



1st Quarter 2008 Market Outlook/Strategy

For the past year, Pugh Capital's outlook has been for weaker than consensus growth. The median Bloomberg forecast calls for GDP growth to average 0.3% for the first half of 2008. We believe that conditions will once again prove worse than consensus expectations. We are now confident that the economy will experience negative growth in the first half of 2008 and that the U. S. is in a recession. The more difficult question is whether we will experience a mild recession or something more severe.

The housing market is more distressed than is reflected in market expectations. An important part of the problem resides in tight financing conditions. Banks and Government Sponsored Enterprises have tightened underwriting guidelines in response to market conditions. However it is a vicious cycle, as lack of credit availability for lower end homes and borrowers has a direct impact on buyers up the housing and credit chain. As housing takes longer to sell and prices fall, it reinforces consumer pessimism and inertia. Meanwhile, the magnitude of losses for financial institutions continues to grow as home price depreciation gains momentum, and the benefits of tight credit are reinforced.

The plight of the consumer has worsened in the face of declining employment prospects. The U.S. economy has lost 85,000 jobs over the past two months and layoff announcements are becoming more prevalent. It appears the nation is now experiencing a persistently weak hiring environment, which further erodes consumer confidence and well being. We expect the unemployment rate to trend upward throughout this year. Consumers are also saddled with higher energy costs, low savings rates and modest income gains. It's no wonder that consumer confidence has fallen precipitously. Further weakness in consumer related sectors is expected.

U.S. policymakers have recognized the catastrophic environment that is plaguing the financial markets, individual homeowners and financial institutions. Monetary and fiscal policymakers are seeking solutions to address the multitude of problems. The Fed aggressively provided liquidity to the markets and went so far as to broker the sudden JPM acquisition of Bear Stearns. The significant policy actions and proposals represent an important inflection point for the markets in our view. While there is not yet a consensus, the market seems a bit more optimistic about the prospects for credit product.

Pugh Capital believes that the week of the Bear Stearns bailout probably represented the wide in spread levels for high quality financial institutions. While the economy will weaken further, we expect the markets will gain visibility about how the problems will be addressed and see glimmers of a better environment in the future. As a result the firm has become more constructive on high quality spread product. During the second quarter we plan to increase our allocation to corporate, mortgage and commercial mortgage securities. While our longer term view is that current spreads are attractive, we anticipate continued volatility given the monumental problems still facing the economy and the markets. We plan to shift our duration target this quarter to an underweight relative to the benchmark.