



Investment Strategy Outlook

Please refer to Appendix – Important Disclosures.

Weight of the Evidence Slips to Neutral

Highlights:

- Economic Fundamentals Down to Neutral
- Fed Moves Towards Quantitative Easing, Part II
- Sentiment Bullish, But Optimism Rising
- Seasonal Trends Warning of Fall Weakness
- Broad Market Keeping Pace with Indexes

The weight of the evidence has deteriorated over the past month as we have downgraded our view of the Economic Fundamentals from bullish to neutral. The other scores remain unchanged. This drops the overall weight of the evidence from a mildly bullish to neutral stance. **A Neutral scoring is consistent with the broadly defined trading range environment that has emerged for the stock market.** Since mid-May, the S&P 500 has traded between 1020 and 1130, with much of that time spent between 1050 and 1130. Within this range, we continue to recommend that investors use periods of weakness to add to income-yielding areas of the market and use periods of strength to reduce exposure to cyclical areas of the market. The net effect of portfolio changes should be equity exposure that is tilted toward lower-beta, higher-quality areas of the market.

Outlook Summary

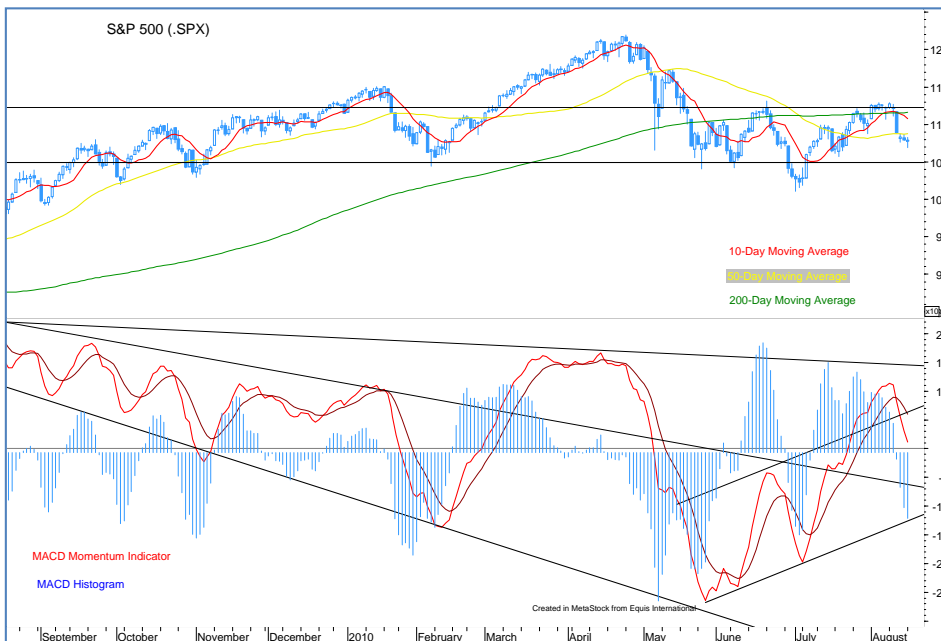
Marketweight Exposure to Stocks, Underweight Bonds

Trading Range Environment Intact

Near-Term S&P 500 Support Near 1065; Resistance Near 1130

Defensive Sectors in the Lead

Investment Climate Favors Quality & Income Across Asset Classes



While stocks rallied over the course of July, the momentum gained during that move has dissipated in August, and the trend indicators are mixed. **Risk management investment approaches that focus on the preservation of principal remain appropriate even absent strong evidence that the cyclical rally off the March 2009 lows has run its course.** Near-term downside risks include mounting seasonal headwinds as we move into the September-October timeframe, a continued rise in levels of investor optimism, and potential breadth breakdowns. Longer-term

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Market Strategy

August 17, 2010

threats remain deflationary risks and the loss of economic momentum. *Tactical investors should consider using near-term rallies to reduce equity exposure in advance of anticipated pre-election weakness.*

Economic Fundamentals have been downgraded from Bullish to Neutral.

