

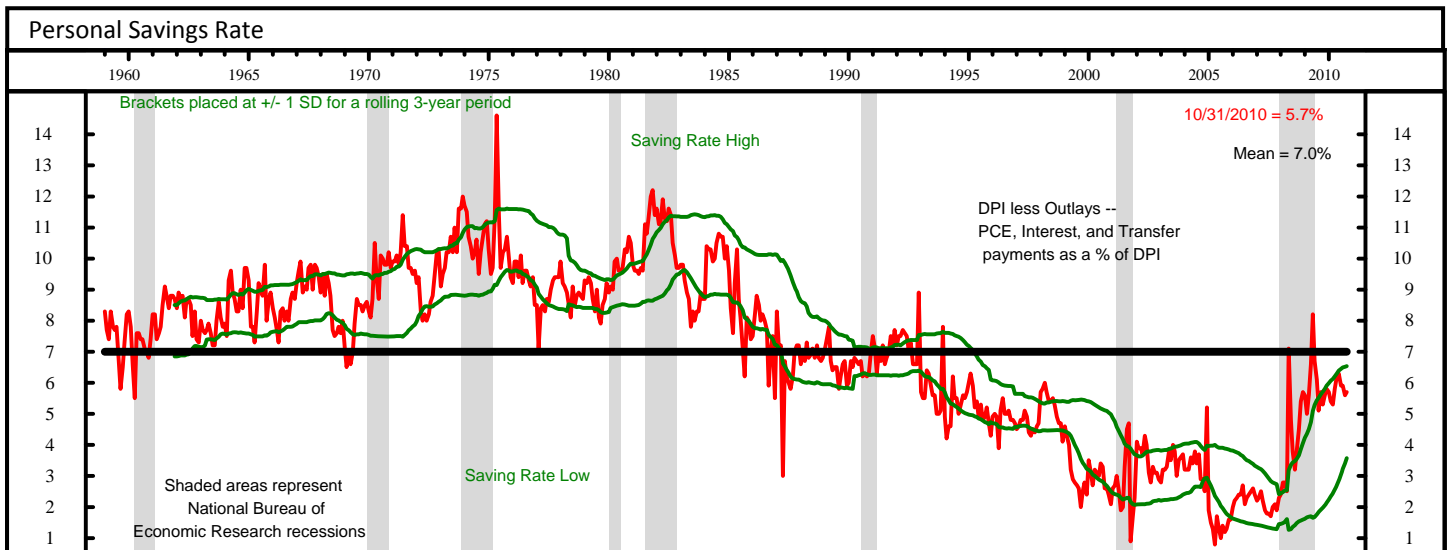


## Ten Conditions for a Sustainable Recovery: Gradual Improvement but Employment and Housing Remain Weak

The 6/22/09 edition of *The Weekly View* set forth ten conditions that we believed were necessary for economic recovery to be sustained. We have revisited this list periodically, last on 6/28/10 at which time most of the conditions were met. In our view, belief in a sustainable economic recovery is critical for higher stock prices over the coming year.

Most of the conditions for recovery remain in place, but the structural headwinds from housing and private sector deleveraging, combined with the eventual need for government spending cuts and tax increases leads us to expect slow growth at best. At worst, a return to recession in Europe thwarts the recovery in the US. Europe's debt crisis and the decision by almost all countries there to reduce government spending and raise taxes worry us. Thus we have all but eliminated exposure to Europe in our portfolios, except for the UK. We are focusing equity exposure on high quality global franchise businesses able to take advantage of growth in Asia and Latin America. We are also investing directly in those regions through our overweight allocation to emerging markets.

