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Second Quarter 2009 Economic Commentary

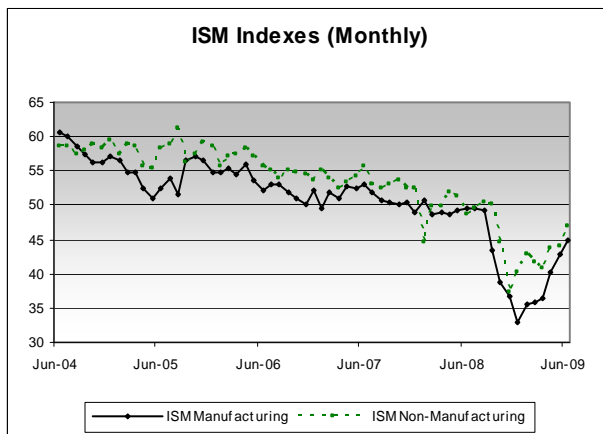
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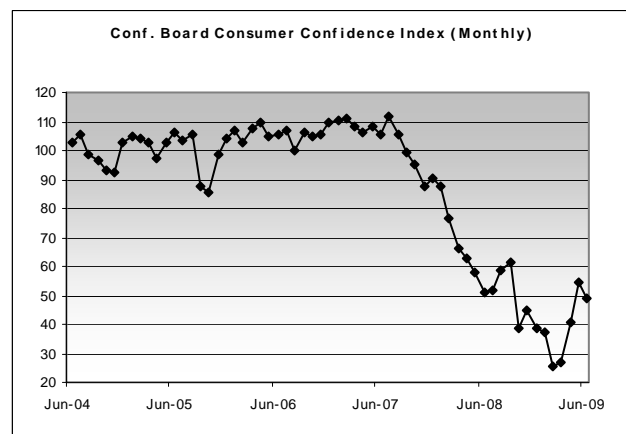
Looking back at our last two quarterly commentaries, the prevailing theme went from “avoidance of an Armageddon scenario,” in the fourth quarter of 2008, to “looking for the second derivative improvement” or “the search for green shoots” in the first quarter of 2009. The current theme du jour in investment outlooks is a discussion about whether or not we are entering a period of a “new normal.” It seems inevitable that over the next market cycle, asset returns may be smaller than those in decades past based on the massive delevering that is occurring across the globe. But will investors even notice? An examination of the decade to date¹ reveals a cumulative total return on the S&P 500 of -25.84% through the end of the second quarter of 2009 and two deep and protracted bear markets at the beginning and near the end of the decade. These data suggest that equity returns had already been depressed and volatile for a significant period of time.

The poor equity market performance is partly explained by a major departure from what had become established monetary policy. Monetary policy deviated from prior models by keeping the Fed Funds rate lower in relation to the output gap and excess inflation. This created extreme imbalances which needed to be corrected. We are now going through a private sector deleveraging and regulatory reform process which hopefully will be the prologue to a return to the monetary policy of the 1982-2000 period and the more balanced and stable economy that existed prior to 1992. Thus the “new normal” is not entirely new, since it results in policy reversion and it involves financial sector consolidation bringing the sector back to its earlier size. From our perspective, if current investor focus on low growth and high unemployment helps avoid the near overnight swings from boom to bust and back to boom that have characterized markets over the last 18 months, then it is a positive development.