We do not fall into the double-dip camp of those looking for another recession in the near term. We have, though, maintained the view that as the effects of government's intervention in the economy faded in the second half of 2010, economic growth would slow. That scenario looks to be playing out. This is some growing concern over the pace at which the slow-down is occurring and indeed the pace of growth prior to the slowdown, but a double-dip remains unlikely at this point. The originally reported GDP growth of 2.4% for the second quarter is likely to be revised substantially lower. Recently received June data on inventories and trade (which were not available when the initial Q2 GDP estimate was released) shows growth tracking closer to 1.0%.

Overhanging the economic outlook is persistent fragility

Indicator Review

Fundamental Factors

Underlying Economic Fundamentals	Neutral	0
Federal Reserve Policy	Neutral	0
Valuations	Bearish	-1

Technical Factors

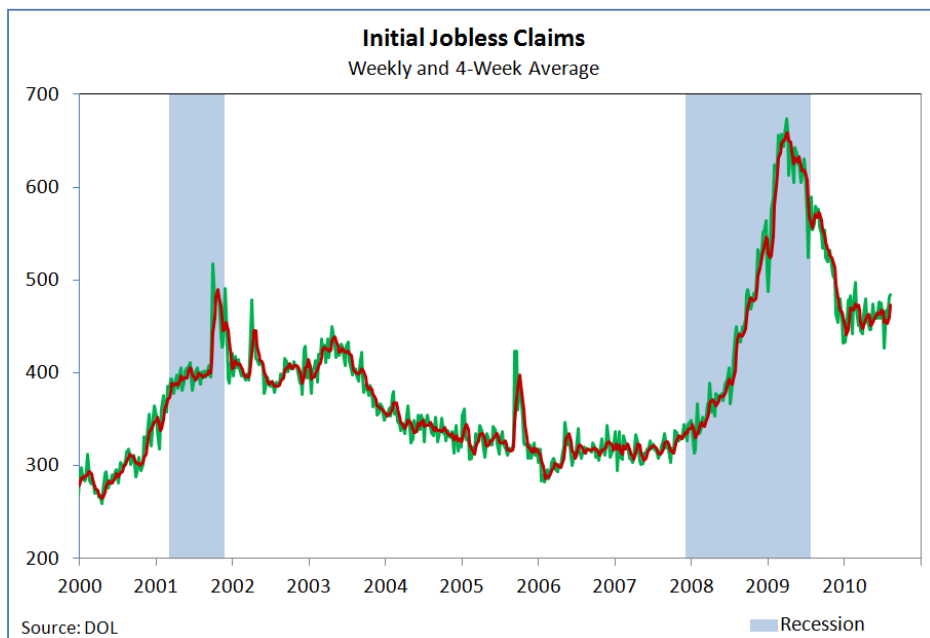
Investor Sentiment	Bullish	+1
Trends/Seasonal Tendencies	Neutral	0
Tape/Breadth	Neutral	0

Weight of the Evidence

Neutral 0

in the labor market and renewed weakness in the housing market. **After a return to payroll growth earlier this year, recent labor market trends have become more suspect.** Household employment has declined in each of the last three months, and the recent drop in the unemployment rate is due to frustrated workers giving up and dropping out of the labor force. Leading indicators for the labor market have also weakened. The temporary staffing sector in July saw its first monthly decline in payrolls in 10 months, and the trend in initial jobless claims has climbed to its highest level since February.

