



Financial Markets Commentary

July 2010

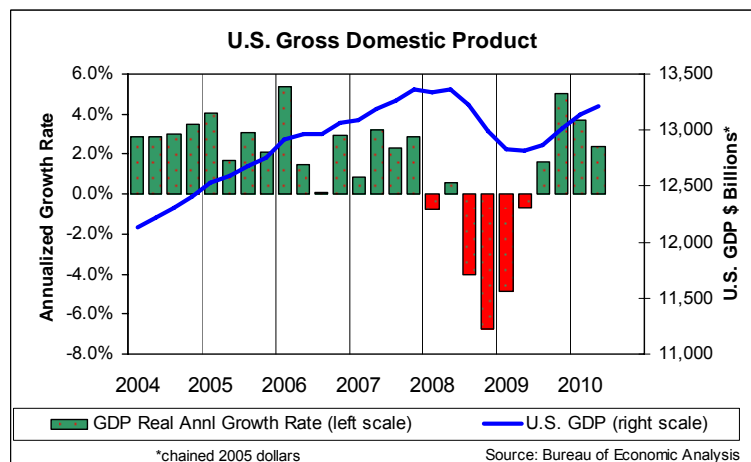
Fear forced its way back into the markets during the second quarter, moving the majority of flows into the “risk-off” trade and sending almost all investments that were not U.S. Treasuries lower. The increase in volatility and the stock market correction was not surprising as we projected clearly in our April commentary. What did surprise us, however, was the swift retreat into U.S. Treasuries, which are apparently still considered to be the least risky asset. Stoking the fear were heightening concerns over the solvency of Greece and other periphery Euro-based countries, the durability of the Euro currency itself, the policy responses of the various Euro member governments as well as the European Central Bank (ECB), a lack of acceleration in U.S. economic growth, disappointing job growth in the U.S., an increase in the divide of opinions about the appropriate U.S. fiscal and monetary policy responses, and concern over the Chinese government’s ability to manage sustainable growth or soft landing. That is a whole lot of moving parts, each with significant ramifications, so uncertainty reigns. Although it is an especially risky environment we do not believe it is prudent (or possible) to avoid risk (hiding in U.S. Treasuries carries risk). As usual, we believe the most appropriate response is to diversify risks.

A summary of our recommendations follows:

- Although we expect continued volatility, slow economic growth and more European debt turmoil, clients should maintain their equity allocations near long-term targets. Furthermore, stay with the tilt toward high-quality, less levered, cash flow-positive businesses, active investment managers and a globally diversified portfolio.
- Maintain allocations to bonds near your long-term targets. Avoid or reduce U.S. Treasury and other sovereign issuers in favor of corporate and municipal issuers and a portion of high yield bonds.
- Maintain a target allocation to managers or funds that execute active global tactical allocation strategies as well as other alternative strategies.

Economy

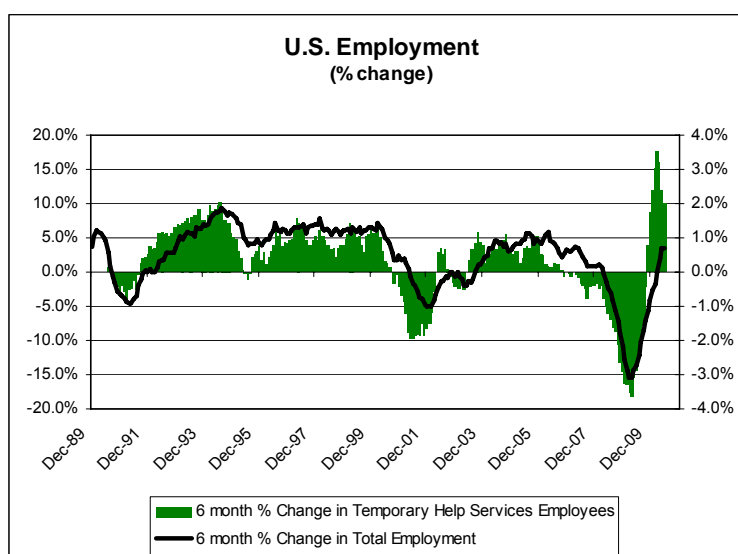
It might not feel like the economy is growing but it has been. The problem is that it has not been growing fast enough to generate job growth. In addition, business managers remain very wary about the sustainability of the growth and uncertain about the ramifications of health care reform, financial regulatory reform and tax policy. So the pent-up demand-led recovery of the second half of 2009 has already moderated into a slow-growth pace. Businesses and consumers alike are saving. The ISM Purchasing Managers Index pulled back from its April peak of 60.4 to 56.2 in June which still indicates expansion, and the Fed’s Industrial Production Index continued to improve through