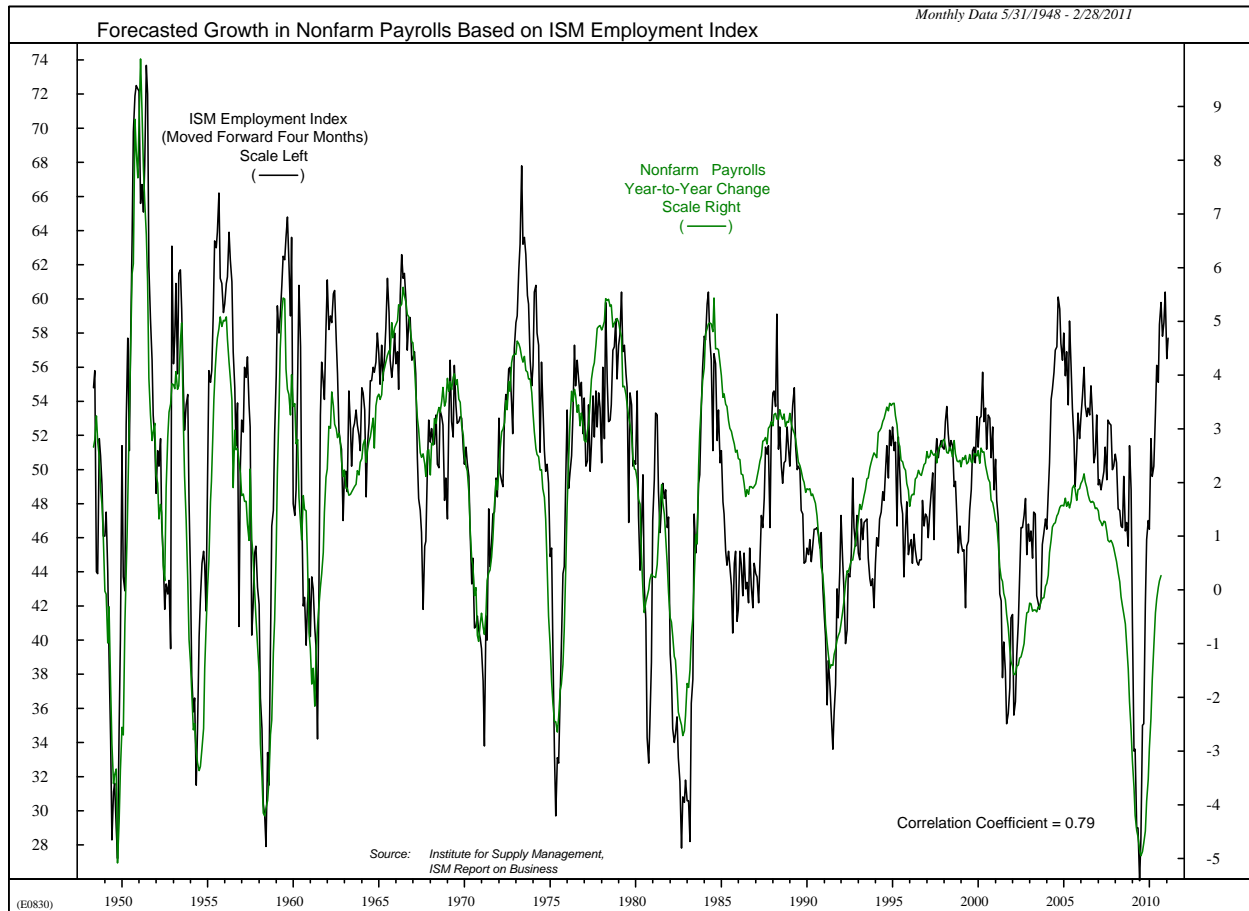
- 1. Savings rates at 8% or higher: Not yet.** Household savings rates were near zero during the housing boom's euphoria because homes were considered an ever-appreciating asset (a savings substitute). The savings rate has rebounded to 5.7%, as the economy and asset prices discount the 'new normal'. Longer term, we expect the savings rate to trend higher due to concerns about high unemployment, the fragile housing situation, and long-term government solvency. Moreover, when the Federal Reserve eventually normalizes interest rate policy, we think households will have greater incentive to save.



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- 2. Home prices within 10-15% of a bottom: Likely.** Home prices are being supported by fundamental measures of value, such as prices relative to income, rents, and inflation-adjusted long term historical trends, but oversupply remains a headwind. The S&P/Case-Shiller Home Price Indices began rising in late-spring 2009, but have stalled since the summer. Home prices have resumed month-to-month declines, following the expiration of home buyer tax credits and the likelihood that foreclosures have not yet peaked (since unemployment is still high and benefits are running out). On balance we think price declines will be limited by record low mortgage rates and an accommodative Fed (see *Weekly View*, 11/22/10).

3. **Mortgage rates below 6.5%: Yes.** This was one of our biggest concerns entering into 2010, but has turned out to be one of the least worrisome with conventional 30-year fixed rates now at 4.2%. We had thought ballooning government debt and the end of the Fed's 'quantitative easing' bond purchases would place upward pressure on bond yields and mortgage rates. Instead, demand for safe-haven investments and additional Fed buying has overwhelmed supply and, with it, the risk of a significant rise in interest rates. At this point, we think a modest rise in real interest rates would be a sign of higher growth expectations. This would suggest that deflation fears are abating and that private credit demand is starting to compete with government borrowing. As it stands, ongoing household deleveraging and balance sheet repair (#10) is not an environment conducive to robust economic growth.
4. **Unemployment rate below 11%: Yes.** Having fallen to 9.6% from a peak of 10.1% last October, the unemployment rate remains within the Fed's 2010 projected range of 9.4% to 9.8%, but above its expected range for 2011. Given the sensitivity of mortgage defaults to unemployment, the economy and financial system cannot be expected to make a full recovery until unemployment begins to trend lower. To put this challenge in perspective, the economy must consistently add more than 200,000 jobs a month to substantially reduce the unemployment rate. With private sector payroll growth averaging only 87,400 per month so far this year through October, there is literally more work to be done, but we expect gradual improvement into 2011 (see #6).
5. **Weekly initial jobless claims falling below 500,000: Yes.** A good real-time indicator of economic activity given its close inverse relationship with real GDP, initial jobless claims are currently 436,000 (four-week average) down from the April 2009 peak of 658,750. This suggests to us that recovery has taken hold. However, we believe further declines towards 400,000 and below are necessary before the positive feedback loop from increasing employment will start to help consumption (the low 300,000s has historically been consistent with around 3% year-over-year real economic growth, which is necessary to put a significant dent in unemployment).
6. **Purchasing Managers Indexes (PMIs) above 50: Yes.** The PMIs provided early indications of recovery — the manufacturing PMI crossed above 50 into expansion territory in August 2009 and the services PMI followed the next month; both have remained above 50 since. Notably, the employment components of the PMIs provide a good leading indication of employment and imply accelerating year-over-year gains in the next few months.



