MARKET COMMENTARY • FEBRUARY 2010

OUTLOOK

We start the new year with pockets of global economic strength — for example, new orders at U.S. industrial companies in December outpaced even the famed BRIC (Brazil, Russia, India and China) countries, while strength in China has led the Chinese government to increase the required reserves held by its banks in an attempt to moderate growth. Developed markets outside the United States, particularly Europe and Japan, have shown more disappointing economic progress. European consumer spending seems to be taking a mid-winter holiday, and Japanese officials have restarted quantitative easing to combat deflationary forces.

Political leaders globally seem to be struggling to develop economic growth plans as a sequel to the broadly successful financial stabilization efforts. This challenge should force the Obama administration more toward the center politically, as a message of job creation and deficit reduction will be needed for the mid-term elections. European leaders are struggling with the varied fiscal woes of their member countries, as exemplified by the challenges surrounding Greece's debt problem. The recently elected Democratic Party of Japan, out of power for virtually the entire last 60 years, is trying to restart economic growth after that economy has now experienced six consecutive quarters of contraction in nominal economic growth.

Significant market appreciation in 2009 left some assets fairly valued and still offering good return potential, while others have a reduced return outlook. We are most interested in those assets that will generate solid returns or offer protection of principal in our base case scenario, which is measured global growth with accommodative central bank policies. But we are also keen to include assets that we feel will perform acceptably in our primary risk case scenario — that of the Federal Reserve and other central banks tightening policy prematurely. We feel the significant appreciation in the U.S. investment-grade bond market, due to a wall of money flooding into it in the wake of improved fundamentals, has left this asset class with a less attractive return profile in the event of a disruptive market event.

U.S. EQUITY

- Strengthening economic data out of the United States has halted the fall of the dollar.
- A stabilizing dollar facilitates the Fed's "low for long" interest rate strategy.

Recent positive U.S. economic data, including better industrial orders and retail sales, has put a floor under the falling dollar. If the dollar settles into a trading range around its current level, as we anticipate, it will be constructive for U.S. equities for a few reasons. First, and most important, it will provide cover for the Fed to continue with its "lower for longer" interest rate strategy. Second, it could potentially convince U.S. investors to keep their assets "in house" while possibly renewing interest from abroad. Finally, a still relatively weak dollar gives U.S. companies with material international exposure (such as large cap names) a competitive advantage.

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EAFE & EMERGING MARKETS

- European retail sales suffer from unemployment and "post-stimulus" hangover.
- Strength in Chinese economic activity leads to tightening measures.

With unemployment across the eurozone reaching 10%, and earlier government stimulus efforts, such as the cash for clunkers program, reaching completion, consumer spending has been struggling. Recent economic growth has depended on government spending and export growth, giving the European Central Bank some leeway before it needs to significantly tighten monetary policy. Japan also is struggling under the pressure of deflation and reduced capital spending by corporations. The opposite case is building in emerging markets, as China's efforts to increase bank reserve requirements to slow bank lending demonstrate. With emerging market stocks trading at a slight discount to developed markets, and at an attractive absolute valuation level, we continue to find them attractive ways to play the global economic rebound.

FIXED INCOME

- Investment-grade debt is increasingly reliant on traditional credit and technical factors.
- The gradual expiration of the Fed's special liquidity measures is a constructive step toward normalized credit markets.

Financial markets have now moved past the point of maximum policy stimulus as the Fed gets ready to start allowing some of its special liquidity programs to expire. Following 2009's massive rally, investment-grade credit now looks fairly valued. Fundamental credit quality has been strengthened by many companies' refinancing efforts, though a trend toward rising Treasury rates would be expected to hurt investment-grade returns. In contrast, residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) markets face a more uncertain outlook. The Fed's purchase program for RMBS is scheduled to expire in March 2010, and the CMBS market faces a wave of refinancings and credit downgrades during the next three years.

GLOBAL REAL ESTATE

- A 3.5% return in December capped a 41% full year return for global real estate investment trusts (REITs).
- U.S. REITs led in the fourth quarter, while Asia was the top performer for the year.

Recent strong performance in the REIT market has been primarily driven by more cyclical property types. For example, hotels and regional malls have outperformed other property types in the last month, as they could be considered the first to be positively affected by a recovery in consumer spending. Although performance remains positive, it appears to be moderating as the market continues to wait for a rebound in fundamentals and further signs that issues in the commercial real estate debt markets will not hold the asset class back. A specific concern is the increasing delinquency rate for commercial mortgage-backed securities. We think the

combination of significantly increased valuations and continued fundamental concerns warrants caution toward this asset class.

COMMODITIES

- Booming Chinese imports reflect metals-intensive infrastructure build.
- Rising oil prices are bringing out incremental production.

The outlook for commodities, especially energy and metals, will continue to be driven primarily by the forecasts for global economic growth and the U.S. dollar. Reflecting the continued infrastructure build-out underway in China, December imports rose 56% and handily outpaced export growth. Leading this surge were copper imports (up 63%) and iron ore imports used in steel production (up 42%).

We think energy prices, especially the price of oil, face a supply-constrained future. Already, the increase in prices has led to an OPEC quota compliance of just 60%, as the Saudis are sensitive to the risk that high oil prices pose to global economic growth. In a scenario where the global economy continues to accelerate and the dollar resumes its decline, energy prices could move significantly higher from current levels.

CONCLUSION

Our expectations for 2010 encompass a base case scenario that envisions continued improvement in global growth accompanied by relatively easy monetary policy. We expect emerging markets to continue to lead the recovery, followed by the United States, Europe and then Japan. We view the most likely risk to this somewhat benign scenario as being premature tightening by central banks that threatens the recovery. The tremendous return realized in investment-grade fixed income during the last year has reduced its attractiveness prospectively. We think investors may benefit from reallocating some exposure here to high yield bonds — either corporate or municipal — which tends to provide a larger yield cushion in the event of interest rate increases. Additionally, we think an increased exposure to gold makes sense today. The metal has pulled back from its recent highs, and we think it should perform well in a strengthening global economy. Gold can also provide diversification benefits in the event that investor concern over sovereign credit reignites.

Commentary provided by Jim McDonald