The government's efforts to spur home sales in the second half of 2009 (which was then extended to cover the first part of 2010) appear to have come at the expense of home sales in the second half of this year. The August data from the NAHB (National Association of Home Builders) shows that the housing market index has fallen in three consecutive months and is now at its lowest level since early 2009. Mortgage applications for new home purchases have dropped by 40% since the end of April even as long-term mortgage rates have fallen by nearly half a percent. While households

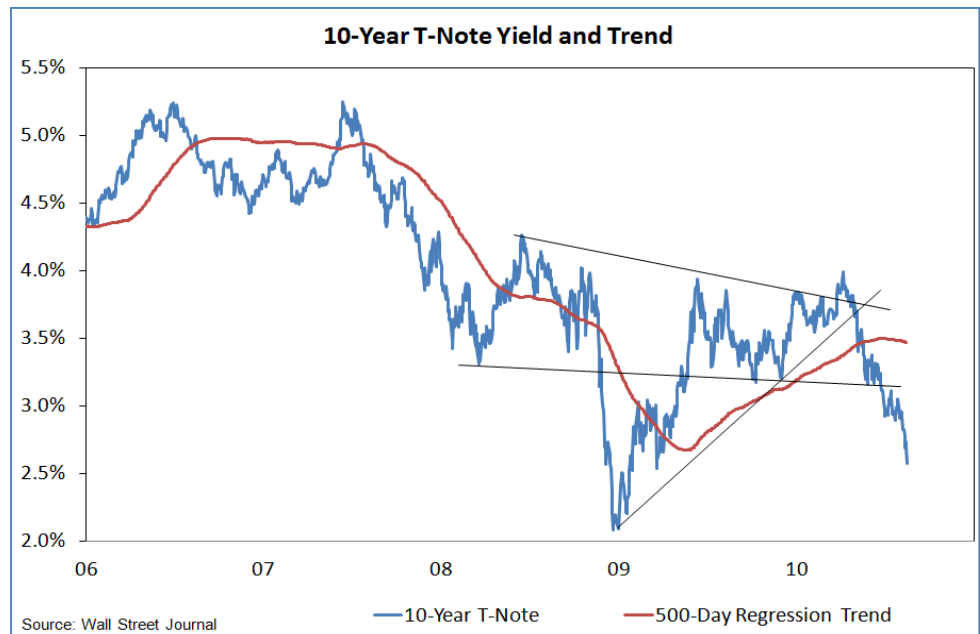


Market Strategy

August 17, 2010

have made progress in reducing their debt levels, more work remains. **Further weakness in the housing market could unleash another round of foreclosures and defaults, adding to deflationary pressures. While debt needs to be destroyed, a more orderly process (i.e., the paying down of debt) poses less risk to the economy.**

Federal Reserve Policy remains neutral. At its latest FOMC meeting, the Federal Reserve downgraded its outlook for the economy and decided to maintain the current size of its balance sheet by buying Treasury debt with the principal received from maturing mortgage-backed debt. **This may well be the first step towards another round of balance sheet expansion geared towards pulling interest rates down across the yield curve in an attempt to support economic growth and stave off a deflationary outcome.** Ben Bernanke is well versed in economic history and knows that deflationary episodes are best nipped in the bud and he has not been shy about talking about (and using) any available methods to prevent a Japanese-style deflation



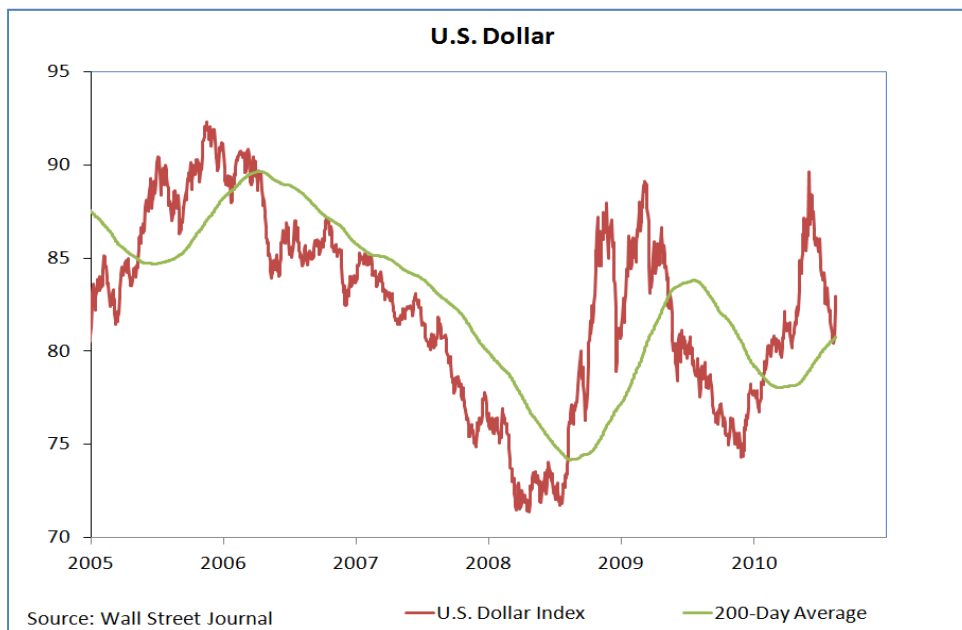
from setting in here in the United States.

