Economic Update

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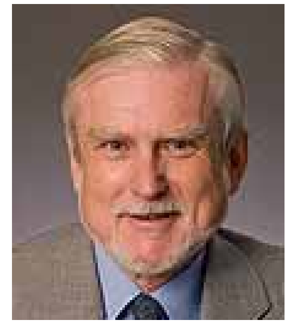

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We continue to expect a sustained global economic expansion, with a global real GDP growth rate of about 4% in both 2010 and 2011. We continue to expect the lagged impact of simultaneous macroeconomic stimulus around the world to generate a sustained global expansion.

The strongest economies in 2010 and 2011 should be those with three characteristics: (1) public policy which places the highest priority on economic growth relative to other objectives, (2) no significant debt overhang and (3) rising productivity of the workforce due to the diffusion of modern technology and business practices. This would include some of the largest emerging market countries.

The U.S. should have the strongest recovery among the major industrial countries. Relative to a normal recovery in the first four quarters after a severe recession, U.S. economic growth should be "subpar" at a real GDP growth rate of 3% to 4%, well below the growth rate of 8% or more, which would be normal after such a severe recession. However, U.S. economic growth should also be "above trend," with growth higher than long-term trend growth near 2.5%. The U.S. economy bottomed in mid-2009, but the labor market initially lagged the recovery. We believe that U.S. employment has just bottomed and should now show sustainable positive growth, even excluding the coming surge of temporary Census jobs.

In Europe, the recent recession has surfaced underlying vulnerabilities. In the early years of the euro, countries in the periphery benefited from low interest rates due to a form of "borrowed credibility" from their association with core Europe, especially Germany. Periphery countries have tended to have somewhat higher inflation rates than Germany, so the real policy rate (short-term interest rate minus inflation) was lower in these countries. This temporarily stimulated their growth, but there was a cumulative loss of competitiveness. While other countries within the euro benefited from German policy credibility, they often did not fully share favorable German fundamentals. Germany has its own economic issues but it does have a long history of monetary discipline, export competitiveness, favorable cost control, a sedate housing market and some degree of fiscal discipline.

If the periphery countries had not been part of the euro, serious weakness in their economies might have fostered a decision to substantially devalue their national currencies to shift the mix of their economy towards exports at a time of weak domestic demand.

However, in recent years, these countries have been sovereign borrowers in the euro, not in their own currencies. As a result, devaluing out of the euro would now be a very disruptive path, both for them and for those countries whose banks own a great deal of their debt. We believe that the most likely case is that no countries within the euro will default or leave the euro any time soon, but the odds are high that the weaker countries will be forced to pursue a restrained fiscal policy in order to be eligible for implicit or explicit financial support, most likely within Europe but possibly from the IMF.

It is still uncertain (1) how much support stressed countries such as Greece will need and receive, (2) how severe the contagion of financial stresses in Europe will be and (3) how much recent events will weaken the economic growth prospects for Europe. Greece represents a small percentage of European GDP while the export competitiveness of the large German economy has just been improved by the weakness of the euro. If financial contagion within Europe is not too severe, the benefits of euro weakness to revenues and profits from exports to the rest of the world could offer some offset to the growth-dampening impact of financial stresses on the European economies. However, European fiscal policy is likely to be hamstrung for some years, with Germany having just tightened its long-term fiscal targets and peripheral countries struggling to restrain the path of their future deficits. Our most likely case is that worst-case scenarios for financial contagion in Europe will not occur, that stresses will gradually ease over the coming year and that Europe will have slower growth than most other industrial countries for an extended period of time. We believe that slow growth is more likely than a double-dip recession. Europe was expected to be a laggard in the global economic recovery in any case, even before the recent strains, so the negative impact on the global expansion should be limited if financial contagion does not worsen.

We expect strong growth to persist in such large emerging market countries as China, India, Brazil and Indonesia. China adopted a hyperstimulative policy in late 2008. It worked and policy is now shifting towards neutral. We expect Chinese economic real growth to run at or near 10% in the near term. Chinese economic policy was appropriately hyperstimulative at the worst of the global recession and is now undergoing an appropriate shift to neutral. The provision of excess liquidity is no longer cyclically appropriate. At some point over the next year, the policy shift may include the onset of gradual revaluation of the RMB against the U.S. dollar as such a policy shift is likely to become increasingly appropriate in response to Chinese economic fundamentals.

