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ECONOMIC AND MARKET COMMENTARY *First Quarter 2010*

As indicated in our letter dated November 12, 2009, there are reasons to believe that the present US recovery will be weaker than average, and especially weak with respect to the depth of the prior recession (normally the greater the decline, the sharper the rebound). A recent International Monetary Fund (IMF) Study found that recessions associated with financial crises tend to have more muted recoveries, with advanced economies growing in the range of 1-2% in the first three years following the recession's end.¹ In the present US situation, two of the typical engines of recovery growth, consumption and residential investment, face larger than usual headwinds because of household deleveraging. Their potential drag on growth is significant as consumption typically contributes three percentage points to real GDP growth in the first year of recovery, while residential investment contributes about 0.8 percentage points.

Economic Growth

Ultimately, we expect that US real GDP growth will be better than what has followed the average financial crisis recession, but less robust than a recovery from a typical recession. As such, our forecast calls for a 2.5% to 3% real GDP growth rate this year. We anticipate that this expansion will be supported by some pick-up in business equipment expenditure, significant export gains, some residential investment growth from a very low base and a stronger than typical inventory rebound. Real consumption growth should contribute a little over one percentage point, with significant employment growth beginning in the next five to six months. Though the unemployment rate is slightly less than double digits and may be moving close to a level not seen since 1982, it remains to be seen whether the present recovery will be as jobless as the previous two that followed the 1991 and 2001 recessions.

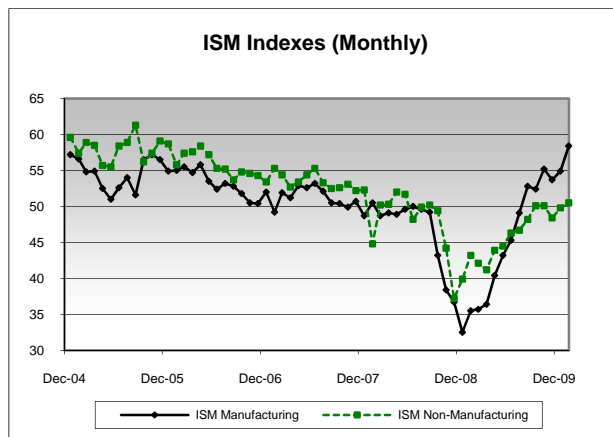
Admittedly, a lot of improvement in economic indicators through December of 2009 was attributable to one-off government stimulus programs, particularly the 'Cash for Clunkers' program and the subsidy for first-time homebuyers. The large, multi-year stimulus package enacted last spring has played a major role, but its effects are likely to be less substantial in the second half of 2010. The Fed's quantitative easing program is also being phased out.

While a recovery in the US appears underway, it is difficult to separate the purely cyclical forces of improvement from those created by government fiscal and monetary spending, which has been unprecedented in peacetime, and which has been accompanied by similar action throughout the G-20. It can be argued that the recovery is not sustainable because it will only last as long as government stimulus continues, and mounting fiscal deficits are a major problem. The largest

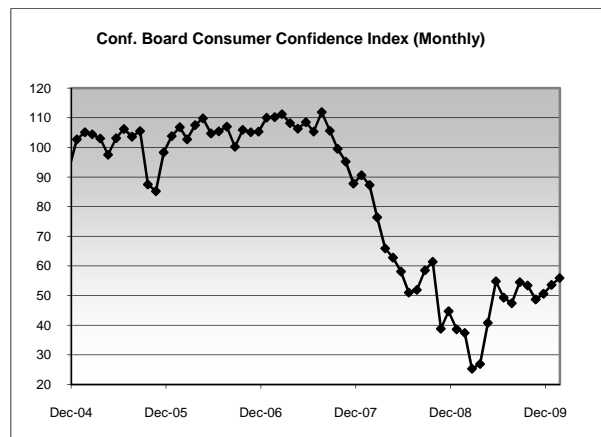
increases in fiscal deficits occurred in those G-20 countries, including the UK and Spain, as well as the US, where the private sector's credit bubble had been the greatest. We take issue with the position that US growth will cease if there is any fiscal and monetary consolidation. Whether the economic growth seen thus far is primarily stimulus-based is less important than whether it creates a perception of recovery that eventually becomes a self-sustaining fact by raising confidence. The improvements seen in a variety of asset markets and the increase in consensus forecasts for growth in 2010, in addition to recent increases in forward looking consumer confidence measures, suggest that this transition may be already occurring. Witness the recently released Conference Board Consumer Confidence Index, which has reached a level not seen since September 2008.

