



STRATEGAS

## Investment Strategy & Technical Outlook

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# STRATEGAS' INVESTMENT OUTLOOK

|                               | 2008  |       | 2009  |       |      |      | 2010 |      |      |      |
|-------------------------------|-------|-------|-------|-------|------|------|------|------|------|------|
|                               | 3Q    | 4Q    | 1Q    | 2QF   | 3QF  | 4QF  | 1QF  | 2QF  | 3QF  | 4QF  |
| Real GDP Q/Q Pct. AR          | -2.7% | -5.4% | -6.4% | -1.0% | 3.0% | 1.5% | 3.0% | 2.0% | 2.0% | 2.0% |
| Core CPI Q/Q Pct. AR          | 2.8%  | 0.6%  | 1.5%  | 2.4%  | 1.0% | 0.0% | 1.0% | 1.5% | 2.0% | 2.0% |
| Fed Funds - End of Period     | 2.0%  | 0.1%  | 0.1%  | 0.1%  | 0.1% | 0.1% | 0.5% | 2.0% | 3.0% | 3.5% |
| 10-Year Yield - End of Period | 3.8%  | 2.2%  | 2.7%  | 3.5%  | 3.8% | 3.8% | 4.0% | 4.5% | 4.5% | 5.0% |
| F = Forecast                  |       |       |       |       |      |      |      |      |      |      |

## 2010 S&P 500 Expected Value Table

| Odds                   | Economy    | Fed Posture | S&P Op Earnings | Expected Multiple | S&P 500    |
|------------------------|------------|-------------|-----------------|-------------------|------------|
| 10%                    | Deep Rec.  | Easy        | \$52            | 10x               | 520        |
| 20%                    | Recession  | Neutral     | \$59            | 13x               | 767        |
| 60%                    | Jobless R. | Tighter     | \$66            | 17x               | 1,122      |
| 10%                    | Too Hot    | Tighter     | \$74            | 15x               | 1,110      |
| <b>Expected Value:</b> |            |             |                 |                   | <b>990</b> |

## Consensus Estimates

|      | Bottom Up |
|------|-----------|
| 2009 | \$58.66   |
| 2010 | \$74.12   |
| 2011 | \$91.35   |

## Strategas Earnings Estimates

|      | 2009    |        | 2010    |       | 2011    |       |
|------|---------|--------|---------|-------|---------|-------|
|      | Level   | Y/Y    | Level   | Y/Y   | Level   | Y/Y   |
| 1Q   | \$10.11 | -39.2% | \$15.75 | 55.8% | \$16.25 | 3.2%  |
| 2Q   | \$13.25 | -22.2% | \$16.50 | 24.5% | \$18.00 | 9.1%  |
| 3Q   | \$14.75 | -7.6%  | \$16.50 | 11.9% | \$17.50 | 6.1%  |
| 4Q   | \$15.75 | NA     | \$17.00 | 7.9%  | \$19.25 | 13.2% |
| Year | \$54.50 | 10.1%  | \$65.75 | 20.6% | \$71.00 | 8.0%  |

## Recommended Asset Allocation

### Balanced

|          |     | B'mark |
|----------|-----|--------|
| Equities | 60% | 60%    |
| Bonds    | 10% | 30%    |
| Cash     | 30% | 10%    |

### Equities

|          |     | B'mark |
|----------|-----|--------|
| Equities | 70% | 80%    |
| Cash     | 30% | 20%    |

### Size

|           |     | B'mark |
|-----------|-----|--------|
| Large-Cap | 75% | 70%    |
| Mid-Cap   | 20% | 15%    |
| Small-Cap | 5%  | 15%    |

### Style

|        |     | B'mark |
|--------|-----|--------|
| Value  | 30% | 40%    |
| Growth | 50% | 40%    |
| Blend  | 20% | 20%    |

## Recommended Sector Allocation

### Overweight

Energy  
Materials  
Staples  
Health Care

### Market Weight

Technology  
Financials  
Industrials

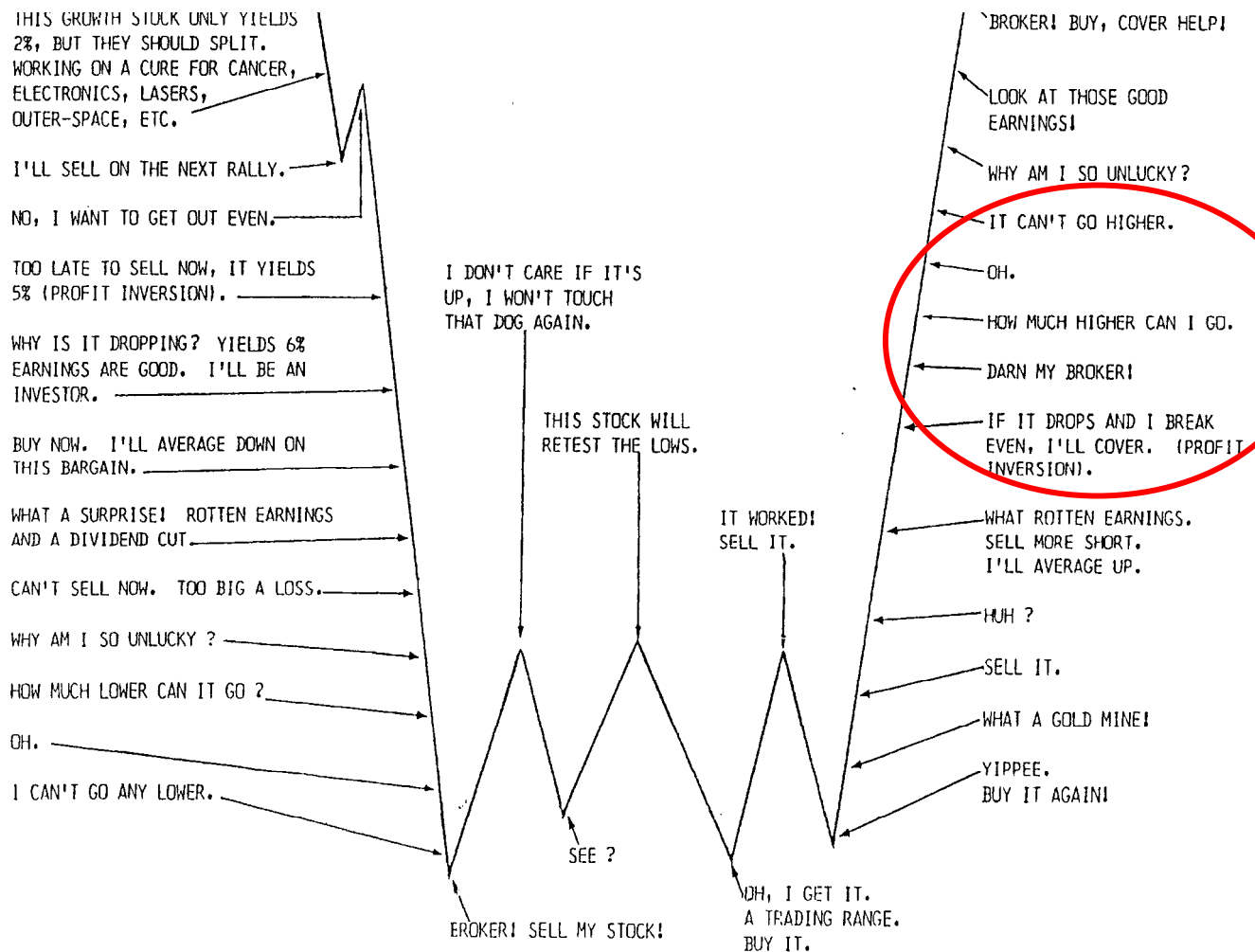
### Underweight

Discretionary  
Utilities  
Telecom

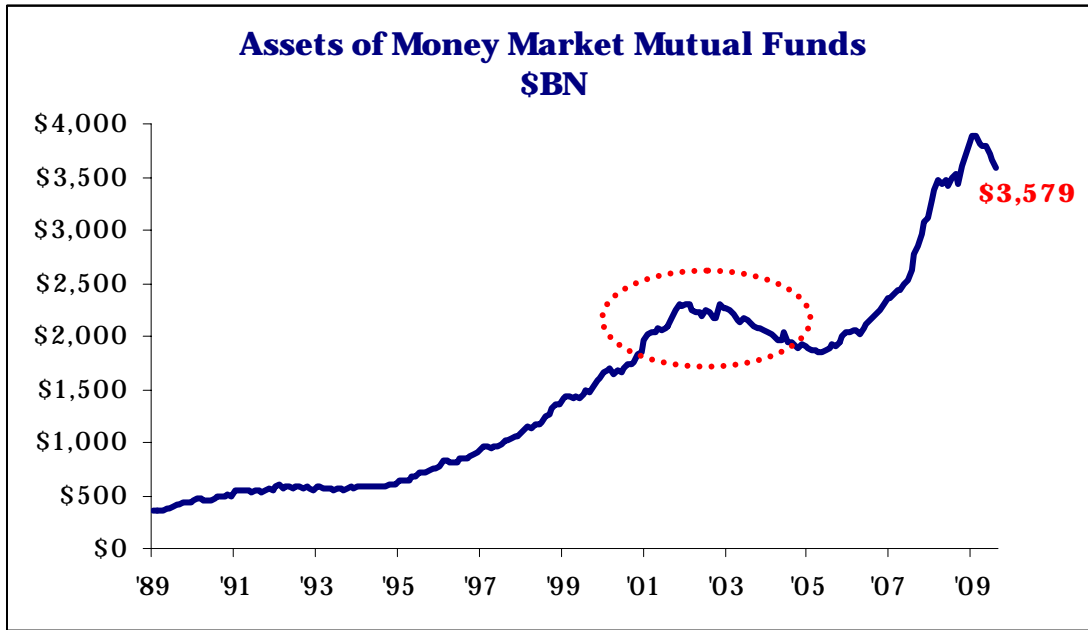
# ARE WE SOMEWHERE HERE?

A good friend and valued client passed this tongue-in-cheek anatomy of market cycles to us, and frankly, it's about as good an exposition as you might find. We think we're somewhere near the HOW MUCH HIGHER CAN IT GO? stage.

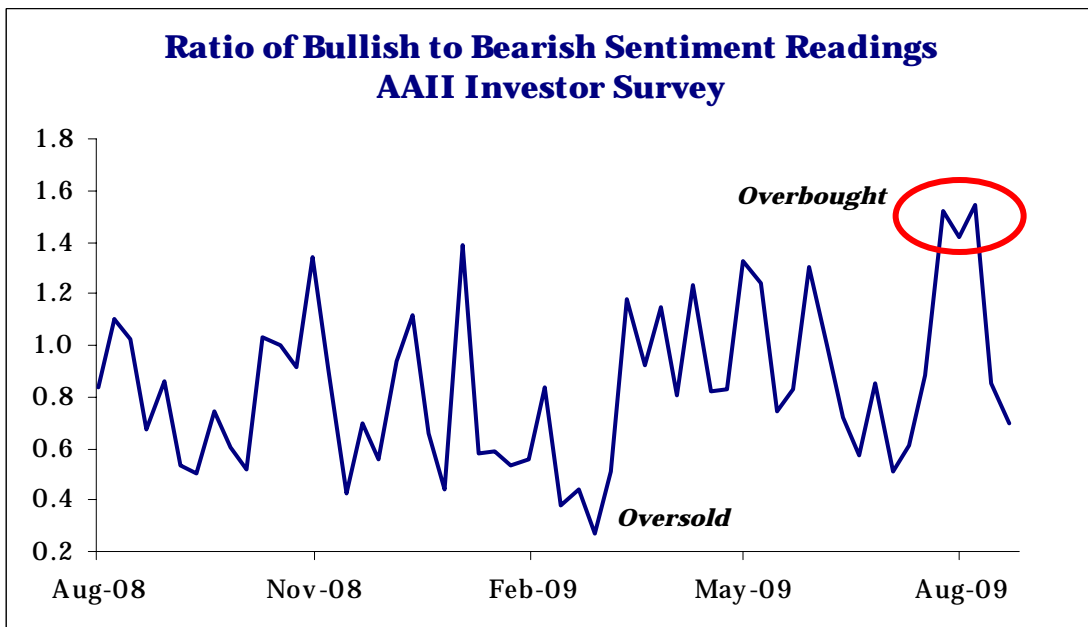
## GREED/FEAR CHART



# STILL PLENTY OF CASH TO FUEL 4Q “MELT-UP”



# SENTIMENT IS REVERSING FROM “OVERBOUGHT” LEVELS



## MARKET'S TREND & MOVING AVERAGE PROFILE ARE ENCOURAGING

- Weekly RSI & MACD charts began to showcase positive divergences by late-'08, an important indication that base-building has been underway for nearly 10-months. Said another way, technical repair did not *begin* with the March '09 rally.
- The 50-day moving average has broken up through the 200-day average (*see table below*).
- S&P 500 consolidated to a “higher-low” during the June to July correction, and 200-day moving average support held firm during multiple tests throughout this period.
- The 200-day moving average has recently begun to rotate higher.
- Monthly MACD on verge of breaking up through signal line (*see next page*).

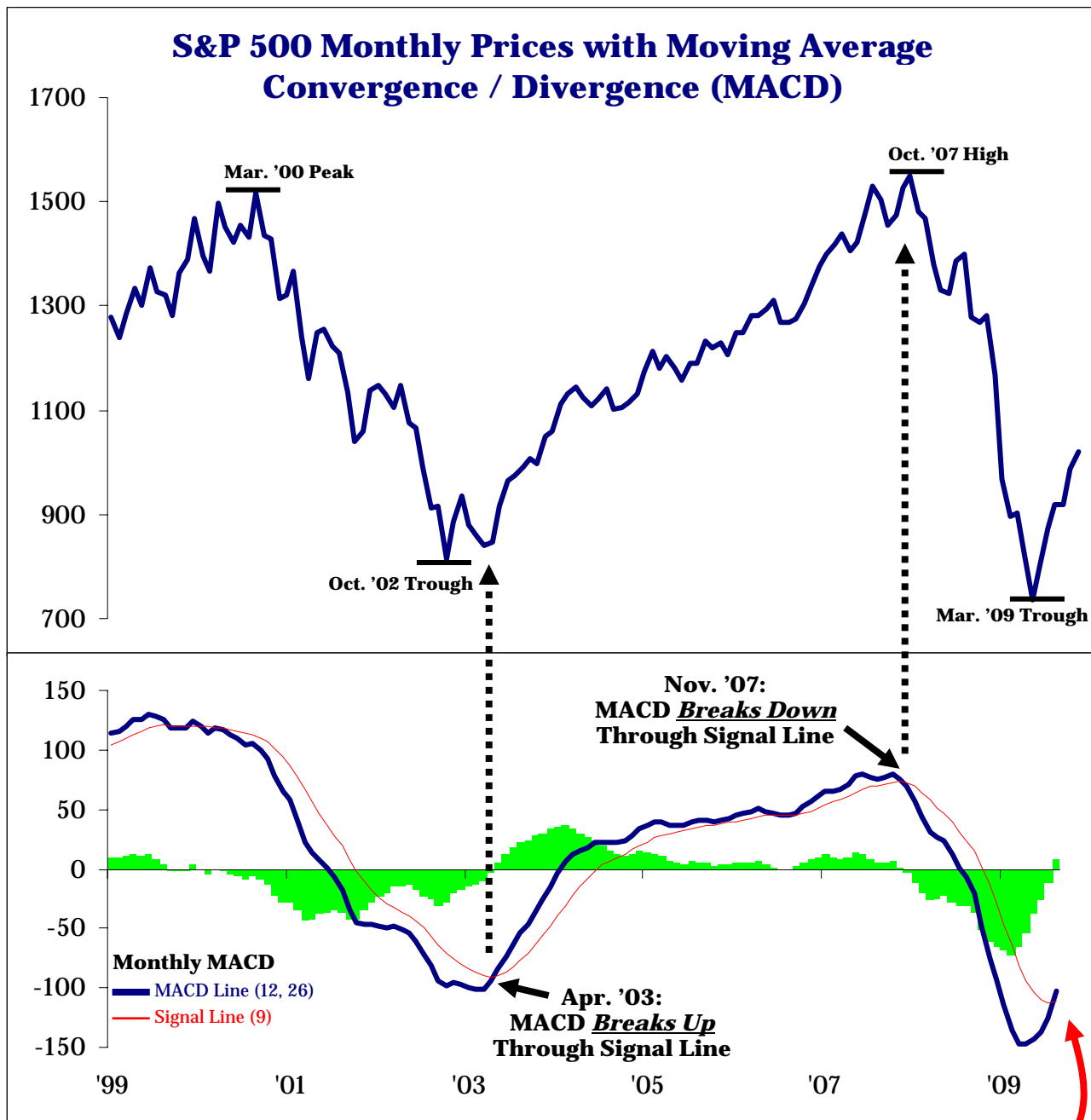
### S&P 500 Performance Following 50-Day Moving Average Breaking Up Through a Declining 200-Day Moving Average

