



2nd Quarter 2010 Market Outlook/Strategy

Volatility and uncertainty have once again moved to center stage. What began with a few isolated headlines regarding Goldman Sachs and Greece rapidly spread to broad based concerns about European contagion and domestic financial reform risk. The oil spill in the Gulf of Mexico, and BP's inept handling of the crisis, added to the global risk aversion sentiment. These concerns have caused investors to revise their growth and inflation forecasts lower and driven spreads to their widest levels of the year for most fixed income spread products.

While the recovery is underway, the U.S. economy is already showing signs of fatigue. The recovery faces headwinds caused by deleveraging, weak housing fundamentals, stubbornly high unemployment, increasing taxes, increased regulations, stimulus withdrawal and a global economic slowdown. The June Bloomberg survey of economists showed the median expectation for 2010 and 2011 economic growth was 3.2% and 3.0%, respectively. June economic data was generally weaker than expectations and we expect growth forecasts to be revised lower. Meanwhile, inflation continues to trend lower, driven by significant excess capacity, weak economic growth and deleveraging. Pugh Capital's outlook is for below-consensus economic growth and for very low inflation over the next couple of years.

The coming quarter is likely to be dominated by volatility. The proposed austerity measures in several European countries would significantly depress growth there for years to come, and may push those economies back into recession. Even China is showing signs of slowing. The financial sector is challenged with regulatory reform and litigation. The proposed financial reform legislation will generally be negative for growth. However, most measures appear beneficial for bondholders, as they increase capital requirements and attempt to limit risk-taking at the large banks. The gulf oil spill just adds to the multitude of risks. The magnitude and varied sources of risk are indicative of challenging times ahead and supports our view that we are entering a period of very slow growth.

Our economic outlook of sluggish growth and declining inflation leads us to project that the Fed will maintain the funds rate at the current level for the next year. Interest rates will be in a trading range, but the yield curve is likely to flatten. We are targeting a neutral duration relative to the Index. The firm remains overweight the corporate, CMBS, and ABS sectors. However, we did reduce exposure to these sectors. We are therefore well positioned to take advantage of the opportunities resulting from the repricing of risk and higher volatility that we expect during the third quarter. We will look to take advantage of wider spreads by increasing exposure to corporates, Build America Bonds and commercial mortgages. Security selection will continue to be defensive, as we expect a prolonged slowdown and continued volatility.