

Economic Outlook is Mixed

October 22, 2010

Investment Strategy:

Equities:

An overweight among S&P groups is advised in Energy, Materials and Health Care. Market weights are advised in Industrials, Financials, Information Technology and Utilities. We are under weighted Consumer Discretionary. Energy was upgraded this month, Industrials were downgraded.

Fixed Income:

Our view on long bonds based on current macroeconomic trends is neutral. We would rate the current duration environment as a 5, the same as last month. Our duration is scaled from 1 to 10, with 1 representing a maximum position in Long Treasuries and 10 representing a maximum position in short term debt.

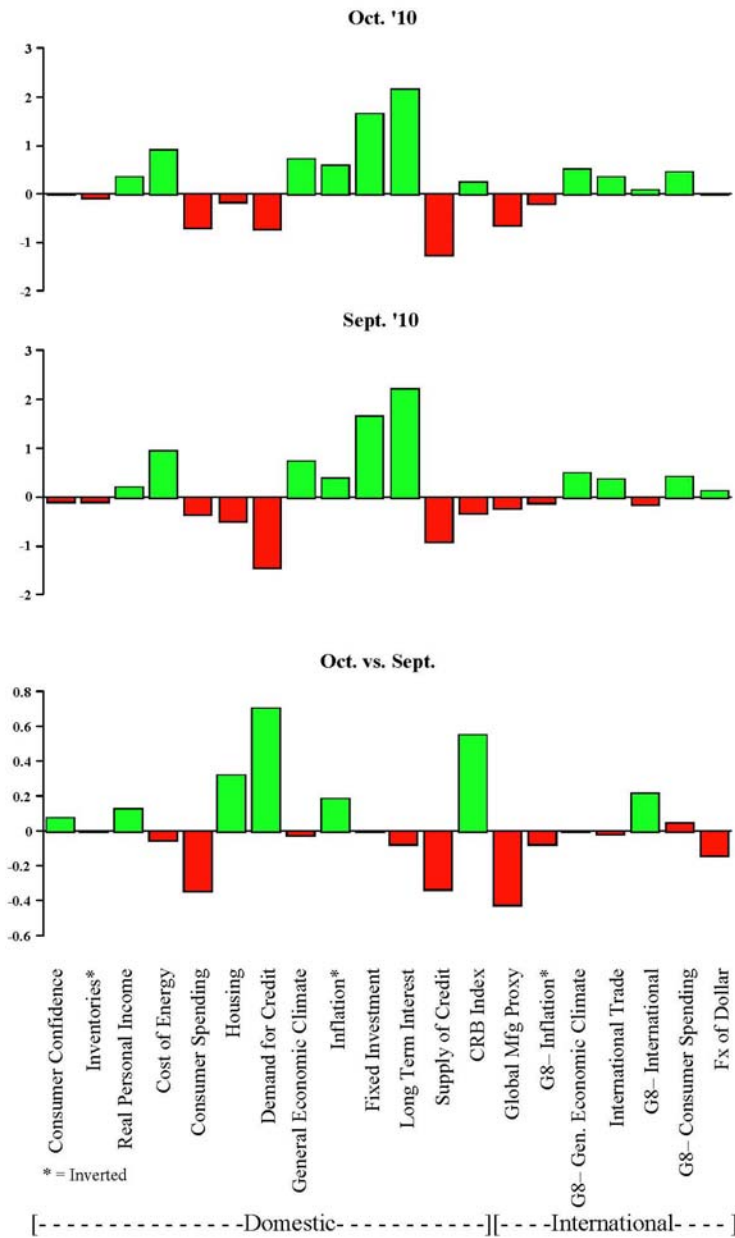
Hedge Funds:

