



Market Outlook/Strategy

The 2011 - 2012 consensus forecast for GDP is 3%. Pugh Capital's outlook is for below consensus GDP growth. In our last quarterly memo, we discussed a number of challenges likely to weigh on the economy. As a result, our expectations were that GDP would fluctuate, with the consensus forecast representing the upper boundary of the range. New risks surfaced during the first quarter as world events have become much more important in influencing the direction of market sentiment and U.S. growth prospects. Escalating conflict in the Middle East and Japan's earthquake, tsunami and nuclear disaster were unforeseen events as we laid out our roadmap for 2011. Rising energy prices further increase the downside economic risks. The current landscape has become more treacherous.

The U.S. economy is slowly healing. Fiscal and monetary stimulus programs have been valuable tools in boosting growth. Strong corporate profitability and cash levels are supportive of an improving environment. The unemployment rate is falling as employers cautiously add to their workforces. Retail sales have surprised on the upside. Offsetting these positives are weaker housing, high debt levels, and declining confidence. The Middle East turmoil increases the risk of higher oil prices, which will further reduce disposable income and consumer confidence.

The significant levels of public and private debt create a shaky foundation for building a *strong* recovery. The magnitude and variety of risks in play around the world increase economic vulnerability. We expect Quantitative Easing to end in June and do not anticipate the program will be extended. The payroll tax cut should also sunset on schedule. State and local governments are addressing budget deficits by raising taxes and cutting expenses. If the Federal Government decides to address its deficit problem, it will also detract from growth. In summary, the U.S. economy faces a number of challenges, which will translate to slower than consensus growth.

While Pugh Capital's moderate growth scenario is positive for risk assets, our expectations of heightened event risk and increased volatility have caused us to shift to a more cautious tactical stance. Over a longer horizon, the firm is still expects risk assets to outperform. The U.S. bond market is a safe haven and is likely to benefit from the flight to quality trade. The higher beta sectors such as CMBS and corporates may experience some modest spread widening as risk premiums increase. While this is our tactical view, we will monitor conditions to determine whether a significant spread widening scenario becomes more likely. We would view significant spread widening as a buying opportunity. Our focus is to be nimble and take advantage of market volatility and resulting opportunities. Mortgage securities continue to benefit from slow prepayments, as government policies makes mortgage financing more expensive and lower housing prices limit refinancing opportunities. We therefore continue to favor higher coupon mortgages. Offsetting these positive attributes is the Treasury's recent decision to reduce its mortgage holdings by \$10 billion per month. We continue to expect a trading range for the 10 year Treasury of 3.00 - 3.75% during 2011. Given our market outlook, we are managing the portfolio duration to be in line with the Index.