



Pugh Capital 3Q2011 Market Outlook/Strategy

In our last letter we indicated that economic growth was slowing even more than our pessimistic projections. That unfavorable trend continued in the third quarter. Our base case is that the U.S. economy manages positive but weak growth. But with GDP averaging 0.85% during the first half of the year, it won't take much to push the economy back into a recession. In the Fed's September statement they acknowledged that "there are significant downside risks to the economic outlook." This is consistent with our view and market concerns.

Unfortunately, there will not be easy fiscal or monetary fixes this time around. Consumers have reduced their debt levels but it will take years to return to historical averages. Job concerns, housing woes, and falling stock prices all reinforce the message to consumers that they need to save more money. Fiscal constraints at all levels of government underscore the inability to spend our way out of the current malaise. It is uncertain whether the Fed can push through another round of quantitative easing given growing discord in its own ranks and political backlash to its policies.

The lack of resolution to Europe's crisis is the most troubling problem facing the global economy. Again, there appears to be no good choices. The crisis demands a massive, concerted rescue plan, but growing political opposition in Germany and other countries make that choice difficult to implement. There is an increasing chance of a catastrophic event in Europe, which would have a negative impact on both stocks and credit. A European recession is quite likely regardless of which scenario occurs. A recession overseas would only make matters worse for the already weak U.S. economy.

While the economic slowdown and European event risk are negative for risk assets, spread levels in many sectors have widened to attractive levels, so we are confident that clients will be well compensated when we increase exposure to the credit sectors. The challenge, of course, is in the timing. There will be no "all-clear" signal from the Fed or the Government or the Street to begin investing. We will likely be early in adding back risk exposure, but expect the peak in credit spreads to occur in the fourth quarter. Pugh Capital plans to scale back into an overweight position in corporates in October. The firm will mitigate the risk of being early by purchasing the securities in which we have the greatest confidence. Well-run corporations and well-structured CMBS dominate our current buy list as we monitor the markets.

Sector weighting decisions will determine fixed income performance in the final quarter of 2011. In addition to corporates, we view the BABS and CMBS sectors as attractive. Both of these sectors have very strong supply/demand fundamentals. The mortgage sector outlook has also improved with the implementation of "Operation Twist." The Fed's purchase of mortgages provides strong support for the mortgage sector, but coupon selection and prepayment protection will be critical. With interest rates likely to remain low for the time being we are positioned with a neutral duration position versus the Index. Our goal will be to opportunistically increase exposure to all of these sectors.