

S&P 500 PRICE



Led by the financial sector, the S&P 500 in August posted a stunning sixth consecutive month of gains. The index's 51% gain since hitting its March 9th closing low of 676 caps one of the best six month periods on record. Still, the index remains some 35% off of its October 2007 high of 1565 (on a price basis).

NOTES/COMMENTARY

As the painful memories of the sharp decline earlier in the year fade, many investors, frustrated to have missed out on the equity rally from the March lows, continue to look to put cash to work. We see plenty of reasons to remain on guard, however, especially as the September/October timeframe has frequently been very unkind to stock markets. The bond market, with low Treasury yields and wide credit spreads, is simply not confirming the V-shaped economic recovery that the stock market is pricing in. It would seem that consumer spending must rebound to justify corporate earnings growth expectations, but high unemployment could pose a big hurdle. Furthermore, issues such as lingering deflation and the lurking wave of commercial real estate loan refinancings, not to mention longer-term concerns about the federal balance sheet and a falling dollar, could muddy things up for the markets. We are encouraged by signs that the recession is receding (recent home price, housing sales and manufacturing data in particular), but would prefer to see better indications of sustainable earnings growth (or more rationally-priced valuations) before jumping back into equities with both feet.

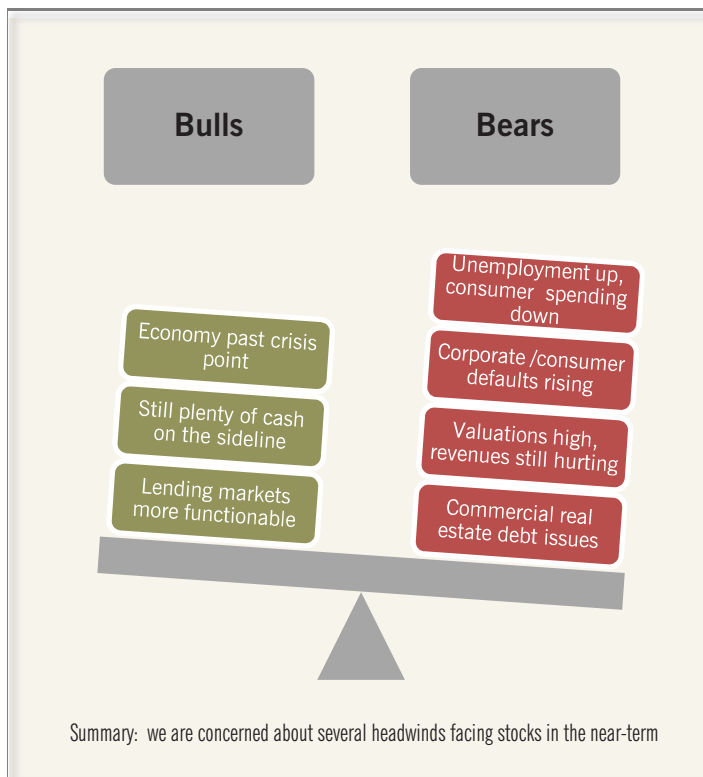
The Bullish Case

- the worst of the recession (or the recession itself) is behind us
- cash on the sidelines continues to be deployed, and there is still plenty in reserve

The Bearish Case

- employment is expected to deteriorate further, hindering consumer spending
- corporate earnings are improved but still bad; valuations have gotten rich
- bonds are pricing stagnant growth; commercial real estate loan problems loom