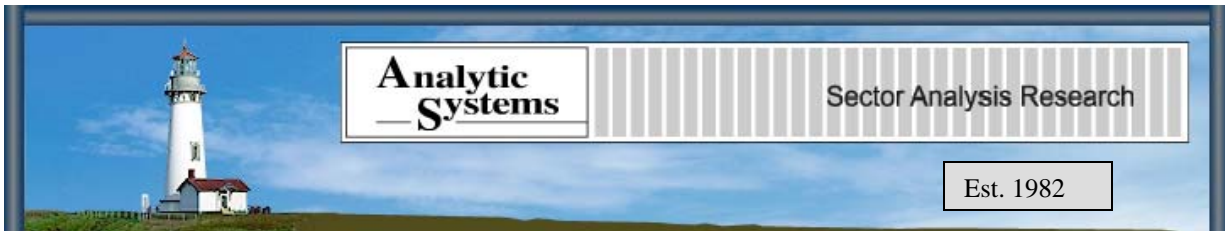
We are long Energy, Materials and Health Care. After a very strong year with ASC's advising a bias toward risk since Dec. 08, the ASC model began suggesting in November '09 that one should gradually begin to opt for more safety in equities, fixed income and alternative investments. July 2010 was the first month since November '09 that we started upping the ante toward risk.

Fact Forward Inferences:

Analytic Systems' approach to forecasting is fact-based, rooted in recent economic history and mathematically driven—incorporating new realities. The top bar graph on the following page shows the velocity (first derivative) of key areas of the US and G8 economies for October 2010, the middle shows the velocity for September 2010 and the bottom bar chart shows the acceleration or deceleration (second derivative) in trends that occurred in October 2010.

The following charts show fact based trends in ASC Economic factors as of October 2010 as compared to September 2010 and changes expressed in standard deviations around the norm, hereinafter referred to as “units.”





The model highlights the units that rose in October 2010	
Demand for Credit	0.71
CRB Index	0.55
Housing	0.32
The model highlights the units that fell in October 2010	
Global Mfg.	0.42
US Consumption	0.34
Supply of Credit	0.33

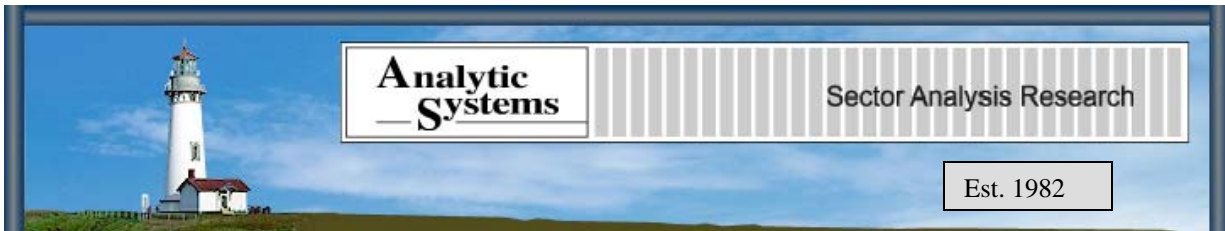
* inverted

Analytic Systems Factor indicators of future activity suggest that the US economy has stabilized at a lower level of growth of around 2%. Deleveraging by the consumer increased last month, with a \$3.3 billion pay down in consumer installment credit. Retail sales were up .6%, .4% ex autos and .4% ex autos and gasoline. Consumption in the US has firmed up slightly. The US economy is likely to be able to muddle through and continue on a recovery path, albeit at a lesser pace than normal. The overall latest score was 104.4 as compared to a restated 103.5 in September 2010.

Our previous thesis that job growth is likely to be less robust than normal because of tight credit for small to medium businesses, which typically are the primary sources of jobs, is still alive. Last month there was a loss of 94,000 nonfarm public and private workers and a gain of 64,000 private nonfarm workers. This is the first month in which there were significant job losses from non-census government workers. The outlook for an improving jobs picture could be adversely affected by accelerating public job losses. The NFIB index, a survey of optimism of small to medium businesses, rose .2% points to 89 from 88.8.

While the ASC factor Demand for Credit firmed up last month. Commercial and Industrial loans appeared to have made a bottom in June of 2010. Although qualifying for a loan is still very difficult, there are scattered signs of life in bank lending. Albeit from a low level, residential real estate remains in recovery mode. There have been reports of a turnaround in commercial real estate.

