



Investment Perspective & Analysis

First Quarter 2010

March 31, 2010

SUMMARY & HIGHLIGHTS

- With the exceptionally strong fourth quarter performance of the U.S. economy in the books (+5.6%), the focus of the markets turns to the first quarter results. Many market observers are now debating the trajectory of economic growth once the stimulus provided by the Federal Reserve and the economic stimulus programs begin to wear off.
- The strong economic growth is indeed welcome as it indicates that the Obama policies are working. However, many people on Main Street are still unemployed as well as underemployed as evidenced by the most recent statistics showing the national unemployment rate remains stuck at 9.7%.
- The Obama Administration recently accomplished one of its top priorities with the passage of the Health Care Reform Act that was signed on March 23rd. This bill provides a sweeping overhaul of the delivery of health services in the U.S. It was proclaimed to be “revenue neutral” by the GAO, but many of the true costs will not be known for years.
- Stock prices moved higher during the first quarter of 2010 as more signs of an improving economy emerged and corporate earnings continued to surprise to the upside. The S&P 500 Total Return Index climbed 5.4% during the quarter but still remains well below the high reached in October 2007.
- Industrials (+12.5%), Financials (+10.8%), and Consumer Discretionary (+10.1%) were the best performing sectors during the quarter as investors tended to favor those companies which will benefit from an improving economy and financial system.
- S&P 500 earnings estimates for 2010 continued to trend higher during the first quarter as the improving economy bodes well for a recovery in corporate profits. Analysts are currently projecting S&P 500 earnings of \$78 in 2010, up 37% from 2009.
- Fixed-income securities underperformed equities in the first quarter of 2010 as investors unwound the flight to quality trade given increased stability in the credit markets and signs the economy has bottomed.
- With the possibility of economic growth stalling in the face of higher rates, the Fed will likely be more inclined to use changes in its language to hint at the timing of tightening. It will also continue to remove, or let expire the many programs they have employed to stabilize the economy over the past year.

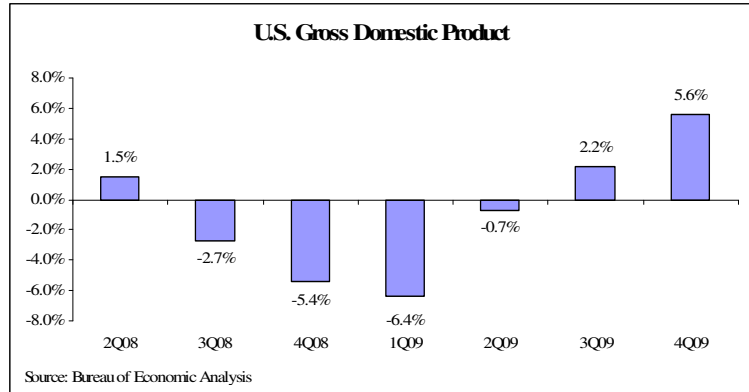
Investment Perspective & Analysis

GENERAL OVERVIEW

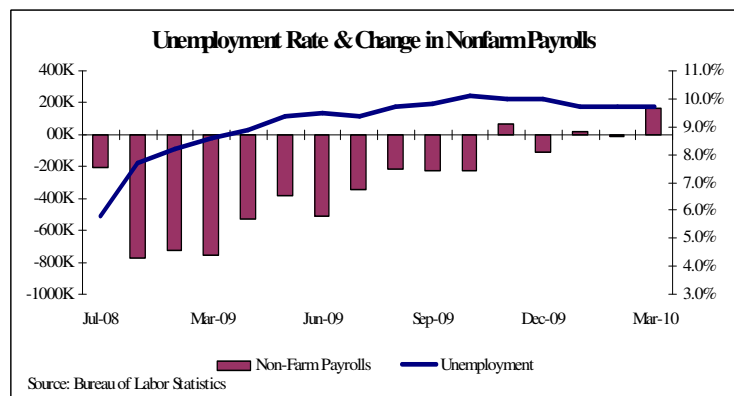
U.S. Economy

With the exceptionally strong fourth quarter performance of the U.S. economy in the books (+5.6%), the focus of the markets turns to the first quarter results. Many market observers are now debating the trajectory of economic growth once the stimulus provided by the Federal Reserve and the economic stimulus programs begin to wear off. Economists are split on the anticipated first quarter results. Some expect GDP growth to slow to about 3.5% - 4.0% in the first quarter 2010 from the 5.6% rate seen in the fourth quarter of 2009 while others expect equally strong results.