SUMMARY OF CURRENT EQUITY MARKET LEANINGS

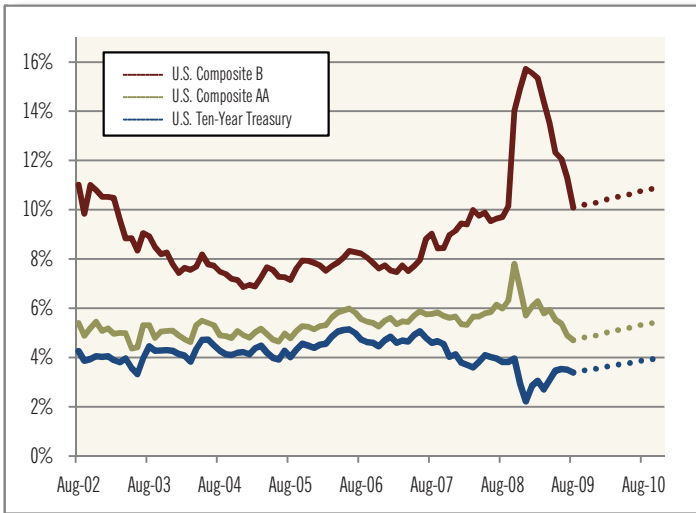


CONVERGENT TACTICAL POSITIONING

Equity		
US Large Cap Equity	underweight	
US Small/Mid Cap Eq.	neutral	
Developed Non-U.S. Eq.	underweight	
Emerging Markets Eq.	neutral	
Private Equity	neutral	
Directional Hedge Funds	underweight	
Real Assets		
Real Estate	neutral to slight underweight	
Commodities	slight overweight	
Arbitrage/Credit		
Multi-Strategy Hedge	neutral	
Opportunistic Credit	overweight	
Fixed Income		
Core Fixed Income	overweight	
Cash Equivalents	neutral	

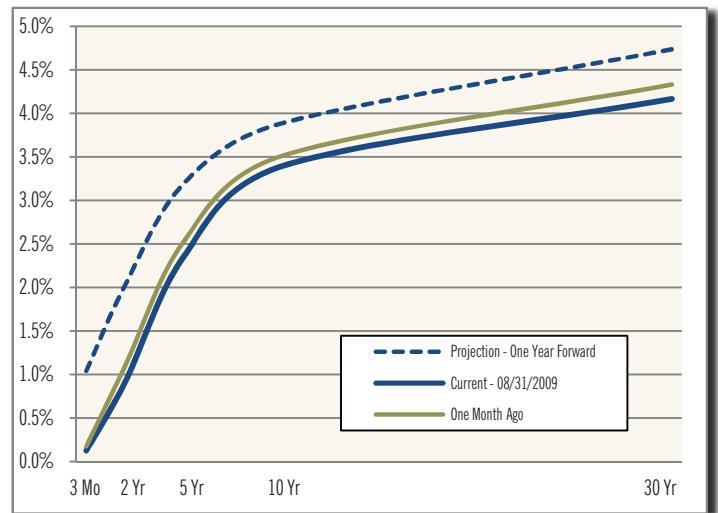
After having served us very well year-to-date (better than equities taking into consideration the Q1 dip), we have partially reduced our tactical overweight to opportunistic credit, particularly in the surging high yield and bank debt sectors. We have yet to fully deploy those dollars back into what we consider to be an overpriced and high-risk equity market, however. Rather, for the time-being, we have shifted into an overweight position in core fixed income as deflation continues to play itself out.

CREDIT YIELD SPREADS



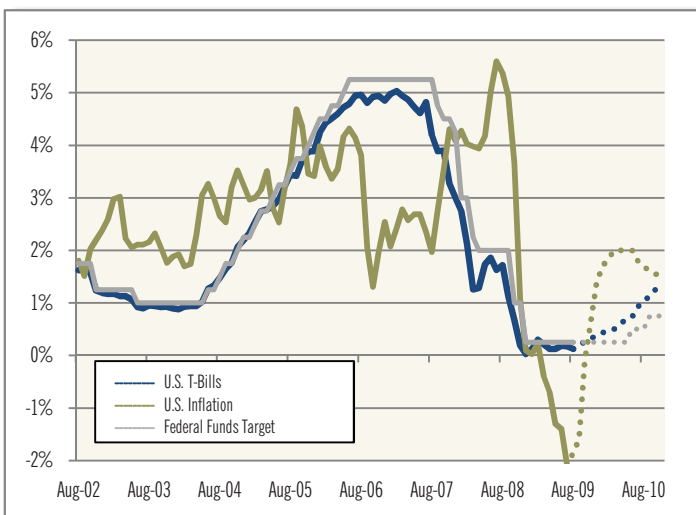
Credit spreads have narrowed significantly but remain wide on a historical basis as bond investors continue to price in a much less robust economic environment than do stocks. While much of the low-hanging fruit in the credit space may have been already picked, there still appear to be plenty of opportunities that look attractive on a risk-adjusted basis as compared to stocks. We have largely shifted out of the dedicated high yield and bank loan segments, which have run up tremendously this year, and into mortgage-backed securities and emerging market local debt. **Advantage: Bears**