May. Similarly, the Conference Board's Index of Leading Economic Indicators continued to move higher through May, but at a slowing rate.

Officially, the Bureau of Economic Analysis (BEA) reported that the U.S. economy grew at an annual rate of 3.7% and 2.4% during the 1st and 2nd quarters of 2010, respectively. The 2nd quarter growth rate was slightly behind consensus of forecasts and most economists are expecting slower but positive GDP growth during the second half. Given the poor consumer spending and sentiment statistics, there is growing concern that we will slip into recession again. Here lies much of the debate about whether or not we need and can afford further fiscal stimulus.

The unemployment rate did improve in June, falling to a rate of 9.5%, despite a decline in payrolls. Sadly, the reason that the unemployment rate dropped was mainly because of a drop in the labor force participation rate; the number of people working and seeking work. This has been moving lower since the middle of 2009. The aggregate hours worked for all employees in the U.S. has grown only slightly (1.4%) so far this year. Logically, we should expect that the number of hours worked will need to establish a convincing trend higher before we can expect businesses to add employees. On the bright side, the ranks of temporary workers, which is typically a leading indicator to broad employment, has been growing briskly since October. On the contrary, there has been a sharp rise in the length of time prospective workers have remained unemployed. Over the last 25 years the median duration of unemployment has ranged between 5 and 10 weeks, but it has recently skyrocketed past 25 weeks. This uncharted territory adds legitimate concern to the possibility of a double dip recession. Furthermore, state and local municipalities are just getting started in their own cost cutting plans and we expect to see negative job creation in the public sector.



Except for certain emerging economies, economic growth outside the U.S. has been sluggish at best. Much of Europe is experiencing growth of less than 1% annualized and is suffering high unemployment rates. As has been well publicized, more than a few countries within the European Economic Union have high debt levels and significant budget deficits. This is straining and testing the political relationships of the European Union and fanning fears about the solvency of the major banks that own the debt of these nations. Growing outrage about the soaring public debt levels has sparked a movement toward strict government austerity plans. There is now a wide public debate about whether governments should be aggressively stimulating their economies (which would require increased leverage) or aggressively cutting spending.

Meanwhile officials in China are trying hard to slow its double digit growth rate without damaging the economy. Throughout the past several years they have been spending heavily in order to build out a self-sustaining economy which would include a large urban and suburban based middle class. This has included massive government funded building projects and stock piling raw materials. Since China is primarily a centrally planned economy and apparently has resources to continue spending, there is reason to believe that it can engineer its growth rate for some period of time. However, there are legitimate concerns that it is overbuilding and setting up an asset bubble. In any case, China and other growing emerging markets have become important components in the global economy and bear watching regardless of one's investment exposure.

Stocks

Stocks rallied through most of April, and then dropped sharply in May and June. The April gains came as a result of 1st quarter earnings reports, which generally came in as good as or better than expected. While much of the earnings growth has been generated through cost cutting, 1st quarter earnings reports did include some revenue gains. It will be important for the market to see follow through in revenue increases during the 2nd quarter (being released currently).

The market rolled over quickly in May, catalyzed by worries that defaults of nations such as Greece would significantly harm European banks, causing another financial crisis. The uncertainty surrounding the ECB's response and the survivability of the Euro drove sentiment and risk appetites lower. In addition, after a roughly 80% run up from the March 2009 lows with limited breaks, the stock market was naturally ready for a correction, and used any adverse news as a catalyst to break. The variability of opinion over the sustainability of this economic recovery and the wide divide over possible governmental policy responses have driven uncertainty and thus volatility sharply higher. The VIX index, which measures the volatility implied in S&P 500 options contracts more than doubled from 16% up to the mid 40%s in May before retreating somewhat to 34% at quarter-end.