This quarterly trend will be closely observed by the Federal Reserve as it contemplates the need to begin to withdraw the extraordinary measures put in place during the financial crisis. As the economic recovery continues over the first half of 2010, interest rates could rise gradually, inducing the Fed to remove its accommodative stance.



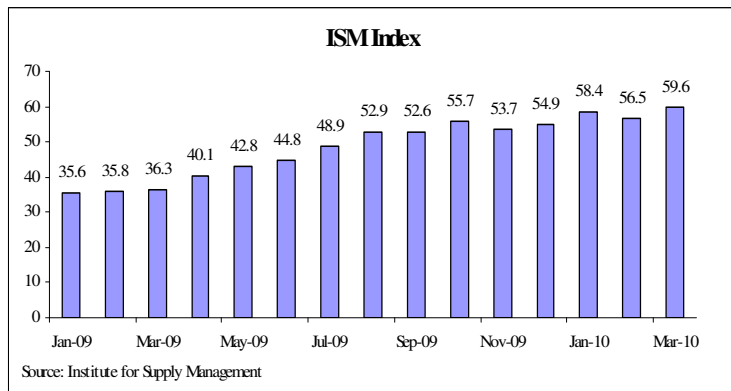
Strong economic growth is indeed welcome as it indicates that the Obama policies are working. However, many people on Main Street are still unemployed or underemployed as evidenced by the most recent statistics showing the national unemployment rate remains stuck at 9.7%. As a result, the U.S. consumer remains somewhat reluctant to spend due to the continuing high rate of unemployment and the ongoing housing market woes. Until employment improves the consumer based economy in the U.S. will be slow to respond. However, just last week Non-Farm Payrolls gained 162,000 net new jobs which will give markets renewed enthusiasm for a sustainable recovery.



Without better job creation, it will be difficult for the housing market to improve and for consumer spending to move significantly higher. Just to maintain the unemployment rate the economy would need to add 100,000 new jobs each month. Over 6.5 million people in the US remain unemployed. Significant amounts more are underemployed. Therefore, even with the recent upturn in jobs, the unemployment rate must improve and continued strong quarterly GDP growth is needed in order to sustain the current level of equity prices.

Investment Perspective & Analysis

Interestingly, the consumer is not leading the economic recovery as has been the case in the past. Currently, the strength of the U.S. economy is coming from increased production, inventory restocking and stronger exports. The Institute for Supply Management Index (ISM Index) which measures economic activity in the manufacturing sector reached 59.6 in March, the highest level since July 2004 as economic activity continued to accelerate. Early last year the U.S. dollar was weak and provided a stimulus for U.S. exports to primarily emerging market countries. Many of



these countries were not involved in the financial/banking crisis and have shown surprisingly strong recoveries. This strength is being driven by internally generated demand from domestic middle class consumers. Traditionally, emerging market economies have been driven by strong exports around the world (particularly the U.S. and Europe) that have fallen off during the financial crisis and economic downturn.

Another big concern for investors is the \$1.56 trillion federal budget deficit for the current fiscal year. This comes on the heels of a \$1.6 trillion deficit for the 2009 fiscal year. This escalating deficit and increasing levels of government debt causes concern among many investors. Creditor countries such as China have already warned the U.S. about its high deficits and have shown concern over future inflation. Thus, it is apparent that something has to be done soon about the deficits. The federal deficit of the U.S. is currently about 10% of GDP (roughly \$14+ trillion) and the net debt is about 65% of GDP. Last week President Obama appointed a non-partisan "Working Group" to recommend solutions for bringing down this unsustainable level of debt. It is our hope that cost-cutting rather than tax increases be the primary tool recommended. However, we are not hopeful and anticipate a series of new taxes that could create doubt about continued strong economic growth.

