

## Outlook for 2010

At KStone Partners the asset allocation decisions made by our Investment Committee are guided by our macro-economic outlook with respect to the future economic, financial and political environment. We would like to share with you our assessment of the challenging conditions that are likely to exist in 2010. We believe that the economy in the first part of 2010 will perform like the Growth Scenario outlined below. Thereafter, the economy will decline towards one of the other two scenarios described below.

The critical drivers to watch in 2010 are housing prices, the commercial real estate market, state and local government deficits, sovereign defaults and most importantly, the level of support from the U.S. Government and Federal Reserve. The expected turmoil will create substantial opportunities to invest and achieve attractive risk-adjusted investment returns.

### **Alternative Economic Scenarios**

<b>Double Dip Recession</b> (Probability: 30%)	<b>Slow Growth</b> (Probability: 40%)	<b>Growth</b> (Probability: 30%)
<b>The Economy</b>		
<i>U.S. Economy</i>		
Real GDP is \$12.9 Trillion – GDP growth is negative 1% – Deflation/very low inflation Population continues to age Unemployment exceeds 12% – State/local down big – Jobless benefits extended Housing prices fall 10-25% – Foreclosures rise significantly Consumer spending falls – Confidence falls hard – Savings rate rises – Personal bankruptcies skyrocket Corporate profits decline	Real GDP is \$13.2 Trillion – GDP growth 0-2% – Low inflation Population continues to age Unemployment flat at 10% – State/local down modestly – Jobless benefits extended Housing prices decline 5-10% – Foreclosures rise significantly Consumer spending up in 1H – Confidence remains low – Savings rate is flat – High personal bankruptcies Corporate profits up some	Real GDP is \$13.5 Trillion – GDP growth 2-4% – Very modest inflation Population continues to age Unemployment below 10% – State/local rolls down – Jobless benefits end Housing prices stabilize – Foreclosures rise Consumer spending grows – Confidence improves – Savings rate stays below 4.5% – Increasing personal bankruptcies Corporate profits grow well
<i>U.S. Financial Institutions</i>		
Banks again under pressure – Large number of bank failures – Lending declines significantly Securitization remains frozen	Banks muddle through – Modest number of bank failures – Lending declines modestly Modest level of securitization	Banks build their B/Ss – Some number of bank failures – Lending stays flat Securitization market returns
<i>World Economy</i>		

The key global issue will be sovereign defaults. Those most at risk are the PIIGS in Europe. Generally, Europe will follow the U.S. lead in terms of economic growth. Japan's economic stimulus will fail once again but interest rates will not soar. Asia & South America will see good to robust growth.

## Alternative Economic Scenarios

Double Dip Recession (Probability: 30%)	Slow Growth (Probability: 40%)	Growth (Probability: 30%)
<i>Federal Reserve</i>		
Broad money supply contracts Keeps short-term rates at 0% Extends many programs – Buys a lot more mortgages	Broad money supply stable Keeps short-term rates at 0% Keeps some programs in place – Extends mortgage program	Broad money supply stable Changes language re: rates Reduces stimulus programs – Ends mortgage buying
<i>Federal Government</i>		
Budget deficit - \$2.0 Trillion – Real operating deficit - \$5.0T+ Net debt grows dramatically – Total debt with all social insurance obligations - \$75T More stimulus enacted – Massive support for GSEs – 2009 stimulus impacts 1st half	Budget deficit - \$1.5 Trillion – Real operating deficit - \$5.0T+ Net debt grows dramatically – Total debt with all social insurance obligations - \$75T Some stimulus extended – Significant support for GSEs – 2009 stimulus impacts 1st half	Budget deficit - \$1.2 Trillion – Real operating deficit - \$5.0T+ Net debt grows dramatically – Total debt with all social insurance obligations - \$75T Stimulus programs reduced – Modest support for GSEs – 2009 stimulus impacts 1st half
<i>State and Local Government</i>		

No matter what the economic environment there will be a meaningful number of defaults and bankruptcies for state and local governments. Tax hikes at all levels will become common and services will be reduced. Pension costs will rise at all government levels.

### U.S. Financial Markets

<i>U.S. Stock Market</i>		
Stocks may retest 2008 lows – Large P/E deflation – Market volatility high	Market will be range bound – Some P/E deflation – Market volatility increases	Market continues advancing – P/E levels stable – Market volatility modest
<i>U.S. Credit Markets</i>		
Credit markets pressured Interest rates decline Treasury issuance is over 3.5T	Credit markets stable Interest rates flat Treasury issuance is \$3.0T	Credit markets improve Interest rates climb Treasury issuance is \$2.5-3.0T

### Politics

<i>United States</i>		
Dems lose House & Senate Jobs are the big issue	Dems keep Senate & lose House Issues - Job/deficits	Democrats keep majority Issues - Jobs/deficits

The coming election will impact all government actions. There will be a significant battle regarding again bailing out state and local governments. California has already requested \$7B. Total budget deficits expected to be \$200B in 2010 with next year worse.

### *Global Politics*

Adversaries will continue to test Obama. Terrorism will increase and become a larger issue. Global hot spots including Iran & North Korea are likely to become more unstable increasing the probability of global conflict. Protectionism will increase particularly under the Double Dip recession scenario.

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