While highly unusual, both deflationary and reflationary industry groups are still highly ranked. Reflationary industries such as energy ranked 2nd and steel ranked 3rd are accompanied by regional phones 4th, insurance 6th and utilities 13th. Energy was upgraded



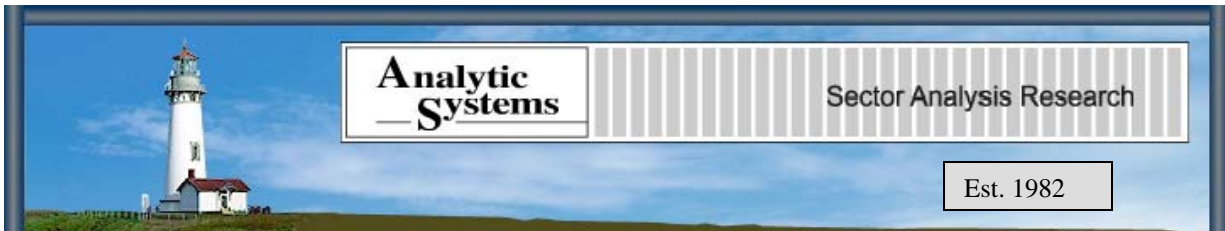
this month, Industrials were downgraded owing to the gradual tilt toward reflation that we highlighted last month.

The Chinese have allowed the renminbi to strengthen slightly to an appreciation of 2.5% since June of 2010. They seem to be trying to head off efforts by the G-20 to issue some directive for China to revalue its currency. The Chinese recently raised interest rates by 25 basis points to try to offset the effects of a weaker currency (as the renminbi tracks the US dollar downward) to avoid further over heating. If China would allow its renminbi to strengthen, then a weaker US dollar would reduce imbalances and also reduce hostilities in the current currency war. By maintaining the peg, the Chinese have in effect left their foot on the accelerator as the US dollar weakens against most every other currency, that acceleration plus the past stimulus is leading to an overheating economy. By raising interest rates they have started to tap on the brakes to try to slow down. The difficulty of achieving a soft landing is that there are different lag times for braking and accelerating. China runs the risks of over reacting as the lagged effects of the weaker currency continue to mount, and finding that braking has had little effect because of the lagged response, may hit the brakes harder. After the US dollar stabilizes, weaker currency effects subsequently diminish, which accompanied by the lagged effects of prior braking could lead to a rather bumpy landing.

One could make the case that the Fed's QE-2 efforts are dealing with the symptoms, focusing on the fever instead of the infection. The real problems are the trade imbalances and the lack of the surplus countries recycling those surplus dollars. A weaker US dollar can only partially reduce the US trade imbalance because the renminbi is pegged to the US dollar. After the Fed made it clear that it was serious about QE-2, equity markets began to shift toward the "reflation trade" and began to do better versus Treasury bonds. For those who are gold bugs and dollar bears, despite the problems the US faces, we aren't likely to become a banana republic any time soon. After all, which currency is going to displace the US dollar, the Renminbi? In addition, the US is still a military super power without major competition. Using the Roman Empire example, the US is likely to be no later than the 8th inning. However time scales have become compressed so that centuries have become decades. If the US addresses its finances by cutting entitlements by 2020, then we should continue to have the US dollar as the major reserve currency. The main challenge is to get out of the current funk without igniting inflation. If that process doesn't go as planned there may be some more financial crises in the next five years that will test our resolve.

Some analysts are saying that QE-2 is already being priced in the equity market. How could that be when no one know what QE-2 will amount to, not even the Fed? It would appear more likely that long Treasury rates are nearer to pricing in QE-2 than in equity markets.

There are economic services out there that are still predicting a double dip and others foreseeing very weak growth in the US. There is one aspect in some of those arguments that appears to be mistaken. Since stimulus spending didn't have the usual positive