The main question for the year is how rapidly to withdraw the monetary and fiscal stimulus and which should be withdrawn first. If policymakers exit too late, they waste resources in excessive public deficits and debt. If they exit too soon, they risk a double-dip recession and its disastrous effect on confidence. Given this asymmetry, policymakers are likely to remove stimulus only gradually. What is harder to predict is the success of these actions. We are in uncharted waters in unwinding a stimulus of this magnitude. This uncertainty is further magnified by the impact of what Goldman Sachs calls the "Washington Risk Premium". Particularly as it pertains to managing the thrust of fiscal policy, the political will that either party will be able to muster may not be sufficient to chart a sustainable course of meaningful action. Whether the signal is the election of Scott Brown in Massachusetts, the rising voice of independents and "Tea Party Conservatives", the diminished stature of the Federal Reserve, or the slipping popularity of President Obama, the main impact of policymakers is likely to be heightened monetary and fiscal uncertainty.

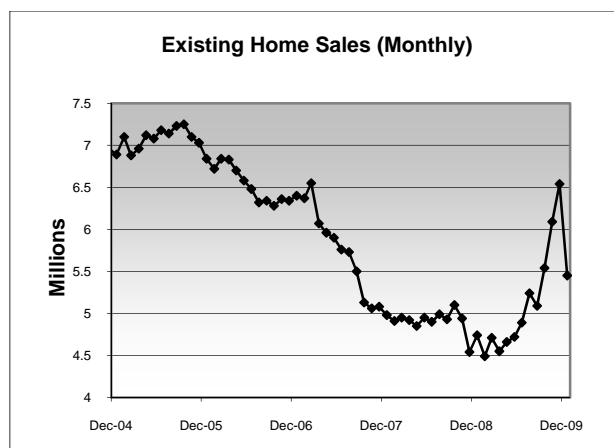
The US fiscal deficit is about two thirds cyclical. This portion of the deficit will reduce itself slowly as the US unemployment rate goes through a long process of declining back to normal levels. One active step toward taking the economy off monetary life support is the scheduled completion of the Fed's MBS purchasing plan by the end of March. We are not too concerned about this interfering with the recovery, since the stock of the MBS securities held by the Fed is much more important than the flow of purchases, and low mortgage rates have done little to stimulate demand. The expiration of the tax credit for first-time home purchases at the end of April would have much greater impact but is likely to be extended further in an election year.



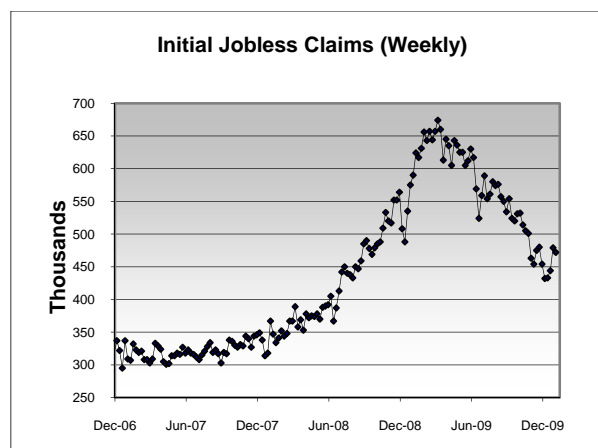
Source: Bloomberg



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

US Equities

It is not surprising that investors have greeted the 2009 US equity rally with substantial skepticism, since it has followed an equity market decline of more than 50%, the largest in the post-World War II period. However, this rally is comparable in magnitude to that which took place in the nine months following early-August of 1982 and thus is not unprecedented, though substantially stronger than the first leg of a typical cyclical bull market. For the most part, the US equity market is fairly valued on an absolute basis, lying close to the average multiple of trend earnings over the last ten years. Although equities are undervalued relative to bonds and cash, fixed income yields are artificially depressed. Further multiple expansion is highly unlikely and we should expect that going forward equity appreciation will be largely earnings driven and will probably be held back somewhat by multiple compression.