| Date of Cross   | S&P Level | +1 Month | +3 Months | +6 Months | +12 Months |
|-----------------|-----------|----------|-----------|-----------|------------|
| Sep. 19th, 1932 | 7.34      | 0.8%     | -5.0%     | -9.7%     | 50.4%      |
| Aug. 18th, 1941 | 10.13     | 2.6%     | -8.6%     | -16.3%    | -13.8%     |
| Aug. 14th, 1942 | 8.58      | -0.3%    | 11.5%     | 24.4%     | 38.0%      |
| Dec. 18th, 1953 | 24.99     | 1.8%     | 7.0%      | 16.2%     | 40.1%      |
| Jun. 3rd, 1957  | 47.37     | 2.3%     | -4.1%     | -12.7%    | -6.1%      |
| May 8th, 1958   | 43.99     | 1.5%     | 9.2%      | 18.8%     | 30.3%      |
| Jan. 3rd, 1963  | 63.72     | 4.1%     | 5.7%      | 9.8%      | 18.5%      |
| Feb. 3rd, 1967  | 87.36     | 1.1%     | 7.5%      | 9.5%      | 5.6%       |
| Oct. 21st, 1970 | 83.66     | 0.1%     | 12.6%     | 23.5%     | 14.3%      |
| Mar. 7th, 1975  | 84.30     | -4.7%    | 9.7%      | 1.6%      | 17.6%      |
| May 22nd, 1978  | 99.09     | -2.9%    | 5.3%      | -3.6%     | 1.4%       |
| Sep. 28th, 1982 | 123.24    | 8.4%     | 14.2%     | 23.2%     | 36.3%      |
| Sep. 12, 1984   | 164.68    | -0.3%    | -1.2%     | 9.1%      | 11.5%      |
| Jun. 28th, 1988 | 272.31    | -2.3%    | -1.2%     | 1.8%      | 19.6%      |

|                                |             |             |             |              |
|--------------------------------|-------------|-------------|-------------|--------------|
| <b>Average Percentage Gain</b> | <b>0.9%</b> | <b>4.5%</b> | <b>6.8%</b> | <b>18.8%</b> |
|--------------------------------|-------------|-------------|-------------|--------------|

**Since 1929, we've counted 14 instances where a rising 50-day moving average has broken up through a declining 200-day moving average. Over the following 12-months, stocks tend to do very well – up, on average, 18.8%.**

# AS MARKET CORRECTS FROM OVERBOUGHT LEVELS, LONGER-TERM TECHNICALS CONTINUE TO STRENGTHEN



**Last week, the monthly MACD broke up through the signal line – this is a very healthy technical indication that trend continues to improve, even as stocks correct. This indicator has generated 19 “buy” signals over the last 50 years, with only two false positives (see next page).**

### S&P 500 Performance Following MACD Buy Signal

| MACD Buy Signal |           | +3           | +6           | +12           |
|-----------------|-----------|--------------|--------------|---------------|
| Date            | S&P Level | Months       | Months       | Months        |
| 2/28/1961       | 63.44     | 4.9%         | 7.3%         | 10.3%         |
| 3/29/1963       | 66.57     | 4.2%         | 7.7%         | 18.6%         |
| 12/31/1965      | 92.43     | -3.5%        | -8.3%        | <b>-13.1%</b> |
| 4/28/1967       | 94.01     | 0.8%         | -0.1%        | 3.8%          |
| 4/30/1968       | 97.59     | 0.2%         | 6.0%         | 6.3%          |
| 12/31/1970      | 92.15     | 8.9%         | 8.2%         | 10.8%         |
| 4/30/1975       | 87.30     | 1.7%         | 2.0%         | 16.4%         |
| 7/31/1978       | 100.68    | -7.5%        | -0.7%        | 3.1%          |
| 10/29/1982      | 133.71    | 8.7%         | 23.0%        | 22.3%         |
| 1/31/1985       | 179.63    | 0.1%         | 6.3%         | 17.9%         |
| 2/28/1989       | 288.86    | 11.0%        | 21.7%        | 14.9%         |
| 6/29/1990       | 358.02    | -14.5%       | -7.8%        | 3.7%          |
| 3/29/1991       | 375.22    | -1.1%        | 3.4%         | 7.6%          |
| 1/29/1993       | 438.78    | 0.3%         | 2.1%         | 9.8%          |
| 3/31/1995       | 500.71    | 8.8%         | 16.7%        | 28.9%         |
| 12/31/1998      | 1229.23   | 4.6%         | 11.7%        | 19.5%         |
| 12/31/1999      | 1469.25   | 2.0%         | -1.0%        | <b>-10.1%</b> |
| 5/30/2003       | 963.59    | 4.6%         | 9.8%         | 16.3%         |
| 9/29/2006       | 1335.85   | 6.2%         | 6.4%         | 14.3%         |
| <b>Average</b>  |           | <b>+2.1%</b> | <b>+6.0%</b> | <b>+10.6%</b> |

**While near-term performance can be choppy immediately following the monthly MACD “buy” signal, market performance over the following 12-month period is compelling – stocks, on average, have advanced close to +11%, with only two false positives. Of note, both false positive signals (12/31/65 and 12/31/99) occurred in aged bull markets – clearly not the case today.**

## VOLUME PICTURE MORE SUPPORTIVE THAN AT FIRST GLANCE

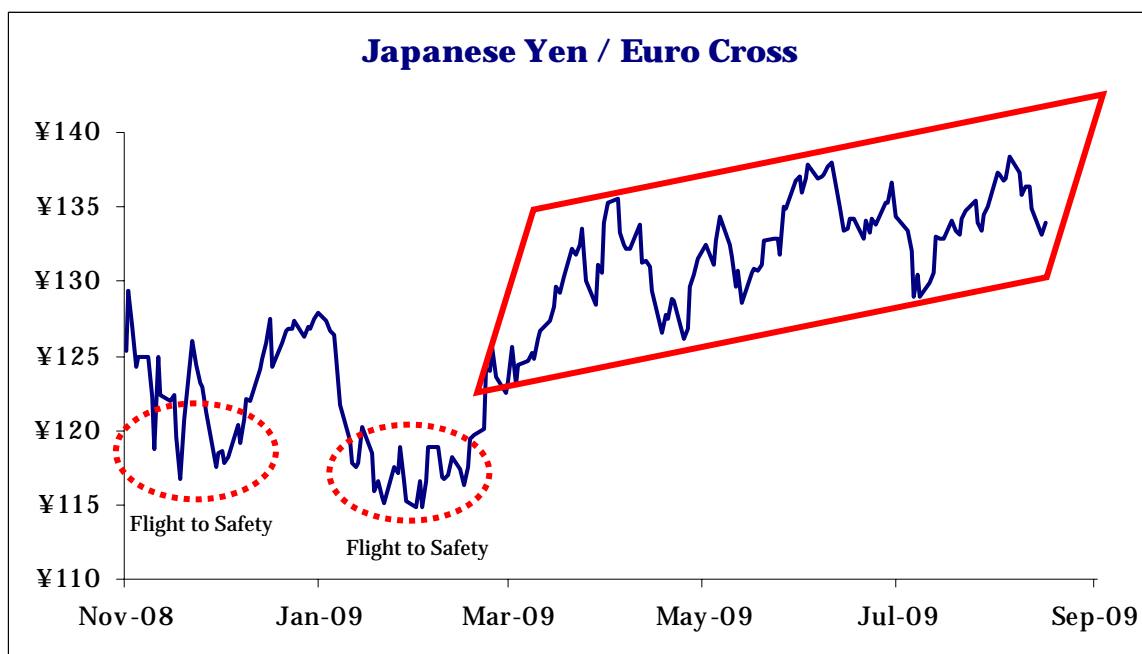
- The primary criticism of the recent rally in stocks has been the lackluster level of volume that accompanied share prices higher. While this is typically a material cause for concern, a closer look at the market's internal volume profile paints a more supportive picture. Aggregate volume levels on 90% down-days have been significantly lighter than 90% up-days. We don't get the sense that there is much conviction to push this market lower.

| <b>Volume Profile Since Mar. 9th Low</b> |                      |
|--|----------------------|
| <b>90% Up Days</b>                       | <b>90% Down Days</b> |
| 11 Days                                  | 7 Days               |
| 1.72BN Share Avg.                        | 1.36BN Share Avg.    |

**NYSE volume has been nearly 25% stronger on 90% up-days than 90% down-days. 90% up-days have outnumbered 90% down-days 11 to 7.**

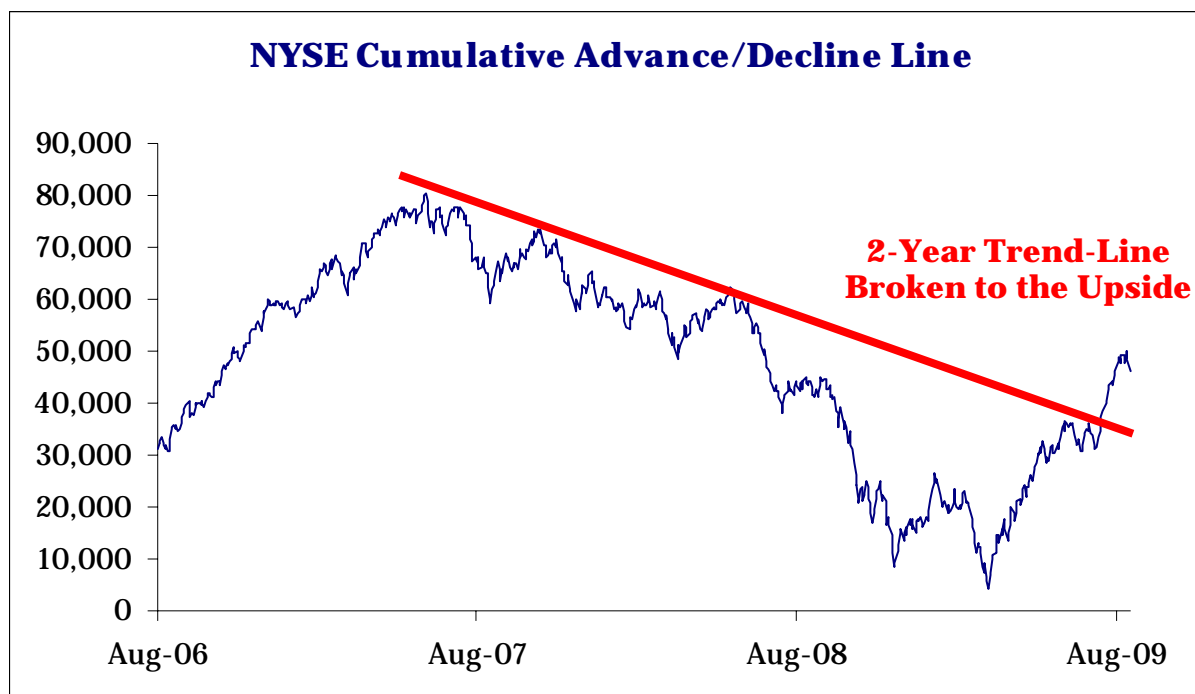
## RISK TRADE STILL IN PLAY

- Despite some volatility in equities, the Yen/Euro cross (a good barometer of risk-taking) has not broken down. While the Yen has strengthened some over recent days, the technical picture hasn't changed much.

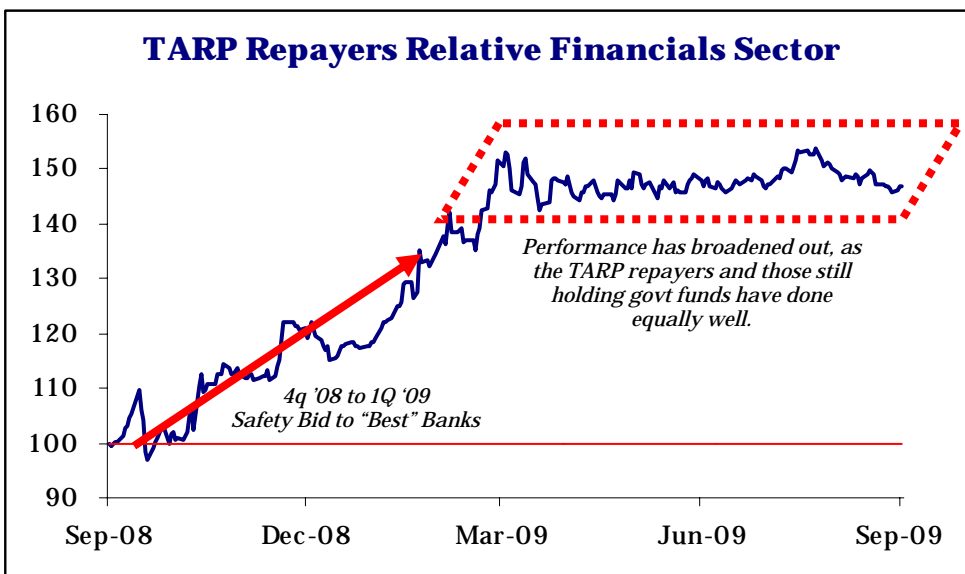
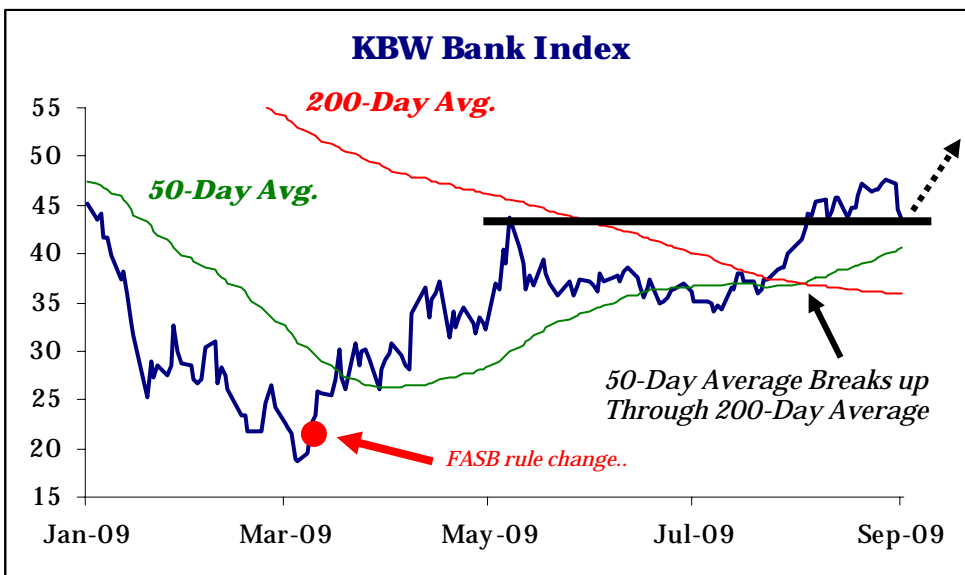
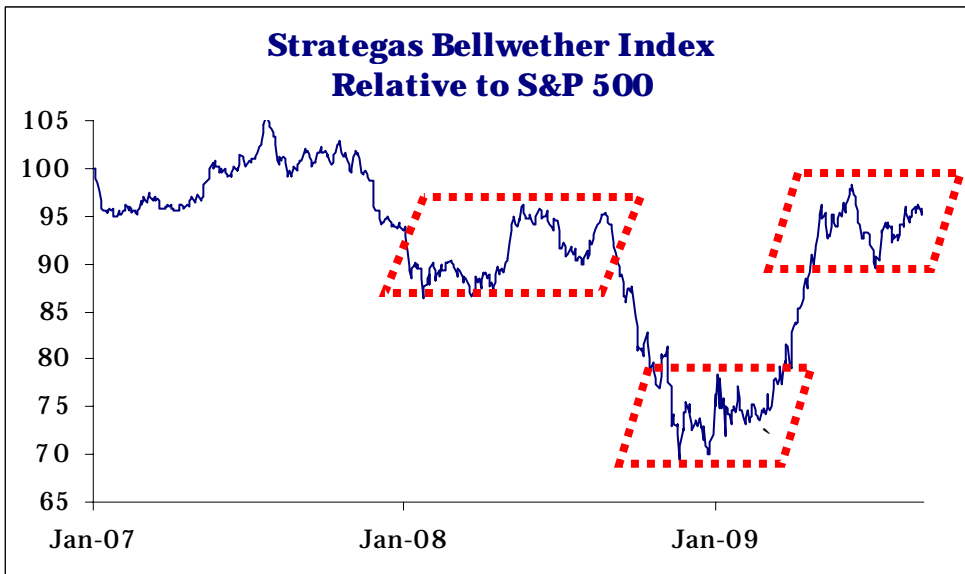


## BREADTH REMAINS VERY STRONG

- The NYSE cumulative advance/decline line is at a 14-month high, is well above pre-Lehman Brothers levels, and has outpaced market gains.
- Over 85% of stocks are above their 200-day MA – but this, in our view, should be considered a “good” overbought signal. Should the market retrace some of its gains, 85% of stocks have their 200-day support base to rely on.