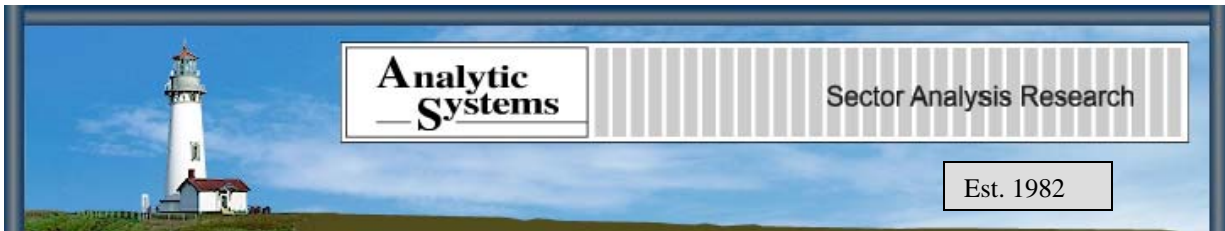
multiplier in the first place, the expiration of the stimulus shouldn't be such a large negative. Simply put, since it didn't help much in the first place, its expiration shouldn't do much harm. Of course, those state governments that are to see cutbacks in funds for Medicaid are going to have to cut spending, raise taxes or both, to make up the difference.

Portfolio Manager's Comments: Pandora's Box?

The skittishness of equity markets was sown by the response to reports that PIMCO, Blackrock and the Federal Reserve Bank of N.Y., wrote letters to Bank of America, citing alleged failures to service mortgage loans properly that it sold to them, adding that they wanted their money back. Within a few minutes on October 19, the Dow dropped from -65 to -225. We have written in past reports of our disappointment that the banking system wasn't allowed to clear in '08. Instead, the government panicked and used basically the same strategy they used to bail out Long-Term Capital in '98 and "save" the financial system when that Black Swan landed in our backyard. It worked then because the Fed and Treasury strong-armed private banks to pony up a bridge loan that provided the time to unwind the derivative positions that had gone sour when the brainiacs at LTC failed to take into account fat tails. Also, there was no financial sludge that would lurk behind that scene in off balance sheet limbo for years after the fact.

Back to today's reality, markets have taken solace in the fact that most of TARP has been paid back. However, there is still this mountain of financial sludge that has not been cleaned up and one of the problems is that much of the hope of resolving it in a positive way depends on the mortgage/foreclosure situation and how successfully it is unwound. On the one hand, we have the Fed announcing that QE-2 is in the wings which they hope will have the effect of reducing mortgage rates and give buyers an incentive to step up and take a foreclosed home off a bank's hands. On the other hand, you have foreclosure-gate that has effectively brought the foreclosure market to a stand still and now you have the first shot across the bow of financial institutions by some of the major players who were hurt by the lax and perhaps fraudulent practices of said institutions. We can't believe how long it took them to get their act together.

The really worrisome aspect of this new development is that it introduces a new player into the fray, the courts. Questions arise concerning who really owns the property. The trail of ownership through the complex process of securitizing gets pretty iffy two or three times removed. Not to mention the charges of conflict of interest of the rating agencies who gave alternative mortgages higher than deserved ratings and the sellers who failed to make full disclosure of salient facts to prospective buyers. If PIMCO et al. goes forward successfully, the first step will finally be taken on the road to clearing the



financial system and healing can begin. But it will open the floodgates of other lawsuits seeking redress from the banks.

That will be a big positive for the public and the country but it could mean trouble for several major banks. There won't be another TARP to bail them out this time. That's almost a certainty if the GOP takes back the House and Senate. Also, the new Dodd/Frank financial bill gives regulators added tools and power to unwind insolvent financial institutions. It may also impede the sale of millions of houses that have been foreclosed and are sitting in inventory. If a buyer cannot be sure he can get clear title to a property and also buy title insurance, he would be foolish to make the purchase even if a loan is available at an attractive interest rate. Taking it one step farther, estimates are that a QE-2 of \$1 trillion would raise GDP growth perhaps ½%; the problems in the mortgage market could easily erase that meager gain and more.

While several analysts view the recent weakness in the bank stocks as a buying opportunity, we believe it's a value trap and would wait for better visibility regarding the developments outlined above before initiating positions or increasing ones exposure to the banks.

We made a presentation at the Contrarian Forum on October 7th with the title "Reflation With a Yield". If you would like to see that presentation please email us at ascsector@comcast.net.

For information on Analytic Systems Corporation's methodology and samples of past reports please visit our web site <http://www.asc-sector.com>.

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