The progression of earnings back to trend represents a major tailwind for earnings growth in 2010, since S&P 500 reported earnings fell by an unprecedented 92% in this cycle, greater than the 75% decrease during the Great Depression. Even operating earnings, which exclude all non-recurring expenses, fell 57%, the steepest decline in the post-World War II period.² Just the abatement of the persistent bank losses of last year sets the stage for impressive earnings per share gains.

In addition to a mean reverting snap-back, there are fundamental factors behind the earnings recovery. First, there is evidence of a permanent reduction in costs. General administrative costs fell at an unprecedented rate in the fourth quarter. Because truly aggressive cost cuts were made in the most cyclically sensitive sectors, the entire earnings base is more levered to economic activity than it was in prior cycles. Second, while mark-to-market accounting overstated the earnings collapse, it also accelerated the loss recognition process. Third, low corporate borrowing costs (for larger companies) and steep yield curves are providing fundamental support for earnings.

The resulting operating leverage is already evident in net profit margin stickiness. Net margins, excluding financials, have bottomed at 6% and have already risen to an estimated 6.8% compared to a range of 4% to 4.5% in prior recessions. We expect reported earnings growth to be up about 35% in 2010, to about \$64, \$5 below trend, and to reach trend in the first half of 2011. A GDP growth rate above 2% should be enough to make the latent operating leverage highly evident. Thus far, the earnings season since the beginning of January has been very solid. The earnings results show that sales growth has turned solidly positive and bested market expectations (as have earnings) in key

cyclical sectors such as materials, tech, and consumer discretionary. The fact that earnings are more than keeping up with already adjusted upward expectations is extremely important.

Although there is some significant downside in US equities, especially if the ten-year Treasury yield should return to normal levels more rapidly than expected, or real GDP growth stalls, many (though not all) technical and sentiment factors still augur well for the stock market in 2010. Both the next retracement level and historical momentum indicators imply technical targets in the low 1,200s for the S&P 500 Index, against a current level below 1,100. In addition, there is still negative sentiment at the retail level, which is a positive contrarian indicator. For example, retail bond holdings are near the highest levels ever, and investors (most of whom were individuals) pulled \$42 billion out of equity mutual funds and ETFs in 2009 despite the equity market's strength. In the current correction mode, the ratio of bulls to bears fell to 63% on January 28, 2010, with the trailing four-week average declining to 72%, with readings of 73% or above having been bearish historically.³

Non-US Equities

The risk/reward ratio for Euroland and Japanese stocks looks interesting. In addition to valuations which are significantly cheap relative to the US, Eurozone and Japanese equities have a high beta to world growth which, along with the IMF, we expect to return to trend this year. This is true because of the high export share of GDP in these two regions. European companies have substantial operating leverage (though not as much as US ones) and earnings are 15% to 30% below trend, which suggests a mean reversion tailwind. Greater sovereign default risk in peripheral countries (Portugal, Spain, Italy, Ireland, and Greece) has recently increased credit spreads over the German bond yield and the cost of capital for many European countries and companies, with a resulting decline in P/E ratios. However, we believe that the risks of European sovereign contagion are exaggerated by capital markets. Absolute valuations are attractive in Japan, with price to forward earnings ratios well below the historical average. If the European Central Bank and the Bank of Japan cause the euro and the yen to depreciate relative to the dollar through either failing to tighten or easing monetary policy at the same time as concern over European sovereign credit contagion abates, both Japanese and European equities could rally significantly, even in dollar terms. The unchecked strength of the euro and the yen against the greenback have prevented export improvement and tightened financial conditions.