# LEADERSHIP IS SOLID: 3 CHARTS WE HAVE OUR EYE ON



With the market off slightly from its August high, we remain encouraged that 3 key charts we frequently monitor have not broken down below trend.

1) Our Strategas Bellwether Index – a collection of the 15 S&P 500 stocks with the highest correlation to nominal GDP growth (82% overall) – has outperformed the broader market since stocks bottomed in early-July. Given the strength to the recent economic data, the next obstacle is for the Index to breakout of its 5-month trading range.

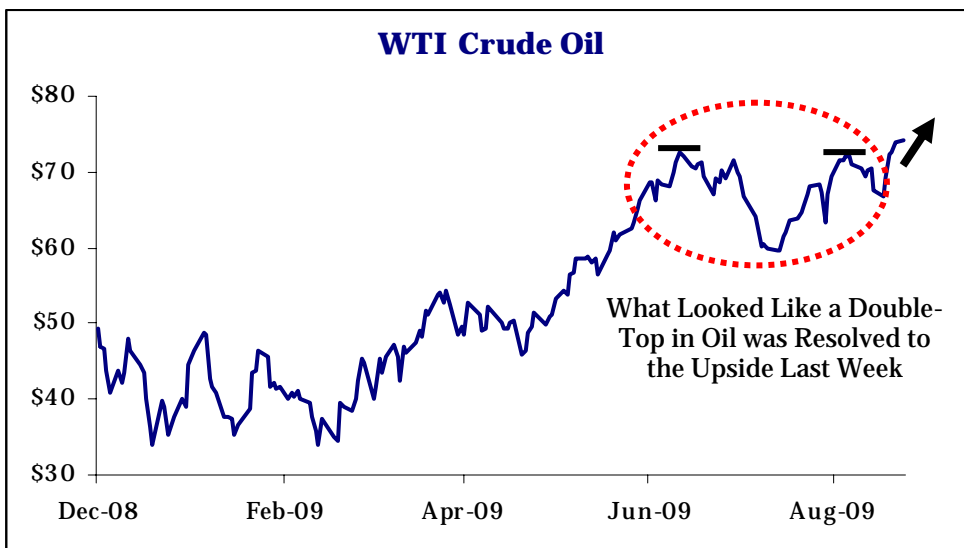
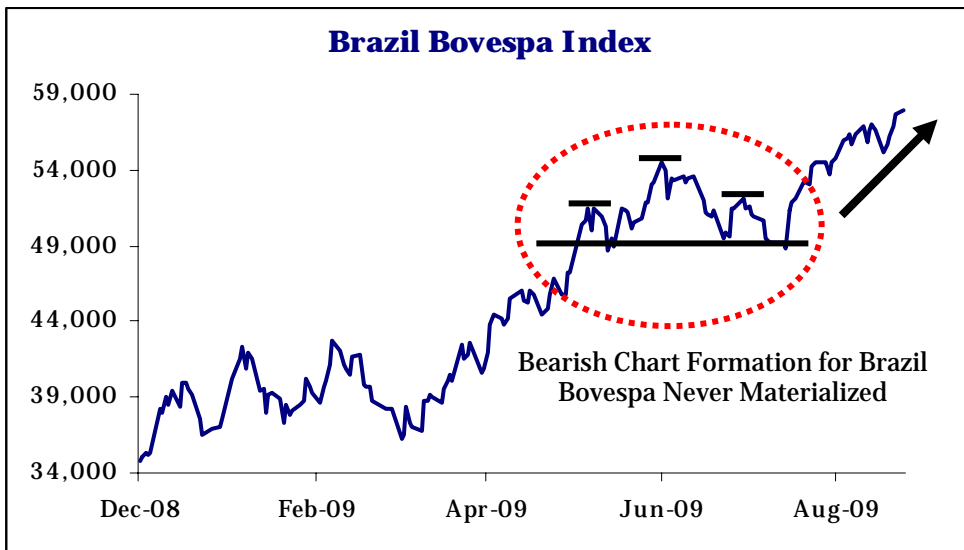
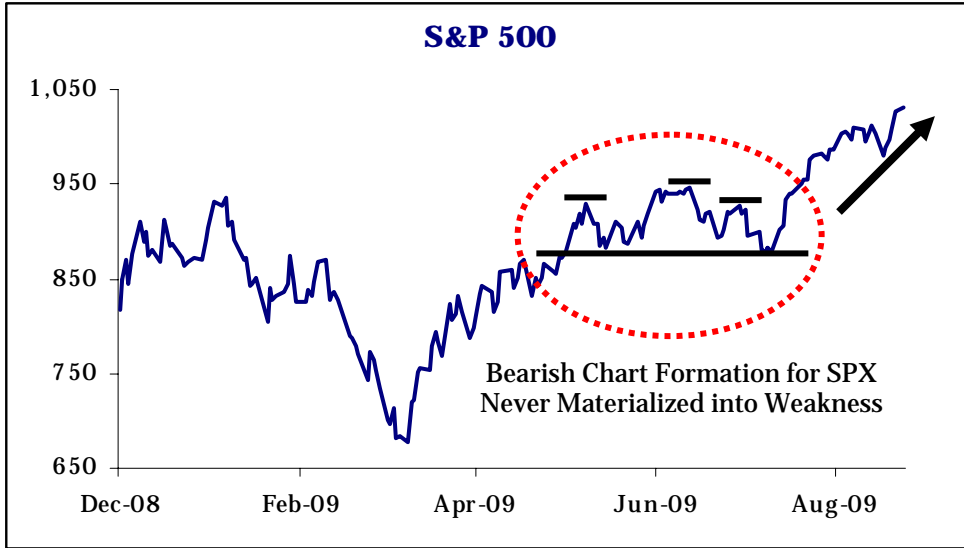
2) After breaking up through resistance and charting new highs in early-August, the KBW Bank Index is holding support.

3) Banks that have repaid their TARP money continue to perform on par with the broader Financials sector, consistent with the theme that the velocity of money is reaccelerating.

*Stay Tuned...*

# KEY PLANK IN THE BULL CASE:

## Bearish Chart Patterns Have Not Materialized into Weakness among Many Indices



Additionally, we've noticed that what are typically bearish chart formations are ultimately moving in favor of the bulls. This, in our view, is illustrative of three important developments:

- 1) Trend is transitioning to the upside.
- 2) Market support levels are firming.
- 3) There appears to be little downside conviction.

Stay tuned...

## PLENTY OF SUPPORT IN 900 TO 1,000 RANGE, PUSH TO 1,200 MORE LIKELY THAN RETEST OF 800?

### Number of Trading Days it took the S&P 500 to go DOWN from...

|                     |                |
|---------------------|----------------|
| 1500 to 1400        | 41 Days        |
| 1400 to 1300        | 41 Days        |
| 1300 to 1200        | 132 Days       |
| <b>1200 to 1100</b> | <b>14 Days</b> |
| <b>1100 to 1000</b> | <b>5 Days</b>  |
| <b>1000 to 900</b>  | <b>8 Days</b>  |
| 900 to 800          | 21 Days        |
| 800 to 700          | 68 Days        |

### Number of Trading Days it took the S&P 500 to go UP from...

|                    |                |
|--------------------|----------------|
| 700 to 800         | 14 Days        |
| 800 to 900         | 29 Days        |
| <b>900 to 1000</b> | <b>63 Days</b> |

Given the speed of last year's decline, there doesn't look to be too much new resistance to contend with in the 900 to 1,200 range as the market currently pushes higher. As a general rule of thumb, it's easier for the market to retrace ground it has already covered than chart new territory.

Since the market's reversal in March, there has been a not inconsiderable period of time, 63 days, for the base building process to mature, providing support in the important 900 to 1,000 range.

# MAPPING THE *TRADITIONAL* PLAYBOOK AS THE ECONOMY BEGINS TO CHART RECOVERY

## **Sector Allocation: Early-Cyclical Rotation**

- The defensive trade and late-cycle performers begin to underperform as traditional early-cyclical industries leveraged to economic recovery pace market gains.
- Typically a good time to own early-leadership: Discretionary Retail, Industrials, and Financials.

## **Factor Analysis: Rotation Away from Quality**

- With the economy beginning to turn, typically a rotation to the “worst of the worst” stocks allows investors to capture leveraged returns.
- Companies with high beta & short interest, high debt, and low return on equity will outperform in the early stages of a new bull cycle.

## **Size & Style: Small-Cap Value Outperforms**

- The outperformance of small-cap value stocks is common as investors exit the flight to quality trade in favor of greater risk exposure.

**Where We Differ:** As the market and economy emerged out of the 2000 to 2002 bear-market, the *traditional* playbook – long small-cap value, early cyclical sectors, and lower-quality stocks – proved to be the winning strategy. However, we believe the key difference this time around is the continued impairment in the credit markets – the *access to* and *cost of* debt financing is likely generationally impaired. Coupled with unprecedented amounts of global stimulus spending and a nominal growth environment that is likely to remain below trend for sometime, we believe exposure to the market’s more traditional “late-cyclicals” (i.e., Energy, Basic Materials, and Consumer Staples) will ultimately be the most appropriate strategy to generate longer-term secular outperformance.

## ANTICIPATING PERFORMANCE SHIFT AS RALLY ENTERS NEXT PHASE

### S&P Performance from March 9th Low to Present by BETA Quartile

| <b>Quartile 1<br/>(Highest Beta)</b> | <b>2</b>     | <b>3</b>     | <b>Quartile 4<br/>(Lowest Beta)</b> |
|--------------------------------------|--------------|--------------|-------------------------------------|
| <b>131.2%</b>                        | <b>63.8%</b> | <b>48.5%</b> | <b>18.3%</b>                        |

### S&P Performance from March 9th Low to Present by MARKET-CAP Quartile

| <b>Quartile 1<br/>(Smallest Cap)</b> | <b>2</b>     | <b>3</b>     | <b>Quartile 4<br/>(Largest Cap)</b> |
|--------------------------------------|--------------|--------------|-------------------------------------|
| <b>118.6%</b>                        | <b>62.0%</b> | <b>58.6%</b> | <b>43.6%</b>                        |

### S&P Performance from March 9th Low to Present by RETURN ON EQUITY Quartile

| <b>Quartile 1<br/>(Lowest ROE)</b> | <b>2</b>     | <b>3</b>     | <b>Quartile 4<br/>(Highest ROE)</b> |
|------------------------------------|--------------|--------------|-------------------------------------|
| <b>85.2%</b>                       | <b>66.3%</b> | <b>45.9%</b> | <b>33.6%</b>                        |

# CONTRARIANS NOTE: U.S. LARGE-CAP GROWTH THE DECADE'S WORST

## By Asset Class,

|                              | 1970s      | 1980s       | 1990s       | 2000s       |
|------------------------------|------------|-------------|-------------|-------------|
| Long-Term Government         | 5.5        | 12.6        | 8.8         | 10.5        |
| Long-Term Corporate          | 6.2        | 13.0        | 8.4         | 8.2         |
| Intermediate-Term Government | 7.0        | 11.9        | 7.2         | 7.2         |
| Small-Cap Stocks             | 11.5%      | 15.8%       | 15.1%       | 4.1         |
| Treasury Bills               | 6.3        | 8.9         | 4.9         | 3.1         |
| Inflation                    | 7.4        | 5.1         | 2.9         | 2.5         |
| <b>Large-Cap Stocks</b>      | <b>5.9</b> | <b>17.5</b> | <b>18.2</b> | <b>-3.6</b> |

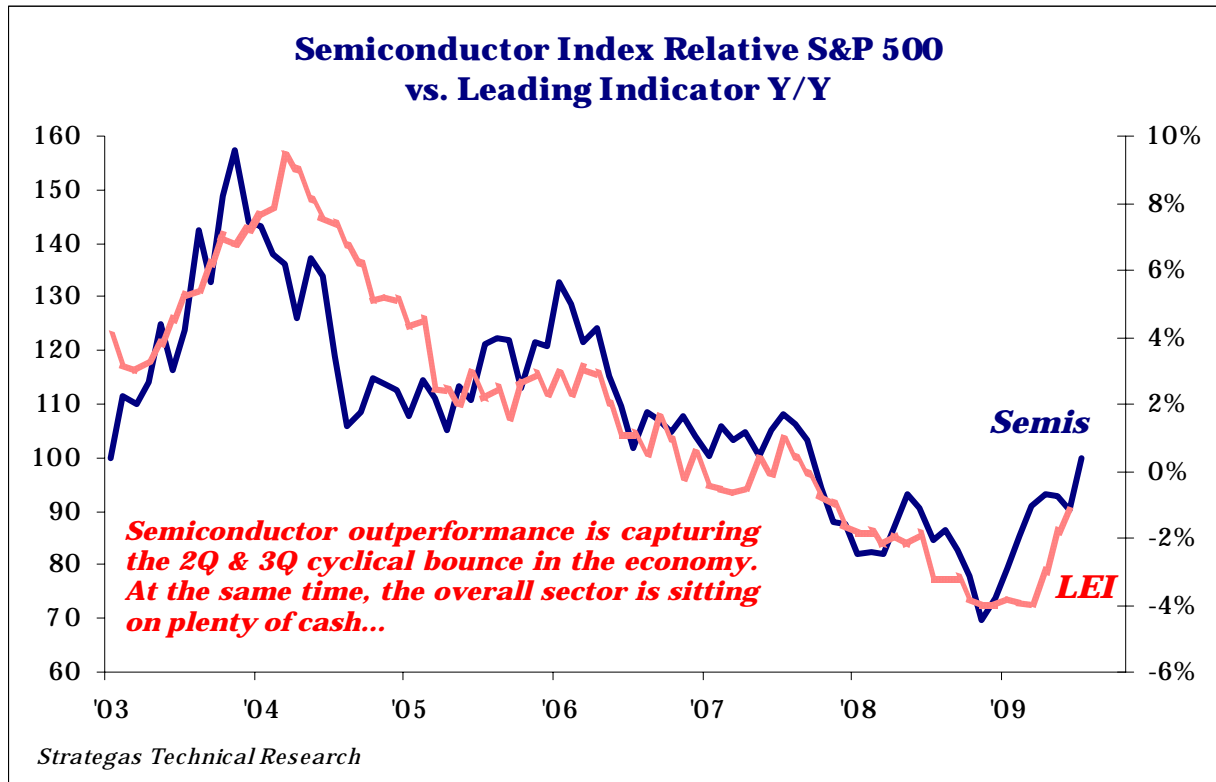
## Style,

|                         | 1970s      | 1980s       | 1990s       | 2000s       |
|-------------------------|------------|-------------|-------------|-------------|
| Small-Cap Value         | 14.9%      | 20.3%       | 14.5%       | 8.0%        |
| Mid-Cap Value           | 12.5       | 19.0        | 14.2        | 5.2         |
| All Value               | 8.8        | 18.4        | 15.6        | -0.3        |
| Large-Cap Value         | 7.7        | 18.1        | 15.8        | -1.7        |
| Mid-Cap Growth          | 5.7        | 15.4        | 16.7        | -2.7        |
| Small-Cap Growth        | 8.6        | 14.4        | 13.1        | -2.8        |
| All Growth              | 3.3        | 15.4        | 20.0        | -6.0        |
| <b>Large-Cap Growth</b> | <b>2.4</b> | <b>15.6</b> | <b>21.4</b> | <b>-6.8</b> |