The effectiveness of these efforts may ultimately lie beyond the Federal Reserve – while funds are being made available to banks, they in turn are not lending it out. This can be seen in the anemic recovery in the rate of turnover of money (known as the velocity of money) and the slowdown in growth of the money supply. Absent a re-acceleration in money supply growth, nominal economic growth is likely to be constrained. The

Federal Reserve's resumption of Treasury purchases could push yields in the middle part of the yield curve lower, leading to an overall flattening of the curve. It could also push the dollar lower, as the Fed will have to print more dollars to purchase this debt.

Valuations are still bearish.

We look skeptically at valuations models that compare expected P/E ratios to bond yields (these models suggest that as bonds rally on economic concerns, stocks are becoming more attractive). We prefer to track reported earnings on a trailing basis (removing the two assumptions of what earnings will be next year and what charges can be excluded from the calculation), looking at the

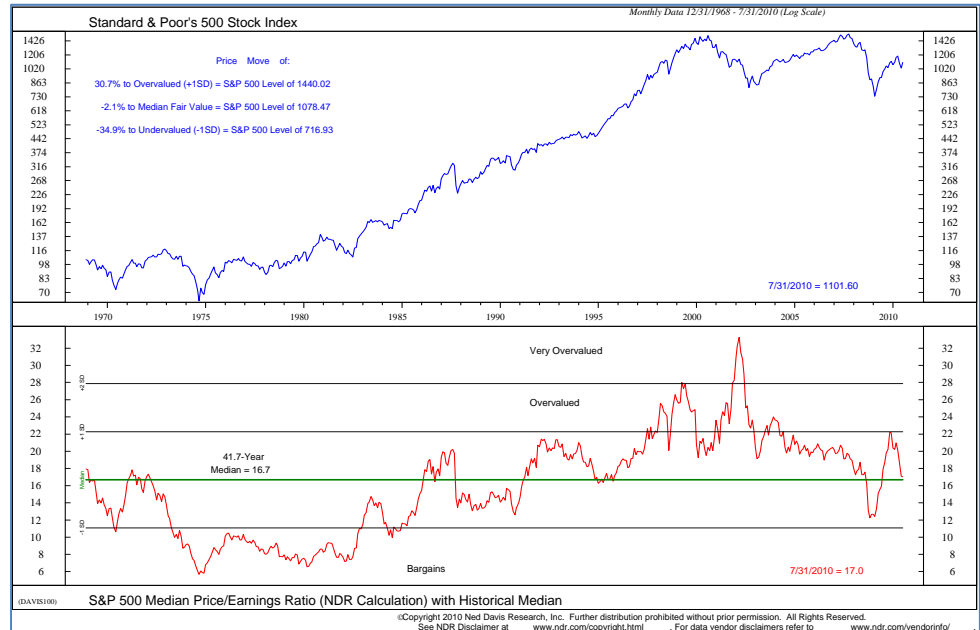


Market Strategy

August 17, 2010

price/earnings ratio for the median company in the S&P 500. This measure shows that stocks are near fair value from a historical perspective. **Earnings growth over the past year, however, has been driven more by government-sponsorship and/or cost-cutting rather than self-sustaining top-line expansion.** This would suggest a below-average valuation may be warranted at this time. Moreover, when compared to other measures (i.e., the overall economy, dividends, sales, etc.), prices look high. **Finally, when looked at from a risk management perspective, valuations at or above their long-term averages in the face of secular headwinds is not consistent with a low-risk opportunity for stocks.**