The Obama Administration recently accomplished one of its highest priority goals with the passage of the Health Care Reform Act that was signed on March 23rd. This bill provides a sweeping overhaul of the delivery of health services in the U.S. It was proclaimed to be "revenue neutral" by the GAO, but many of the true costs will not be known for years. Roughly 32 million new people will now have access to more affordable health insurance. The costs associated with this change must be covered either by new revenue from taxes, fees or cost-shifting. Unfortunately, the bill was passed hastily without bi-partisan support, since most Republicans felt the reform program was ill-timed and ill-conceived. Rather, the Republicans wanted the Administration to focus on job creation and deficit reduction before taking on a massive health care overhaul with so many unknowns, especially the cost impact.

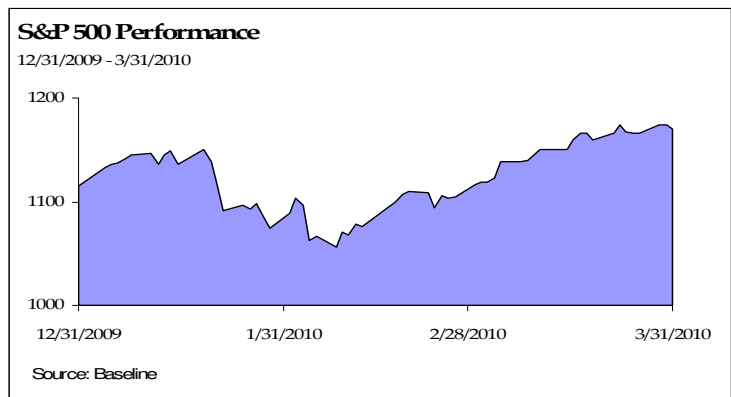
Will the U.S. economy be able to sustain growth in years ahead after the recovery in 2010? That is the question on the minds of many investors. Most respected economists and scholars now agree that a double-dip recession is becoming less likely. However, this does not mean the recovery will be strong. In fact, most economists anticipate U.S. growth will be slow and below the 4%+ prior GDP growth experienced in the late 1990s and early part of this decade. "The new normal" is a term frequently heard implying economic growth in the range of 2% to 3%. This is due to expectations of high unemployment, anemic credit creation, deleveraging and de-risking, the impact of new regulation, higher taxes and slower export demand. This all remains to be seen, but "the new normal" is a scenario gaining wide acceptance and has strong implications for corporate earnings and future stock prices.

Investment Perspective & Analysis

EQUITY MARKET OVERVIEW

Equity Market Performance

Stock prices moved higher during the first quarter of 2010 as more signs of an improving economy emerged and corporate earnings continued to surprise to the upside. The S&P 500 Total Return Index climbed 5.4% during the quarter but still remains well below the high reached in October 2007. Industrial production rebounded as companies began restocking inventories depleted last year in an attempt to conserve cash during the economic and financial turmoil. The employment picture also stabilized as the unemployment rate remained steady at 9.7% through the first quarter.



The numerous government stimulus programs put in place over the past year seem to have put the economy on a more stable growth trajectory. We continued to see that play out in the equity markets during the quarter as investors continued to push stocks higher. The economy has shown significant improvement over the past few quarters with the chance of a double-dip recession less likely, giving investors more confidence in the prospects for corporate earnings and further gains in stock prices.

The move higher was not without a few speed bumps along the way. Stocks traded lower during the second half of January and into the early part of February. China has been a major focus of investors, as it is expected to lead the global economic recovery. In January, China began reversing its economic stimulus measures by tightening bank lending standards. This created concern that more countries were soon to follow China's actions (e.g. the Fed raising interest rates) and that removal of such stimulus measures might derail the economic recovery. At the same time, Greece's fiscal problems began to intensify causing fear they may spread to other troubled European countries. While stocks have since recovered from that short-lived downturn, it was a good reminder to investors how sensitive the equity markets remain to the economic turmoil caused by the financial crisis.

All the major U.S. indices continued on their upward trend during the first quarter, albeit at a slower pace than in the previous few quarters. After underperforming in the fourth quarter of 2009, small cap stocks outperformed in the first quarter of 2010 as measured by the Russell 2000 Index which gained 8.5% versus a return of 5.4% for the S&P 500 Total Return Index. International