While many emerging market economies have strong underlying growth, there has not been a consistent historical relationship between such growth and equity returns. Long-term structural growth tends to be tempered by cyclical factors over a typical investment horizon. For example, the stronger growth in emerging markets is fueling inflationary concerns with the resulting pressure for policy tightening, a clear headwind for valuation multiples. It is interesting that despite a very high real GDP growth rate of around 8%, the average annual real return on Chinese equities has been negative since 1993. Finally, after each of the three times that the multiple in emerging market equities has exceeded that of the S&P 500 since 1990, there has been a sharp decline in emerging market relative to advanced country equity prices.

As Goldman Sachs has shown, China (and most of the emerging world) and the US (and most of the developed world) are in very different places, with very different risks. This can be seen by looking at Peter Oppenheimer's four quadrant diagram on which the horizontal axis measures GDP growth and the vertical axis monetary tightness. The risks to investing in Chinese equities, together with

many other emerging world equities involve the possibility of overheating growth and overly restrictive policy responses, which would place them in the northeast quadrant of the diagram. In the US and other high income countries, except for Australia, the concerns are the opposite. Lower than expected growth and accommodative but ineffective monetary policy are larger risks to significantly positive equity returns from current levels. They are thus more likely to fall into the southwest quadrant. Emerging market equity positions should be trimmed substantially if there are indications that real GDP growth in the more rapidly expanding economies will be higher than expected and advanced country equity exposure should be reduced on evidence of unexpected growth weakness. This is especially true if the overheating or growth disappointment is accompanied by policy overreactions. We will closely monitor these risks in determining our tactical stock weightings.

Returns of Indices- as of 12/31/2009

	3 Month	YTD	12 Months	3 Year (annualized)		3 Month	YTD	12 Months	3 Year (annualized)
<u>DOMESTIC EQUITY</u>					<u>FIXED INCOME</u>				
S&P 500	6.04	26.46	26.46	-5.63	Citigroup 3-month T-bills	0.03	0.16	0.16	2.22
Russell 1000	6.07	28.43	28.43	-5.36	BarCap U.S. Aggregate	0.20	5.93	5.93	6.04
Russell Midcap	5.92	40.48	40.48	-4.59	BarCap Muni	-0.95	12.91	12.91	4.41
Russell 2000	3.87	27.17	27.17	-6.07	BarCap Int. Govt.	-0.42	-0.33	-0.33	6.08
Russell 3000 Growth	7.65	37.01	37.01	-2.06	BarCap TIPS	1.77	11.41	11.41	6.69
Russell 3000 Value	4.17	19.76	19.76	-8.91	BarCap Int. Corporate	1.34	18.67	18.67	5.66
					BarCap High Yield	6.20	58.21	58.21	5.98
<u>INTERNATIONAL EQUITY</u>					<u>ALTERNATIVES</u>				
MSCI World	4.18	30.79	30.79	-5.09	CS/Tremont AllHedge	5.02	16.26	16.26	-2.38
MSCI EAFE (net)	2.18	31.78	31.78	-6.04	Barclays CTA	0.30	-0.10	-0.10	7.05
MSCI Europe (net)	3.24	35.83	35.83	-6.07	Wilshire REIT	9.15	28.60	28.60	-13.62
MSCI Japan (net)	-2.76	6.25	6.25	-10.36	DJ UBS Commodity	9.03	18.91	18.91	-3.83
MSCI Emerging Mkts (net)	8.55	78.51	78.51	5.11					
MSCI BRICs (net)	10.51	93.12	93.12	7.60					

Fixed Income

We do not expect sustained weakness in the US Treasury market until late in 2010 despite building fiscal pressures and abnormally low real rates of interest, as reflected in TIPS (Treasury Inflation-Protected Securities) yields. Thus far, the ballooning Treasury supply has been counteracted by a decline in net private sector bond issuance, although gross issuance has been significant due to a need to extend maturities. The US government bond market has also received support from both the Fed and foreign buyers. The Treasury has not had trouble financing its large budget deficit.