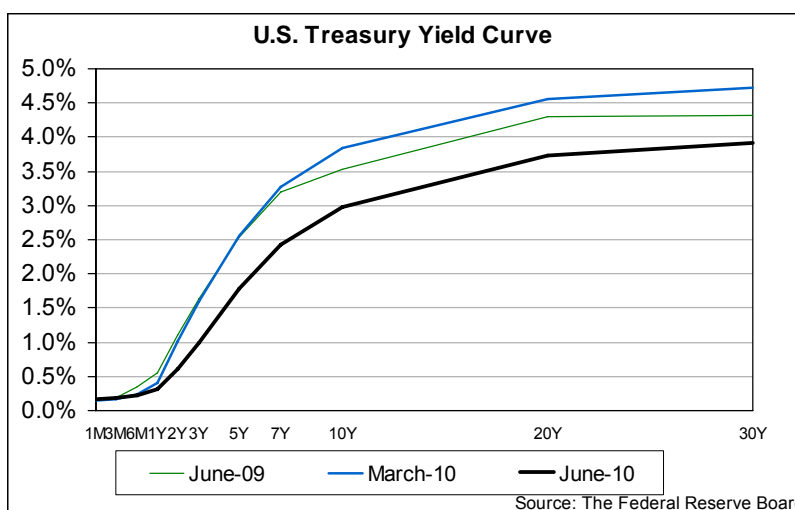
Virtually all stocks retreated during the 2nd quarter. There was little difference between value and growth styles, and large caps fell slightly more than small and mid-cap indices. The differences in returns across style and capitalization gradients were most likely arbitrary as the sell-off seemed to be an indiscriminant paring of risk exposure. From a sector perspective, the less economically sensitive sectors such as utilities and consumer staples and telecom fell the least, while most sectors dropped by more than 10% during the 2nd quarter.

European stocks fared about the same in local terms, but dropped slightly more in U.S. Dollar terms due to the weakness of the Euro. Pacific region markets, including Japan also moved sharply lower. Not surprisingly, most emerging markets also suffered from the brisk withdrawal of risk exposure, but the Chinese market only dropped about 4.5%, and the Indian market fell only 2% in USD terms. Recall that these markets had performed poorly during the 1st quarter so these may be merely differences in timing.

The S&P 500 Index returned -11.43% during the 2nd quarter, while the S&P Mid-Cap 400 returned -9.59%, and S&P Small Cap 600 returned -8.73%. The MSCI EAFE index returned -13.97% and the MSCI EM Index returned -8.37% (USD) for the 2nd quarter. This left most broad domestic and international indices down between 6% and 10% for the year to date, while small and mid-cap indices were down only slightly.

Bonds

Long-term U.S. Treasury bonds were the best performing asset during the 2nd quarter as investors rushed out of risky assets and into U.S. Treasuries in May and June. The yield on 10-year U.S. Treasury bonds moved lower by 87 basis points (0.87%) to just under 3%. The yield for the 30-year bond moved similarly to a level just below 4%. In the absence of the rush to safety we would have expected Treasury yields to rise slightly as a result of the Fed's termination of its quantitative easing program, investors' concern with the expanded money supply, the amount of debt outstanding and the heavy future issuance expected. Although it flattened, the yield curve remains historically steep because short-term yields are being held to a minimum through Fed policy. The Citi 10-

