



Fort Washington Investment Advisors, Inc.

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Market Update

Markets at Mid-Year: Stabilization Does Not Spell Strong Recovery

Following a poor start at the beginning of this year, stock and bond markets have rallied over the past four months, with risky assets posting the largest gains. The rally has been fueled by two key developments. First, efforts by the Federal Reserve and U.S. Treasury to backstop the financial system have succeeded in calming investors' fears about a systemic collapse and nationalization of the banks. Second, evidence that the U.S. and global economy are stabilizing has bolstered confidence about economic recovery in the second half of this year, and has even caused some observers to anticipate a pick up in inflation.

Our assessment is that the worst of the economic and financial storm is past. One of the most encouraging developments is that businesses have worked off excess inventories and are expected to resume production in the second half of this year. Also, consumer spending stabilized in the first half of this year, after having declined at a 4% annual rate in the second half of 2008. Furthermore, economic growth in China and other parts of Asia has turned positive, which should help bolster worldwide trade, after it plummeted in late 2008 and early 2009.

Nonetheless, we do not anticipate a robust economic recovery. Although conditions in credit markets have improved from the virtual standstill last autumn, they are still not functioning normally, and banks are continuing to hold substantial excess reserves (beyond those needed to meet reserve requirements). Furthermore, consumers are not well positioned to increase spending materially, with personal incomes growing modestly and household net worth having fallen by a record amount in 2007-2008. While increased transfer payments have provided a temporary cushion, individuals have opted to increase their saving rates from very low levels, especially as job losses have continued to mount. Conditions in the residential housing market appear to be stabilizing in terms of housing starts and home sales, albeit at extremely depressed levels, and home prices are still depressed owing to delinquencies and foreclosures.

Overall, we look for the U.S. economy to expand at a modest 1%-2% annual rate in the second half of 2009. While this may meet the technical definition of a recovery, it will not appear that way to most people: job losses are likely to continue into the first half of 2010, when the unemployment rate could reach 10 ½% or more. Businesses are also likely to keep capital spending in check until profitability is restored, and capacity utilization will likely stay below 70% into next year.

Given the substantial slack in the U.S. and global economy, we believe talk of rising inflation or of monetary tightening by the Federal Reserve is premature. While oil and raw material prices have risen this year, they have also been extremely volatile; consequently, they have not been reliable indicators of broad-based inflation as measured by the consumer price index. For its part, the Federal Reserve has never raised interest rates coming out of a recession when the unemployment rate is rising. And we do not expect the Fed to set a new precedent, especially with the U.S. economy and financial system suffering its worst downturn in the post war era.



One area of concern is the prospect of a massive build-up of federal government debt, not only in the next year or two, but continuing into the coming decade. The latest projections by the Congressional Budget Office (CBO), for example, call for budget deficits to average 5.5% of GDP in the coming decade, with the federal debt burden roughly tripling over that period. An increase of this magnitude poses a risk that it could undermine investor confidence, especially on the part of foreign investors such as China, who already have large holdings.

Weighing these considerations, we are continuing to favor high quality corporate bonds over treasuries in our fixed-income portfolios. This strategy has worked out very well thus far, as credit spreads versus U.S. Treasuries have contracted from record levels. While credit spreads are unlikely to narrow as much in the second half of this year, we believe investors are being adequately compensated for credit risk.

With respect to equities, we are continuing to hold excess cash positions, and are waiting for a further market pullback to add to positions. While the stock market appears to be fairly valued now, we do not see a catalyst to take the market significantly higher in an environment of sluggish economic growth.

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