## And Region

|                                    | 1970s      | 1980s       | 1990s       | 2000s       |
|------------------------------------|------------|-------------|-------------|-------------|
| Canada                             | 11.0%      | 11.6%       | 9.9%        | 4.8%        |
| Europe                             | 8.6        | 18.5        | 14.5        | -0.8        |
| EAFE (Europe, Australia, Far East) | 10.1       | 22.8        | 7.3         | -1.4        |
| World                              | 7.0        | 19.9        | 12.0        | -2.7        |
| Pacific                            | 14.8       | 26.4        | 0.5         | -2.7        |
| <b>United States</b>               | <b>5.9</b> | <b>17.5</b> | <b>18.2</b> | <b>-3.6</b> |

# CONSTRUCTIVE ON TECHNOLOGY – CAPTURING THE “BETA” & “DEFENSIVE” TRADE

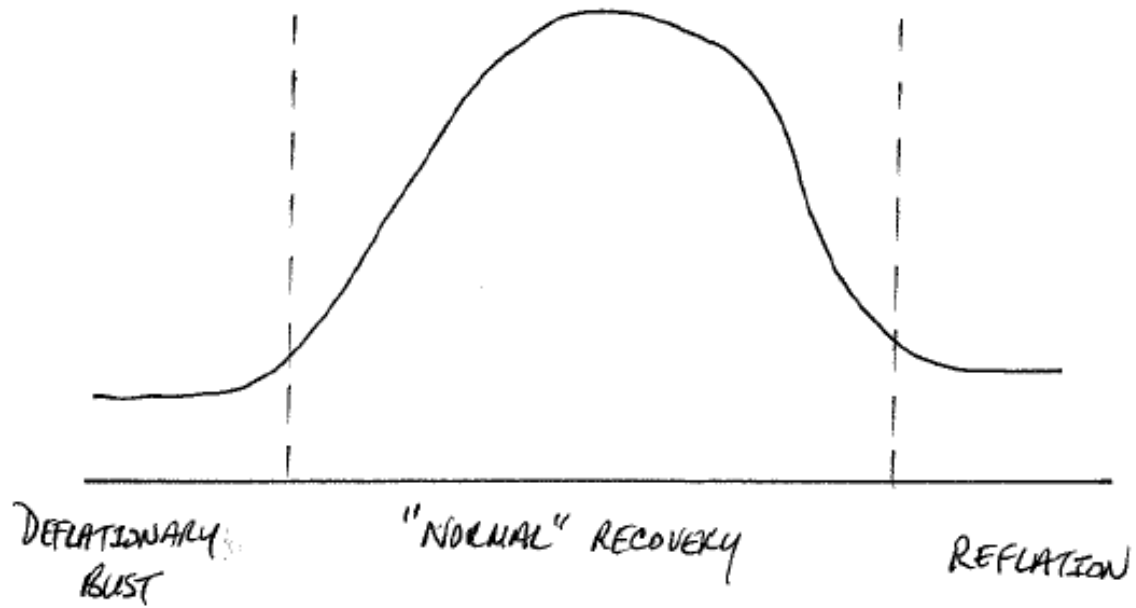


## Technology Sector - Cash as % of Assets - Top 25

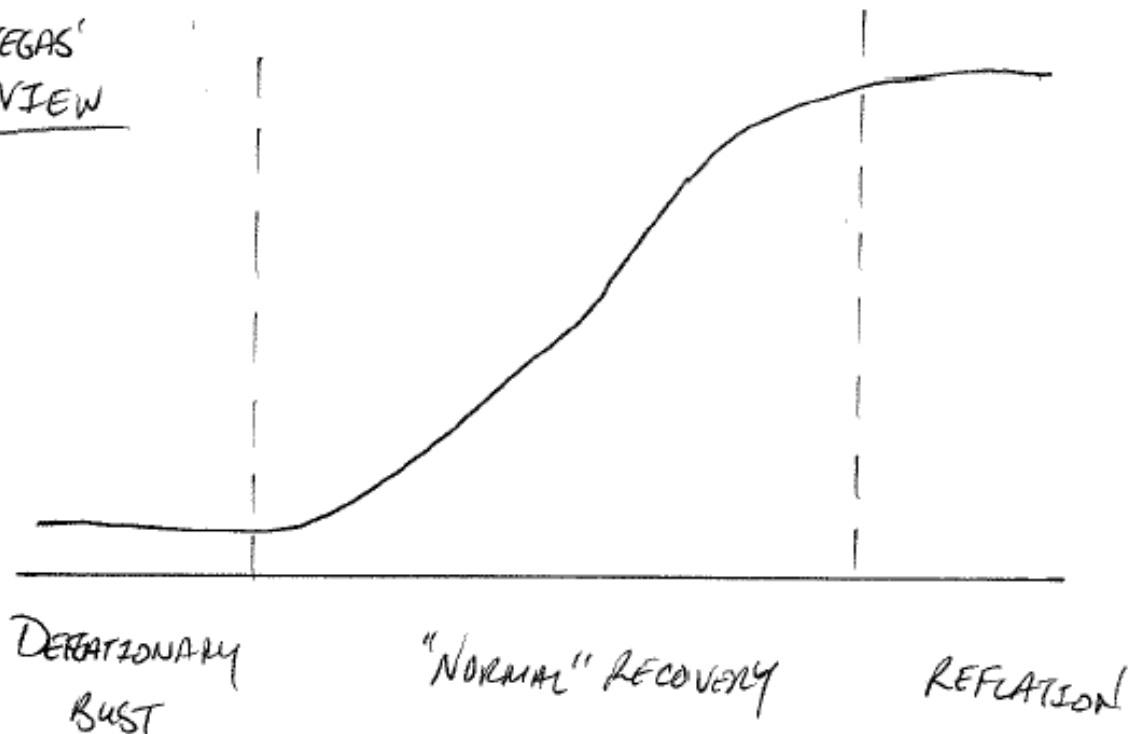
|    |      |                      |       |
|----|------|----------------------|-------|
| 1  | PAYX | Paychex              | 77.9% |
| 2  | CIEN | Ciena                | 70.6% |
| 3  | ALTR | Altera               | 63.5% |
| 4  | LLTC | Linear Technology    | 61.1% |
| 5  | MCHP | Microchip Technology | 57.4% |
| 6  | GOOG | Google               | 55.0% |
| 7  | TLAB | Tellabs              | 54.9% |
| 8  | ERTS | Electronic Arts      | 53.9% |
| 9  | CSCO | Cisco Systems        | 51.9% |
| 10 | AAPL | Apple                | 50.3% |
| 11 | XLNX | Xilinx               | 50.1% |
| 12 | NOVL | Novell               | 49.1% |
| 13 | NTAP | NetApp               | 47.6% |
| 14 | BRCM | Broadcom             | 45.4% |
| 15 | ADI  | Analog Devices       | 44.7% |
| 16 | ADBE | Adobe Systems        | 43.9% |
| 17 | QLGC | QLogic               | 43.2% |
| 18 | ADSK | Autodesk             | 42.3% |
| 19 | NVDA | NVIDIA               | 42.1% |
| 20 | JDSU | JDS Uniphase         | 40.0% |
| 21 | TDC  | Teradata             | 39.1% |
| 22 | VRSN | VeriSign             | 38.7% |
| 23 | DELL | Dell                 | 38.7% |
| 24 | QCOM | QUALCOMM             | 38.4% |
| 25 | MSFT | Microsoft            | 36.8% |

# THE WAY WE SEE IT

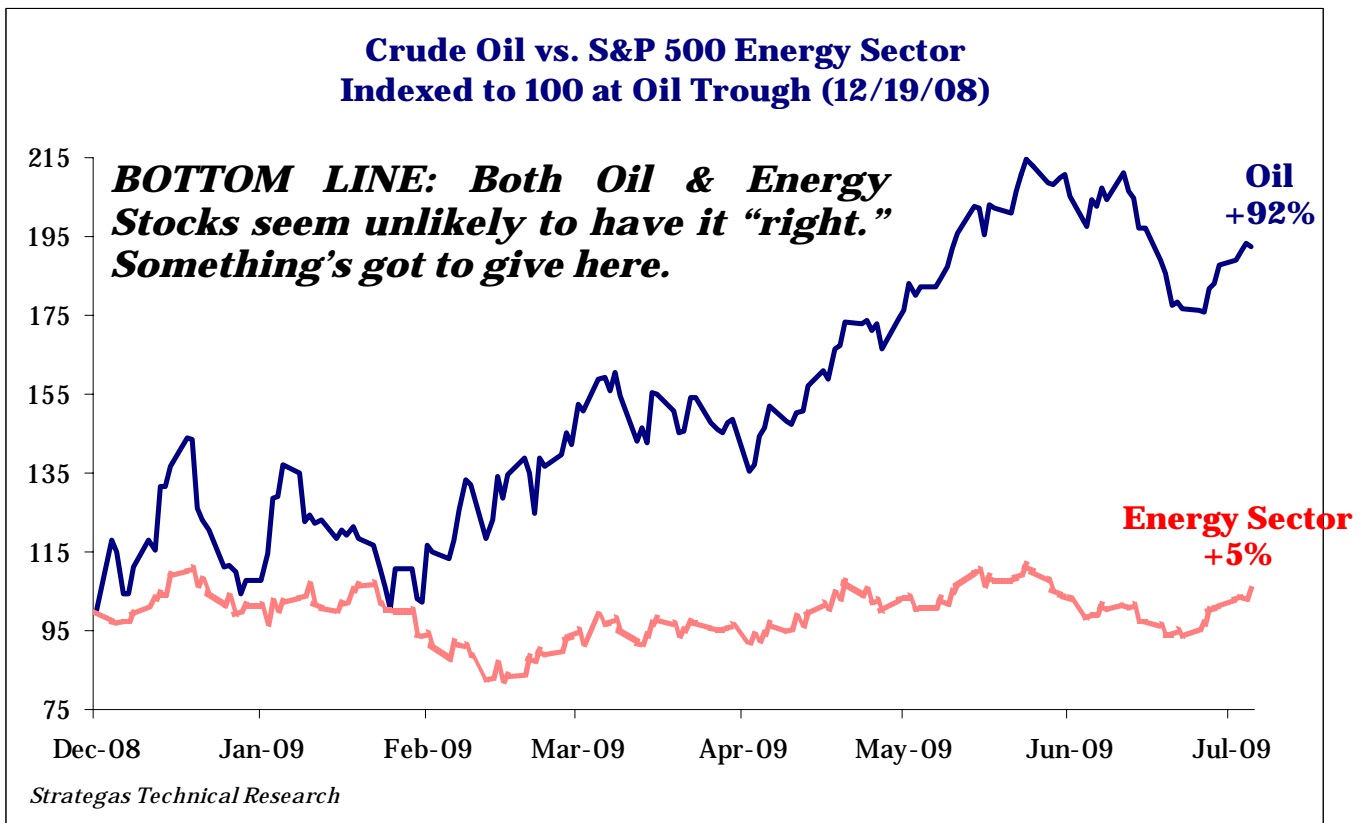
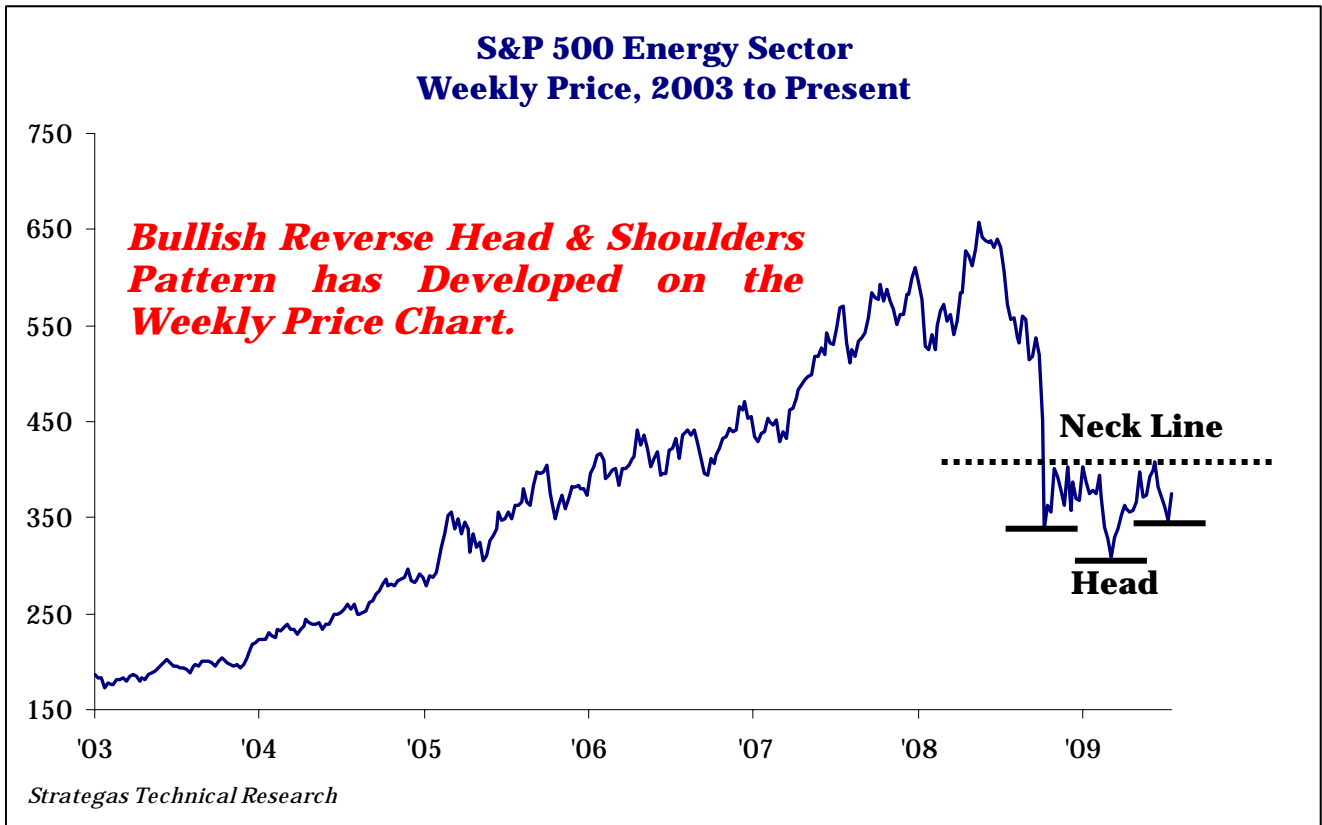
TYPICAL



STRATEGAS' VIEW



# LEGGING BACK INTO THE REFLATION TRADE – ENERGY STOCKS IN SECULAR BULL



# ENERGY & MATERIALS

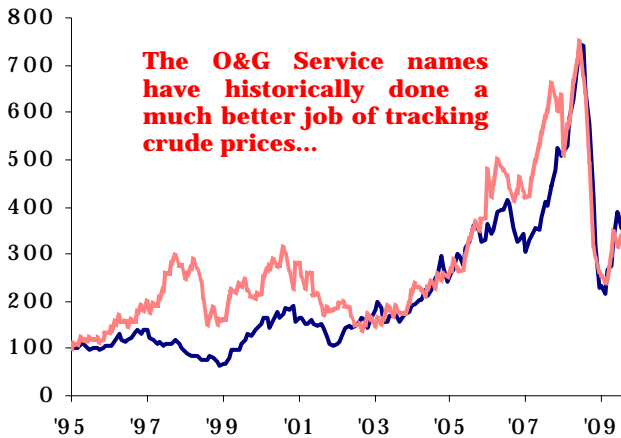
## Recommended Sector Allocation – Overweight (Long)

|   |  |
|---|--|
| <b>Integrated O&amp;G</b>                             | Have significantly lagged the rebound in crude oil this year. We would view outperformance of the Integrations as suggesting that investors are again rotating into “quality” names. Until we see this move – a sign the “risk” trade is abating – we would continue to be cautious on the space. <b>Long-term</b> – Peak oil theorists will note the group's increasing difficulty and cost in replacing proved reserves. |
| <b>O&amp;G Equipment &amp; Services</b>               | Offers perhaps the best equity play on the direction of crude oil; stocks should do well relative sector peers when crude prices are stable. Group is leveraged to the Emerging Market demand story.   |
| <b>O&amp;G Exploration, Drilling &amp; Production</b> | With economic aggregates likely to get stronger off their 4Q '08/1Q '09 bottom and the Emerging Market demand story entrenched, commodity prices appear likely to continue their move higher. We are reminded of the outperformance of E&P shares in '08 as crude prices charted toward \$150 by mid-year – makes sense (higher demand x higher product price) = good for business.  |
| <b>O&amp;G Refining &amp; Marketing</b>               | The cost of crude is an input cost for Refiners making extremely high prices punitive and volatile prices difficult to hedge – this is likely to weigh on the relative performance of the group in the near-term. <b>Secular</b> – The story may be somewhat brighter as emerging economies are (and likely will be for some time) importers of refined products.  |

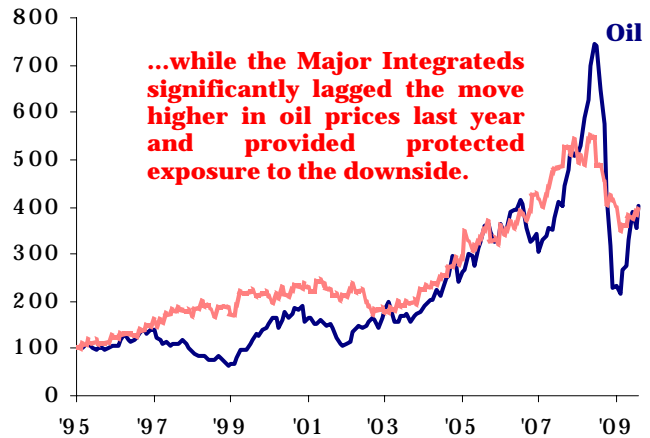
As we highlight in the table and charts below, the relationship between crude oil and Energy industries is stronger in some places than in others.



