

Outlook

Transamerica Investment Management, LLC

Spring/Summer 2009



Gary U. Rollé
Chief Executive
Officer

A Message from the CEO

May marked the 18th month of a recession that began in December 2007, making the present downturn the lengthiest in the post-Depression era. When added to first-quarter '09 gross domestic product (GDP) of -6.1% and the contraction in 2008, it also makes for one of the most severe economic tempests since the 1930s.

The question now is: How long before the storm clouds break? And what can we expect when they part?

Amid the May data we have found tentative signals of impending improvement. For example, the Commerce Department reported that construction spending rose in March 2009, after five consecutive monthly declines. Corporate earnings estimates have been revised upwards in recent weeks,¹ and consumer sentiment improved in March and

April – the first positive year-to-year change since mid-2007.²

These few indicators may represent no more than the passing calm at the eye of the storm. Nonetheless, they suggest that the rate of economic decline is moderating and give support to our belief a new economic cycle will develop by early 2010.

We anticipate that in this new cycle:

- Two broad-scale trends, debt reduction by consumers and businesses and government-driven income redistribution, will emerge, as governments spend more and individuals save more.
- Over the longer term, record-setting levels of government spending will propel inflationary pressures higher. Interest rates will follow suit.
- These shifts, in combination with the focus of government spending, will force businesses to adapt.
- During this transition, different catalysts for positive change will take shape, giving rise to a new set of investment opportunities in both equity and fixed income markets.

These trends and adaptations are already taking shape. We look for them to become more visible over the next several quarters. In the meantime, we expect this recession – the causes of which were several and complex and have defied easy fixes – will do further damage before giving way to a gradual, moderate recovery.

A handwritten signature in black ink, appearing to read "Gary U. Rollé".

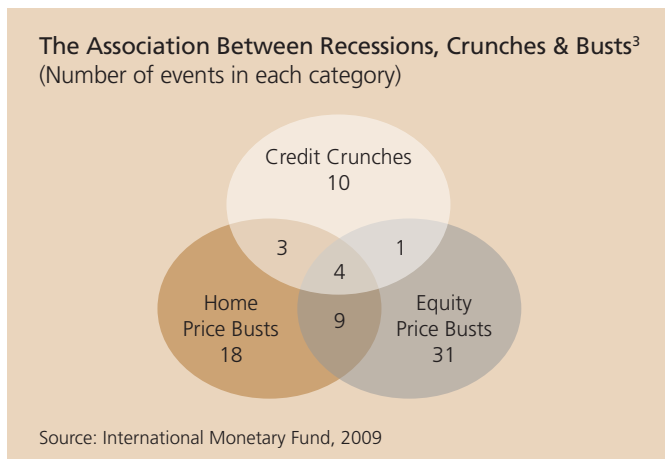
—Gary Rollé
CEO, CIO, Principal and Portfolio Manager

 **TRANSAMERICA**
INVESTMENT MANAGEMENT, LLC

No “Ordinary” Recession

Our belief that the economic clouds will part slowly is predicated on the unusual nature of this recession. The downward spiral that created the cataclysm was multi-faceted: the most severe housing-price bust in seven decades, leading to a once-in-a-lifetime credit crisis and a bear market in equities.

This combination of a concurrent credit crunch, housing price bust and equity bear market is rare. An International Monetary Fund analysis concluded that of 122 recessions in 21 countries between 1960 and 2007, 76 involved at least one of these forms of wealth reduction. Just four involved all three.



The current recession seems different because it is. The underlying causes are complex and more numerous than in most economic contractions.

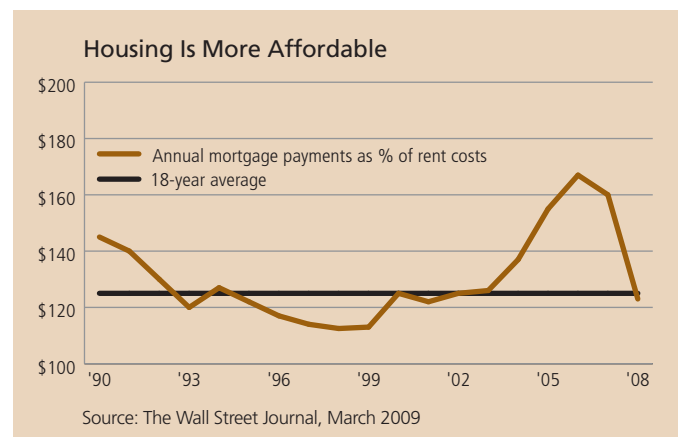
No-Holds-Barred Response

The U.S. government responded to the credit crisis and recession with extraordinary and aggressive measures. Massive government financial commitments – at least \$8 trillion to date, if all were to be fulfilled – have eased the intensive strains on the financial system and are slowly working their way into the economy, where they can stimulate growth.

