KStone PARTNERS LLC

Trustworthy, Conservative & Experienced

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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

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

World Economy

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

State and Local Government

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

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

Politics

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