U.S. TREASURY YIELD CURVE



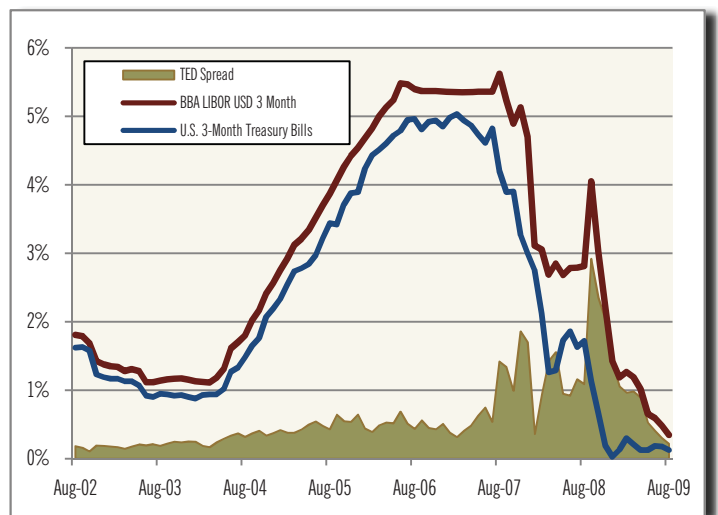
The steepness of the yield curve (the gap between two- and ten-year notes) remains at wide levels, as short-term maturities reflect uncertain economic growth and flight-to-quality aspects, while longer maturities fight off concerns about heavy new issuance and future inflation. While higher yields may be a potential threat to equities if they drive up the cost of borrowing too high, any further near-term increases may be muted by concerns about the economy. **Advantage: Neutral**

T-BILLS, FEDERAL FUNDS AND INFLATION



Inflation, which has remained subdued, is expected to pick up around the end of the year thanks to the huge monetary stimulus (after having been held in check due to high unemployment and weak consumer spending). Pricing levels seem to still be a two-pronged issue: deflation is a concern in the short-term, though the Fed keeping the economy out of a deflationary spiral has been a positive for asset prices; longer-term (post-2010), inflation could cause problems. **Advantage: Neutral**

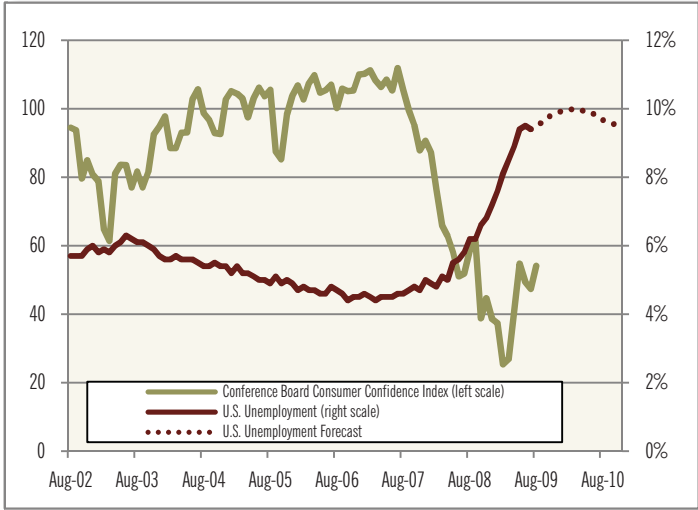
LIBOR/T-BILL RATES AND TED SPREAD



The TED spread is a measure of how tight the credit markets are as illustrated by the difference between T-Bill yields (a risk-free loan) and LIBOR yields (the rate at which banks lend to one another). During last year's credit crisis, extremely wide TED spreads indicated a high degree of anxiety and riskiness in the bank lending market as liquidity was being withdrawn. The recent decline (to lower levels than well before the crisis began) illustrates that the risk of bank defaults is considered to be dramatically decreased. **Advantage: Bulls**

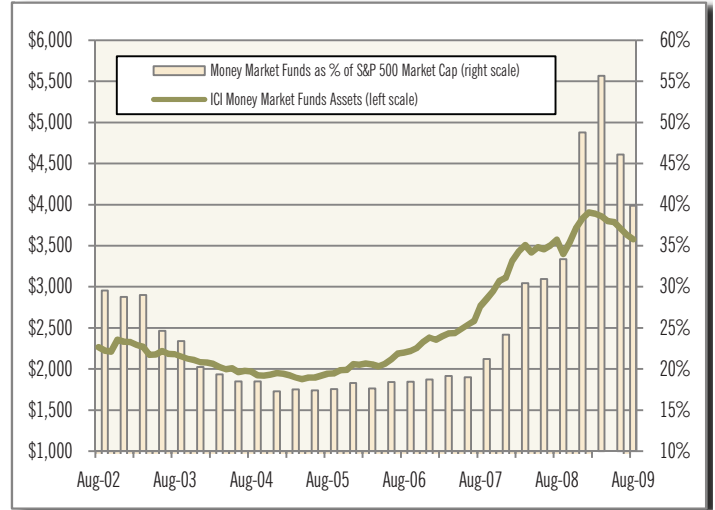
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