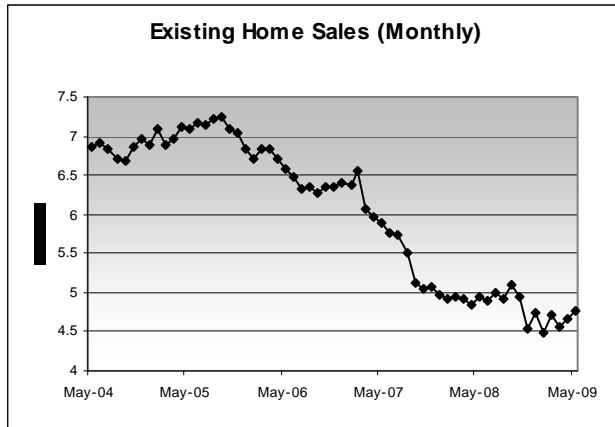
Economic Conditions



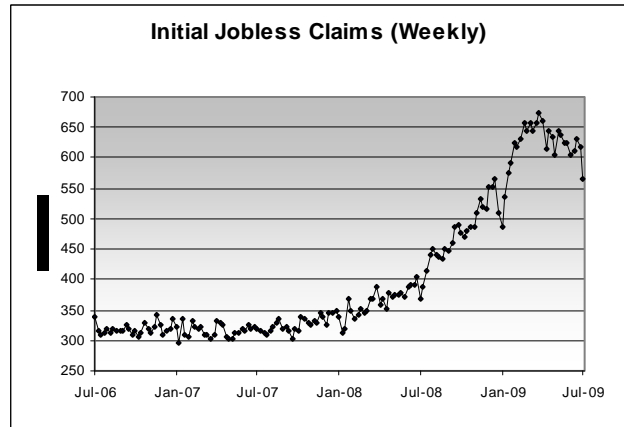
Source: Bloomberg



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

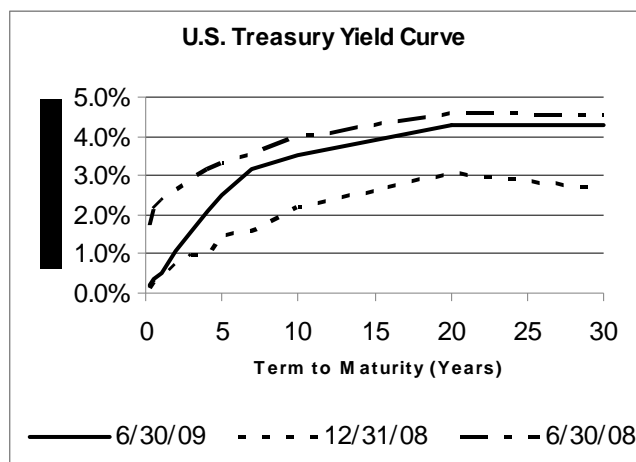
Expectations about market performance are tied to an understanding of the shape of the economy. The markets were generally encouraged by the economic data that came in during the second quarter, as evidenced by the record quarterly return of 22.3% for the MSCI All Country World Index. There has been a recent, abbreviated pause in the positive momentum that was brought to a head with the release of the June employment data. While a pause after such a run in equity prices seemed logical, it was less certain that the driver of the pause is as troubling as it was perceived to be. The 467,000 decline in non-farm payrolls in June, up from 322,000 the month before, was certainly a precipitous drop. More importantly, it broke the four consecutive months of improved releases. However, as we have discussed in the past, while the employment release is an important indicator and goes directly to sentiment, it is a lagging indicator that should be viewed and interpreted as such. Weekly unemployment claims (a coincident indicator) seem to have fallen below 600,000 based on the last two readings.² Though the drop in claims may be largely due to the technical impact of seasonal adjustment and an unusual timing of auto sector layoffs this year, the worst of the labor market deterioration appears to have passed.

Two days before the jobs report, the Institute for Supply Management (ISM) released its report on manufacturing and five days later,³ it released its report on the non-manufacturing sector. We believe the ISM data is a much better leading indicator of economic conditions than the jobs report. Significantly, both ISM releases contain an employment index. The employment components of both ISM series lead the three-month moving average of the monthly change in payrolls by one to two months with correlations of over 80%. The ISM manufacturing employment index improved from a reading of 34.3 to 40.7. Its non-manufacturing counterpart improved from 39.0 to 43.4. Taken together, the two readings predict payroll declines in the coming months of roughly 200,000, down from their predictions earlier this year of a 650,000 decline. If historical correlations hold, and we see readings at that level in the coming months, market sentiment should improve measurably and the 19 month recession will be declared over. That said, improvements in the ISM data point to modest GDP expansion of 0.5% annualized. Whether that figure, in part fueled by an inventory rebuild, will be a first positive step in an upward trajectory or a point at which the economy stalls, is a key issue to consider. Estimates of global production have fallen well below those of global sales, and the ISM group forecast (which has had a good track record since 1982) calls for 4% US GDP growth in 2010. It remains to be seen whether a continuation of the recent US export gains due to the global monetary stimulus and higher federal expenditure in the G20 countries will be significantly offset by continued unwinding of US consumer leverage and the headwinds of rising US federal tax rates and severe distress at the state and local levels.

The future strength of global economies may hinge upon the shifting direction of current account imbalances, both from the surplus and deficit sides. In recent years, we have seen a decline in the US current account deficit and a simultaneous decrease in China's current account surplus. Demand growth for both domestic and imported goods and services in surplus countries should continue to outpace growth in deficit economies as savings ratios converge. Products that are sensitive to demand growth in surplus countries will experience much greater price increases than those that rely upon demand growth in deficit countries. Current account surplus countries have higher marginal propensities to consume fuels, mining, and agricultural products as they grow, prices of which are likely to rise in relation to those of other goods.