A fair number of the dozen-plus initiatives by Congress, the U.S. Treasury or the Federal Reserve are aimed at ending the housing market freefall. We believe this effort is on point. Housing will be a key to achieving economic recovery. Stabilization of the housing market must occur before banks and consumers can regain – and maintain – an appetite for risk.

We are encouraged by a few early signs that the value destruction in housing may end before long.

- An important measure of housing affordability is the ratio of average annual mortgage payments to annual rent costs. This ratio has fallen back to the 18-year average.⁴ Historically, declines of this type have been a spur to home buying.



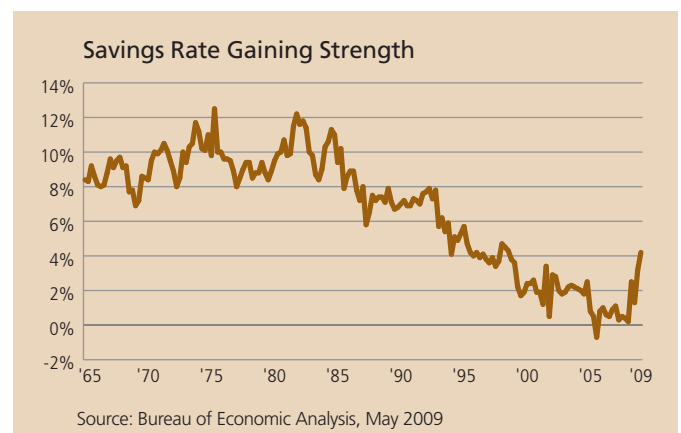
- After reaching a record low in January, the National Association of Realtors index of pending home sales rose in February and March.

Forecast: New Patterns

It is too early to call the inflection point for home prices. We will, however, forecast that newly emerging, large-scale trends will play a role – we think an important one – in the recovery for housing and other asset classes. These megatrends are being shaped by a mixing of economic, social, and political forces.

- **Debt Reduction.** The use of debt by individuals and financial institutions increased dramatically since 1952. Household debt as a percentage of GDP peaked at nearly 100% in the 2008 second quarter, compared to 22% or 23% in the early 1950s. Over that same period, financial sector debt escalated from single-digit percentages to slightly less than 120% of GDP.⁵

More recently, individuals have reduced debt levels, out of fear of job loss, anxiety over home-price and stock-market declines, and higher borrowing costs. The personal savings rate climbed to 4.2% of disposable income in February, compared to the near-zero rates of the recent past.⁶



Economists view paying down debt as akin to saving. Both increase net worth and result in lower levels of consumer spending.

Financial institutions are reducing debt loads as well. Reflecting the need to mend damaged balance sheets and restore confidence in the financial system, they are and will undoubtedly remain focused on raising capital, rather than debt levels, for some time to come.

- **Income Redistribution.** In repairing their financial condition, banks have received a significant hand-up from government, via programs that have allowed them to continue functioning without the need for further borrowing in rickety capital markets. In effect, the government has redistributed assets from taxpayers to the financial sector to meet a broader agenda of restoring order to the financial system. Such redistribution will be a recurring theme as the government becomes more deeply involved in moving the country through and past the crisis, using a combination of spending initiatives and new regulations.

Government Spending Initiatives	Possible Government Regulation
• Bank bailout	• Reregulation of the financial industry
• Rescue of U.S. auto makers	• Protectionism
• Stimulate economy through job creation	• Support for unions
• Make U.S. more energy efficient	• Limits on carbon emission
• Improve access to health care	• Generic-drug legislation

Time to Look for the Next Opportunity Set

While there is growing evidence for the optimist's view – aggressive efforts by the government and the Fed are gaining traction – we do well to remember that the causes of this economic malaise are multiple and complex. Many factors must be addressed and remedied before victory is declared. So, though the bottom is edging closer, it seems likely that, economically speaking, climbing out of the trough will be a relatively slow, laborious process.

We believe that investors' best approach at this time is to identify the tailwinds and headwinds that will arise due to the current dislocations or the efforts to rectify them. More specifically, we anticipate that the drivers of the economy and securities markets will shift as the megatrends of debt reduction and income redistribution weave themselves into the economic fabric.