CONSUMER CONFIDENCE & UNEMPLOYMENT



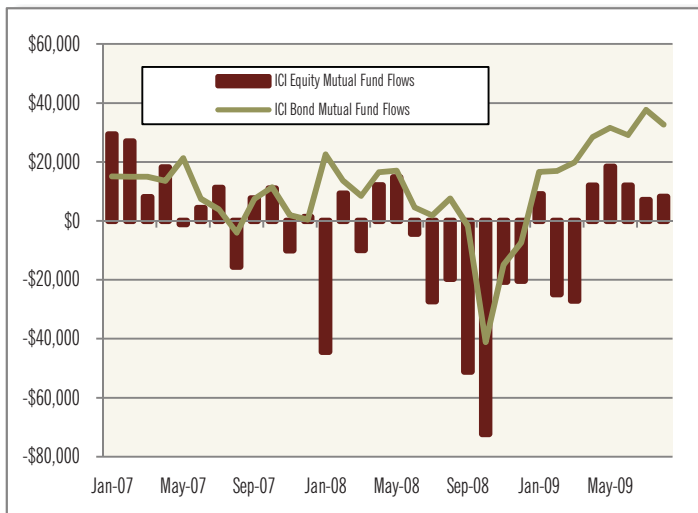
Worries about job security continue to keep the confidence readings well below levels that generally signal a solid economy, as employment figures are not expected to show reprieve until perhaps mid-2010. Job losses will remain a headwind that could crimp consumer spending (which makes up more than 2/3 of U.S. economic activity) and impede recovery in the housing market. **Advantage: Bears**

MONEY MARKET FUNDS ASSETS (\$ BILLIONS)



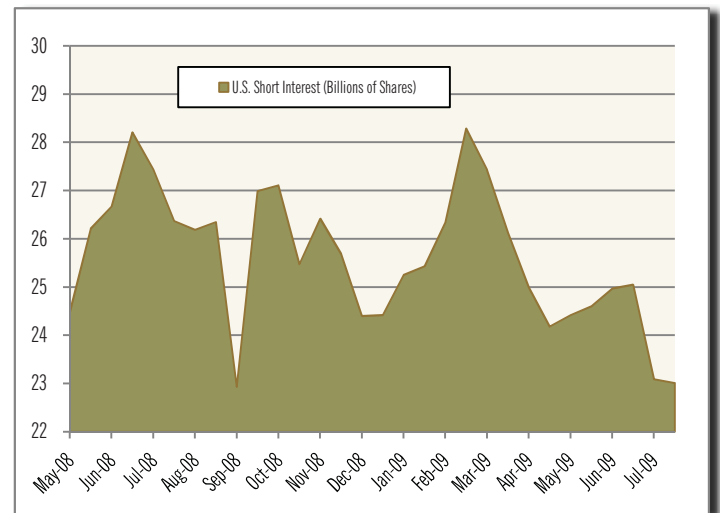
As the equity market rally has progressed, many investors have been driven to put some of the huge amount of cash on the sidelines to work in fear of otherwise missing out, creating a significant boost for the market. We have seen many of our equity managers selectively increasing their exposure (both gross and net) and reducing their cash balances. Still, unless investors decide to dramatically increase their savings rate, there remains plenty of powder available for equities. **Advantage: Bulls**

MUTUAL FUND CASH FLOWS (\$ MILLIONS)



According to estimates for August, dollars continue to flow into bond and equity funds. Curiously, given the extent of the stock market rally, equity inflows have lagged those into bond funds throughout the year. According to data from stock exchanges, buying pressure is certainly not coming from corporate insiders, a perhaps ominous sign, but rather purchases are likely to a large degree coming from portfolio managers reducing their cash balances. **Advantage: Neutral**

