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More of the Same: More Market Volatility, More Mixed Economic Results and More Government (Financial Reform Act).

The second quarter of 2010 was somewhat reminiscent of the fall of 2008. The Greek debt crisis followed by the decline and partial recovery of the Euro were global economic events that the U.S. economy managed through without a major market swoon or renewed liquidity crisis. Although equity markets posted poor second quarter results, fixed income held its ground, with most major benchmarks posting positive returns for the quarter. After discussing the debt crisis, we will update our economic forecast and provide our opinion on the latest government intervention (also known as the Financial Reform Act) and how it will affect financial markets for the remainder of 2010 and 2011.

Lessons Learned from the European Sovereign Debt Crisis

The European debt crisis serves as an example to solidify two important economic premises that are important to our domestic economy. First, real debt levels, as measured as a percentage of Gross Domestic Product (GDP), do matter. We have lived in a financial environment that has been extremely tolerant of out-of-control sovereign debt issuance. What starts out as a minor problem turns into a crisis when efforts to remedy the problem actually make it worse. Cutting the primary deficit by reducing government spending, increasing taxes or both may increase the ratio of government debt-to-GDP resulting in a sovereign restructuring or default. Greece's sovereign leverage ratio grew faster due to their higher debt service costs (higher coupon rates) experienced during this crisis. Greece's sovereign debt ratio is estimated to be 120% of its GDP. Their efforts to reduce this percentage by increasing taxes and lower spending compounds the problem because these efforts reduce GDP faster than they cut debt.

Our second premise is that the U.S. dollar will continue to serve as the world's reserve currency and a safe haven for global investors for at least the medium term. Despite the government's profligate spending, our economy and federal debt leverage is still in better financial shape than that of many European countries. Estimates vary, but the U.S. debt-to-GDP ratio currently stands at approximately 60% and should reach 67% by 2019 under current spending projections. In the Book "This Time is Different" authors Carmen Reinhart and Kenneth Rogoff suggest that risk and volatility jump when the debt-to-GDP ratio reaches around 60% in emerging markets and 90% in developed economies. U.S. government spending on debt service interest will triple over that time from $200 billion to an estimated $700 billion, taking it from 1.4% of GDP to 3.2% of GDP. Primary evidence of the world's view of the U.S. dollar was the decline in the 10-year Treasury yield from 4% to under 3% during the flight to quality in the second quarter. We should be able to continue to refinance existing debt and finance annual deficits at reasonably low interest rates while we try to get spending under control.

Another important factor when considering government debt-to-GDP ratios is to compare Japan's situation to Greece. Japan's debt-to-GDP ratio reached 200% but it did not lead to increased interest rates or inflation. Rather, the opposite occurred; deflation took hold and interest rates have been very low for an extended period creating the opportunity for the GDP-to-debt ratio to decline even with a very low level of positive GDP growth. It should also be remembered that Japan's tax collecting ability is more in line with the US's. In neither case is there a significant "shadow" economy going untaxed. In reality, a Japanese scenario with deflation being more of a threat than inflation may have some credibility for the US than a "Greek-like" outcome; however our ability to be a nation of savers is likely much less than what Japan has demonstrated.

The Economy: Not a True Double Dip, Something Closer to Soft Serve...

The unemployment picture has only modestly improved from our last commentary. Although the headline unemployment rate as of the June employment report declined to 9.5% from 9.7% in May, the number of discouraged workers – those no longer actively seeking employment (dropouts) – actually contributed to most of the decline. Construction continues to be a weak employment sector with another 20,000 jobs lost after 33,000 were reported lost during May. Financial Services also posted similar declines, as weak credit demand and tighter credit translated into a reduced need for bankers. The pending Financial Reform legislation clearly did not help on this front. Education and Health were positive areas, but that is nothing new. These sectors are driven by positive demographic trends and have only been negative for one month since 2004. We anticipate the unemployment rate will remain firmly above 9% for at least the next six months.

Housing follows in step with employment. Until we see solid improvement in the employment picture, housing will remain weak, regardless of tax credits or other federal incentives. Furthermore, the tax credit that the federal government granted to homebuilders that allowed them to carry-back current losses against three years of prior profits (at a cost of approximately $6 billion dollars to taxpayers) only delayed the inevitable need to reduce capacity by either weeding out poorly-financed builders or industry consolidation. Housing will continue to be negatively impacted by foreclosures and the resulting shadow inventory. Banks have done a good job of managing this inventory of homes down, however this has only resulted in a slower recovery. We anticipate a weak residential market throughout 2011 and potentially into 2012. Do not look to construction as a source of employment to those discouraged workers anytime soon.