By the end of the year, however, we expect upward pressure on the ten-year Treasury yield. Markets will anticipate an increase in the Fed Funds target, which is likely to occur when the unemployment rate starts to fall, and there is a clear positive correlation between the Fed Funds rate and the ten-year Treasury rate in past tightening cycles. As the economy expands, higher corporate sector credit demand should also begin to drive up Treasury yields as it has in the past. The case for fiscal restraint is substantially stronger than that for monetary restraint, but given partisan divisions,

it will be difficult for Congress to pass major legislation to address the federal deficit as it did in 1985, 1990, 1993 and 1997. While we would underweight Treasuries, we would not eliminate them; they are still an excellent hedge against global equity market weakness. We would also hold some investment grade corporates since credit spreads are unlikely to widen nearly as much as they did in late 2008.

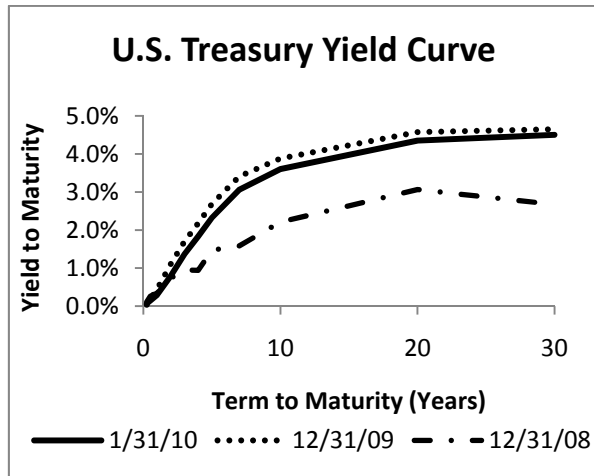
Longer term, the ratio of federal debt to GDP cannot be ignored. According to the IMF, the equilibrium ten-year bond yield tends to rise by three to four basis points for every percentage point in the federal debt to GDP ratio. This ratio is expected to increase by 35 percentage points between 2010 and 2014, which means that the long-term equilibrium bond yield should rise by 125 basis points in the next four years. For this reason, we are in the process of reducing duration in our bond portfolios.

We anticipate that following the stunning decline in spreads since the first quarter of 2009, a more normal risk/reward balance has now been restored in most sectors of the bond market. In fact, mortgage-backed securities and agency bonds will likely underperform as the Fed completes its asset purchase plan in the first quarter of 2010. After the first quarter, achieving a decent return on a bond portfolio will require taking significant credit risk. Fortunately, the environment for adding exposure to credit-sensitive issues remains positive, at least in certain cases. Investment grade and high yield corporate bond spreads are less than one third the levels reached at the height of the financial crisis, but, given current, depressed Treasury rates, still offer a reasonably attractive yield pick-up compared with their longer-term averages. In addition, a rebound in profit growth, along with balance sheet retrenchment, has led to a major improvement in the financial strength of the non-financial corporate sector.

According to the Bank Credit Analyst corporate health monitor, a remarkable turnaround in corporate balance sheet strength was caused, in part, by a significant reduction in leverage in response to the financial crisis and recession. The rebound in equity prices during the past nine months has also been a positive, but in addition the corporate sector has shown considerable restraint in terms of net debt issuance, while net equity issuance has turned positive for the first time since 2002. A complete reversion to the mean implies longer-term targets for the Merrill Lynch US Corporate Index OAS at 125 basis points for investment grade and 480 basis points for high yield bonds, against current levels of 190 and 676 basis points, respectively. Reaching these levels over the next two years would imply annual average excess returns over the Treasury Index of 234 and 1034 basis points, respectively.⁴ However, given the expected increase in Treasury yields the absolute return on five-year duration corporate bonds is likely to be close to zero for investment grade issues. This could also lead to multiple compression in equity markets and may warrant taking some US equity, as well as investment grade corporate, risk off the table. At the same time, high yield bonds, particularly shorter duration ones rated in the BB range, are still quite compelling. The main risk in the overall high yield market is that a much larger than normal quantity of bonds rated below BB mature in 2011 and it is still unclear how well they will be rolled over.