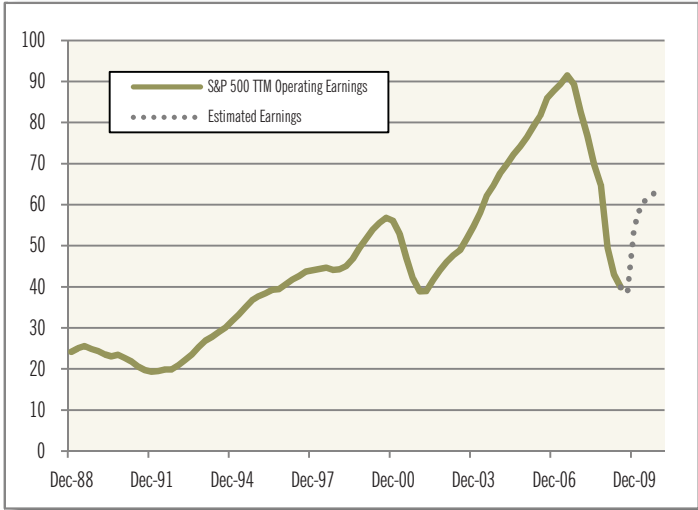
U.S. SHORT INTEREST



Short interest (the number of shares sold short but not yet covered) can be a telling indicator of investor sentiment, though it is often viewed as a contrary indicator since high levels of short positions are eventually covered, providing upward pressure on stock prices. Short covering appears to have been heavy since mid-March, and perhaps a significant contributor to recent stock gains. **Advantage: Bears**

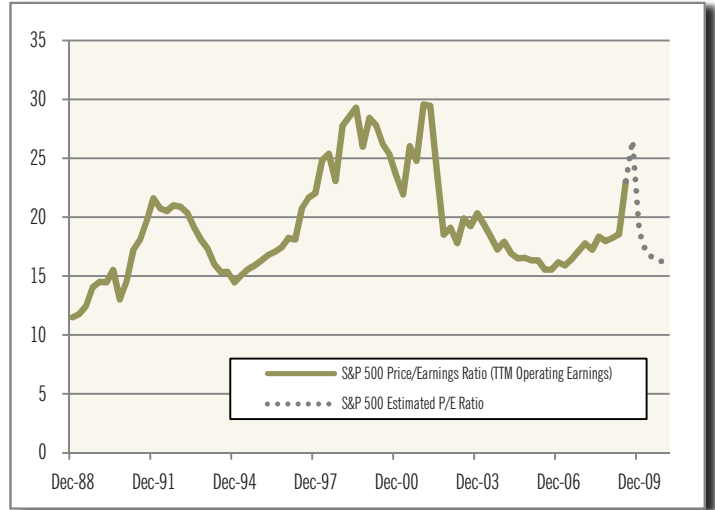
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

CORPORATE EARNINGS



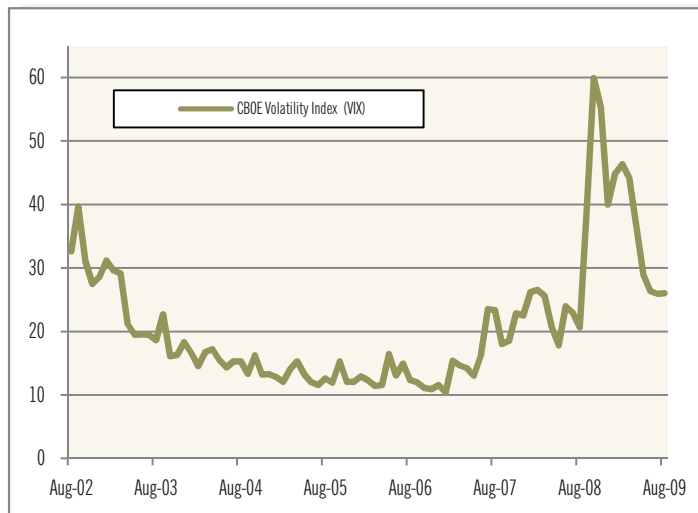
Earnings were down in Q2 but not as much as expected, and that buoyed investors. Much of that outperformance, however, has been due to unsustainable cost cutting instead of top-line revenue growth. Nevertheless, data from Standard and Poor's suggests that trailing 12-month operating earnings could rebound to \$55-60 by the end of the year, much more optimistic than previous estimates. The market seems to be pricing in better than that, however, and additional improvements will be needed for sustained stock growth. **Advantage: Bears**

