



1st Quarter 2010 Market Outlook/Strategy

The recovery is underway. The median expectation for economic growth is 3%, with the range of forecasts between 1.9% and 4.1%. The median forecast for the Consumer Price Index is 2.1%, while the range is 0.8 - 4.4%.¹ Dispersion is much greater for inflation than it is for growth, indicating that investors are confident about growth rates, but divided about the direction of inflation. Pugh Capital's outlook is for below consensus growth of 2.5 - 2.9%, and for inflation to trend lower over the next twelve months.

The pre-recession economy was defined by easy money, increasing leverage, rising asset prices and strong growth. The recession highlighted the damage inflicted by high unemployment, declining asset values and too much leverage. The recovery must overcome these impediments to strong growth. Large budget deficit problems will constrain public sector spending, and historically high debt levels and elevated unemployment will curb consumer spending. Small businesses accounted for 65% of job growth over the past 15 years, but are pessimistic about future prospects and will likely be slow to hire. Housing and commercial real estate, key assets for wealth accumulation, face the headwinds of prolonged foreclosures. Over the next year, the economic landscape is likely to be defined by household and public sector deleveraging, limited asset appreciation, changing ownership of real estate assets and high and sticky unemployment.

The tremendous excess slack in the economy is supportive of Pugh Capital's expectations for lower inflation. High unemployment and underemployment are pushing labor costs lower. Excess capacity at corporations, combined with strong competition, is also disinflationary. Another theme taking hold during this downturn is an increased willingness for consumers to shift from branded to private label products. This shift has driven costs lower for the consumer through substitution, another positive for minimizing inflation. Probably the biggest threat to our outlook is the potential for reaching a tipping point of too much government debt. This risk, if not properly addressed, could have negative inflationary and economic implications longer term.

Our economic outlook of moderate growth and declining inflation leads us to project that the Fed will maintain an accommodative monetary policy, and interest rates will remain in a trading range. The firm is overweight the corporate, CMBS, ABS and Build America Bond (BABS) sectors. A modest economic recovery will be supportive of these sectors. The corporate sector is well positioned to benefit from the recovery, and spreads still have some room to tighten. Within corporates, we believe financials represent the best value. The commercial mortgage and municipal sectors are lagging the economic recovery and still face fundamental challenges. However, their spreads compensate for their poor fundamentals. Pugh Capital is currently underweight agency mortgages and government securities, which are trading at tight levels.

¹ Bloomberg March 2010 Economic Survey