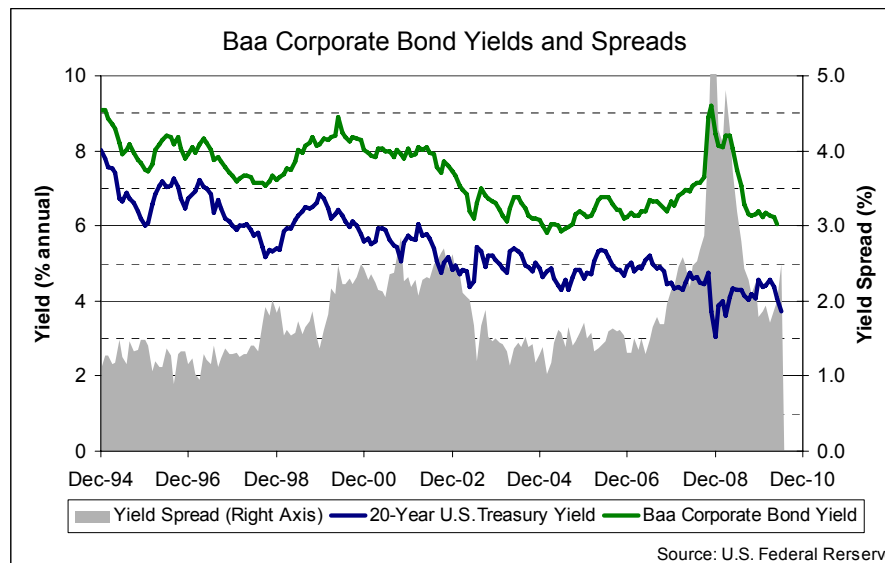


year U.S. Treasury Index returned 8.32% during the 2nd quarter, while the Merrill 3-month T-bill Index returned 0.04%.

Investment grade and high yield credit spreads widened as investment grade yields did not drop as much as Treasuries, and high yield rates backed up in the flight from risk. With the return from income, investment grade bonds provided attractive returns while total returns for high yield bonds were only slightly negative on average. At almost 250 basis points (2.50%) we view the yield spread for Baa bonds as relatively attractive. The yield spread for high yield bonds is again in excess of 600 basis points (6.00%).

The BarCap U.S. Aggregate Bond Index returned 3.49% during the 2nd quarter, the Merrill Lynch Corporate Bond Index returned 3.26%, and the BarCap US High Yield Index returned -0.11%. Foreign bonds did not fare as well since the herd's migration was generally

out of everything and into U.S. Treasuries and the U.S. Dollar. The BarCap Global Aggregate Bond Index returned -0.04% for the 2nd quarter.



Yields on high quality municipal bonds dropped marginally so that the relative yield to Treasuries improved during the quarter. The yield on the BarCap Municipal 10 Year Index is at a premium to 10-year U.S. Treasuries even though it is tax-free. The BarCap Municipal Bond Index returned 2.03% for the quarter while the shorter term BarCap Municipal 5 Year Index returned 1.68%.

Cash

In reaction to heightened fears over the health of European banks given their exposure to the sovereign debt of countries such as Portugal, Italy, Greece and Spain (PIGS), LIBOR (London interbank offered rate) moved higher during the quarter. Three month LIBOR increased from 0.29% at the end of the 1st quarter to 0.53% at the end of June. This is a significant concern as it is reflective of the general health and psychology of the financial markets, and a sharp rise in LIBOR was an ingredient in the 2008 financial crisis. In order to quell widespread fears and increase visibility of the banks' finances, European Union regulators ordered stress tests, similar in nature to those performed on U.S. banks in early 2009, on all European banks. The results, released in mid-July suggested that most banks were satisfactorily capitalized. LIBOR has since moved modestly lower. Aside from the rise in LIBOR, all other short-term funding rates have remained near all time lows and the commercial paper markets are functioning. According to iMoneyNet, the current yield for the average money market mutual fund is 0.04%.

Alternatives

Following the equity and commodity market declines and widening credit spreads in May and June as explained above, nearly all hedge fund styles had negative performances during the 2nd quarter as measured by the Dow Jones Credit Suisse Hedge Fund Indexes. Not surprisingly, the major exception was the Dedicated Short Bias strategy. Year-to-date, average hedge fund results for the first half of the year are fairly flat.

April's strong performance encouraged managers to further lever established long positions in global equities and commodities and to add to short positions in U.S. rates. However, market nervousness over

the Gulf oil spill, sovereign European credit downgrades, slowing global economic growth and growing government deficits soon led to volatility spikes, flights to credit safety, and asset price declines. As these price reversals unfolded, managers delevered (liquidated) positions to cut losses. They are currently reevaluating their economic and geopolitical outlooks for the 3rd quarter and plan to reenter the markets cautiously.

