



### **2<sup>nd</sup> Quarter 2009 Market Outlook/Strategy**

Pugh Capital's outlook is for a weak recovery characterized by below trend growth for the next couple of years. Although the economy is bottoming, numerous imbalances will impede a strong recovery. Inflation will continue its trend lower, driven by tremendous excess capacity, high unemployment and declining demand.

The consumer is under siege. The initial pain arrived via the housing downturn, followed by staggering investment losses. In 2009, job losses and declining wages add to the misery. The unemployment rate has increased from 5.6% a year ago to 9.5% today. We expect unemployment to peak above 10%. Importantly, if discouraged and underemployed workers are included the unemployment rate rises to a depressing 16.8%.

Salaries and wages are under pressure. Corporations, non-profits and governments are all grappling with more difficult financial circumstances. Salary freezes, work furloughs and outright pay cuts are prevalent. There is also tremendous pressure on struggling companies to trim the salaries of top earners. Lower leverage and less credit will exert further downside pressure on salaries. The most recent Employment Cost Index showed private industry wages grew by 0.2% in the first quarter, the lowest reported increase on record. Economic weakness combined with the deleveraging trend increase the possibility of flat to negative wage growth. These conditions are certainly not supportive of an inflationary environment.

Consumers are rebuilding their savings and spending more frugally, a trend that we believe is likely to be maintained. From 1970-1985, the U.S. savings rate was between 8-12%. More recently, the savings rate has moved up from a meager 0.1% at the beginning of 2008 to 6.9% currently. If this trend toward a more conservative financial profile is maintained, it will be one of the key differentiators that will explain sluggish growth coming out of the recession.

The banking system is on a path to recovery, but there are impediments limiting growth potential. Regulators are increasing capital requirements and mandating lower risk profiles. These steps will translate to less leverage and lower profitability. Banks will also continue to battle asset devaluation in their loan portfolios over the next couple of years, causing them to maintain tight underwriting and provide less credit. Less credit availability will result in a slower growth rate for the economy.

Pugh Capital's strategy for the third quarter will be to remain patient, allowing the portfolio positioning to continue its strong performance. There may be modest increases in exposure to the corporate and CMBS sectors, as we still view these sectors as attractive. But the weak economic environment and tight credit conditions will prove extraordinarily challenging. Security selection will be important as weaker players will struggle to survive in this environment. We will also look at security swaps to reposition credit along the yield curve and to take advantage of relative value opportunities. In the CMBS sector we will continue to emphasize seasoned securities. Within the mortgage sector we will overweight higher coupons and minimize duration extension risks.