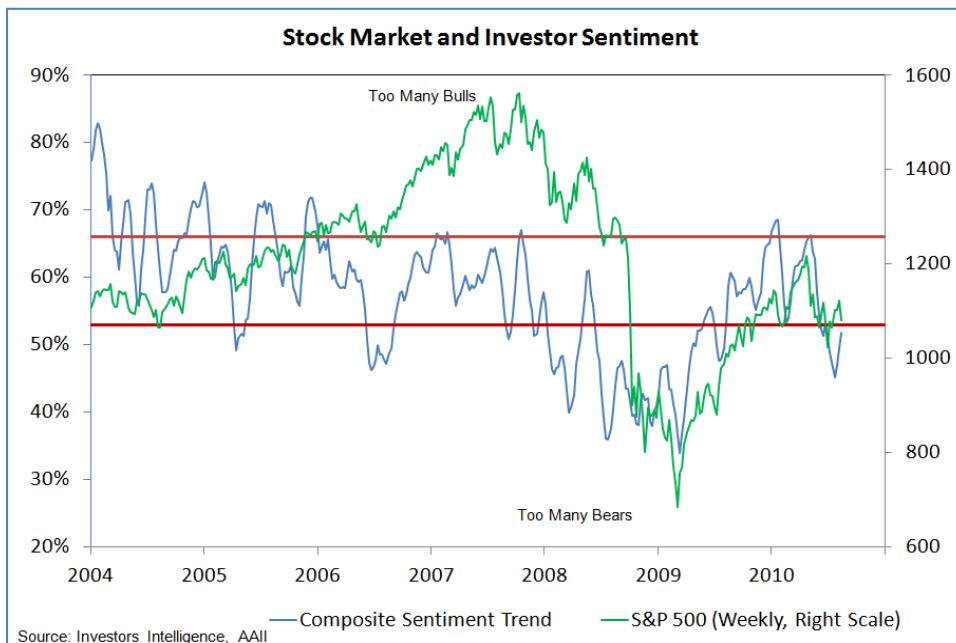
Sentiment is bullish, although rising optimism could soon push this indicator to neutral. A surge in bearish sentiment in July helped fuel last month's rally, but early-August readings from the Investors Intelligence (advisory services) and AAll (individual investors) surveys show the most bulls and fewest bears since May. **While optimism in these sentiment surveys is hardly extreme, the favorable conditions of a month ago**



have begun to reverse. In the AAll survey, the past four weeks have seen the number of bulls double and the number of bears cut in half.

Mutual fund flow data show that investors continue to pull funds out of equities. **This appears to be a secular shift away from equity exposure, a response to 10-years of volatility but no gains in equities, and brought on by the flash crash in early May that has rattled investor perceptions of the financial markets.**

Adding to the pressure has been that mutual fund portfolio managers have been fully invested this whole time – they lack cash reserves to buy stocks on pullbacks (thereby providing support to equities) and have had to sell to meet redemptions (thereby putting further on equities). On a shorter-term basis, put/call ratios have failed to soar as stocks have weakened in August, suggesting options traders have grown complacent and fear has not re-entered the market. Further declines in the put/call ratios and increases in the number of bulls in the weekly surveys would suggest that sentiment has ceased to be a bullish factor for the stock market.