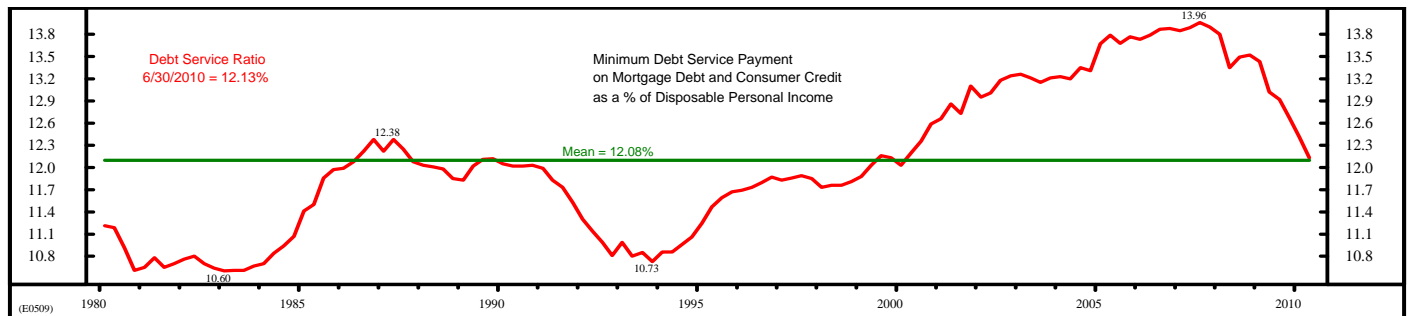
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7. **Inflation expectations under 3%: Yes.** We think the Fed’s goal of economic revival would be harder to achieve if inflation expectations were to rise above 3%. In this event, to maintain its credibility, we believe the Fed would be unable to remain accommodative. However, 10-year inflation expectations are only 2.1% at present, based on the difference between 10-year real Treasury yields at 0.7% and nominal yields at 2.8%. In early 2010, concerns were focused on whether extraordinary Fed accommodation would overstay its welcome, potentially leading to higher sustained inflation. Concerns have now shifted to whether Fed accommodation (alone) can continue to keep the economy growing.
8. **Credit spreads stabilizing or narrowing: Yes.** For us, narrowing credit spreads have been a crucial benchmark of an improved financial environment because companies can roll over debt at attractive levels with interest rates so low. Credit spreads narrowed to ‘pre-Lehman’ levels in September 2009 and have since leveled off, which we view as consistent with stabilizing business conditions. Widening high yield credit default swap spreads (above 700) would concern us, suggesting deteriorating economic fundamentals. Levels currently around 500 suggest few companies face any funding difficulties.



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9. **Positive productivity: Yes.** Rising productivity — making and doing things better and more efficiently, utilizing less time and resources — is the key to long-run prosperity. Without it, an economy is destined to grow no faster than its population. Higher productivity requires investment (by business and government) with no certain outcomes. Fortunately, while nonfinancial productivity growth has decelerated somewhat in recent quarters, it is still up a robust 6% from a year ago. High levels of productivity growth have been evident in higher profits that, if maintained, are likely to lead to greater hiring and investment. In addition, it makes the Fed’s job of reflating the economy — to facilitate the deleveraging process — much easier and less likely to result in damaging inflation (#7) and destabilizing higher interest rates (#3).
10. **Lower leverage: Underway.** As debt is paid down or defaulted on, savings rates naturally increase (#1). This may be seen in household deleveraging with debt service as a percentage of disposable personal income falling to 12% in the second quarter from 14% at its 2007 peak. However, we expect several more quarters, if not years, of deleveraging for the debt service ratio to trough (historically just under 11%). We expect more defaults, ongoing restructuring, asset sales and income generation to be a slow process, but one which will ultimately leave US consumers better able to support sustainable economic growth.



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