Inflation concerns remain distant. We have seen no leading signs of cost-push inflation, as most input prices (wages or commodities) have remained stable or declined recently. State and local government spending reductions and modestly increasing personal savings rates, reduce any impact of the mild improvement in private wage and salary growth (+.04% month over month in May). Demand-pull inflation leading indicators are non-existent. Deflation is of greater concern now than during the liquidity crisis of 2008. First quarter GDP growth was revised downward for the second time to 2.7% after a stimulus-aided 5.6% reading in the fourth quarter. It appears the effect of the $787 billion American Recovery and Reinvestment Act of 2009 was short-lived. The Conference Board's consumer confidence index plummeted from 62.7 in May to 52.9 in June. Without artificial government support, demand for housing will decline or stagnate for an extended period pressuring home prices and stoking deflation fears.

The Financial Reform Act of 2010:

Many of you may have read or heard what Senate Banking Committee Chairman Chris Dodd said when the bill was sent out of Committee and back to Congress for a vote (already passing the House), but in the event you did not, allow us to provide you with his quote:

"No one will know until this is actually in place how it works. But we believe we've done something that has been needed for a long time."

If he is not sure what the effect of the 2,500+ page bill is going to be, how can the financial markets or anyone else who reads the bill from cover to cover? The bill admits these shortcomings and creates a remedy to fix the inevitable implementation problems by creating the Financial Stability Oversight Council ("FSOC") and entrusting it with significant authority. Some are calling it a new super regulator. The FSOC will consist of ten voting members which include the Secretary of the Treasury (Chairperson), the Federal Reserve Chairman, the Comptroller of the Currency, the Director of Consumer Financial Protection Bureau (newly created entity), the Chairman of the SEC, The Chairman of the FDIC, the Chairman of the CFTC, the Director of the FHFA, the Chairman of the National Credit Union Administration Board and an independent member with insurance expertise appointed by the President. The FSOC has the ability to

Oppenheimer Investment Management LLC
Sales and Client Service

630 W. Carmel Drive, Suite 250
Carmel, IN 46032
CONTACT: Cyndi Cardenas, 317.843.3607

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choose which current governmental body will have authority over banks and the level of capital that will be required by this entity. They can decide if a company is in distress or if the company poses a systematic risk through its activities, scope, size, concentration or interconnectedness.

Some of the other major provisions of the Act are:

- The creation of the Consumer Financial Protection Bureau in an effort to consolidate all of the existing regulations relating to consumers into one entity. It will regulate transaction fees banks can charge and consolidate consumer loan information submitted by banks. Although the consolidation of consumer-oriented regulation will be a positive, the increased regulatory filings as well as limitations on fees and charges will negatively impact profitability of banks.
- The "Volcker Rule" restricts proprietary trading, but allows a small carve-out for firms to invest up to 3% of Tier 1 capital in private equity or hedge fund seed capital. This should reduce risk from speculative investments depending on the degree of enforcement.
- Loan originators that securitize their inventory must retain 5% of the risk of every deal. We strongly favor forcing originators to keep some skin in the game, even if it reduces overall industry capacity.
- Stress tests will be carried out annually under at least 3 scenarios (Baseline, Adverse, and Severely Adverse). Complete details are unknown; however one of the unintended consequences of the stress tests and new capital requirement is the reduced attractiveness of U.S. consumer financial products relative to foreign opportunities on a risk-adjusted basis.
- Systemically Important Companies will have to pay Systemic Regulation fees to pay for the cost of future government intervention. The shape and form of these fees will be determined over the next two years and create even more uncertainty.

We anticipate that the biggest impacts this Act will have on the economy will be both the overall inertia from additional macro uncertainty and creative force for financial institutions to find ways around the regulations to meet client needs profitably.