**Crude Oil vs. O&G Service Index**  
Indexed to 100 in January 1995

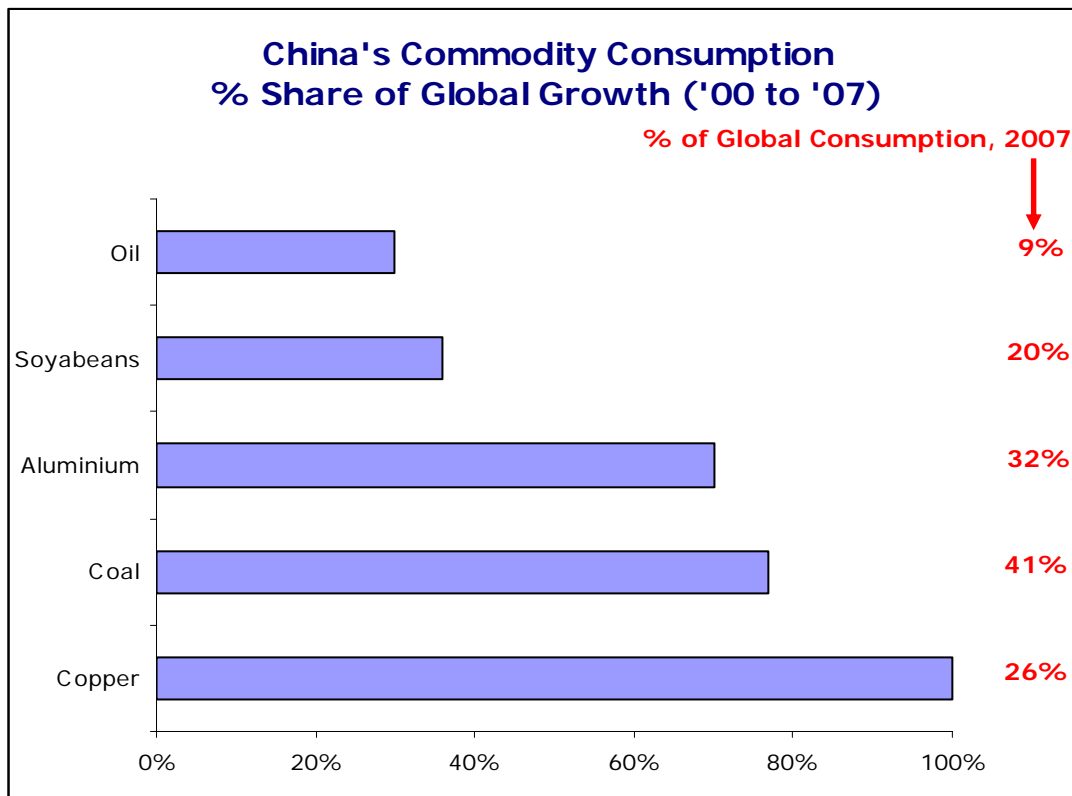


**Crude Oil vs. Integrated O&G Index**  
Indexed to 100 in January 1995



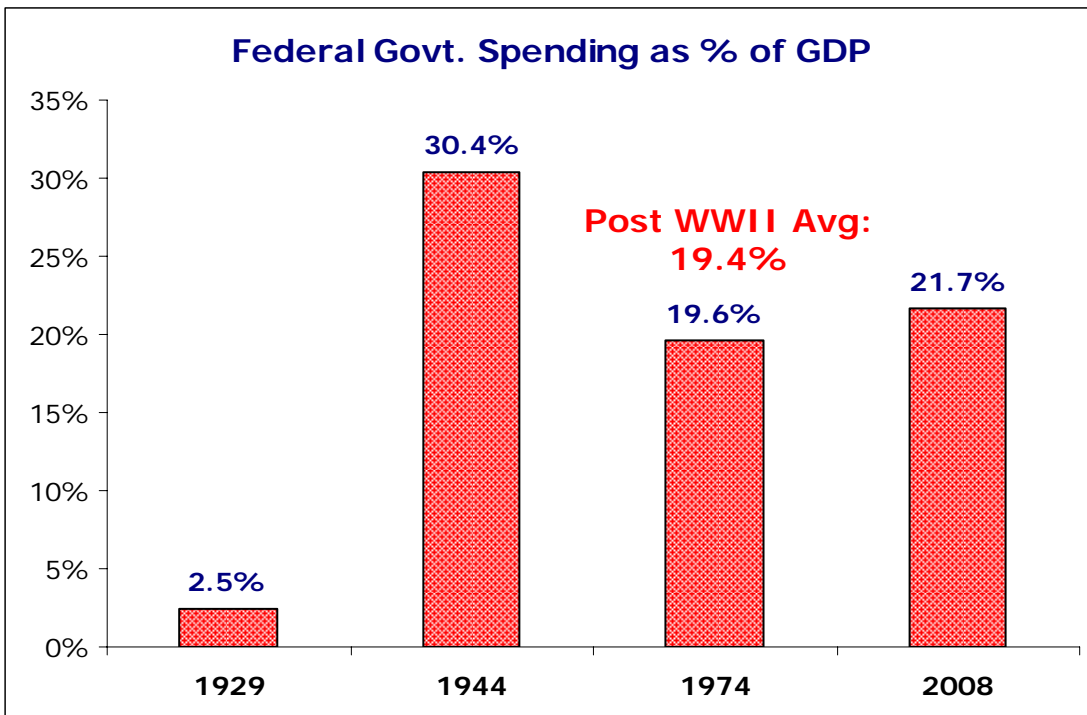
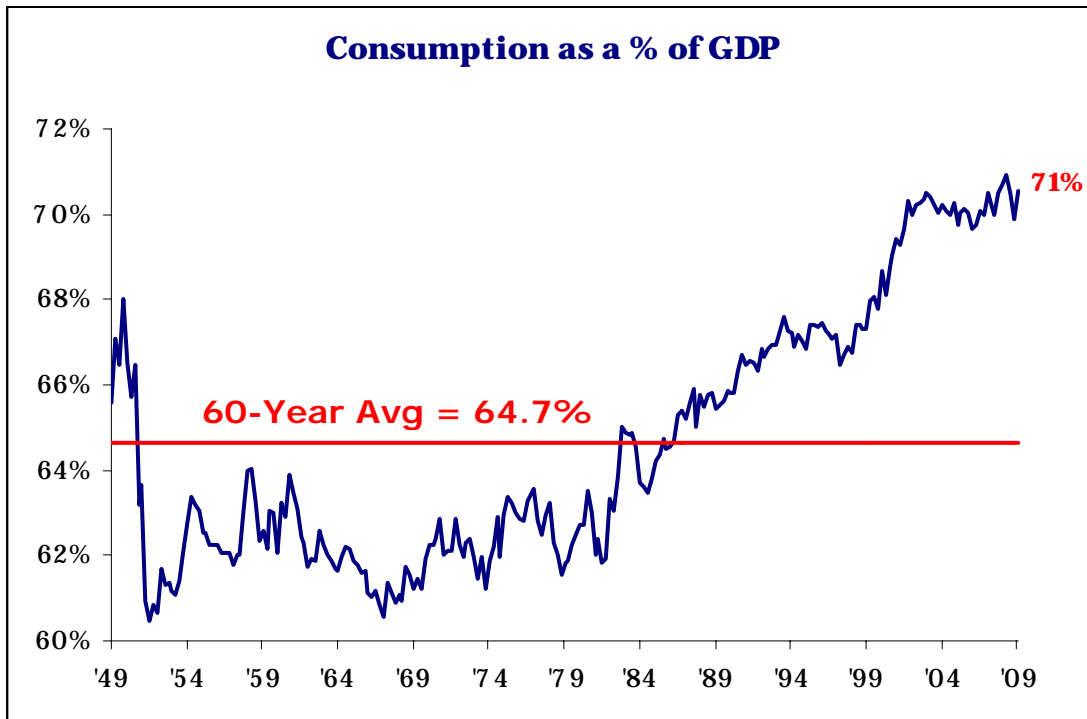
# SHOVEL READY IN CHINA

| <b>Breakdown of Chinese Stimulus</b> |              |                       |
|--------------------------------------|--------------|-----------------------|
|                                      | <b>\$BN</b>  | <b>% of China GDP</b> |
| Infrastructure                       | \$463        | 9.7%                  |
| Environment & Energy                 | \$52         | 1.1%                  |
| Housing                              | \$42         | 0.9%                  |
| Innovation & Manufacturing           | \$24         | 0.5%                  |
| Healthcare & Education               | \$5          | 0.1%                  |
| <b>Total Package</b>                 | <b>\$586</b> | <b>12.3%</b>          |



## LONGER-TERM, FADE DISCRETIONARY: CONSUMER RESTRUCTURING COULD TAKE SOME TIME

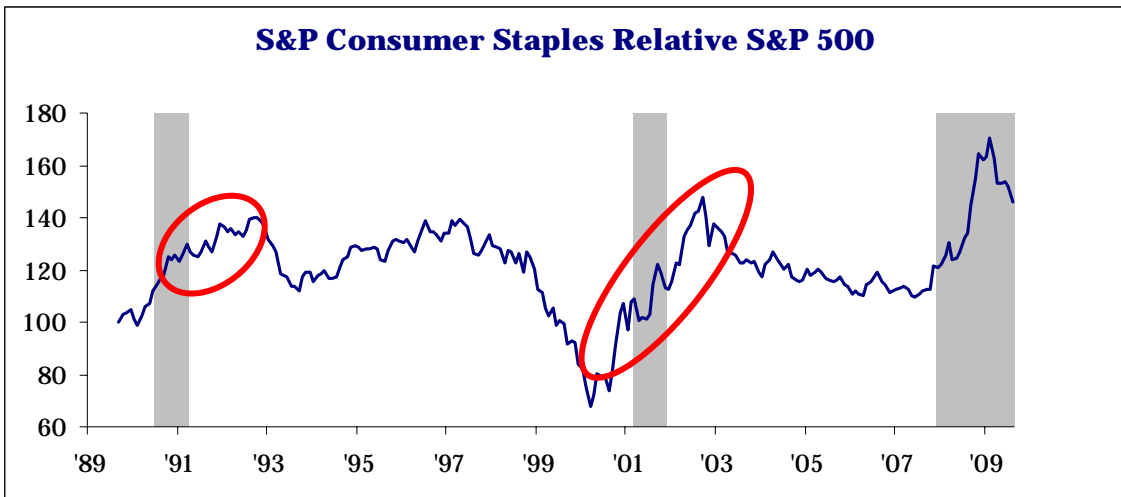
It has become part of the standard pabulum of economic commentators to say that consumer spending is 2/3 of the economy. That is indeed the long-term average, but it ignores the fact that consumer spending as a percentage of GDP actually peaked at roughly 71% in early 2008. In a \$14 trillion economy, the difference between 71% and 66% is significant and not easily corrected.



# CONSUMER STAPLES A BETTER BET:

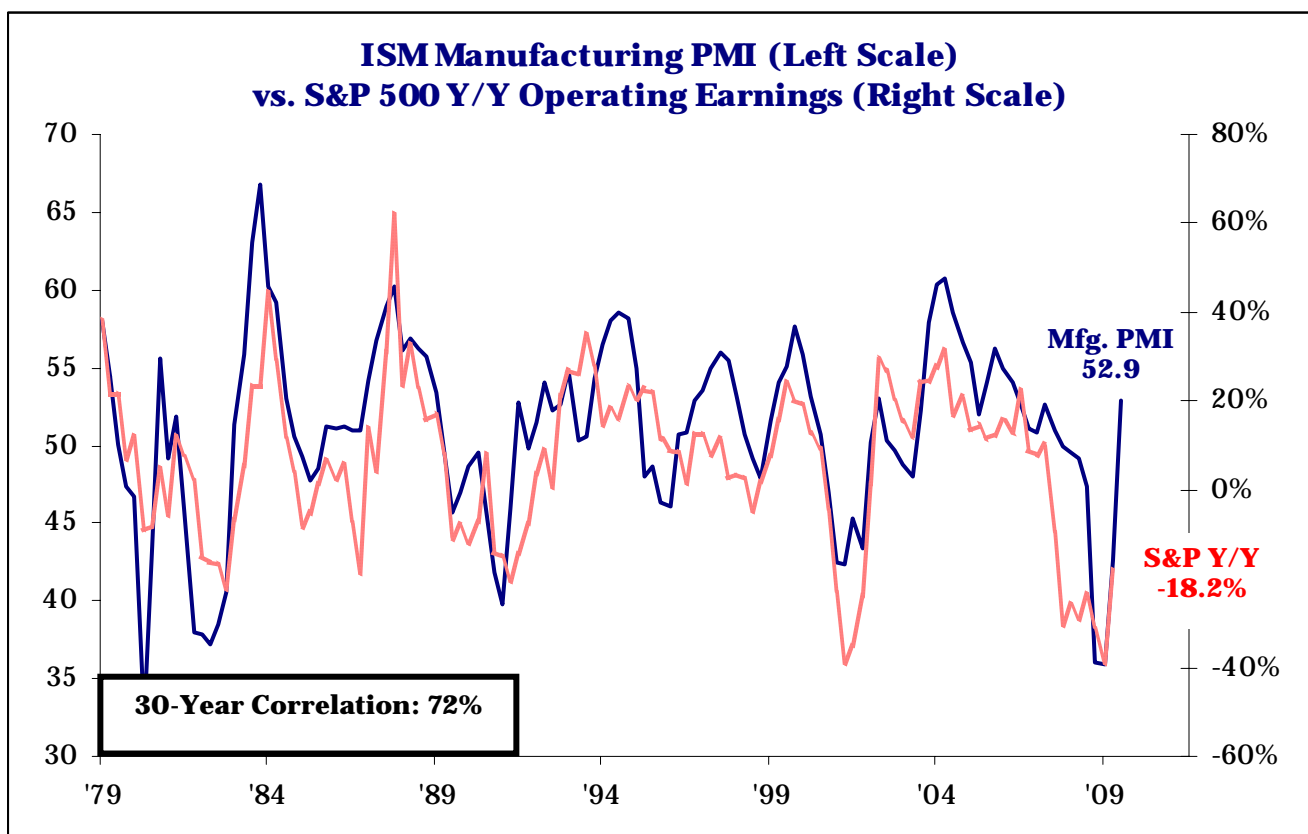
Recommended Sector Allocation – Overweight (Long)

|   |   |
|---|---|
| <b>Agricultural Products</b>            | <b>Cyclical</b> – Soft demand and good crops have made for generally lower prices. <b>Secular</b> – The longer-term story remains enticing. A growing global population – particularly in Asia, the Middle East and Latin America, should drive demand growth.  |
| <b>Beverages</b>                        | We believe the power of the “global” brand will take prominence for companies looking to “win” in the global economy. Both alcohol and non-alcohol producers understand the importance of branding and are beneficiaries of an underleveraged emerging market consumer. <b>Brewers</b> – Global consolidation continues. <b>Soft Drinks</b> – Distribution chains continue to be a focus (note Pepsi’s bid for its bottlers). As are non-carbonated brands. As noted in the 2Q earnings conference call by Coke's CEO, “We continue to invest our robust cash flow and profits into key markets and growth strategies, which in turn, enables us to deliver solid performance in fast-growing economies like India, Brazil, Mexico, and China. These investments also give us the ability to expand our footprint in these key market economies.” |
| <b>Food &amp; Drug Retail</b>           | <b>Food</b> – Classically defined, they are losing share to Hypermarkets (like WMT – see below); an effort to protect market share through pricing will be punitive to the bottom-line, where most companies are cutting costs to achieve gains given a dearth of top-line. The group could be positioned for consolidation. Restaurant weakness could be a tailwind for the group. <b>Drug</b> – should see increased volume given the trajectory of healthcare reform. The potential for H1N1/09 to impact a third of Americans could drive volumes. However, the FTC is reviewing aspects of the '07 CVS/Caremark merger, which may present headline risk for the group in the coming months.  |
| <b>Household Products</b>               | Despite strong global competition, the group derives an above market degree of revenue from foreign-sources. With consumers acting more judiciously, products sold through discount retailers and clubs should do well.   |
| <b>Hypermarkets &amp; Super Centers</b> | 2Q earnings season made one thing clear – it’s all about revenue growth. In an environment where employment is likely to remain under pressure, we believe companies like Wal-Mart and Costco remain best positioned to grow top-line and take market share from more discretionary alternatives.   |
| <b>Packaged Foods</b>                   | Soft commodities have lagged Hards by a wide margin throughout the '09 commodity recovery making reduced input costs a likely tailwind for the food makers.   |
| <b>Tobacco</b>                          | Industry consolidation anticipated following the passage in June of legislation allowing the FDA to regulate the industry. A study on the health impact of menthol and a trade dispute over the banning of flavored cigarettes relative to menthol. If these issues become resolved LO remains an attractive takeover target.   |