Prior to the market disruptions, new hedge fund launches raised almost \$11 billion, a marked increase over the first half of 2009. Larger hedge funds garnered most of the new assets.

The private equity sector is still managing its existing portfolios and suffering from a lack of new investors. Most new fund launches have been delayed until the end of the 2010. According to one survey (Preqin), over the near term, existing clients are only planning to use distributions to honor previous commitments, and net new investment funds may not appear until the second half of 2011.

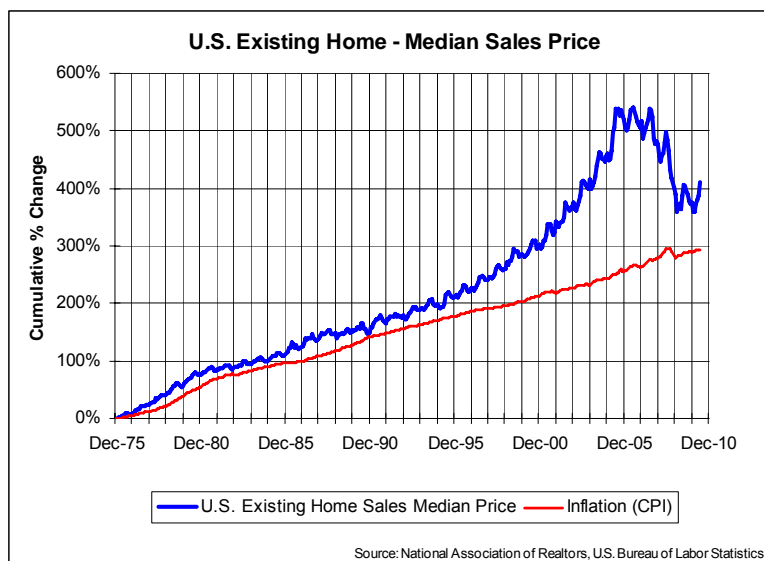
Cambridge Associates (CA) U.S. Private Equity Index latest results through March, 2010 show the fourth consecutive quarter of positive performance and a one year return of 22.5% (versus 46.93% for the S&P 500 Index). Cambridge Associates believes there is a large capital overhang – money raised that remains uncalled – that stands at \$445 billion. As these funds are invested, the overall performance of outstanding offerings should be reduced given CA's forecast for lower expected returns.

Real Estate

REITs and publically traded REOCs followed the equity markets lower during the quarter although REITs performed better, possibly due to their income component. The Dow Jones Wilshire Global REIT Index returned -6.02% for the 2nd quarter. Despite the yield advantage we continue to believe that the commercial real estate market offers more risks than potential rewards and still presents a significant risk to the banking system.

Residential real estate prices rose modestly during the quarter and have stabilized since the end of 2008. Importantly, the number of transactions has rebounded from its early 2009 low of about 4.5 million per annum rate back to a rate of about 5.5 million homes per year. Although many of these transactions may be foreclosure sales and many others are motivated by first-time home buyer tax credits, the stabilization and increase in volume is critical.

We do not expect home prices (on average) to rise meaningfully any time soon, nor do we think that the government should try to promote rising real estate prices. Residential real estate prices are not depressed (on average). Years ago, noted economist Robert Shiller postulated that over the long-term, real estate prices should appreciate in line with inflation and that the acceleration of price increases beginning in the mid-1990s was an unhealthy aberration. From a long-term historical perspective, residential real estate prices are somewhere between back to normal and still slightly over valued, depending upon the statistic and time period one analyzes. Because of extremely low interest rates, the affordability of housing is about the best it has ever been and that is good for the economy, as it frees up consumers' income for other uses. If we refrain from the recently formed habit of viewing residential real estate as a naturally appreciating or speculative asset class and instead



view it as a necessary cost of living we can rejoice in stable prices instead of lamenting the lack of price inflation. The American dream may be to own a house, but it shouldn't be to get rich by virtue of owning one or four.

