

MAY CLIENT INVESTMENT REVIEW

GLOBAL SOVEREIGN DEBT CRISIS

The month ended with a downgrade of Spanish sovereign debt – another outward sign that the largest-ever private sector financial crisis is spreading to sovereign debt worldwide. The resignation of Japanese Prime Minister Yukio Hatoyama, along with the secretary general of the ruling Democratic Party, Ichiro Ozawa, because of scandals and rampant deflation in the second largest global economy, is another sign of the growing crisis. Foreign-policy conflicts, natural extensions of domestic internal tensions, are erupting in North Korea, the Middle East, Japan, and Germany, with the resignation of German President Horst Kohler. Globally, there is a breakdown of international cooperation and a rise in nationalism among the G-20 countries as unilateral financial regulation and fiscal policy discipline are demanded as the price for assistance. In every instance, the economic solution is common: huge amounts of new debt placed upon already excessive debt to solve immediate liquidity problems, while solvency issues (capital insufficiencies) are left unresolved. The loss of global liquidity in every market sector is evidenced by the tremendous increase in volatility, most notably in the equity market's 'flash crash' on May 6, 2010.

The eurozone crisis has and will continue to provide an extended respite for the US dollar while attempts at economic stimulus via huge deficits go on. Offsetting this, however, is the British Petroleum (BP) oil spill in the Gulf of Mexico, now the world's largest manmade crisis and with no end in sight at least until the end of August. At this point, there is a poor ability to assess the huge environmental and regional economic losses from the curtailment of drilling, less travel and tourism in the summer season, and the abrupt halt to the region's fishing industry. It is probably severely underestimated both in terms of time and money.

May's financial market gross performance is shown in the following table for the month- and year-to-date, unadjusted for taxes, risk, or inflation/deflation. Fixed income has outperformed equities for both the month- and year-to-date, and gold has significantly outperformed all sectors. The Market Highlights table on the next page shows gold materially outperforming the CRB Commodities Index, which declined 8.25% for the month while gold rose 3.14%.

Total Return	May 2010	YTD
DJIA	-7.98	-1.49
S&P 500	-5.81	-5.49
NASDAQ Composite	-8.16	-0.13
BCGC*	0.81	3.62
BCMB*	0.75	3.25
COMEX Gold Spot \$/oz. (% chg.)	3.14	10.87

*BCGC: Barclays Capital Government/Credit Index, BCMB: Barclays Capital Municipal Bond Index

TAXABLES

The performance of the various fixed income sectors below shares a common element in current market conditions: coupon levels this low make price the dominant variable of total return. This is further accentuated by the shortness of a monthly timeframe. This is seen in the contrast between US Treasuries and Baa credits.

During the month, the Treasury yield curve flattened as a flight to quality drove down yields on longer maturities more than the already low-yielding short end of the curve. We further added to our Build America Bonds (BABs) and, early on, very adroitly sold our British Petroleum (BP) and Kreditanstalt fuer Wiederaufbau (German state bank) holdings, realizing gains in each instance. In view of our deflation outlook, we continue to favor nominal Treasuries, TIPS (at opportunistic break-even levels), American industrials, energy, utility, and BAB credits. Because of the very positive yield curve, we continue to seek opportunity in the longest possible maturities permitted by client guidelines in each of our product strategies.

Barclays Taxable Indices	Price (%)	Coupon (%)	Tot. Ret. 5/10 (%)
Aggregate	0.54	0.30	0.88
Government/Credit	0.49	0.33	0.81
US Governments	1.27	0.26	1.53
US Treasuries	1.45	0.26	1.71
US Agencies	0.60	0.26	0.86
TIPS	-0.18	0.17	-0.01
Credit	-0.82	0.44	-0.38
Corporate	-1.01	0.45	-0.55
Credit Aaa	0.45	0.27	0.72
Credit Baa	-1.38	0.50	-0.88

TAX-EXEMPT/MUNICIPALS

Tax-exempt markets were also affected by the evolving European solvency and banking crisis in May. For the first time this year, municipal credit spreads widened as can be seen in the California GO scales and index performance data. Curves steepened as the front-end and intermediates out-performed longer maturities.