STOCK MARKET VALUATIONS



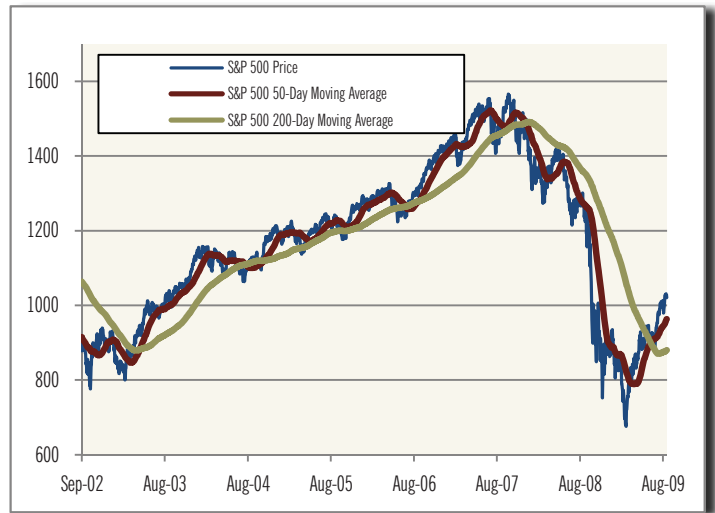
Despite a relatively strong earnings season, overall earnings for the S&P 500 are still down about 40% from Q2 2008 on a year-over-year basis. As such, valuations are not cheap, at about 23x operating earnings and a somewhat nonsensical 120x "as reported" earnings. Trailing twelve month statistics are getting misleading, however, due to low 2008 comparisons. Despite difficulties in evaluating earnings, it is clear that revenue growth needs to continue to show improvement for valuations to become more attractive (outside of simple stock price declines). **Advantage: Bears**

STOCK MARKET VOLATILITY



Stock market volatility continues to drop and is well below peak observations, indicating that investors are perceiving less downside risk. While the cost of hedging by using options becomes cheaper as the VIX declines, allowing investors to potentially be more comfortable maintaining long positions, bears may argue that it could also be a sign that complacency is back in the market. **Advantage: Neutral**

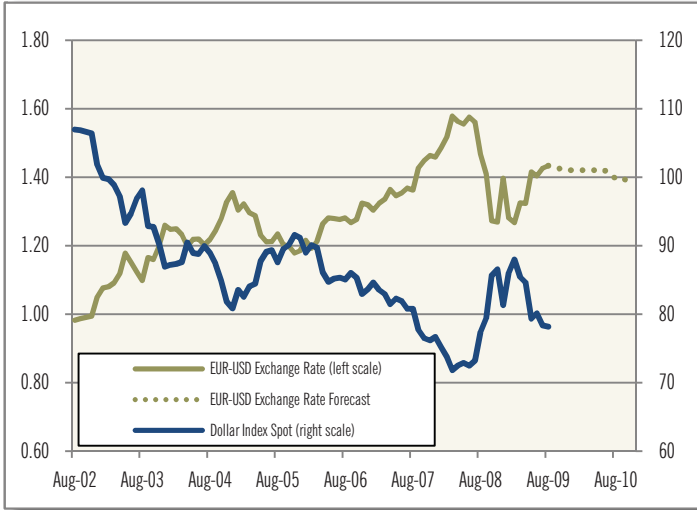
STOCK MARKET TECHNICALS



Some technical indicators have been very supportive of the recent equity market surge, though upcoming seasonal factors could be viewed as a headwind. The 50-day moving average of the S&P 500 is higher than the 200-day moving average, interpreted by many as a bullish signal. **Advantage: Bulls**

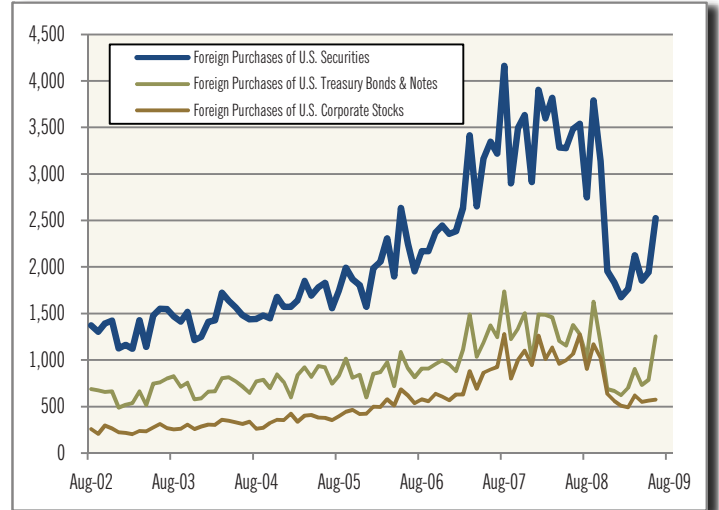
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U.S. DOLLAR