## ISM MANUFACTURING PMI ABOVE 50 SETTING THE STAGE FOR UPSIDE PROFIT SURPRISE IN 3Q

Past experience tells us that it's generally not wise to "blow off" "blow-out" reports. While the headline ISM Manufacturing report might have fallen just shy of that distinction, the new orders component of release certainly qualified. This could be important as we move into the 3Q earnings season since, as the chart below indicates, there is remarkable correlation between the ISM and S&P Y/Y earnings gains. During most recessions, companies tend to lay people off but keep wages constant for workers that remain. What's been odd about this cycle is that companies have laid off workers **AND** cut wages for the employees that have stayed-on (FedEx, Yellow Roadways, Wynn Resorts, Caterpillar and AMD). This sets the stage for big operating leverage gains in earnings in the coming quarters. On the next page, we've assembled a list of companies that have had the biggest declines in their COGS and SGA and might therefore provide the best opportunities for upside earnings surprises.



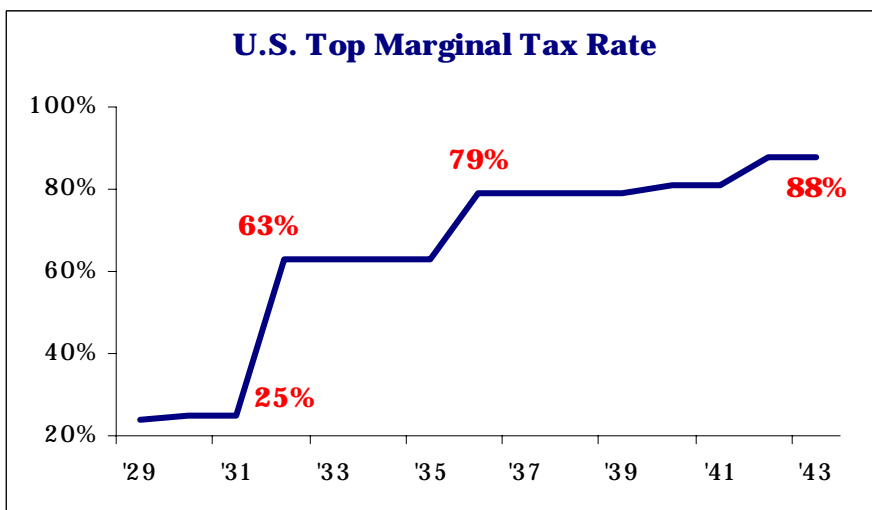
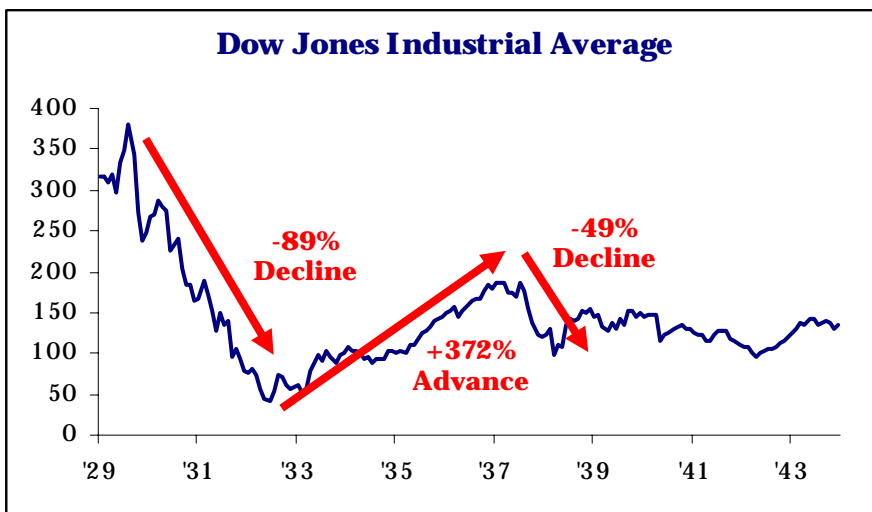
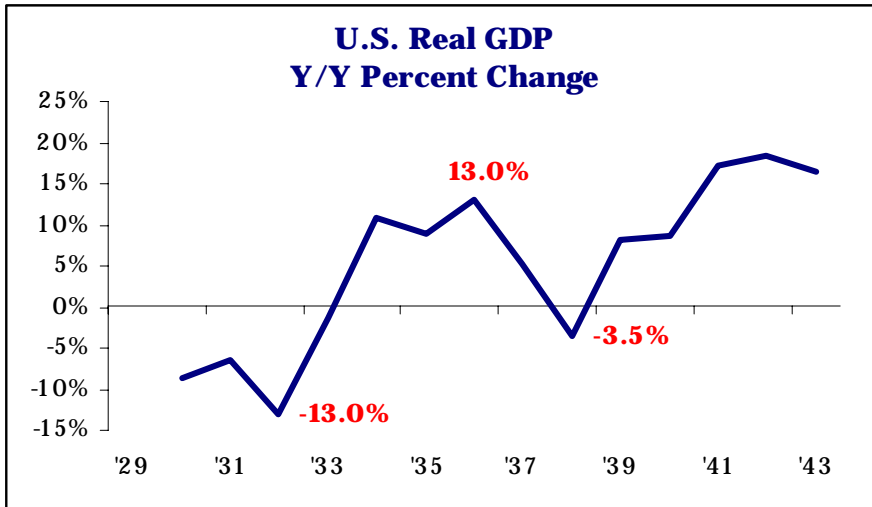
## COMPANIES WITH GREATEST OPERATING LEVERAGE MIGHT BE BEST BET FOR 3Q EARNINGS SEASON

In the table below, we've indentified the 50 S&P 500 stocks with the greatest Y/Y decline in COGS + SG&A. Should top-line begin to showcase sustainable improvement, these stocks might provide investors with the greatest operating leverage in the quarters ahead.

### S&P 500 Cos. Top 50 with the Greatest Y/Y % Decline in COGS + SG&A

|      |                          |        |      |                           |        |
|------|--------------------------|--------|------|---------------------------|--------|
| AKS  | AK Steel Holding         | -56.7% | HES  | Hess                      | -35.2% |
| NUE  | Nucor                    | -56.6% | RHI  | Robert Half International | -32.8% |
| TAP  | Molson Coors Brewing     | -55.7% | KLAC | KLA-Tencor                | -32.8% |
| X    | United States Steel      | -53.7% | WY   | Weyerhaeuser              | -32.7% |
| TSO  | Tesoro                   | -53.0% | CMI  | Cummins                   | -32.5% |
| SUN  | Sunoco                   | -52.2% | EMN  | Eastman Chemical          | -32.2% |
| PHM  | Pulte Homes              | -51.1% | MOT  | Motorola                  | -31.9% |
| TLAB | Tellabs                  | -50.9% | BK   | Bank of New York Mellon   | -31.5% |
| VLO  | Valero Energy            | -48.9% | DOW  | Dow Chemical              | -31.1% |
| KBH  | KB Home                  | -48.6% | HAR  | Harman International      | -30.7% |
| CVX  | Chevron                  | -48.3% | DVN  | Devon Energy              | -30.6% |
| COP  | ConocoPhillips           | -48.1% | PPG  | PPG Industries            | -29.1% |
| WMB  | Williams Cos.            | -45.7% | APD  | Air Products & Chemicals  | -29.0% |
| F    | Ford Motor               | -43.6% | AN   | AutoNation                | -28.7% |
| XOM  | Exxon Mobil              | -43.0% | PH   | Parker Hannifin           | -28.5% |
| MRO  | Marathon Oil             | -42.7% | MU   | Micron Technology         | -28.5% |
| MUR  | Murphy Oil               | -42.3% | NSM  | National Semiconductor    | -28.4% |
| ATI  | Allegheny Technologies   | -42.1% | LEG  | Leggett & Platt           | -28.1% |
| CHK  | Chesapeake Energy        | -41.5% | AA   | Alcoa                     | -27.9% |
| DHI  | D.R. Horton              | -41.4% | PX   | Praxair                   | -27.9% |
| CAT  | Caterpillar              | -41.4% | DOV  | Dover                     | -27.6% |
| EXPD | Expeditors International | -39.7% | JCI  | Johnson Controls          | -27.5% |
| STT  | State Street             | -38.1% | SNDK | SanDisk                   | -27.5% |
| NVLS | Novellus Systems         | -37.1% | PCP  | Precision Castparts       | -27.3% |
| FCX  | Freeport-McMoRan         | -35.7% | ETN  | Eaton                     | -26.9% |

## “G” CAN WORK FOR MARKETS & ECONOMY UNTIL THE BILL COMES DUE

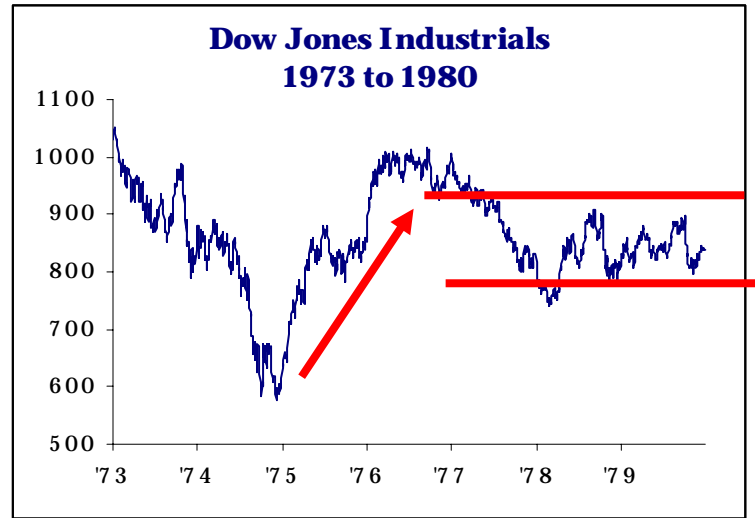
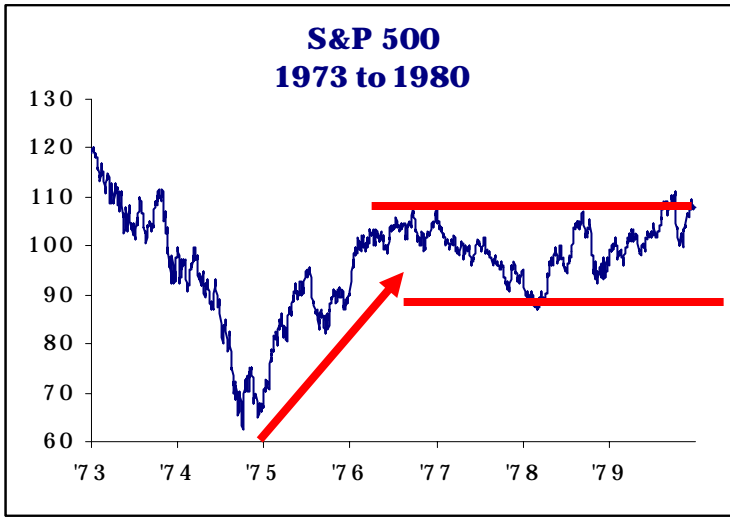


While monetary stimulus is dependent upon the health of the financial sector to act as a proper transmission mechanism, fiscal stimulus is directly in the GDP equation and thus can have effects on both the economy and the markets. While it's one thing to fade monetary policy and say the Fed is “pushing on a string”, it's much harder to fade fiscal policy – even in the 1930s, once the government decides to spend money, it generally “works”.

That is until, of course, the bill comes due. The 1930s is again a good case in point: massive fiscal stimulus resulted in year-over-year GDP gains of 10.8%, 8.9%, and 13% in 1934, 1935, and 1936 respectively. The Dow rallied 372% during the same period, weakening only when the bill for government spending came due with higher marginal tax rates in 1937. For the time being, it might be hard to fade government spending (cyclical bounce). In the long-term however, stocks are likely to have trouble when both long-term interest rates and taxes move higher (secular problems).

# LATE 1970s REDUX? RANGE-BOUND MARKET, REAL ASSET APPRECIATION

Many of our clients and friends that have seen multiple cycles believe that over the next several years, the market will be reminiscent of the period following the '73-'74 bear market. After an initial rally off the bottom, the major market indices marked time for several years. As we've written over the last six months, we feel the investment landscape over the next several years is bullish for real assets, neutral for stocks, and bearish for bonds.