We are optimistic about the prospects for the U.S. to have a sustained economic expansion at a 3% to 4% rate. However, skeptics propose three main negative theses on the U.S. economy: (1) there is so much vulnerability in the consumer and housing sectors that the U.S. is likely to have a double-dip recession, (2) the excess liquidity provided by the Fed is likely to trigger a major inflation upsurge over the next year or two and (3) there will be a deficit-triggered rate spike in response to high budget deficits. We strongly disagree with the first two scenarios (*double-dip recession*, *inflation surge*) and believe that the third is substantially premature (*deficit-triggered rate spike*).

We do believe that the drag of the long-term hangover in the housing and consumer sectors does help explain why the economic expansion is likely to run closer to a 3%-4% growth rate than the growth rate of 8% or more that might be expected if the normal cyclical pattern after severe recessions was repeated. However, we believe that the odds of a double-dip recession are quite low, given the substantial easing of financial conditions and the likely persistence of stimulative monetary policy. We believe that employment has bottomed. We reject the idea that consumer spending growth and deleveraging cannot occur at the same time. It depends on the circumstances. Consumer spending growth and deleveraging can easily occur together if wage and salary income is growing, house prices stabilize and the stock market recovery persists. The passive deleveraging via a combination of low credit usage for new spending and amortization of existing debt should not prevent an expansion of consumer spending.

Double-dip recessions are rare. The main precedent was that the brief 1980 recession was followed by a severe recession in 1981-1982. However, the intervening recovery did not die a natural death. The economic recovery in late 1980 and early 1981 was halted by aggressive monetary tightening which was designed to generate a renewed recession and a slowing of inflation. At the time, the priority of the Federal Reserve was to halt an uptrend in inflation which had persisted for many years. So the Fed engineered a huge interest rate increase, which helped drive the 90-day Treasury bill rate to 17%, the prime rate to 21.5%, the 10-year Treasury yield to 16% and generated an inverted yield curve. It is hard to believe that anyone at the Fed was surprised when this severe interest rate spike in 1981 caused a second recession. In contrast, current U.S. monetary policy is anti-deflationary rather than anti-inflationary. The 90-day Treasury bill rate is 0.15%, the prime rate is 3.25%, the 10-year Treasury bond yield is 3.7% and the yield curve is very steep. One of the current objectives of the Federal Reserve is to drive core inflation back up towards 2% from the 1% pace likely to be reported for core inflation by the end of 2010. Our overall conclusion is that the stark difference in monetary policy is likely to result in a stark difference in outcomes. There is a substantial difference between a Treasury bill rate of 0.15% and a Treasury bill rate of 17%. We do not expect a double-dip recession.

We believe that U.S. inflation is likely to remain low for the next several years. One can view the inflation outlook from a variety of perspectives. From an output gap perspective, the excess supply of labor in the U.S. and competing industrial countries is likely to persist, holding down wage inflation. In addition, economic policies in emerging markets are tilted towards expanding the capacity to export to the advanced countries. Emerging market demand for energy continues to increase but we believe that the still depressed level of economic activity in the developed countries and the expanding supply of some energy sources (such as natural gas) should prevent a rapid tightening of the supply/demand balance for total energy beyond what has already occurred. From the current level of energy prices, we do not expect major upward pressure on the U.S. inflation rate in the near term.

The monetary perspective on inflation is complex in the current context since the transmission mechanism from high levels of excess reserves to credit growth and ultimately to inflation has been disrupted by the aftermath of the financial crisis. Bank balance sheet growth has been weak in a context of (1) weak loan demand to finance new debt-financed spending, (2) continuing loan losses in keeping with market expectations and (3) procyclical regulatory tightening, both announced and anticipated. The equity and bond markets have recovered, driving down the cost of equity and bond finance to companies that can access the securities markets. However, credit availability is still relatively tight for small and mid-sized businesses.

We believe that excess reserves are currently dormant and at some stage will begin to be mobilized. At that stage, the central bank will need to reduce the excess reserves. We do not doubt the technical capacity of the central bank to achieve that goal. While the technical complexities of the exit strategy will preoccupy short-term traders for the next year, their significance for long-term investors is limited. Because near-term inflationary pressures are weak due to excess unemployment and excess productive capacity, we believe that central banks (including the Fed) will have sufficient time to remove the excess reserves before the seeds of a major inflation upsurge have been planted. From a longer-term perspective, Federal

Reserve independence in making monetary policy is critical to the avoidance of a major sustained upsurge of inflation. The best practical hope for a well-managed fiat currency is for the central bank to have enough political independence to correct its mistakes on a timely basis.

