

Economic Review and Outlook

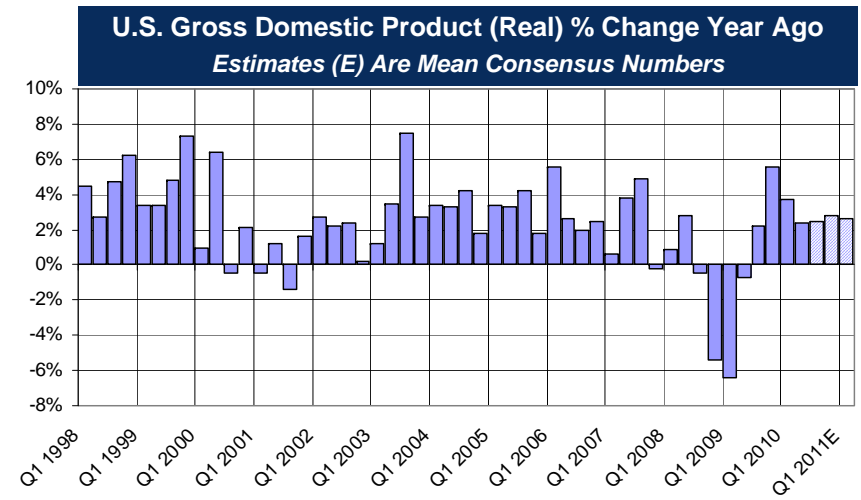
September 2010

GLOBAL AND DOMESTIC ECONOMY

- The global economy's recovery is maturing and its pace is slowing down. This is clearest in global industrial production, where its growth rate has begun to fade. Sectors unrelated to industrial production such as consumer spending will help prolong the U.S. economic expansion through the rest of 2010.
- Since this was a global recession, fiscal strains on government budgets are widespread. Developed economies' government tax revenues have shrunk, but spending priorities and safety net provisions remain intact or have increased. In developed economies, the recovery will be hampered by high deficits and indebtedness. In contrast, the supply of emerging market debt is relatively constrained.
- The sovereign debt crisis in Europe has ebbed as the depressed euro has made manufacturing exports from Germany and France attractively priced. This has temporarily obscured the underlying fiscal problems of Europe as these economies show growth.
- Although many U.S. banks have restrained lending due to uncertain asset quality, regulatory restraints on lending and new higher required capital levels, there are some early signs of improved lending activity.
- U.S. and foreign financial institutions continue to take write-downs on their bad debt. Exposure to commercial and residential real estate remains a threat. The consumer has also reduced debt, often through bankruptcy. The rate of foreclosures may increase anew. Many debts in the private sector have been transferred to sovereign balance sheets, thereby raising sovereign credit risk.
- U.S. unemployment looks to deteriorate further as the economy slows. The long-term unemployed present a particular challenge for policymakers.

INTEREST RATES, INFLATION AND CORPORATE PROFITS

- Due to the drop in industrially sensitive materials prices, inflationary



pressures especially in the U.S. have essentially evaporated. The Fed now has a greater flexibility to further expand the money supply.

- There is a divergence of central bank strategies globally. Many developed market banks, such as the ECB, the Bank of England and the Fed, have restarted stimulative programs to fight the slowdown. Other banks, notably in Canada and around the Pac Rim, continue to tighten to fight inflationary pressures and slow their economies.
- By keeping interest rates low, the Federal Reserve has created the opportunity to delever personal and corporate balance sheets. Ironically, these actions are pushing investors to take on risk to achieve returns. We are concerned about the markets' reaction if the Fed were to be less accommodative, causing interest rates to rise.
- Due to broad cost cutting, profit margins have expanded significantly. As revenue expands, the resulting corporate earnings growth has surprised on the upside and should turn positive for the year for the first time since 2006.

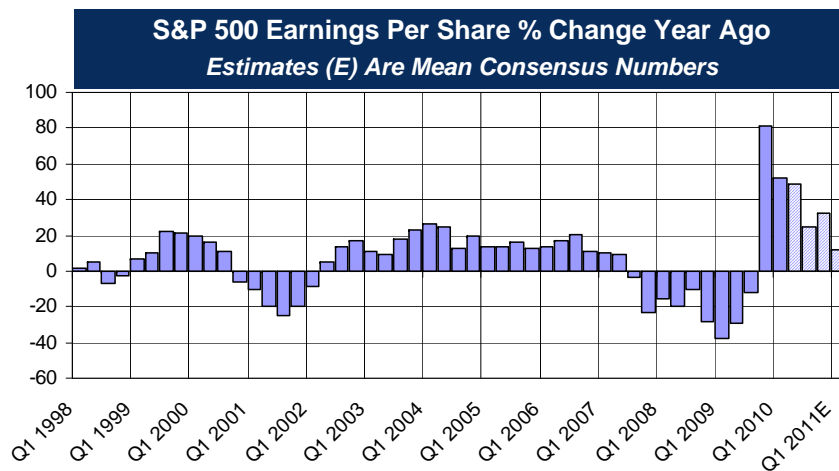
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Markets Review and Outlook

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MARKETS

- Estimates for 2010 earnings per share are 33% above 2009. Recently reported earnings have exceeded expectations due to cost cutting and revenue growth. Revenue growth is necessary for job growth to begin. Earnings for 2011 are forecasted to grow 17% over 2010 earnings. This would seem to be overly optimistic.



- Globally, equity markets have had a strong rally off their March 2009 lows. Volume has been light. Lower quality investments have provided the best returns. Higher quality, growth-oriented issues should perform better as the recovery matures and the rallies falter.
- Recently, market volatility has picked up due to changes in China's central bank policies, sovereign debt issues, uncertainty about U.S. policy direction and a slowing growth of U.S. money supply. These uncertainties begin to raise concerns about equity risk exposure.
- We expect that the U.S. dollar will decline on a secular basis, but it had been viewed as a safe harbor through May. This caused it to appreciate versus the euro as investors fled the euro to safety.

- The equity rally in 2009 had initially been driven by an expansion of the price-earnings (P/E) multiple. Last year's low inflation and a growing GDP caused stocks to rise. In 2010 we see sequential revenue and earnings growth being reported. Next, we expect to see earnings and revenue growth to slow as the recovery matures.
- Because of Fed intervention, low inflation expectations, and an anemic economy, Treasury rates have stayed low for much of 2009 and 2010. We expect that interest rates will stay low for the foreseeable future.
- Credit spreads continue to narrow and corporate default rates remain moderate. Credit markets have healed significantly from late 2008.
- Large purchases of U.S. bonds by foreign entities as they seek "safe harbor" security have provided our economy with needed liquidity, helping keep our interest rates low.

WHAT WE LIKE; WHAT WE DON'T LIKE

- The current earnings outlook has improved and inflation is presently not an issue. The dollar has appreciated over the short-term. We remain concerned about the sustainability of the recovery. Consequently, we are reducing risk levels in client portfolios.
 - We stress the use of high-quality companies for domestic equities, especially those with strong overseas operations.
 - Emphasize non-dollar exposure by using international stocks, REITs and bonds, including those of the emerging markets.
 - Incorporate a balance of inflationary hedges such as TIPS, REITs and commodities and deflationary hedges such as longer duration Treasuries and timber. Gold serves as a hedge for both inflation and deflation.
 - Favor short-term, high-grade corporate bonds as an attractive alternative to low-yielding money market funds.

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