



Pugh Capital Management

INCORPORATED

3rd Quarter 2009 Market Outlook/Strategy

It has been a year since the credit crunch escalated and the financial system was at risk of shutting down. The Government proactively worked to re-open the markets, minimize counterparty risk and jumpstart the economy. They have been successful and the systemic risk premium has disappeared. However, there are significant economic challenges that need to be addressed and many barriers to a strong and sustained recovery. What will the recovery look like? What is different this time from past cycles?

The current recession has the devastating combination of a credit crunch and an economic slowdown. While banks have raised capital and issued debt, they are not well positioned to propel growth higher. Asset values are still declining, losses continue to rise and regulators are requiring higher capital. Credit is harder to access and is more costly. In addition to tighter credit standards, borrowers are less interested in taking out loans. Unlike past cycles, an increase in borrowing will not be a significant contributor to economic growth.

The unemployment rate currently stands at 9.8%, and is expected to peak above 10%. Importantly, if discouraged and part time workers are included unemployment is at 17%. The economy has lost 7.2 million jobs since December 2007. State and local governments are implementing furloughs to help balance budgets. Wages are trending lower. What might prove different during this cycle is the impact of the deleveraging process on employment. How many high paying jobs will never come back as a result of changes in behavior and business models?

The consumer balance sheet has been under siege over the past two years. Losses in home values and the stock market have eroded wealth and consumer confidence. Debt levels remain near record highs. When less wealth is combined with the weak employment outlook, it indicates consumers are not in a position to spend in sufficient magnitude to pull the economy into a strong growth cycle.

The present engine of growth is the Federal Government, which is spending at unsustainable rates. Economic growth will slow as the programs targeted to consumers expire. The excesses of the past decade have not yet been purged, but the ability to borrow to maintain one's lifestyle has been curtailed. This circumstance should translate to below trend growth over the next couple of years.

Our economic outlook is supportive of a measured strategy that embraces an overweight to the spread sectors, while emphasizing more defensive security selection. Higher beta spread sectors generally do well as the economy recovers. We have positioned the portfolio to take advantage of spread tightening and carry by overweighting sectors such as corporates and CMBS.

However, the tight credit environment favors borrowers who have strong credit profiles and solid balance sheets. During this recovery we do not expect that a “rising tide will lift all ships”. Thus, our strategy focuses on securities that will thrive in a challenging, tight credit environment. We expect interest rates to remain in a narrow trading range as the market grapples with the many cross currents in play.