

March 2010 CAPITAL MARKETS COMMENTARY

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“Many people want the government to protect the consumer. A much more urgent problem is to protect the consumer from the government”

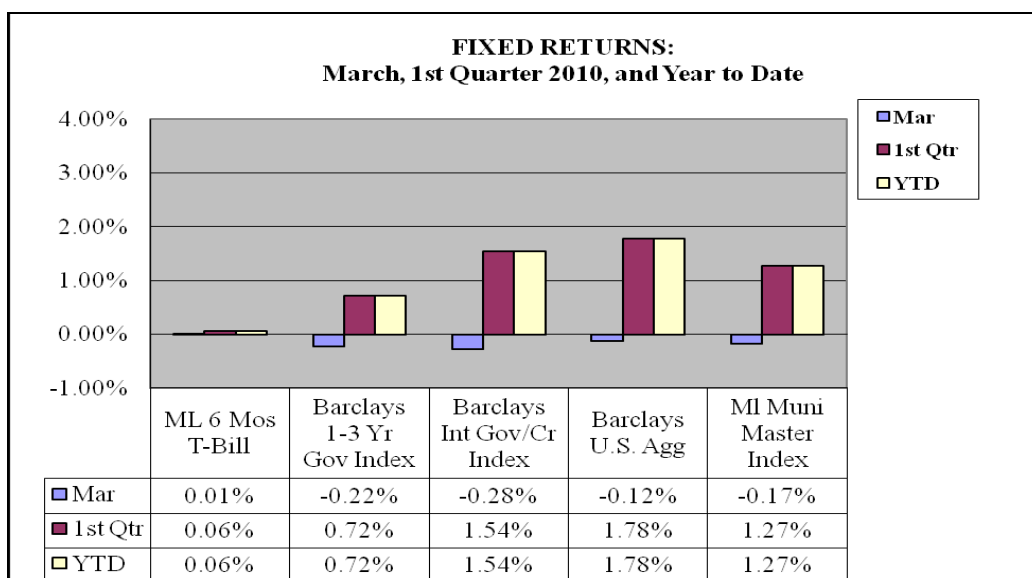
Milton Friedman

Fixed Income

The fixed Income market rally of 2009 continued in the first quarter of 2010 as treasury yields fell slightly in the intermediate to long end of the yield curve. In all sectors yield spreads to treasuries remain tight, which is why lower quality corporate bonds and high coupon Mtge product has retained much of their value.

The Mtge-backed sector continued to be the best performing sector defying market expectations. This was due to the tight spreads vs the Treasury sector that has been there since 2009. What really seemed to cause the large disparity in returns in the Mtge sector is that it is purely supply and demand driven. No new CMBS and RMBS product has been issued in any size. Therefore market participants are holding on to the product they currently have.

Although yields moved higher at the end of the quarter, returns for the bond market were positive due to the strong January and February yield movement. Returns were positive across all areas of the yield curve as yields moved down approximately 10 bps across the curve. The short end of the curve had flat returns in the quarter. However, in the intermediate to long end of the curve, returns were positive. The intermediate returns of + 1.54% and 1.78% were due to the intra-quarter volatility, (as exemplified by the 10 yr Treasury yielding as low as 3.60% and as high as 3.98% during the quarter). The 2 year Treasury yield started the quarter at 1.13% and ended at 1.01%. On the 5 year Treasury, the yield started the quarter at 2.67% and ended at 2.54%. On the long end of the curve the 10 year Treasury yield started the quarter at 3.84% and ended at 3.82%, but as mentioned had a low of 3.60%.



Fixed Income Markets - Looking Ahead

The Fed continues to maintain a zero rate policy, or an intention to keep rates low for an “extended period of time”. However, if the economy grows and unemployment abates, as anticipated, the Fed may make a move to raise rates towards the end of the year.