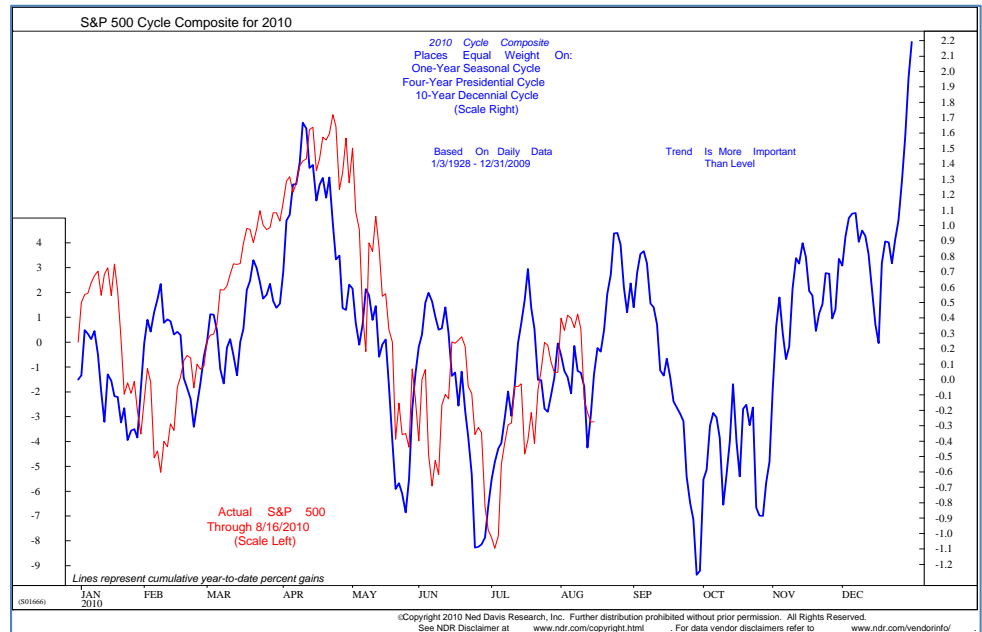


Market Strategy

August 17, 2010

Seasonals/Trends are still neutral, but upcoming seasonal weakness represents a looming headwind for the stock market. The composite trend through August remains favorable, but the September/October time-frame, particularly in advance of mid-term elections, could be more uncertain. If the historical seasonal patterns hold, stocks could be weak in advance of the elections, but as uncertainty over the outcome dissipates, a rally opportunity into year-end could emerge. While the longer-term trend indicators have weakened this summer, the trends at this point can be best characterized as no longer rising, and not yet falling. A break below the July index lows (near 1020 on the S&P 500) could signal the emergence of a cyclical downtrend.

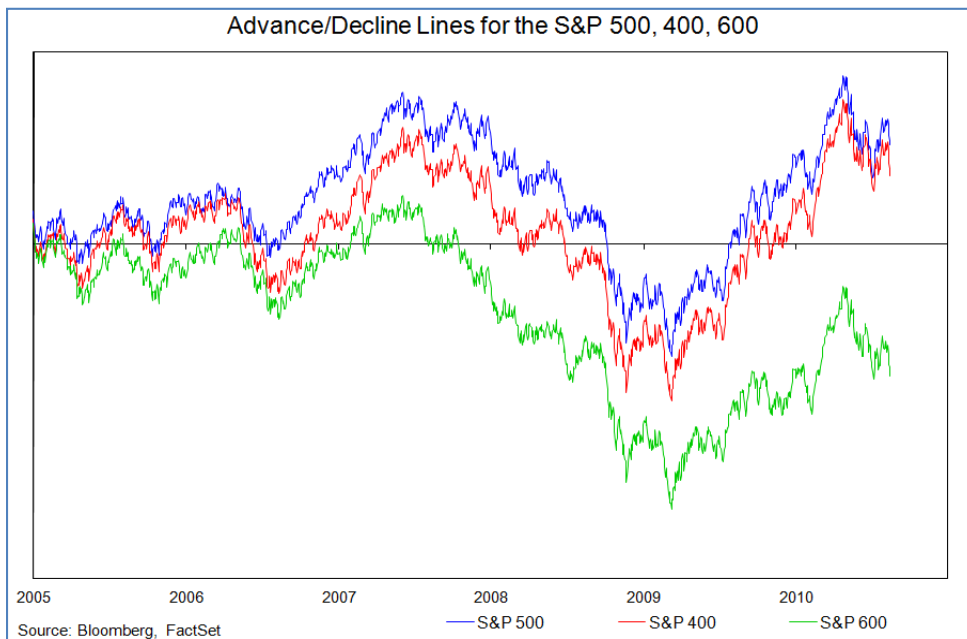
Broad Market indicators are neutral. Breadth measures continue to move in tandem with the stock market, and the divergences typically seen at the tail-end of a cyclical rally have yet to emerge. A **bearish signal could be sent by new lows in the breadth**



