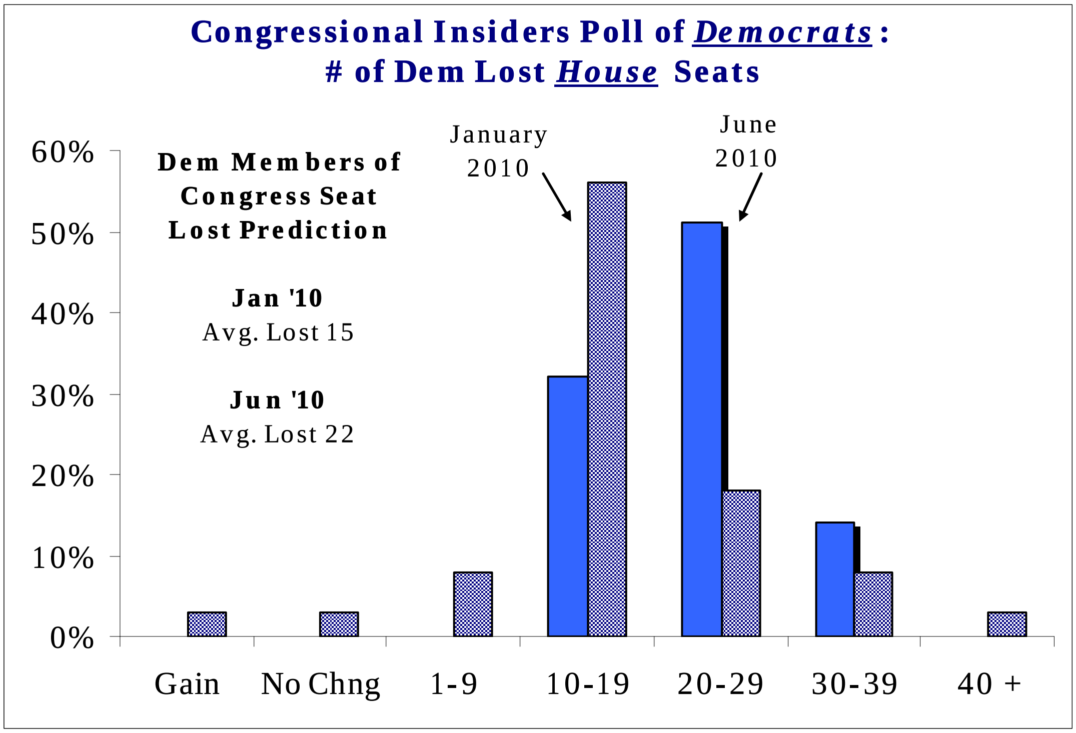
Net Losses for the President's Party

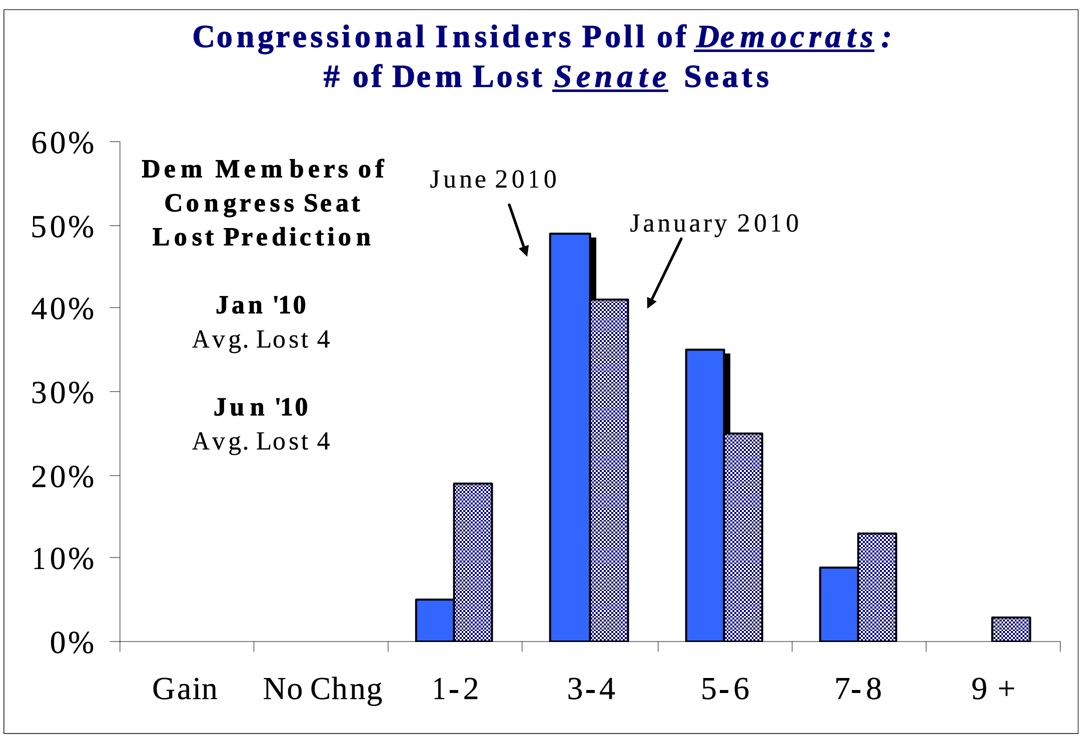
Year	President	President's Last Post-Election Job Rating	House Seats Lost	Senate Seats Lost	Governor Seats Lost	State Seats Lost
1954	Eisenhower	61%	-18	-1	-8	-483
1962	Kennedy	58%	-4	+3	0	-112
1970	Nixon	58%	-12	+2	-12	-264
1978	Carter	49%	-15	-3	-5	-357
1982	Reagan	42%	-26	+1	-7	-158
1990	Bush I	58%	-8	-1	-2	-29
1994	Clinton	46%	-52	-8	-9	-514
2002	Bush II	63%	+8	+4	-1	+177
Average		***54%***	***-16***	***-4***	***-5.5***	***-218***
2010	Obama	50% (1/20)	?	?	?	?

Sources: Cook Political Report, Gallup Poll, Vital Statistics on Congress, National Conference of State Legislatures



DEM CONGRESSIONAL MEMBERS HAVE RAISED THEIR ESTIMATE OF SEAT LOSSES SINCE JANUARY





IN THE 70 CONGRESSIONAL DISTRICTS WHICH MATTER, OBAMA APPROVAL RATING UPSIDE DOWN.

REPUBLICAN INCUMBENTS UP, DEMOCRAT INCUMBENTS DOWN