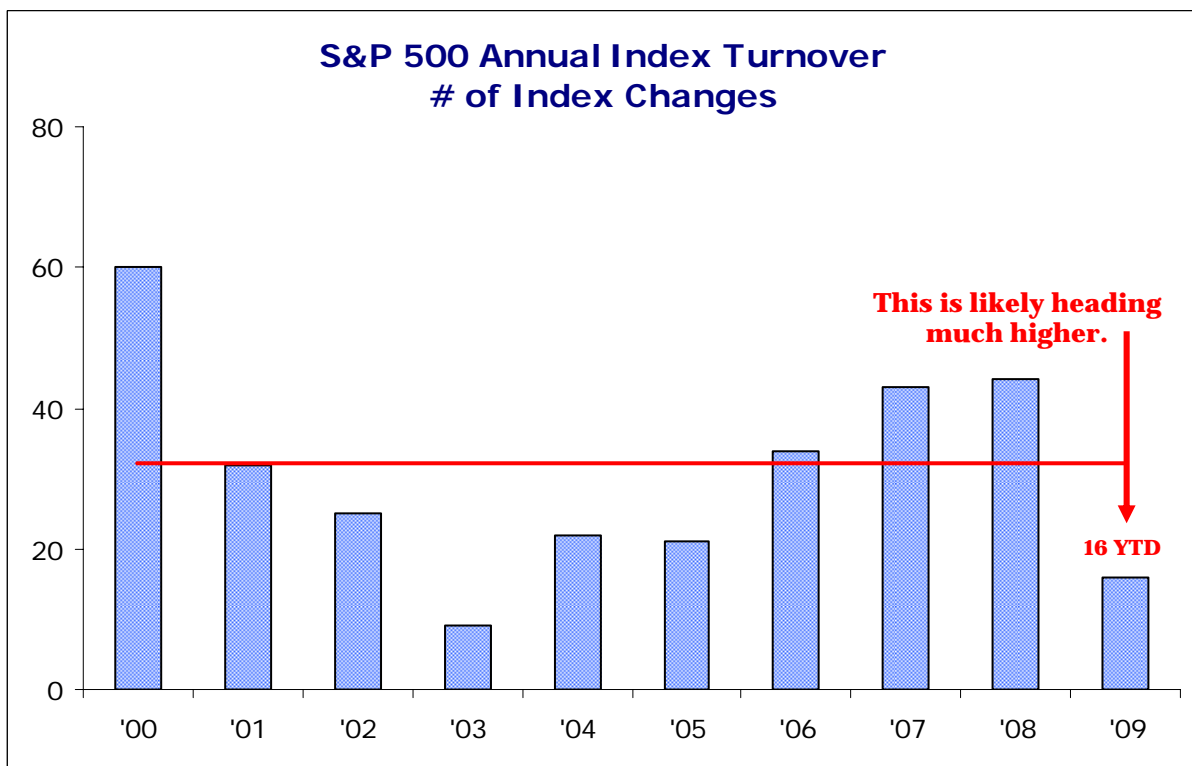
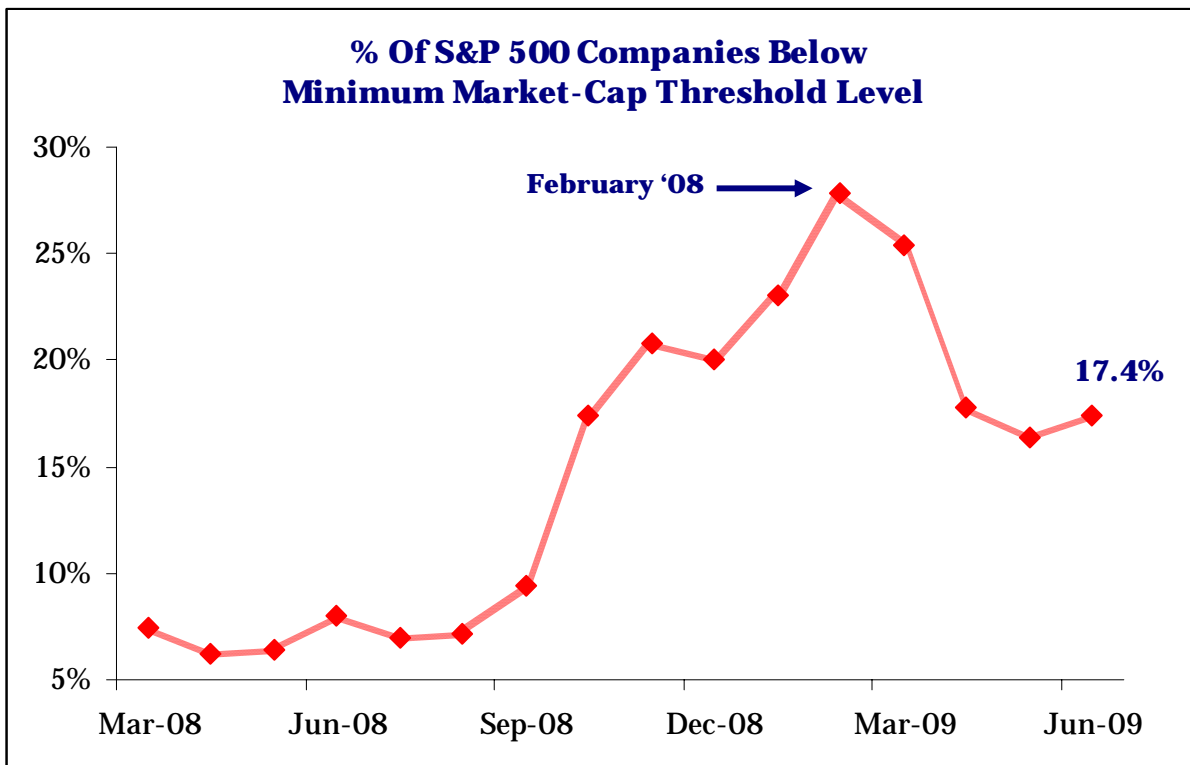
## Real Returns Across Asset Class (1975 to 1980)

|                 | Gold       | Large-Cap Stocks | Home Prices | T-Bills    | Long-Term Corp. Bonds | Long-Term Govt. Bonds |
|-----------------|------------|------------------|-------------|------------|-----------------------|-----------------------|
| 12/31/1974      | \$1        | \$1              | \$1         | \$1        | \$1                   | \$1                   |
| 12/31/1975      | \$0.67     | \$1.28           | \$1.01      | \$0.97     | \$1.06                | \$1.00                |
| 12/31/1976      | \$0.61     | \$1.51           | \$1.03      | \$0.96     | \$1.19                | \$1.11                |
| 12/31/1977      | \$0.70     | \$1.31           | \$1.09      | \$0.95     | \$1.13                | \$1.03                |
| 12/31/1978      | \$0.91     | \$1.29           | \$1.16      | \$0.94     | \$1.05                | \$0.94                |
| 12/31/1979      | \$1.96     | \$1.38           | \$1.19      | \$0.93     | \$0.89                | \$0.82                |
| <b>% Return</b> | <b>96%</b> | <b>38%</b>       | <b>19%</b>  | <b>-7%</b> | <b>-11%</b>           | <b>-18%</b>           |

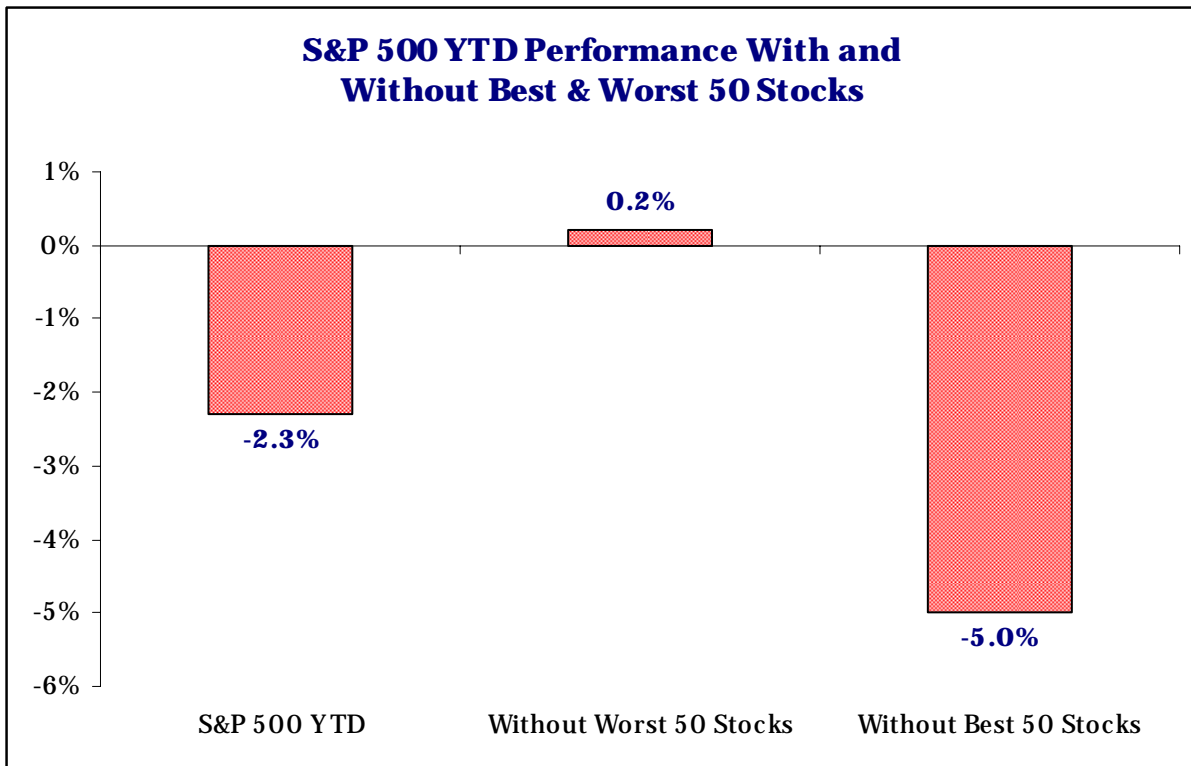
**Commodity Exposure  
Outperformed**

**Fixed Income Underperformed  
by a Wide Margin**

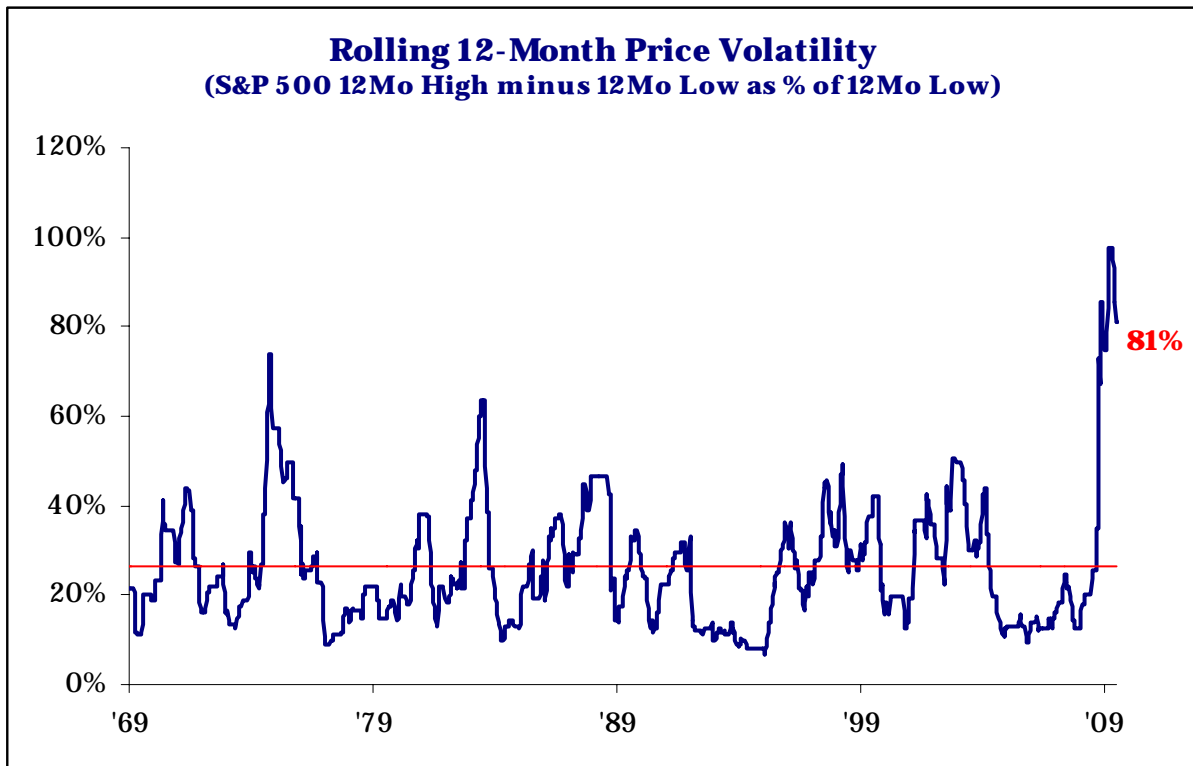
## 17.4 PCT. OF S&P 500 STILL BELOW MINIMUM \$3BN MARKET-CAP THRESHOLD



# MISTAKES HURT – STOCK PICKING IMPORTANT

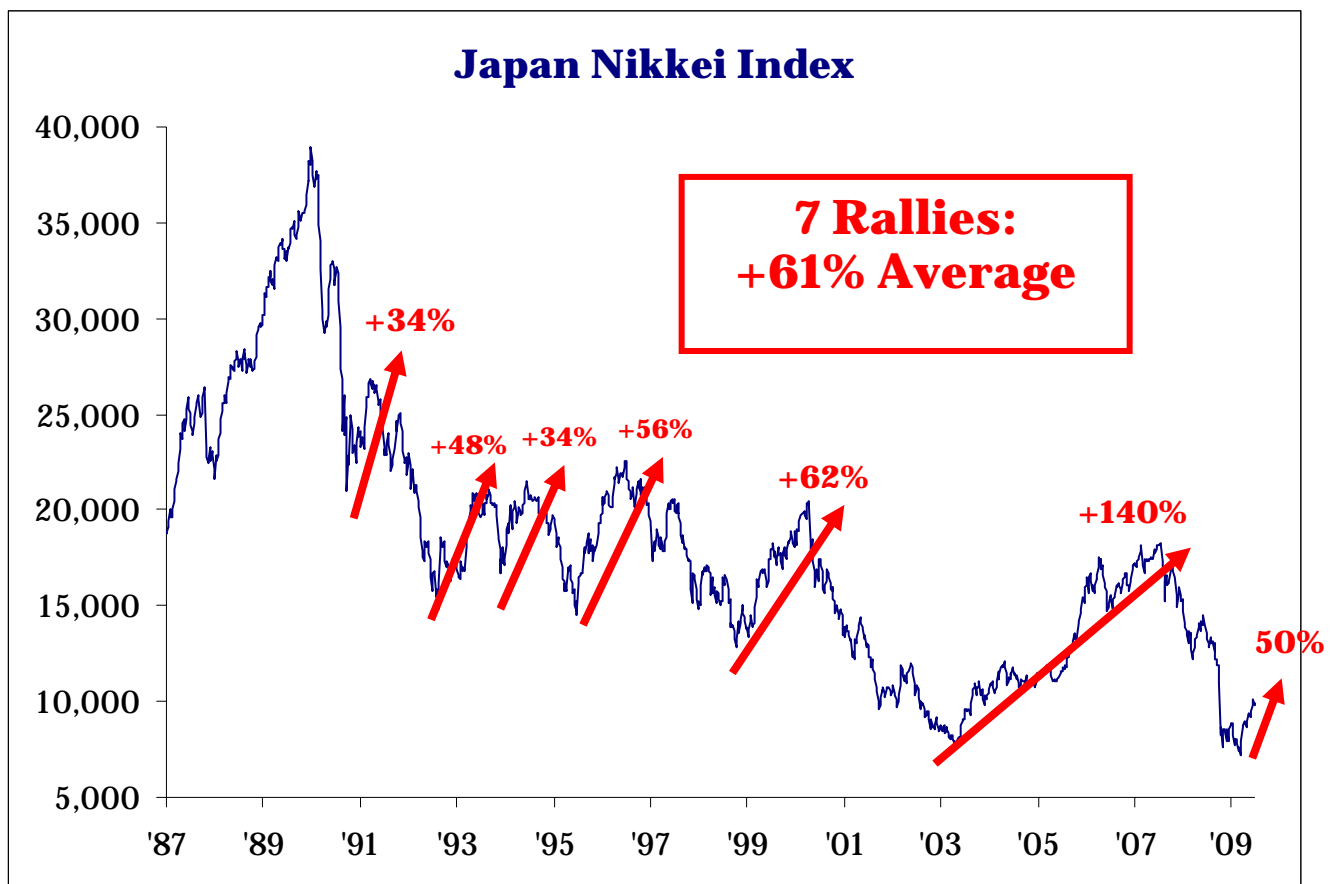


# VOLATILITY REMAINS ELEVATED



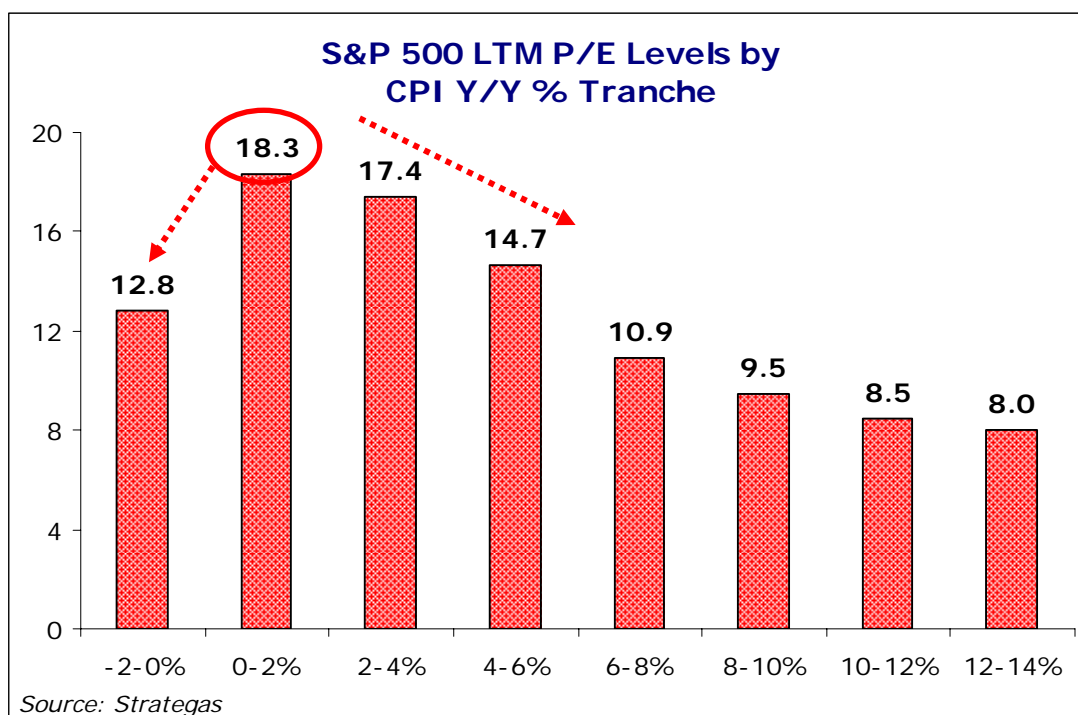
## NIKKEI HAS HAD SEVEN +30% RALLIES IN 1989 TO PRESENT BEAR-MARKET

We believe the alacrity with which fiscal and monetary stimulus has been applied in the U.S. may make Japan's lost decades a poor guide for U.S. investors in the years to come. Still, we believe it's worth noting that the Nikkei has seen six rallies of 30% or greater since it reached its all-time peak of 39,000+ in 1989. Beware of bull markets in bear's clothing.