indicators that are not accompanied by new lows in the indexes, or new highs in the indexes that are not endorsed by highs in the breadth indicators. We have seen new highs on the NYSE advance/decline line, but this was driven by gains in the bond-related issues that trade on the NYSE which have benefitted from falling yields. Either broadening the universe (aggregating data from both the NYSE and NASDAQ) or narrowing it (looking at breadth from an index-level perspective) is more relevant. The A/D lines for the S&P indexes actually show more strength at the large-cap level than the small-cap level, which may be a first move towards an overall contraction of breadth. Our industry group trend indicator has yet to meaningfully diverge from the price indexes, but its level is consistent with a neutral breadth score.

Tactical Outlook

- The momentum from the July rally has faded, but stocks remain in a trading range. **Forthcoming rallies should be used to tilt away from cyclical equity exposure and towards defensive areas of the market in anticipation of an anticipated**



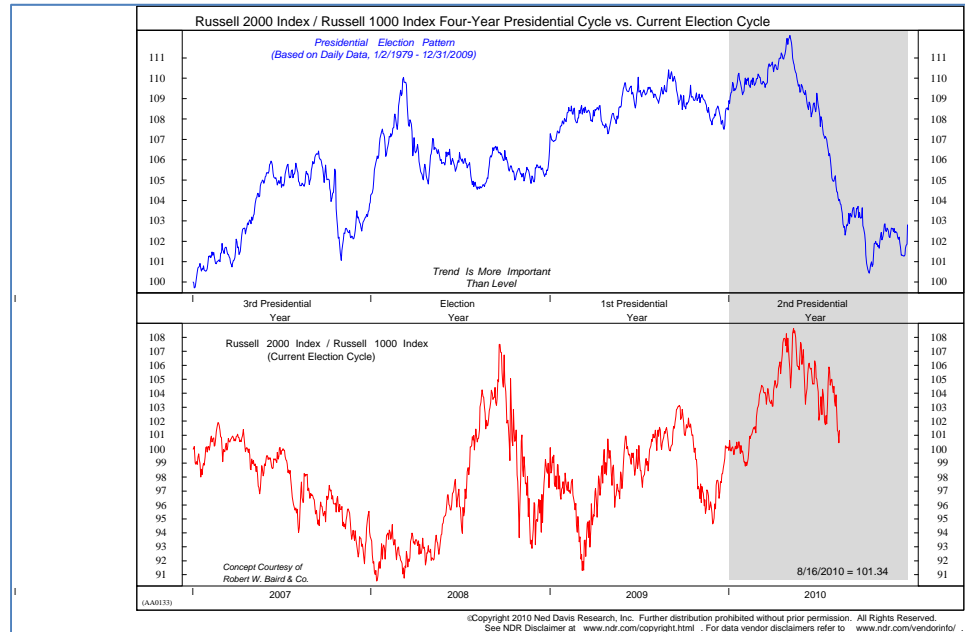
Market Strategy

August 17, 2010

September/October pull-back. Weakness in that time period, particularly if it is accompanied by stable breadth readings and a surge in pessimism can be used to tilt back towards the equity markets and increase beta.

- **Investors should be tilting away from small-caps and towards large-caps.** The trends have shifted in favor of large-caps, seasonal patterns show a pronounced tendency for small-caps to lag heading into mid-term elections, and our industry group relative strength work shows leadership moving towards large-caps and away from small-caps.