Capital Markets and Performance

The European Union meltdown and growing concerns about the strength of the economic recovery had a negative impact on the financial results in the equity markets for the second quarter. For the six months ending June 30, 2010, the Dow Jones Industrial Average has a total return of -5%, the S&P 500 Index has returned -6.7%, and the NASDAQ Composite has returned -6.6%. However, after an almost 80% increase in the S&P 500 from March 9, 2009 through March 31, 2010, it's not unexpected to have a pull-back in equity valuations.

While equity returns were discouraging in the second quarter, the fixed income markets performed admirably. The investment grade bond market, as measured by the Barclays Capital Aggregate Index, returned 3.49% in the second quarter bringing the year-to-date return to 5.33%. The high yield market, as measured by the Merrill Lynch High Yield Master II Index (MLHYI II), returned -0.07% in the quarter and 4.74% year-to-date.

During the second quarter, nervous investors sought high quality investments. U.S. Treasury securities led all fixed-income sectors returning 4.68% measured by Barclays Capital. While corporate and mortgage credits preformed well in the quarter, returning 3.42% and 2.87% respectively, they could not match Treasury returns. The OIM Core and Core Plus composites underperformed the Barclays Capital Aggregate Index. The Intermediate composite also underperformed the Barclays Capital Intermediate Government/Credit Index. Our underweight to Treasury securities hampered our returns in the second quarter. Over the longer term, we strongly believe corporate bonds offer the best opportunity for outperformance and continue to be overweight that sector. Last year we began to increase our high yield exposure in the Core Plus accounts and we have opportunistically increased our exposure to 19% over the past six months. We plan to hold our position at these levels provided the economic environment remains favorable.

Our High Yield composite returned a positive 24 basis points for the quarter. We have moved to an index weighting for low quality credits due to the continued strengthening of the economic recovery and the ability of our selected credits to generate free cash flow and reduce debt levels.

Outlook and Strategy

The overall pace of U.S. economic growth is likely to decelerate in the next couple of quarters as the impact of fiscal stimulus wanes, unemployment benefits are exhausted and employment stagnates or shows little improvement. We anticipate that GDP growth will remain positive during 2010, but that the level will be in the low 3% or high 2% area. We have reduced our estimates due to the European debt crisis and the resulting domestic economic downturn. The employment trend across the U.S. will remain the key determinant of economic recovery. High unemployment and government regulatory uncertainty has led to a decline in consumer confidence. While Treasury securities performed well in the second quarter, corporate debt continues to offer the best opportunities for fixed-income investors. Individual security selection is becoming more important than sector selection, especially for securities with lower credit quality.

During the second quarter we experienced more "bumps in the road" but our portfolios tolerated those as expected, withstanding any significant performance declines. The Financial Reform Act further strengthens our precept that there will always be a place for long-only, fixed-income managers with a bottom-up security selection style. Should you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Michael Richman, CFA
(317) 843-3602
michael.richman@opco.com

Leo J. Dierckman
(317) 843-3603
leo.dierckman@opco.com

John Saf, CFA, CPA
(317) 843-3610
john.saf@opco.com

Michael Richman, CFA is Senior Vice President, Portfolio Manger for Oppenheimer Investment Management. Prior to joining Oppenheimer Investment Management, Mr. Richman was Vice President, Portfolio Manager and Head of Corporate Trading at 40|86 Advisors, Inc. He holds a B.S. in business from Indiana University and is a Chartered Financial Analyst. Mr. Richman has 11 years of financial services and investment experience.

Leo J. Dierckman is a Senior Vice President, Portfolio Manager for Oppenheimer Investment Management. Leo has research responsibilities for the Healthcare, Homebuilding and Restaurant Industries as well as the Municipal Bond Sector. Prior to joining Oppenheimer Investment Management he was Vice President, Portfolio Manager for 40/86 Advisors, Inc. He holds a B.S. from Indiana University. Mr. Dierckman has 14 years of financial services and investment experience.

John C. Saf, CFA, CPA is Senior Vice President, Portfolio Manager for Oppenheimer Investment Management. Mr. Saf has been in the financial industry since 1986. Prior to joining Oppenheimer Investment Management, Mr. Saf was a Vice President and Portfolio Manager for 40|86 Advisors, Inc., performing and overseeing Asset Liability Management (ALM) work. Mr. Saf is a Certified Financial Analyst, a Certified Public Accountant, a Fellow in the Life Management Institute and holds a B.S./B.A. from Drake University.

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