## INFLATION AND EARNINGS MULTIPLES

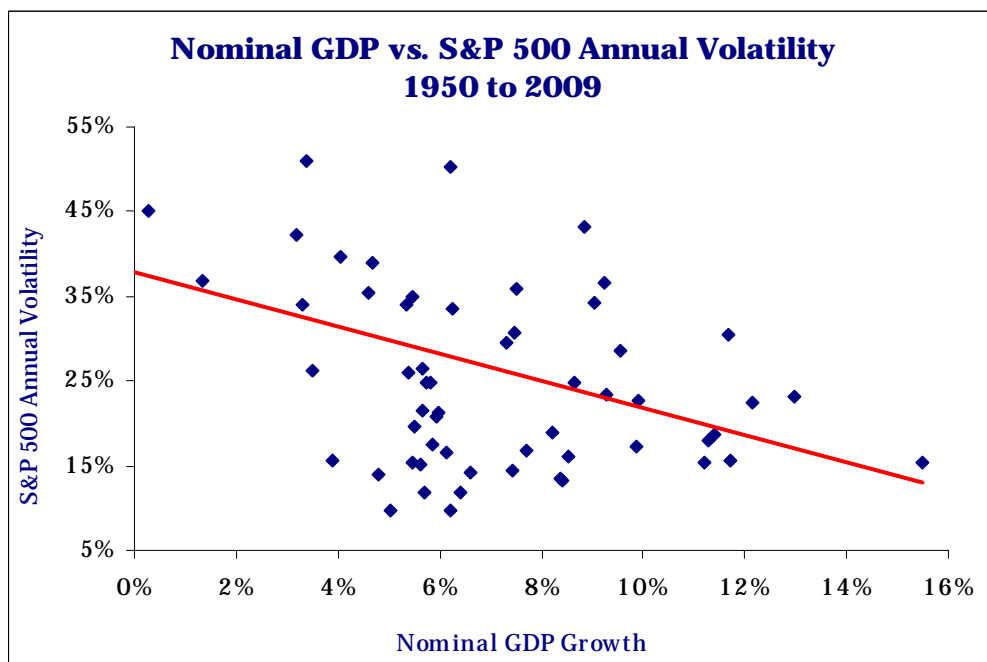
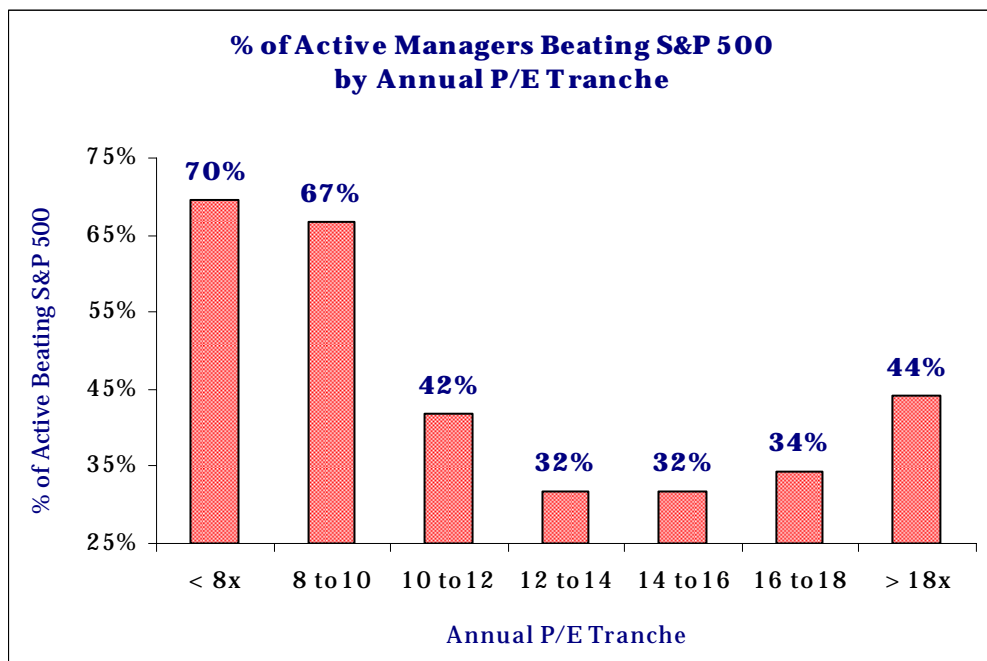
The sweet spot for multiples is in the 0-4% inflation range, with statistical breaks both below 0% and above 4%. The fair value table below is a Rorschach test of sorts but we believe current market levels are pricing in a lot of bad news.



### Historical Market Bottoms: Multiples, Treasuries, Inflation, & Taxes

| S&P 500 Trough      | Level  | Trailing P/E | 10-Year Yield | Inflation    | Top Marginal Tax Rate |
|---------------------|--------|--------------|---------------|--------------|-----------------------|
| 6/1/1932            | 4.40   | 10.5x        | 3.8%          | -10.5%       | 63.0%                 |
| 4/29/1942           | 7.47   | 7.7x         | 2.4%          | 12.6%        | 88.0%                 |
| 6/14/1949           | 13.55  | 5.8x         | 2.4%          | -1.0%        | 82.1%                 |
| 10/22/1957          | 38.98  | 12.2x        | 4.0%          | 2.9%         | 91.0%                 |
| 6/27/1962           | 52.32  | 16.1x        | 3.9%          | 1.2%         | 91.0%                 |
| 10/7/1966           | 73.2   | 14.8x        | 5.0%          | 3.8%         | 70.0%                 |
| 5/26/1970           | 69.29  | 14.0x        | 7.9%          | 6.0%         | 71.8%                 |
| 10/3/1974           | 62.28  | 8.3x         | 7.9%          | 11.8%        | 70.0%                 |
| 8/12/1982           | 102.42 | 8.8x         | 13.1%         | 6.0%         | 50.0%                 |
| 12/4/1987           | 223.92 | 12.6x        | 9.0%          | 4.3%         | 38.5%                 |
| 10/11/1990          | 295.46 | 13.1x        | 8.7%          | 6.4%         | 31.0%                 |
| 10/9/2002           | 776.76 | 19.8x        | 3.9%          | 2.0%         | 38.6%                 |
| <b>Average</b>      |        | <b>12.0x</b> | <b>6.0%</b>   | <b>3.8%</b>  | <b>65.4%</b>          |
| <b>3/9/2009 Low</b> |        | <b>13.6x</b> | <b>2.9%</b>   | <b>-0.2%</b> | <b>35.0%</b>          |

# ENVIRONMENT REMAINS RIPE FOR ACTIVE MANAGEMENT TO OUTPERFORM PASSIVE STRATEGIES



In the past 40 years there were really only two periods in which active managers handily beat passive strategies – the U.S. in the late ‘70s/early ‘80s and Japan in the 1990s. Both examples were marked by low real growth, elevated volatility, and one-decision sector bets – overweight Energy in the U.S. in the late ‘70s and underweight Financials in Japan in the ‘90s. As the accompanying table indicates, active managers tend to perform better when multiples are declining, while underperforming in periods of stable growth and stable multiples. One could surmise from all this that depressed growth environments and periods of multiple contraction tend to widen the differences between winners and losers across all industries, provide fertile ground for winner-take-all markets, and often introduce exogenous shocks in public policy that benefit the manager willing to trade around long-term, core holdings.

## AUGUST '82 THIS AIN'T

### Then & Now: August 1982 vs. June 2009

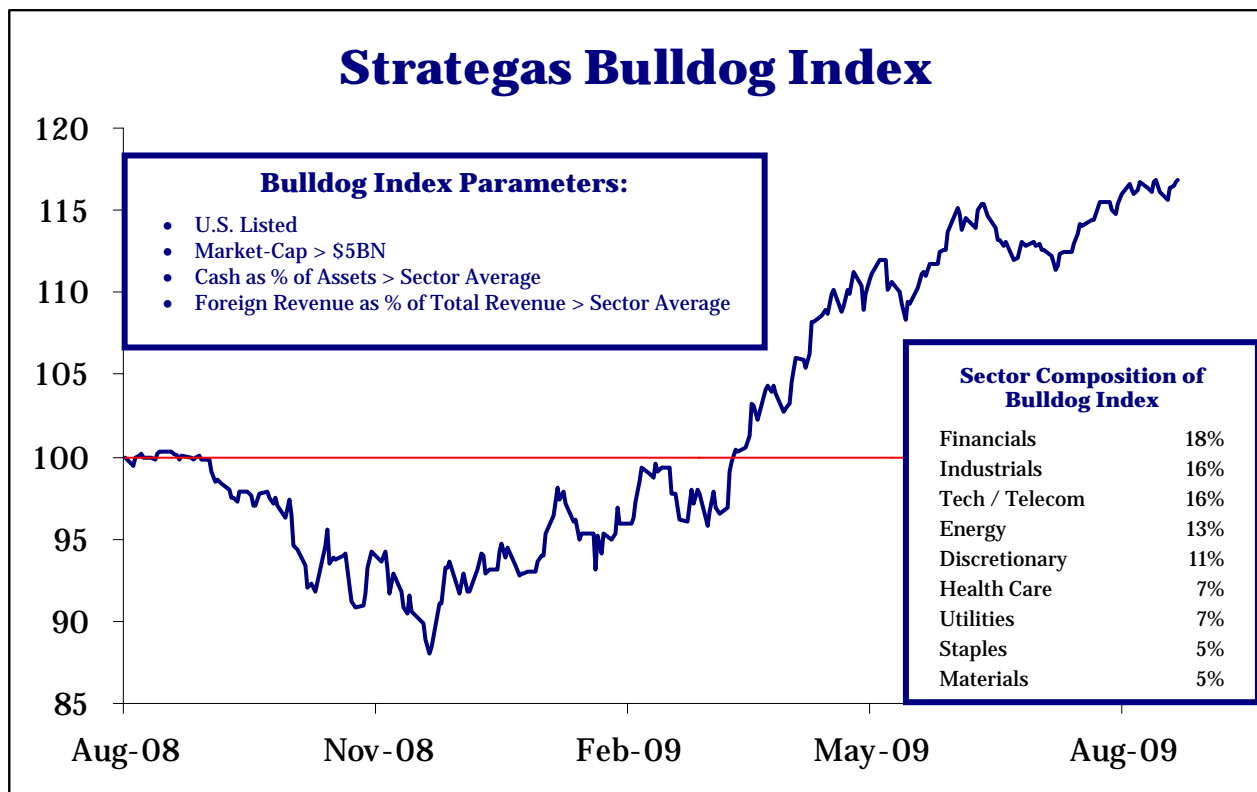
|                         | August '82 | Current |
|-------------------------|------------|---------|
| Fed Funds Rate          | 10.25%     | 0.13%   |
| Prime Rate              | 14.39%     | 3.25%   |
| 10-Year UST Yield       | 13.6%      | 3.5%    |
| Trailing S&P 500 P/E    | 8.8x       | 21.8x   |
| Price to Book           | 1.0x       | 2.0x    |
| Dividend Yield          | 6.6%       | 2.4%    |
| Top Marginal Tax Rate   | 50%        | 35%     |
| Capital Gains Tax Rate  | 20%        | 15.0%   |
| % of Workforce in Union | 20.1%      | 12.4%   |

### Real Returns Across Asset Class (1982 to 1989)

|                 | Large-Cap<br>Stocks | Long-Term<br>Corp. Bonds | Long-Term<br>Govt. Bonds | T-Bills    | Home<br>Prices | Gold        |
|-----------------|---------------------|--------------------------|--------------------------|------------|----------------|-------------|
| 12/31/1982      | \$1                 | \$1                      | \$1                      | \$1        | \$1            | \$1         |
| 12/31/1983      | \$1.19              | \$1.03                   | \$0.97                   | \$1.06     | \$1.00         | \$0.81      |
| 12/31/1984      | \$1.22              | \$1.16                   | \$1.08                   | \$1.11     | \$0.99         | \$0.62      |
| 12/31/1985      | \$1.56              | \$1.47                   | \$1.38                   | \$1.16     | \$1.00         | \$0.63      |
| 12/31/1986      | \$1.82              | \$1.73                   | \$1.69                   | \$1.21     | \$1.04         | \$0.74      |
| 12/31/1987      | \$1.85              | \$1.66                   | \$1.59                   | \$1.23     | \$1.08         | \$0.89      |
| 12/31/1988      | \$2.09              | \$1.77                   | \$1.67                   | \$1.25     | \$1.08         | \$0.72      |
| 12/31/1989      | \$2.65              | \$1.98                   | \$1.90                   | \$1.31     | \$1.09         | \$0.67      |
| <b>% Return</b> | <b>165%</b>         | <b>98%</b>               | <b>90%</b>               | <b>31%</b> | <b>9%</b>      | <b>-33%</b> |

# INTRODUCING STRATEGAS' BULLDOG INDEX

Former Chairman of CJ Lawrence, mentor, and friend, Jim Moltz, was the first to coin the phrase “bulldog” when referring to stocks that were committed to growing market share. Today, we introduce our take on this theme – the Strategas Bulldog Index. We’ve developed a simple screen that tries to isolate companies that are self-funding, not reliant on accessing the credit markets, but who also have strong global brands. **The idea is simply that these should be the companies that should be able to maintain, if not expand, market share in an increasingly global economy in which the access to credit has been generationally diminished and nominal growth is likely to remain below trend for some time.** We’ve come up with 55 stocks across the market’s 10 sectors that pass our screening parameters.



## Strategas Bulldog Index Constituents

|      |                           |       |                          |
|------|---------------------------|-------|--------------------------|
| MMM  | 3M                        | FLR   | Fluor                    |
| ADBE | Adobe Systems             | FTI   | FMC Technologies         |
| AES  | AES Corp.                 | F     | Ford Motor               |
| ALTR | Altera                    | BEN   | Franklin Resources       |
| AMZN | Amazon.com                | HAL   | Halliburton              |
| AXP  | American Express          | HOG   | Harley-Davidson          |
| AMT  | American Tower            | JEC   | Jacobs Engineering Group |
| ADI  | Analog Devices            | KLAC  | KLA-Tencor               |
| AOC  | AON                       | MRK   | Merck                    |
| ADSK | Autodesk                  | MCO   | Moody's                  |
| AVP  | Avon Products             | MS    | Morgan Stanley           |
| BHI  | Baker Hughes              | NWS.A | News Corp.               |
| BK   | Bank of New York Mellon   | NKE   | Nike                     |
| BA   | Boeing                    | NTRS  | Northern Trust           |
| BMJ  | Bristol-Myers Squibb      | NVDA  | NVIDIA                   |
| C    | Citigroup                 | PCAR  | Paccar                   |
| KO   | Coca-Cola                 | PFE   | Pfizer                   |
| CL   | Colgate-Palmolive         | PPG   | PPG Industries           |
| DE   | Deere                     | PPL   | PPL Corp.                |
| DO   | Diamond Offshore Drilling | QCOM  | QUALCOMM                 |
| DOV  | Dover                     | ROK   | Rockwell Automation      |
| DD   | E.I. DuPont de Nemours    | SLB   | Schlumberger Ltd.        |
| ESV  | ENSCO International       | SRE   | Sempra Energy            |
| EQT  | EQT Corp.                 | SIAL  | Sigma-Aldrich            |
| EXPE | Expedia                   | STT   | State Street             |
| EXPD | Expeditors International  | WYE   | Wyeth                    |
| XOM  | Exxon Mobil               | XLNX  | Xilinx                   |
|      |                           | XL    | XL Capital               |

## CREDIT SPREADS OFF PEAK LEVELS, BUT *COST OF* & *ACCESS TO* DEBT LIKELY GENERATIONALLY IMPAIRED