Congress seems to have reached a compromise on the BABs extension, which will renew the program for two years while dropping the subsidy to 32% for 2011 and to 30% for 2012. This has passed the House and now goes to the Senate. Florida, meanwhile, decided to stop issuing BABs over concern about the ability of the federal government to net subsidy payments against funds owed by the states from totally unrelated program disputes.

Continuing the pattern of the year so far, municipal new issuance rose 21.2% (\$36.9 billion vs. \$30.4 billion) in May compared to last year, but with tax-exempt new issues down 7.2% (\$24.5 billion vs. \$26.5 billion), while taxables were up 211.8% (\$12.1 billion vs. \$3.9 billion). YTD issuance remains positive by 9.8% (\$167.6 billion vs. \$152.6 billion), although tax-exempt volume is down 16.8% (\$111.8 billion vs. \$134.5 billion).

Barclays Tax-Exempt Indices	Price (%)	Coupon (%)	Tot. Ret. 5/10 (%)
Municipal Aggregate Bond	0.36	0.39	0.75
5-Yr. Municipal	0.33	0.36	0.69
10-Yr. Municipal	0.65	0.37	1.02
20-Yr. Municipal	0.58	0.40	0.98
Aaa-Rated	0.38	0.37	0.75
Baa-Rated	0.13	0.43	0.55
California-Exempt	0.09	0.39	0.48
New York-Exempt	0.48	0.38	0.86

OUTLOOK

Moving forward, Congress is attempting to devise remedies for a crisis not yet properly understood while at the same time legislating to prevent recurrence as mid-term elections bear down. New regulation increases uncertainty in financial markets – another drag on a weak recovery produced so far only by the support of a record stimulus. After 18 months of stimulus, the 5-year US Treasury hovers around 2.1%. In Europe, the dilemma among the heavily indebted Southern-tier countries is their inability to print money or alter their currency as they have donned the European Union fiscal straitjacket. The deflation portfolio playbook that we have consistently fostered – namely, focusing on liquidity, income, and risk

management – continues to provide yardage in this game of investment survival. Income may come from multiple sources but the key is in the analysis of the balance sheet supporting the production of income. Our focus continues with high-quality fixed income either taxable or tax-free, with maturity continuing to be an investment posture. Gold should be a sector allocation where permitted. Because the EU is the problem and not the solution, we believe the dollar will continue to be strong. This, of course, makes investing in US domestic equities better than multinational, international, and – yes – emerging market equities.

MARKET HIGHLIGHTS*

Foreign Money & Bond Markets	4/30/10	5/31/10	US \$ Tot. Ret. (%)
3-mo. LIBOR BP Fixing	0.67719	0.71063	N/A
ML UK Gilt 10+ Index	4.37	4.15	-1.98
3-mo. LIBOR Yen Fixing	0.24000	0.24563	N/A
ML Japanese 10+ Index	1.87	1.85	3.83
Currencies	% Change		
British Pound (US \$ per pound)	1.5274	1.4538	-4.82
Japanese Yen (yen per US \$)	93.85	91.26	-2.76
Euro (US \$ per euro)	1.3294	1.2306	-7.43
Commodities			
Gold Comex Spot (\$ per oz.)	1,179.20	1,216.20	3.14
CRB Future Com Pr. Index	277.71	254.80	-8.25
W. Tex. Int. Crude (\$ per bbl)	86.15	73.97	-14.14
Equities	US \$ Tot. Ret. (%)		
S&P 500	1,186.69	1,089.41	-7.98
DJIA w/ Income	11,009.00	10,137.00	-5.81
NASDAQ	2,461.19	2,257.04	-8.16
NIKKEI (TOKYO)	11,057.40	9,768.70	-8.83

*Source: Bloomberg

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Smith Affiliated Capital:
800 Third Avenue, New York, NY 10022
TEL: 212-644-9440 FAX: 212-644-1979
www.smithcapital.com