We expect a long-term dollar downtrend because of the large structural deficit of the US Government relative to the G20 average, which is likely to raise US public federal debt from 40% to 80% of GDP over the next five years. The looming decision about how to pay the bill for a healthcare plan that will provide medical insurance for the millions who lack it, at a projected cost of \$1 trillion over the next decade, will likely compound the situation as cost cutting measures are expected to hit a ceiling far below that figure. Even relative to the yen, which has shared the dollar's status as a safe haven investment, the dollar may be poised to fall based on the shrinking spread between dollar Libor and yen Libor. This weakening of the dollar will further exacerbate the aforementioned commodity prices, which tend to be priced in US dollar terms.

Fixed Income and the Question of Inflation



Source: Bloomberg

Latest Quarter End (6/30/09)	Latest Year End (12/31/08)	One Year Ago (06/30/08)	Three Years Ago (06/30/06)
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CURRENCY

U.S. Dollar Index Value	80.13	81.31	72.46	85.16
USD vs. Yen	96.65	90.64	106.21	114.44
Euro vs. USD	1.40	1.40	1.58	1.28
GBP vs. USD	1.65	1.46	1.99	1.85

COMMODITIES

Gold (\$ per troy ounce)	926.60	882.05	925.40	615.85
Crude Oil (\$ per barrel)	69.89	44.60	140.00	73.93
CRB Metals Index	611.60	402.56	829.25	627.15
CRB Food Index	303.90	294.20	441.97	261.89

Source: Bloomberg

Capital markets in the second quarter continued largely where the month of March left off, as risk capital flooded back into both equity and spread fixed income product. Our thesis regarding the opportunity in high yield fixed income proved accurate, as the Barclays Corporate High Yield Index was up over 23% for the three-month period. The easy money has been made in the space, particularly in the lower rated credits, though we still believe that the BB and single-B credits should yield attractive returns at current spread levels. In Europe the high yield returns were even more impressive, totaling over 33%⁴ for the quarter. Investment grade fixed income had a strong quarter as well, as the Barclays US Credit Index returned almost 9%. Elsewhere in fixed income, returns were more muted, as the strong run in Treasuries during the fourth quarter of 2008 and to a lesser extent municipal bonds in the first quarter of 2009, both had the wind removed from their backs.

With respect to bonds, we believe that duration and issuer management are going to remain critical. Much discussion in financial forums centers around the need to control duration based on concerns about future inflation resulting from expansion of the Fed's balance sheet. While inflation may be an issue down the road, we think the ongoing global deleveraging will keep it in check for at least the next twelve months. When economists talk about excess reserves inevitably proving inflationary, there is an implicit assumption that the reserves in question are distributed throughout the economy via banks to the eventual consumer. There are two particular variables in play in the current landscape that, in our estimation, will delay the traditional cause and effect: 1) In a move that may have gotten lost at the height of the financial maelstrom, Congress granted last fall the Fed the legal authority to pay interest on bank reserves on deposit with the Fed. This was a brand new tool in the Fed's growing toolbox. This authority provides the Fed with a means of incentivizing banks to hold onto their reserves rather than lend them to the public, which may delay the desired credit thaw, but it can also delay the inflationary push coming from the velocity of new money supply. 2) As the Fed has repeatedly pointed out, the monetary policy framework they initiated to combat the disappearance of the securitization market was, in their words, credit easing, not quantitative easing. With quantitative easing, such as that employed by Japan earlier this decade, the central bank specifically targets an amount of excess reserves to be injected into the system. According to Chairman Bernanke, the credit easing approach "focuses on the mix of loans and securities that it holds and on how this composition of assets affects credit conditions for households and businesses."⁵ By holding securities designed to affect credit spreads rather than the indiscriminate flushing of money through the system, the Fed has a bit more control over the timing of the great unwind. While there will be a price to pay for measures taken to avert disaster, it may not come as soon as consensus expectations would indicate.