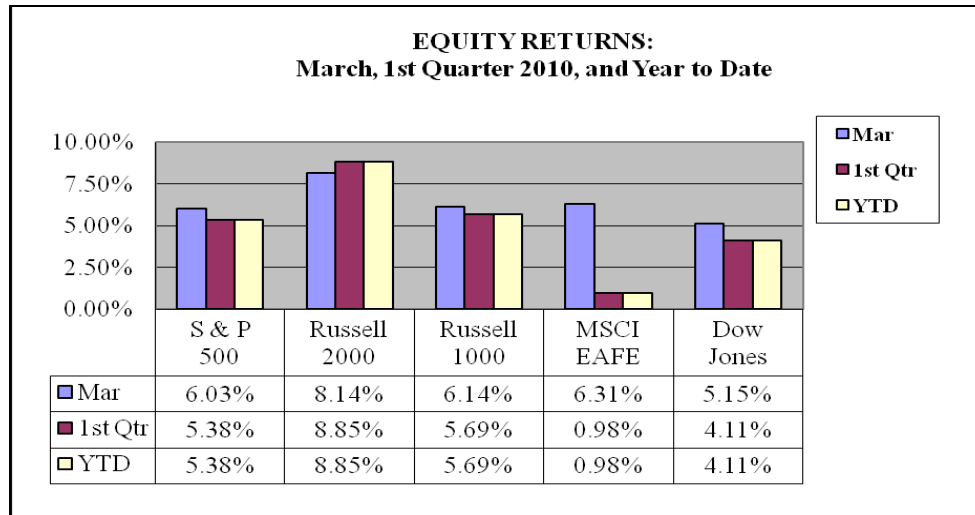
With the volatility the bond market is seeing, it will be summer and maybe into fall before investors have a better idea of the direction of interest rates. With the Fed beginning its exit from the financial markets, there has been some upward pressure on interest rates. However, continued world-wide economic problems and a subnormal economic recovery has kept the demand for high quality securities, i.e. Treasuries, in high demand and may keep bond rates in the lower end of the trading band.

Equity

The stock market recovery of 2009 has continued into the first quarter of 2010 as stocks shook off early weakness to post solid gains. First quarter equity returns followed a strong fourth quarter with 6 month returns on the S & P at almost 12.0%. Returns were positive across all sectors, and many investors continue to believe that the recovery has started. The positive returns for equities at the end of the quarter had the markets happy, as the returns for the first quarter were up between + 4.0% and + 8.0% on the domestic side. The international sector had a good March, but not enough to overcome the weak start to the year.

Small cap stocks outpaced large cap and strong numbers in the financial sector helped register solid gains. Other areas that gained strength were consumer discretionary and industrials.

All the major equity indices posted positive returns in the first quarter. The Russell 2000 was by far the leader with a return of + 8.85%. Other indices also did well. The return for the S&P 500 was +5.38%, the Russell 1000 was up + 5.69%, and the Dow was up +4.11%. The International EAFE returned a disappointing +0.98% for the quarter, due to poor early year performance.



Equity Markets - Looking Ahead

Given the rally at the end of the quarter to above 10,800 on the Dow and above its resistance level, the market has gained momentum and may move higher until the fundamentals truly outweigh upward price movement.

Although the job market is showing slight gains it may be too early for high hopes on a sustained recovery. The U.S. economy still has weakness in housing, commercial mortgages are just starting to raise eyebrows, and consumer spending is still sluggish. Add to that the ending of monetary support by the government, and the markets may in fact have problems holding on to the recent gains.

The 6.0% monthly gain cannot be sustained at this point in the market, the gains have happened too fast. The coming months could be very choppy for the equity markets if there is a downward pressure on the economy.

The Economy

The FOMC met twice during the first quarter of 2010. The two meetings had the following outcome: the Fed maintained the target rate of 0% to 0.25% on Fed funds and they raised the discount rate charged to commercial banks by 0.25%.

There were signs that the economy is strengthening as shown by a rise in factory output and declining layoffs. However, consumer spending is still sluggish and job growth, especially in trades, is non-existent. That coupled with slow housing numbers has kept the economy from showing any sustainable progress.

The Economy - Looking Ahead

We mentioned last quarter that the improvements in the economy and the financial markets in 2009 were great, and evidence of that improvement has rolled over to 2010.

Most recent data support a positive turn to our economic woes. Unfortunately there is always a however when looking at economic releases. Here are a few:

A large part of the financial market improvement is due specifically to the almost \$ 3 trillion of government money that was pumped into the economy. What happens when that flow is reversed?

Although payroll employment grew during the first quarter, 50% of the 160,000 jobs gained were from the federal government. In order to have sustainable growth the private sector has to grow at a better pace.

Retail sales have increased in the last few months after declining in 2008 and early 2009. However, the increases have been slight, and in order for the economy to grow the consumer has to spend money. If they don't have jobs they cannot spend.

Housing is a major element in any recovery, and although home values have risen from their lows, prices are only 3% off their bottom.

However, any recovery, especially coming from the depths that we reached, will be on an uneven path. Again, there is always a however.

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