



Pugh Capital 4Q10 Market Outlook/Strategy

The fiscal stimulus package is a game changer for the economy and growth prospects for 2011 have become more positive. We have revised our previous slow growth outlook higher, and now expect a moderate growth scenario for 2011. The risk of a double dip scenario has also diminished. Most economists have increased their GDP forecasts for 2011 by 0.50-1.00%. While the balance of power has shifted to a stronger growth scenario, headwinds still exist and are likely to resurface throughout the year.

In late 2010 many indicators began to show positive momentum, including personal income, consumption and manufacturing. Household net worth improved during the third quarter, as capital gains from equity appreciation more than offset real estate losses. Confidence is rising for both consumers and small business owners. The November elections and the passage of a significant stimulus package removed some of the uncertainty that had weighed down the recovery and paves the way for stronger growth. Importantly, the downside risks to U.S. economic growth have been minimized. The combination of improving fundamentals in some segments of the economy, a consumer-oriented fiscal stimulus package, and the actions of the Fed to actively encourage investors to embrace riskier assets all support a more positive outlook for the first half of the year.

While optimism is running high, there are a number of challenges that are likely to weigh on the economy. The unemployment rate will trend lower, but still remain at an unacceptably high level. If consumers decide to use the payroll tax cut to pay down their still high debt levels, growth will not be as strong as market expectations. State and local governments will continue to experience contracting budgets. Housing remains weak and creates an overhang that impacts a significant portion of the population. Stable to declining home prices will offset some of the benefits of a rising stock market. Finally, the longer term challenge and overhang for the economy is the increasing Federal deficit. At some point, fiscal policy must address this issue. Outside of the United States, China is tightening and the European Union is in crisis.

Core inflation will continue to be low and well behaved this year. The Fed's goal is to modestly increase inflation and they will ultimately have some success, but the impact will be further down the road. The large output gap and high unemployment rate provide support for continued low inflation over the next year. However, inflation in emerging economies and commodity based assets has accelerated, providing some cause for concern.

The Fed will maintain short rates at current levels through 2011. Fed purchases should also provide support to the market over the first half of the year. We expect a trading range in the 10 year of 3.00-3.75% during 2011. Interest rate volatility is likely to provide portfolio positioning opportunities within the trading range. Quantitative easing, in combination with fiscal stimulus, sets the stage for risky assets to outperform treasuries. We favor higher beta securities in this environment and expect corporates, Build America Bonds, and CMBS to outperform other sectors. Mortgages valuations have improved as rates moved higher. We therefore will look to increase allocations to MBS.