The US Treasury bond market may have just ended a secular bull market and now entered a secular bear market. We believe that this inflection point was seen in December of 2008, when the yield on the ten-year Treasury hit 2.02% and the 30-year Treasury hit 2.52%.⁶ There is historical precedent which should serve as a warning at the beginning of secular bear bond markets, and that is the potential danger from simply buying and holding longer dated bonds without consideration of the interest rate environment. The greatest of all secular bear bond markets began in April of 1946 and ended in September of 1981. If a 30-year Treasury bond index with a yield at 2.5% had been measured through this bear market, its price would have declined from 101 in 1946 to 17 in 1981, or 83%.⁷ While, as previously stated, we do not think incipient inflation is around the corner, we do believe that a strategic allocation to TIPS should be considered as a hedge. Empirical studies are increasingly showing that TIPS have higher risk-adjusted returns than nominal Treasury bonds, and that there is a place for them in an optimal portfolio.

Municipals had a solid quarter, up 2.11%, and continued to outpace similar duration Treasuries for the year. They gave up ground on both an absolute and relative basis in June, as \$41 billion of new issuance was enough to overcome the continued steady flow of money into municipal vehicles. This development left munis in an attractive position to end the quarter, as 10-year muni yields sat at 92% of 10-year Treasuries. We think munis will continue to perform well against taxable options, as expected income tax increases at the Federal and State levels enhance their attractiveness. There may be supply constraints that coincide with heightened demand, as the Build America Bond program continues to gain traction. The Federal program promotes taxable bond issues by municipalities by providing them subsidies that allow them to offset interest costs. This incentive from the government also allows Washington to collect taxes on a segment of the bond market whose tax-free income had previously been off limits. Given that dynamic, it is not hard to envision the program sticking around.

Tax-free issues that depended heavily on insurance for their rating continue to suffer. The insurance model had always worked well in municipals as there have traditionally been few defaults. However, when the insurers expanded into more profitable yet riskier lines of business, such as structured finance, including mortgage-backed securities and collateralized debt obligations, the game changed. Not only did insurance start to have a discounted rather than premium effect on prices, the market has become far less relevant. Insurance participation declined to 18% in 2008, to 12% through May of this year, and to 5% of new issuance in June.⁸ Strong underlying credit analysis will continue to be the best course of action. We have always stressed the importance of this exercise, so this does not represent any shift in focus for our firm in the municipal bond space.

Global Equities

As referenced earlier, global equity markets experienced a record quarter. The MSCI All-Country Index, which includes both developed and emerging markets, was buoyed by the strength of the BRIC⁹ country markets which returned over 41% in the quarter. Within domestic markets, small capitalization stocks outperformed their large cap counterparts, which is to be expected in an environment in which risk is indiscriminately seen as desirable. Now that the relief rally has seemingly played out, based on evidence of stabilization, the focus and scrutiny of market participants will turn to earnings. Not unlike our earlier discussion about leading and lagging economic indicators, the analysis of corporate earnings will prove most rewarding if emphasis is placed on impending trends. Given the likelihood that US output is just turning a corner, Q2 earnings may be less relevant than they would be in a less cyclical environment. Profits should follow the rise in output (with a slight lag), and the dramatic decline in employment referenced earlier, together with the fall in capital expenditure, should result in a sharp rise in operating leverage. This will become evident once volumes begin to increase.

Earnings and cash flow multipliers for emerging market equities are at a substantial premium in relation to their trailing five-year average and to those of developed market equities based on historic norms.¹⁰ This may adversely affect the relative performance of these stocks, despite the strong fundamentals of many of them, at least in the short term. Moreover, one size does not fit all in the emerging market space. There are clearly opportunities, such as China and India, which are less cyclically sensitive and can achieve substantial GDP growth even in a global recession like the current one. China, for one, has a stimulus package that is much more effective at stimulating investment than those in developed countries. However, outside of the BRIC countries and several Asian economies, major turnaround in emerging market growth has not yet occurred. Small, open economies with heavy reliance on external capital are likely to have the weakest recovery.

While we think that equities linked to basic materials and other commodity prices will display relative strength, the strategic call is less singular with respect to other securities requiring more bottom-up analysis on countries, sectors, and companies. The price/earnings (P/E) ratio in a sector should equal the reciprocal of the sector's real cost of equity capital. There has been a recent convergence of earnings multiples among US non-financial sectors. No major sector has a five-year cyclically-adjusted P/E ratio outside of the 10-21 range, and seven major sectors (oil and gas, basic materials, industrials, consumer goods, consumer services, telecoms and utilities) lie in a 10-16 range.¹¹ This unusually small spread between the P/E ratio of traditionally defensive sectors and cyclical sectors, despite large differences in their real cost of equity capital, should provide an important opportunity for relative value and growth-at-a-reasonable-price investors.