Another perspective on inflation is the currency perspective. Over the last year, we have not shared the expectations by some for a plunge in the dollar since we have believed that U.S. growth and inflation outcomes would be favorable. In addition, the other developed countries with major financial currencies suitable for international reserve allocations (euro, pound sterling, yen) have their own problems.

What about the emerging market currencies? Due to their currency undervaluation, strong real growth and rising interest rates, some of the emerging market currencies are likely to appreciate against the major financial currencies, including the dollar. However, the level of emerging country labor costs will still be well below those in the developed countries, even if the difference in labor costs narrows slightly. Thus the most likely result of any weakening of the major financial currencies against some of the major emerging market currencies should be a reduction of disinflationary pressure on the inflation rates of those developed countries, rather than the creation of any major inflation upsurge.

Another negative thesis is that high budget deficits will generate an interest rate spike which will disrupt the economic expansion. On this issue, we have a more confident view on the short-term outlook than on the long-term outlook. While we expect a normal cyclical updrift in interest rates over time, we believe that near-term cyclical fundamentals imply that very high budget deficits can be financed in an orderly way over the next year or two. The very steep yield curve should be helpful in encouraging the purchase of Treasury securities by financial institutions and individuals who wish to restore their liquidity and financial flexibility. Inflation is low and we do not expect the Fed to begin the first rise in the Federal funds rate or the IOR (interest on reserves) rate until late 2010, possibly not until early 2011. We expect a gradual upward drift in interest rates over time rather than any dramatic spike.

We are less sanguine about the long-term risks of persistently high structural budget deficits in the U.S. In early March 2010, the Congressional Budget Office reviewed the President's budget proposals and raised its estimate of the national debt for 2020 to $20.3 trillion, substantially above its January 2010 estimate. According to the CBO, "Under the President's budget, debt held by the public would grow from $7.5 trillion (53 percent of GDP) at the end of 2009 to $20.3 trillion (90 percent of GDP) at the end of 2020. As a result, net interest would more than quadruple between 2010 and 2020 in nominal dollars (without an adjustment for inflation); it would expand from 1.4 percent of GDP in 2010 to 4.1 percent in 2020." The CBO estimates Federal spending as a share of GDP to rise 3.4 percentage points to an average of 24.1% for 2011 to 2020, well above the historic 20.7% average. The budget deficit is forecast to fall to about 4% of GDP in 2014 and then rise steadily, reaching 5.6% of GDP in 2020. A further uptrend is likely thereafter, given demographic realities. For the year 2020, the CBO estimates a budget deficit of $1.253 trillion, consisting of its March 2010 baseline estimate of $683 billion plus the effects of the President's proposed budget, namely Federal revenues lower by $150 billion and Federal spending higher by $420 billion. Some of these increments represent adjustment of politically unrealistic assumptions traditional for baseline budget estimates and some reflect new initiatives. Investors may wish to review both the "Preliminary Analysis of the President's Budget Request for 2011," dated March 5, 2010, and "The Long-Term Budget Outlook," dated June 2009, both available at www.cbo.gov.

What is needed is a *credible path to a balanced budget*. We are skeptical whether that will occur without a future crisis. The political left and political right fundamentally disagree about the most appropriate Federal spending share of GDP over the coming years and appear quite unlikely to modify their views. Political conditions do not appear favorable for a major compromise to deal with the structural budget deficit prior to a fiscal crisis. The U.S. may be gradually drifting towards a "future fiscal train wreck," perhaps four, five or six years down the road. The cyclical conditions under which this might occur would tend to be the opposite of today's cyclical conditions: (1) high and rising inflation, (2) aggressively restrictive monetary policy and (3) "crowding out" stress as persistent demand for Treasury financing conflicts with strong corporate credit demand due to a financially illiquid corporate sector stressed by weakening profits. We do not expect such cyclical conditions for a number of years, so any "future fiscal train wreck" is unlikely to occur soon. It is somewhat encouraging that public concern about excessive long-term budget deficits is rising, but the long-term fiscal outlook remains worrisome.

It is easy to overestimate the inevitability of adverse economic trends and to underestimate how powerful policy decisions can be to create positive or negative outcomes. If the U.S. wants a better economic outlook, Americans need to make better economic decisions. The same is true for other developed countries facing demographic aging, fiscal stresses and the prospects of slow economic growth.

In the meantime, we have an optimistic view of the cyclical prospects for sustained global economic expansion.