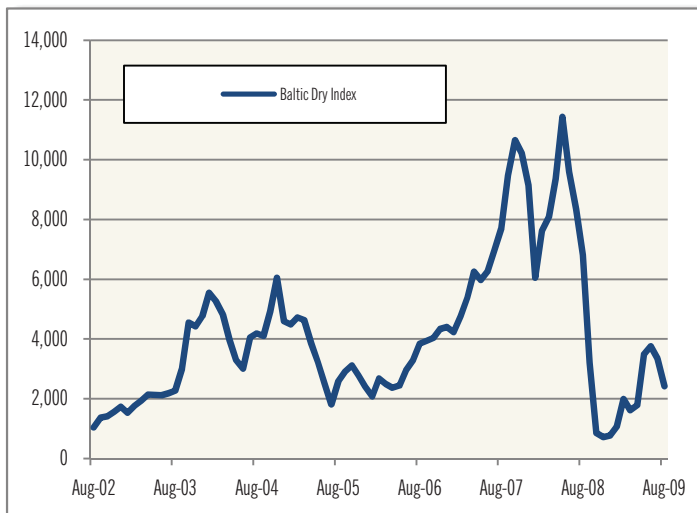
The U.S. dollar remains under pressure, undermined in part by concerns over the size of the U.S. budget deficit. Dollar weakness and future inflation expectations have also contributed to rising interest in commodities. Some of the countries that rank among the world's largest exporters of commodities have seen the greatest appreciation in the currencies so far this year. There are fundamental reasons for continued secular dollar weakness and exposure to commodities as well as international equities and bonds could provide a hedge for U.S. investors. **Advantage: Neutral**

FOREIGN PURCHASES OF U.S. SECURITIES (\$ BILLIONS)



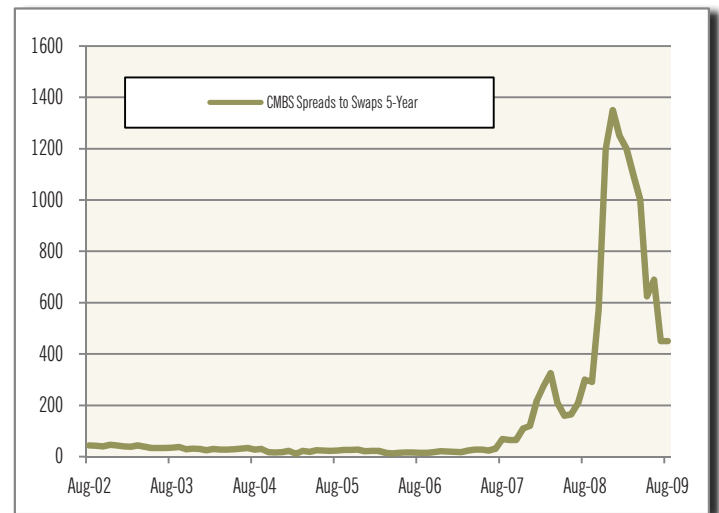
Foreign purchases of U.S. securities declined dramatically during the recent market crisis as investors pulled their capital back home. A significant pick-up in foreign purchases of Treasuries was being seen heading into summer, though stock buying remained muted. Going forward, a concern is that dollar worries may keep some foreign investors away. In the long-run, a lack of demand for American investments is bad news for U.S. markets. **Advantage: Bears**

BALTIC DRY INDEX



The Baltic Dry Index (BDI), a measure of world trade, provides a barometer of the price of moving major raw materials by sea, taking into consideration the demand for shipping capacity versus the inelastic supply of dry bulk carriers. The BDI, in a troubling development for signs of improving health of the global economy, has slipped on slowing Chinese raw-material demand and in conjunction with a precipitous fall in the Shanghai stock composite. **Advantage: Bears**