The current US recovery, though more balanced, is likely to be slower and bumpier than those in the past. We believe that the low end of the stock market trading range has been established and that there is more upside before the upper limit is attained. We are thus attempting to focus our domestic equity exposure on companies that can achieve above average earnings or dividend growth under these economic conditions with a below trend rate of expansion. These include many companies in the large-cap growth space, such as the staple techs, drugstores, pharmacy benefit management firms, discount retailers, and secondary auto parts suppliers. We also prefer strategies that focus on stocks with high operating leverage and on firms with high sales exposure to the BRIC countries which should grow faster than the US.

Alternative Investment Strategies¹²

The alternative investment landscape continued to stabilize, and in some cases explode, with the re-emergence of risk in the marketplace. The delineation between stabilization and explosion fell predictably along the lines of those investments that serve as hedges versus those that serve as risk capital. The CS/Tremont AllHedge Index was up 5.07% for the quarter, leaving it at 4.25% for the year, ahead of both equities (S&P 500) and bonds (Barclays Agg). There were net inflows into the space for the first time since the third quarter of 2008, as investors gained confidence that the tools used by hedge fund managers were again functioning properly. One such measure of belief in these tools is the Citi Macro Risk Index which is an equally weighted index of implied foreign exchange, equity, and swap rate volatility, as well as US credit and emerging market sovereign spreads. The index, which at 0 indicates low aversion to these investments and at 1 a high aversion, was at .76 to start the year, .56 to start the quarter, and at .36 to close the quarter. With respect to other alternative asset classes, those designed to reduce portfolio volatility, like managed futures, were up but muted as the Barclays CTA Index rose only 1.08%.³ Asset classes expected to add volatility and directional exposure did extremely well in the quarter, as the Wilshire REIT Index was up 31.66% while the Dow Jones UBS Commodity Index was up 15.05%. One important consideration with respect to hedge fund investments is that while in general the landscape has become more investor friendly – with more transparency, fee negotiability, and better liquidity provisions going forward – investors will need to be vigilant about managers and firms that might be vulnerable because they have gotten too far below their high water marks and cannot charge performance-based fees.

Finally, in the more esoteric investment world there appears to be a split among collectors. Fine wine is coming back with the market, as the Liv-ex 100 Benchmark Fine Wine Index, which is derived from live prices taken from the London International Vintners Exchange – the global trading platform for fine wine merchants, is up from a level of 204.92 at the beginning of the year to 214.27 at the end of the quarter. Art values, on the other hand, continue to drop, as the Art Market Research Art 100 Top 25% Index, which tracks price movements in all sectors of the art world and is used by Christie's and Sotheby's as well as leading banks and insurance companies, is off from a level of 17,351 to begin the year to 15,052 to end the quarter. It would appear that in a scramble to choose which collectible to sacrifice in order to meet capital calls, investors are dumping the art and keeping the wine.

	3 Month	YTD	12 Months	3 Year*
DOMESTIC EQUITY				
S&P 500	15.93	3.16	-26.21	-8.22
Russell 1000	16.50	4.32	-26.69	-8.20
Russell Midcap	20.80	9.96	-30.36	-9.25
Russell 2000	20.69	2.64	-25.01	-9.89
Russell 3000 Growth	16.82	11.52	-24.53	-5.65
Russell 3000 Value	16.81	-3.05	-28.73	-11.20

	3 Month	YTD	12 Months	3 Year*
INTERNATIONAL EQUITY				
MSCI World	21.05	6.79	-29.01	-7.48
MSCI EAFE (net)	25.43	7.95	-31.35	-7.98
MSCI Europe (net)	25.26	7.03	-34.53	-8.39
MSCI Japan (net)	23.05	2.59	-23.12	-10.16
MSCI Emerging Mkts (net)	34.73	36.01	-28.07	2.95
MSCI BRICs	41.07	47.92	-30.91	7.38

* annualized

	3 Month	YTD	12 Months	3 Year*
FIXED INCOME				
Citigroup 3-month T-bills	0.05	0.09	0.78	3.04
BarCap U.S. Aggregate	1.79	1.91	6.06	6.43
BarCap Muni	2.11	6.42	3.78	3.90
BarCap Int. Govt.	-1.43	-1.51	6.43	6.99
BarCap TIPS	0.65	6.21	-1.11	5.77
BarCap Int. Corporate	10.44	8.31	3.84	4.49
BarCap High Yield	23.07	30.43	-2.41	2.09
JPM EMBI+ Composite	9.95	12.71	2.43	6.43