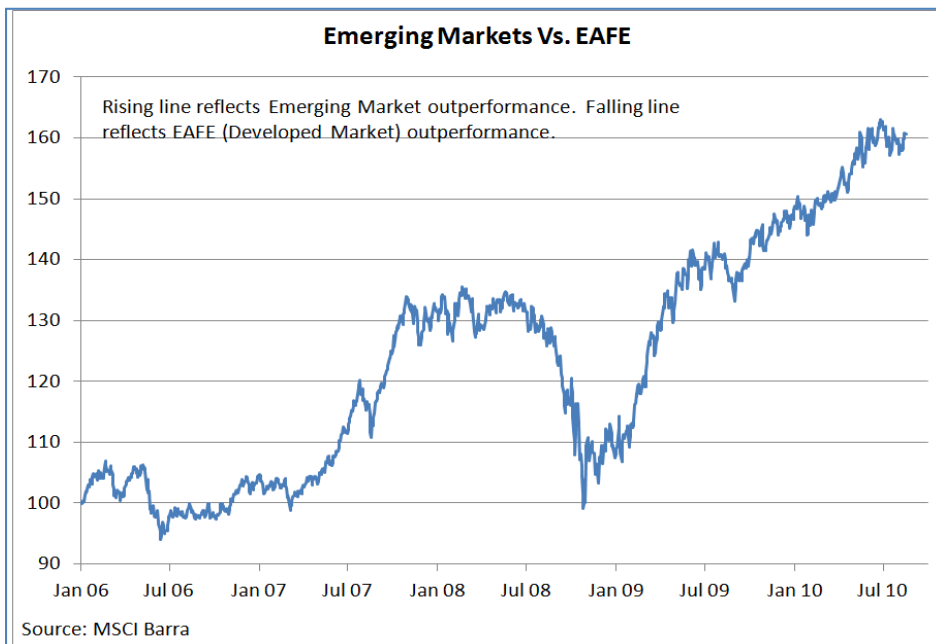
- **Sector leadership is with Utilities and Telecom, defensive areas of the market that also generate income.** Materials and Industrials are also among the leaders now and can be used to provide quality growth exposure within portfolios. Consumer Discretionary and Technology show weakening trends, while Financials are at the bottom of the relative



strength rankings.

- With the Federal Reserve again buying Treasuries, and likely poised to expand this effort, the yield curve could continue to flatten as long-term yields drop. **Tactical bond investors could use yield rallies (towards 3.0% on the benchmark 10-year T-Note) that emerge in the near term to move out on the yield curve, capturing higher yields and the opportunity for price appreciation if yields resume their move lower.** We would recommend staying with only the highest-quality exposure in this environment.

- **Emerging markets are again getting in gear,** and while there are renewed concerns about Europe, Latin America and Asian markets remain strong. We will again stress our caveat that in periods of financial market stress, correlations among risk-assets moves towards one, meaning the diversification benefits of overseas equity exposure dissipate.



Market Strategy

August 17, 2010

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
Conservative Income	20 / 80	Well below average	Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.
Capital Preservation	0 / 100	Well below average	Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.

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Asset Class / Model Portfolio	All Growth	Capital Growth	Growth with Income	Income with Growth	Conservative Income	Capital Preservation
Equities:						
Suggested allocation	95%	80%	60%	40%	20%	0%
Normal range	90 - 100%	70 - 90%	50 - 70%	30 - 50%	10 - 30%	0%
Fixed Income:						
Suggested allocation	0%	10%	30%	40%	45%	60%
Normal range	0 - 0%	10 - 30%	30 - 50%	40 - 60%	45 - 65%	55 - 85%
Cash:						
Suggested allocation	5%	10%	10%	20%	35%	40%
Normal range	0 - 10%	0 - 20%	0 - 20%	10 - 30%	25 - 45%	15 - 45%

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Market Strategy

August 17, 2010

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