Equity Performance	2Q09	3Q09	4Q09	1Q10
Dow Jones Industrials	11.9%	15.7%	8.1%	4.8%
S&P 500 Total Return	15.9%	15.6%	6.0%	5.4%
Nasdaq	20.1%	15.7%	6.9%	5.7%
Russell 2000	20.2%	18.9%	3.5%	8.5%
Wilshire 5000	16.2%	15.8%	5.4%	5.8%
MSCI-EAFE	25.4%	19.5%	2.2%	0.9%
MSCI-Emerging Markets	33.6%	20.1%	8.3%	2.1%

equities underperformed domestic equities during the quarter as measured by the MSCI-EAFE Index (+0.9%) and MSCI-Emerging Markets Index (+2.1%). Many of the European Union (EU) countries experienced a sell-off as Greece's fiscal troubles began to weigh on its EU counterparts. Emerging market stocks were the big winners in 2009 returning 74.5% but appeared to take a bit of a breather to start 2010. The Chinese equity markets in particular cooled off as the Chinese government began removing stimulus measures to rein in economic growth and prevent asset bubbles from materializing.

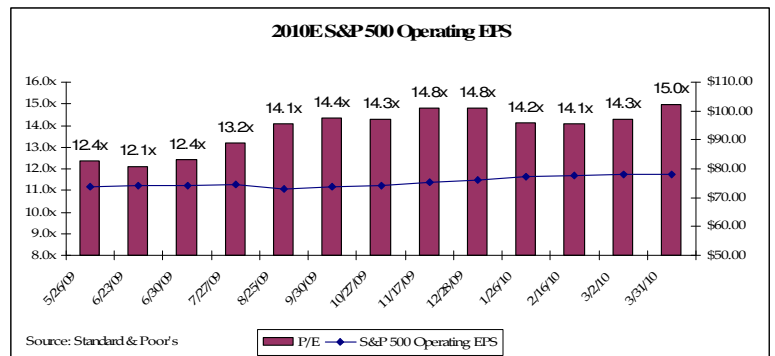
Investment Perspective & Analysis

Industrials (+12.5%), Financials (+10.8%), and Consumer Discretionary (+10.1%) were the best performing sectors during the quarter as investors tended to favor those companies which will benefit from an improving economy and financial system. Berkshire Hathaway performed exceptionally well gaining over 20% as the company split its "B" class shares 50-to-1, making the stock more alluring to small investors. The company was also added to the S&P 500 causing a spike in demand from index fund managers that needed to purchase the shares for their funds. Defensive sectors such as Telecom Services (-5.7%) and Utilities (-4.6%) continued to underperform as investors continued to flock toward assets with a higher risk/return profile.

S&P 500 Sector Performance	2Q09	3Q09	4Q09	1Q10
Consumer Discretionary	17.7%	18.9%	8.6%	10.1%
Consumer Staples	8.9%	10.5%	4.2%	5.0%
Energy	10.1%	9.5%	5.0%	0.1%
Financials	35.1%	25.1%	-3.7%	10.8%
Health Care	8.3%	8.9%	8.5%	2.9%
Industrials	18.0%	21.2%	4.8%	12.5%
Information Technology	19.4%	16.7%	10.5%	1.7%
Materials	15.5%	21%	6.9%	2.4%
Telecom Services	1.9%	4.0%	5.9%	-5.7%
Utilities	8.8%	5.0%	6.1%	-4.6%

S&P 500 Earnings

S&P 500 earnings estimates for 2010 continued to trend higher during the first quarter as the improving economy boded well for a recovery in corporate profits. Analysts are currently projecting S&P 500 earnings of \$78 in 2010, up 37% from 2009. Fourth quarter and year end 2009 earnings reported over the past few months were generally better than expected, helping to boost confidence that the economic recovery is taking hold. Going forward, it's important to keep an eye on earnings expectations as the government begins to retract its stimulus programs. There is still much debate over how much of the economic recovery has been driven by these government programs.



BOND MARKET OVERVIEW

Bond Market Performance

Bond prices limped out of 2009 to sit near their worst levels since June on 10-year Treasuries, the yield flirting with 4.0%, briefly. Bond prices and yields move inversely. The recent run-up in rates was reflected in the latest mortgage rate data, with Freddie Mac reporting the 30-year fixed rate averaging 5.14% over the past week, up from 5.05% and the highest since last August. Those rates are expected to increase as the Fed withdraws its mortgage purchasing program in the second quarter.

With the possibility of economic growth stalling in the face of higher rates, the Fed will likely be more inclined use changes in its language to hint at the timing of tightening. It will also continue to remove the many programs it has employed to stabilize the economy over the past year. Those moves are seen as small steps toward lessened accommodation. The market should respond to further chatter on those measures by pressing rates higher.