Within the municipal bond space we continue to believe that careful security selection is of paramount importance. Across the country municipalities are facing economic hardship based on a diminishing tax base, residential real estate difficulties, and the failure of revenue generating projects. Municipal bankruptcy filings have been extremely rare since the US Bankruptcy Code was updated in 1937, and we are not predicting a significant number of them going forward, but there is a heightened risk in play. In Pennsylvania, the capital city of Harrisburg is openly

discussing the possibility of filing for Chapter 9 protection. In this case the culprit is a waste incinerator, the Harrisburg Resource Recovery Facility, which is projected to create deficits totaling \$164 million over the next five years.⁵ However, if stable credits can be identified the total return prospects are still attractive. It is not uncommon to see municipal bonds outperform Treasuries during a period of rising rates. In the current environment, the enhanced supply of taxable municipal bonds (part of the Build America Bond program) which in turn limits the supply of traditional tax-exempt paper, as well as expected higher state and federal tax rates are both forces that should keep municipal yields from rising in conjunction with Treasuries.



Source: Bloomberg

Currency and Commodity Returns

	Latest Quarter End (12/31/09)	Latest Year End (12/31/08)	One Year Ago (12/31/08)	Three Years Ago (12/31/06)
CURRENCY				
U.S. Dollar Index Value	77.86	81.31	81.31	83.65
USD vs. Yen	93.02	90.64	90.64	119.06
Euro vs. USD	1.43	1.40	1.40	1.32
GBP vs. USD	1.62	1.46	1.46	1.96
COMMODITIES				
Gold (\$ per troy ounce)	1096.95	882.05	882.05	636.70
Crude Oil (\$ per barrel)	79.36	44.60	44.60	61.05
CRB Metals Index	809.14	402.56	402.56	693.88
CRB Food Index	344.70	294.20	294.20	275.99

Source: Bloomberg

Alternative Investment Strategies⁶

Hedge funds returned 3.1% for the quarter to finish the year up 18.6%, the best calendar year for the group in over a decade. The success was broad based and consistent, as 83% of all funds posted positive returns and the benchmark index was up in every month other than February.⁷ One valuable lesson taught by the tumult of the recent two-year period is the importance of diversification of style within hedge fund portfolios, and the benefits that can be gleaned from rebalancing. This is evident based on a quick glance at the level of performance across styles and sectors. Within the eleven recorded hedge fund styles, the number one and two performers in 2008 were Managed Futures and Short Bias funds. In 2009 those two finished tenth and eleventh, respectively. On the flip side, in 2008 Convertible Arbitrage ranked tenth and Emerging Market funds ranked ninth, while in 2009 those two finished first and second, respectively.⁸

Strong returns were one factor that helped push hedge fund assets up to \$1.5 trillion at the end of 2009, but the drawdown recovery relative to global equities, as well as increased awareness of both regulatory oversight and investor friendly terms also contributed to the pace of inflows. Looking back at the results left behind by recent market volatility, investors recognized that hedge funds as a group fell by 19.5% peak to trough relative to global equities which fell 52.7%, and as of the end of 2009 hedge funds are now only 4.5% off their 2008 peak while global equities ended the year still 26.5% off their 2007 peak.⁹ Calls for increased regulation, both within the U.S. in proposals such

as the Hedge Fund Transparency Act and in Europe in a draft directive from the European Commission, helped support measures the industry was already undertaking to boost investor confidence. The industry has responded strongly to investor feedback by increasing transparency as well as available liquidity in many funds.

Clearly the level of distressed credits has calmed, with Moody's speculative-grade corporate distress index, which measures the percentage of rated issuers that have debt trading at distressed levels, ending the quarter at 18.8% relative to 28.5% from the previous quarter and 54.1% from the year earlier period.¹⁰ However, as indicated earlier, we do feel that an opportunity is looming. Not only do a significant number of high yield bonds mature in 2011, but the spate of LBO activity from 2005-2007 will lead to huge volumes of leveraged loans maturing in 2012 to 2014. To put it in context, combining 2009 and 2010 there will be roughly \$23 billion in leveraged loan maturities while it soon jumps to \$98 billion in 2012, \$160 billion in 2013, and \$263 billion in 2014.¹¹ If distressed investment opportunities have subsided, they are only taking a temporary respite.