Commodities

Just like most other risky assets, most commodities prices moved lower during the 2nd quarter and particularly in May. The S&P GSCI Index fell -10.41% for the quarter. Energy and industrial metals were down sharply, -12.6% and -18.0%, respectively. Agricultural commodities were virtually flat on average, although coffee rose sharply in June, and livestock fell modestly. Sugar continued to be extremely volatile, rising almost 12% in June after dropping almost 16% in April and May. Precious metals displayed their recent properties as one of the places investors run to reduce risk. Flows into the Gold and Silver ETFs continued to be strong, and the spot commodities prices appreciated 11.7% and 6.4%, respectively, for the quarter.

Looking Forward

Much has been made of the large amount of cash now present on corporate balance sheets. Many commentators have declared this a positive for the market, but is it really? We agree that it provides corporations with flexibility to operate and execute with less dependence upon the capital markets and it provides a floor in valuation. Hence, it lowers risk and enhances corporations' ability to exploit opportunities. However, the question remains as to why businesses have not utilized their cash to a greater extent.

This is not a new situation. With the exception of the financial sector, corporate balance sheets have been flush with cash for several years. Yet, growth in capital expenditures has been sluggish, mergers and acquisition activity has been generally meager, and more conservative uses of cash such as the repurchase of outstanding stock or increases of dividends, have been limited. PIMCO's Mohamed El-Erian has opined that businesses are self insuring against economic and financial risk due to the extreme uncertainty surrounding changes in tax, regulatory, and health care policy, not to mention the uncertain economic environment. It may simply be that there are very few opportunities for investment. Until there is evidence that corporations are more aggressively putting cash to work we should expect a low return environment

It is well understood that the markets and economy are most uncertain near inflection points and that we are currently going through a period of inflection. There remains a wide disparity of expectations for inflation/deflation and diverse possibilities of policy actions in the U.S and abroad. Although the fervor over the possible default or restructuring of PIGS debt seems to have ebbed, we do not believe that situation is settled and it is likely to flare again in the coming months. For all of these reasons we expect continued above average volatility.

The battle between inflation and deflation is not yet settled, although the recent slowing of leading indicators has further reduced the likelihood of inflation. Until employment and capacity utilization demonstrate a strong trend higher we should expect disinflation or deflation in the immediate term. While a severe deflationary spiral would favor only high-quality bond investments, we believe that the most likely scenario is one of moderate deflation or very low inflation in which stocks of companies that generate cash earnings and can grow revenues and earnings will perform best. In addition, stocks will perform much better than bonds in an environment where inflation is higher than expected,

From a long-term perspective and relative to Treasury yields, stocks are attractively valued. However, valuation is not a reliable guide to short-term price movements. Currently, the stock market's technical characteristics (price patterns and volume statistics) are unattractive, reflecting market participants' uncertainty, skepticism and risk aversion. The debt markets, with extremely low Treasury yields and higher than average credit spreads corroborate the skepticism. The vitality of the economy and the strength and quality of corporate earnings reports will be the key going forward. So far in this "earnings season," 2nd quarter earnings reports have been coming in mostly better than expectations, with evidence of revenue growth to go along with expense reductions.

Ultimately, our basic recommendations and investment themes remain unchanged. Despite above average expected volatility, low economic growth and the significant probability of further sovereign debt

problems, we believe it is prudent for clients to maintain their stock allocations in line with their long-term strategic allocations. Because of the high-risk environment we continue to advocate a tilt toward high-quality companies with solid balance sheets and positive cash flow. There remains solid growth potential in emerging markets in which companies domiciled throughout the world can participate. In the debt markets we find that investment grade corporate and high-quality municipal bonds offer attractive yields. If the Treasury curve rises, we would expect spreads to tighten so that corporate and municipal bonds will hold value. We advocate a selective and limited allocation to high yield and emerging market bonds where yield spreads are still slightly above average. Finally, we continue to observe that tactical asset allocation and other selective alternative strategies can generate positive returns and bring diversification to ones portfolio.

July 30, 2010

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Chief Investment Officer

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