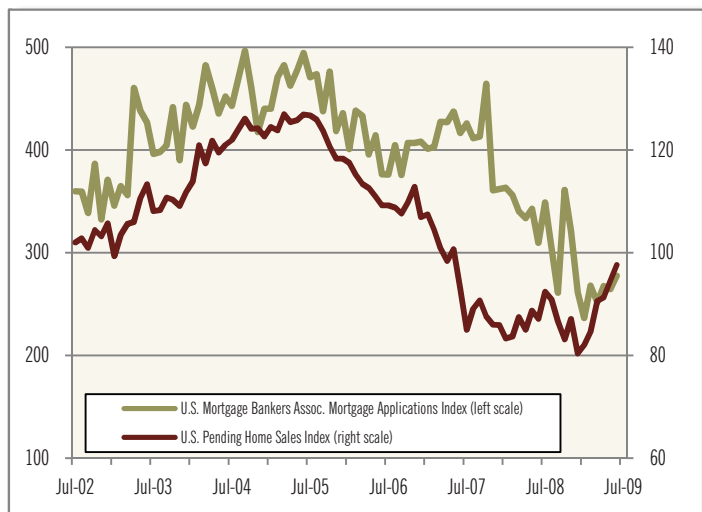
CMBS SPREADS



Despite a significant pullback in CMBS spreads since last fall, levels are still high in a historical context and concerns are rising about commercial real estate loans. Loss expectations remain high thanks in part to a large amount of loans that need to be refinanced in the next couple of years at the same time that vacancies are rising, rental rates are falling, and many commercial real estate owners are struggling to pay their mortgages. Commercial real estate loan delinquencies and defaults will likely continue to accelerate until job losses revert. **Advantage: Bears**

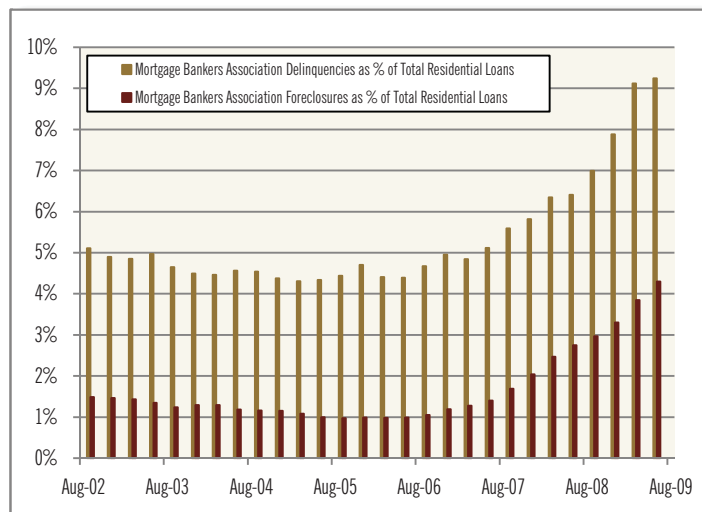
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

MORTGAGE APPLICATIONS & PENDING HOME SALES



There are increasing indications that the residential real estate market has formed a bottom, essential to sustained economic recovery. Pending home sales (used to predict actual home sales activity) continue to show signs of life, and home prices have shown signs of rising on a monthly basis (though they are still down significantly from their peak). Inventories remain high, however, mortgage applications still have not shown much increase, and foreclosures continue to hit the market. As such, housing will likely be a drag on the economy for some time. **Advantage: Bears**

RESIDENTIAL DELINQUENCIES & DEFAULTS



Home owners, saddled with debt, remain under pressure as mortgage delinquencies and foreclosures are spiking. Huge amounts of outstanding consumer credit and rising unemployment will likely be a headwind to the housing market and economy for some time. The wave of foreclosures is spreading to borrowers with good credit and is not expected to crest until next year. **Advantage: Bears**

STOCK PERFORMANCE AFTER MARKET TROUGHS

S&P 500 Performance after Bear Market Troughs since 1970
(based on daily simple price appreciation)

Peak	Trough	Peak to Trough	Initial 3 Mo of Recovery	Months 4-6 of Recovery	Months 7-12 of Recovery
Jan-73	Oct-74	(48.2%)	13.5%	15.3%	5.4%
Nov-80	Aug-82	(27.1%)	36.2%	5.8%	9.8%
Aug-87	Dec-87	(33.5%)	19.4%	(0.1%)	1.8%
Mar-00	Oct-02	(49.1%)	19.4%	(6.6%)	19.9%
Oct-07	Mar-09	(56.8%)	39.3%	--	--
Average		(42.9%)	25.6%	3.6%	9.3%

After market troughs, stocks tend to move higher in rapid fashion (i.e. during the first three months) before taking a breather. 1974-1975 was the exception, though the initial recovery in that case was much more gradual than recent observations. **Advantage: Neutral**

Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

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