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

Asset Class	Base Case Projection	Downside Risk
U.S. Corporate Bonds	<ul style="list-style-type: none"> Some additional spread narrowing is likely but may be offset by a rising yield environment. On a risk-adjusted basis high yield is more compelling than investment grade. 	<ul style="list-style-type: none"> If economic growth stalls spreads would likely widen out. With rates unlikely to fall further principal losses would ensue.
Developed Country Government Bonds	<ul style="list-style-type: none"> Anticipation of a steepening curve will keep us fairly short. Primary benefit may be as a hedge against global equity market weakness, as muted returns are likely. 	<ul style="list-style-type: none"> A quicker than expected withdrawal of stimulative monetary policy and/or further signs of weakness in the European periphery would spell trouble.
U.S. Large-Cap Equities	<ul style="list-style-type: none"> An earnings recovery and the ongoing impact of increased operating leverage are a tailwind. Anticipated difficulties from policy shifts in the second half of the year leave us neutral. 	<ul style="list-style-type: none"> Either a double-dip recession or multiple contraction present a negative environment for stocks.
Other Developed Market Equities	<ul style="list-style-type: none"> Valuations that are cheap relative to the US and a higher beta to emerging economies should lead to returns that outpace US equities. 	<ul style="list-style-type: none"> Any sign of global crisis that renews interest in the dollar will hurt dollar-based returns.
Emerging Market Equities	<ul style="list-style-type: none"> Overvalued equity markets lead to sluggish performance in the short-term but strong growth prospects drive performance over a longer horizon. 	<ul style="list-style-type: none"> A double-dip recession felt globally reduces investor risk appetite and drains investor dollars from the space.
Commodities/Hard Assets	<ul style="list-style-type: none"> Oil and base metals should be the beneficiary of a cyclical recovery in the world economy. 	<ul style="list-style-type: none"> Continuing signs of Chinese tightening may choke off credit flows.

Currencies	<ul style="list-style-type: none"> • Yen depreciation is likely, USD/Euro is a mixed bag, and the Pound will likely benefit from improving fundamentals in UK economy. 	<ul style="list-style-type: none"> • A weaker than expected global recovery or a shock felt by global markets strengthens the US dollar in its return to safe haven status.
Municipals	<ul style="list-style-type: none"> • Rates should be kept down by supply/demand forces but individual issue difficulties remain a threat. 	<ul style="list-style-type: none"> • A second leg down in the US economy, particularly housing, will magnify problems already plaguing municipalities.

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

James L. McCabe, Ph.D.

Adam B. Landau, CAIA

February 9, 2010

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 12/31/09. All returns for periods exceeding one year are annualized.

The forecasts and opinions in this piece may not actually come to pass. The views and opinions expressed above are those of the portfolio management team at the time of writing and are subject to change based on market, economic and other conditions. They should not be construed as recommendations, but as illustrations of broader economic themes.

Equity securities are more volatile than bonds and subject to greater risks. Bonds are subject to interest rate, price and credit risks. Prices tend to be inversely affected by changes in interest rates. Unlike stocks and bonds, U.S. Treasury securities are guaranteed as to payment of principal and interest if held to maturity. Note that it is not possible to invest in a market index.

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¹ Rogoff, Kenneth S., and Reinhart, Carmen M. *This Time is Different: Eight Centuries of Financial Folly*, pg 165. Princeton: Princeton University Press, 2009

² Source: Goldman Sachs

³ Elaine Garzarelli: garzarelli.com

⁴ Source: Bloomberg

⁵ Source: BMO Capital Markets

⁶ 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.

⁷ Source: Credit Suisse, reference index is Credit Suisse/Tremont Hedge Fund Index

⁸ Source: Boomerang Capital

⁹ Source: Credit Suisse, global equities represented by MSCI World Index

¹⁰ Source: Hennessee Group LLC

¹¹ Source: JP Morgan