	3 Month	YTD	12 Months	3 Year*
ALTERNATIVES				
CS/Tremont AllHedge	5.07	4.24	-21.80	-4.09
Barclays CTA**	1.08	-0.80	2.68	7.13
Wilshire REIT	31.66	-13.00	-45.26	-19.69
DJ UBS Commodity	15.05	7.79	-45.48	-7.37

** estimated

In summary, our outlook for traditional asset classes, commodities and currencies, is as follows:

Asset Class	Base Case Projection	Downside Risk
Developed Corporate Bonds	<ul style="list-style-type: none"> Spreads are historically wide, even after recent narrowing. We believe they should narrow further. 	<ul style="list-style-type: none"> The recovery is so weak that default ratios fall to Great Depression levels and extreme risk aversion returns.
Developed Country Government Bonds	<ul style="list-style-type: none"> Expectations of monetary tightening are postponed, but unprecedented fiscal stimulus drives up longer term rates. 	<ul style="list-style-type: none"> The recovery is stronger than anticipated and output gaps narrow more than we expect, leading to high inflation rates.
U.S. Equity Large-Cap Equities	<ul style="list-style-type: none"> High operating leverage and improving credit market conditions will cause per share earnings to rise more rapidly than expected. 	<ul style="list-style-type: none"> Stocks will not rise above the 750 to 1050 trading range. Lack of consumption growth and residential housing investment expansion will stifle output and earnings growth.
Other Developed Market Equities	<ul style="list-style-type: none"> Prices advance, but less rapidly than those of U.S. equities, but not necessarily in dollars. 	<ul style="list-style-type: none"> Prices stay within a trading range of global economy, recover less rapidly.
Emerging Market Equities	<ul style="list-style-type: none"> Emerging market equities are trading at premium multiples in relation to developed market equities based on historic norms. We do not expect the relative outperformance in the first half of 2009 to be repeated. 	<ul style="list-style-type: none"> A weaker than expected global economic recovery reduces risk appetites and capital flows to emerging markets, as well as the growth of the smaller, more export-dependent economies.
Commodities/Hard Assets	<ul style="list-style-type: none"> Dollar weakness, supply constraints and stronger than expected global economic recovery will boost commodity prices (especially oil and industrial metals) from current levels, despite recent counter-trend correction. 	<ul style="list-style-type: none"> If anticipated rebound in global demand does not occur in 2010, inventory rebuilding will result in large overhang to weigh on prices.

Currencies	<ul style="list-style-type: none"> • A global recovery or questions about reserve currency status drive dollar lower on a trade weighted basis. 	<ul style="list-style-type: none"> • Unexpected economic weakness prompts a substantial increase in safe haven demand for dollar and yen.
Municipals	<ul style="list-style-type: none"> • As the effect of diminished supply continues to work through the system, the bid for municipals should strengthen, bringing the ratio of muni yields to Treasury yields below 90% and enhancing the value of current holdings. 	<ul style="list-style-type: none"> • If economic growth picks up faster than anticipated, then Treasury yields will rise, potentially diminishing the value of other fixed income securities like munis that are in part valued at a spread to Treasury bonds. This may help issuing municipalities while simultaneously hurting the relative strength of the asset class.

We are grateful for your allowing us to manage your funds and for your continued confidence and support.

All information contained herein is based on past performance and is not intended to be indicative of future results. The indices used are unmanaged and return figures reflect the reinvestment of dividends and earnings. There is no guarantee that historical risk and rate of return will persist in the future. All market prices, data and other information are not warranted as to completeness or accuracy, may not be audited information and are subject to change without notice. All returns shown are for the period ending 6/30/09.

¹ Decade beginning January 1, 2000.

² Readings recorded on 7/3/09 and 7/10/09.

³ Readings recorded on 7/1/09 and 7/6/09.

⁴ Source: Barclays Capital

⁵ Ben Bernanke, "The Crisis and the Policy Response,"

<http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm>

⁶ 10 year Treasury yield low occurred on 12/30/08 and 30 year Treasury low yield occurred on 12/18/08.

⁷ Source: S. Homer and R. Sylla, A History of Interest Rates

⁸ Source: Belle Haven Investments

⁹ BRIC or BRICs is an acronym that refers to the fast-growing developing economies of Brazil, Russia, India, and China.

¹⁰ Source: New York Times, July 19, 2008

¹¹ Source: Capital Economics and Goldman Sachs

¹² The financial instruments described may not be suitable for all investors. Investment in alternative investment products requires that the investor meet certain suitability standards, and therefore, investment in these alternative investment products may not be suitable for all investors.