Economists at New York-based JPMorgan Chase & Co. and Goldman Sachs Group Inc., the second- and fifth-largest U.S. banks by assets, say there's so much deflationary pressure coming from excess labor and plant capacity in the economy that the Fed won't raise interest rates until at least 2011.

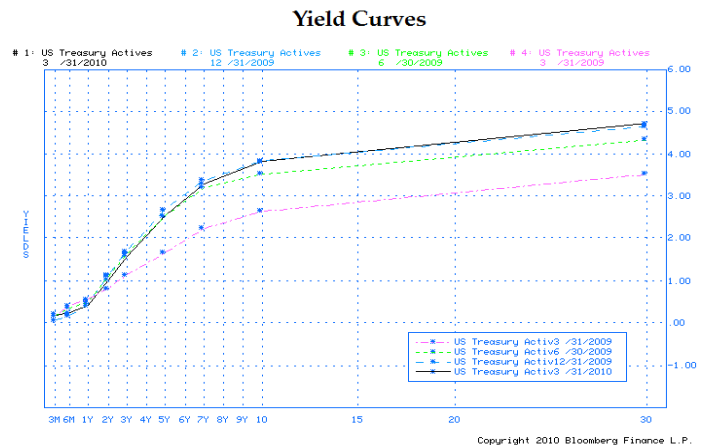
Investment Perspective & Analysis

Fixed-income securities underperformed equities in the first quarter of 2010 as investors unwound the flight to quality trade given increased stability in the credit markets and signs the economy has bottomed. High yield bonds gained 4.9%, outpacing all other categories as the risk premium for those bonds continued to decrease. As prices increase, the once higher yield that reflected the extra perceived risk decreases.

Bond Market Performance	2Q09	3Q09	4Q09	1Q10
90 day T-bills	0.1%	0.1%	0.0%	0.0%
10 year T-notes	-6.3%	2.7%	-3.6%	1.1%
Corporates	9.4%	7.9%	1.1%	2.4%
Agencies	0.7%	4.4%	-0.3%	2.3%
GNMA Bonds	0.3%	2.7%	0.4%	2.0%
TIPS	1.2%	5.7%	3.2%	1.0%
High Yield Bonds	26.2%	15.4%	6.8%	4.9%
Municipal Bonds	2.4%	8.1%	-1.1%	1.4%

Yield Curve

The current yield curve included in the graph to the right could retest the June highs in both short and long term interest rates. Long rates have moved up over the last year signaling investors' growing concern about the at-record issuance of Treasuries. However, the Treasury and the Fed are keeping short rates down. Many see low interest rates as the engine for keeping the economy out of another recession.



Spreads

Credit spreads tightened over the past year as the perceived risk of corporate bonds vs. Treasuries decreased. The Twos/Tens Spread (yield difference between Two-Year Treasuries and Ten-Year Treasuries), a measure of the steepness of the yield curve, widened to 283 bps at the end of the quarter after being as tight as 140 bps at the beginning. A normal spread of about 250 bps indicates healthier margins at financial institutions that normally borrow at short term rates and lend at long term rates.

The Credit Spread (yield difference between U.S. Treasuries and Corporates), a good measure of fear, reached a twelve month low in March 2010 at 101 basis points having contracted during the first quarter. Spreads had moved to as wide as 361 basis points during the market lows.

The Junk Spread (yield difference between U.S. Treasuries and High Yield Corporates), a good measure of risk-premium or the amount of additional return necessary to accept significant default risk, reached a twelve month low of 314 basis points near the end of the first quarter. Since the peak in spreads at 1116 basis points in December of 2008 spreads have moved past historical norms and into low risk premium territory.

The TIPS Spread (yield difference between U.S. Treasuries and TIPS), a good indication of inflation expectations ended, the quarter at 245 basis points as inflation expectations have risen. Over the past fifteen months we have seen it steadily widen from a low of 21 basis points in January 2009.

Richard A. Mayer
Peter C. Amling
Seamus P. Caruso, CFA

Written 4/7/2010 Dow: 10,897.52 S&P: 1,182.44
 ©2010 Ridge Investment Advisors, Inc. All Rights Reserved.