- **Individuals will save more and spend less.**
Deleveraging will send ripples through the economy.

On the negative side, paying down debt will mean lower consumer spending rates, precipitating a painful readjustment in demand that will retard the pace of economic recovery. On the plus side, a culture of thrift will take shape, creating new opportunities as consumers pinch pennies by "trading down" to less-expensive goods and services.

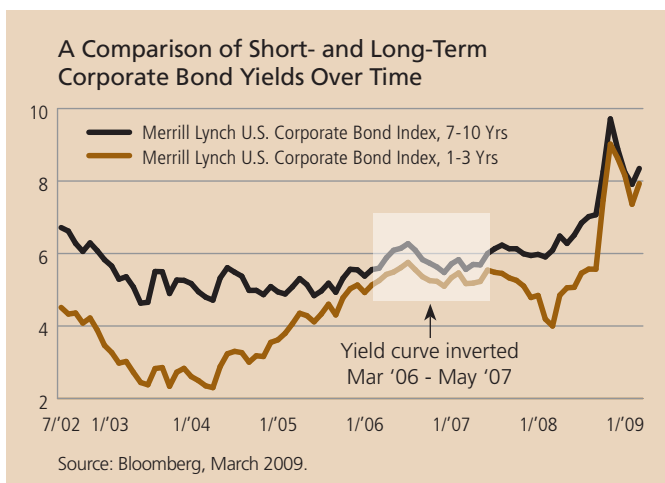
- **Government spending will increase,** making government and government agendas larger factors in shaping the economy.
- **Inflation and interest rates to rise.** In 2008, the government injected a record-breaking amount of money into the economy; in 2009, it will be necessary to do the same, *times four*, to fund various initiatives. Meanwhile, inventories and capital spending are plunging. This is a classic case of too many dollars chasing too few goods and will inevitably lead to inflation over the longer term. Interest rates will rise, to compensate for the heightened threat to purchasing power.
- **Businesses will adapt to all of the above by cutting costs and finding ways to increase productivity.**

Fixed Income Opportunities

Dislocations in the credit markets continue to signal that issues in the financial system have yet to be resolved. Although the yield differential between Treasuries and other securities has narrowed since March, it remains wide by historical standards. That spells attractive current-income opportunities from investments in spread products. Given our view that real improvement in the economic situation will come slowly, we expect this opportunity to persist into late 2009 or longer.

The corporate sector is pricing in all-time high default rates, even for investment-grade companies with iron-clad balance sheets and sturdy cash flows. Investors in this area are being well compensated presently. Of particular interest is the short end of the maturity spectrum; yields there are approaching or equal to yields on longer-maturity bonds of comparable quality. Further, short-duration securities will be less impacted by the inevitable uptick in interest rates.

Yields in the non-investment grade sector are very attractive as well. However, we are proceeding with caution in this area. Record-level defaults are factored into current prices, but the market also appears to be projecting a high level of recoveries (from default). We doubt that defaults will reach the heights implied by current prices but also are skeptical that recoveries will be as robust.



Yields on shorter-maturity bonds are approaching those of long-term bonds, suggesting that investors perceive an elevated level of risk in the near term.

The possibilities in agency mortgage-backed securities are attractive as well. The government's *de facto* takeover of the issuing agencies strengthened the guarantees backing these securities. Another plus for agency MBS is a government program to stabilize the housing market by creating a stronger market for mortgage securities. Toward that end, billions have been earmarked to buy mortgage securities on the open market.

Cautious Optimism for Equities

The stock market has rallied by more than 26% since March 9.⁷ The financial sector led the rally after bellwether banks reported returns to profitability. Positive earnings surprises in other sectors contributed as well. We welcome the change but are also mindful that the fundamentals do not as yet point toward a sustained, across-the-board upturn. Signs that the business cycle is past the worst, such as a stable labor market and renewed corporate investing, are needed. Neither is in evidence currently, so our near-term expectations for the broad market remain muted.

At this juncture, investors would do well to seek out the equities of companies that:

- Are effectively generating free cash flows
- Will benefit from the new consumer, government and business trends. We believe the leaders of the next market cycle will be companies that help consumers stretch their buying power; provide business with tools and processes to enhance productivity; or position themselves to benefit from the government spending on infrastructure, energy, environmental, healthcare and other initiatives.

In Summary

- The current recession is the worst since the 1930s. Both financial and real assets have been repriced.
- Proactive government response is having some effect on easing the strains in the financial system and slowing the decline in home prices.
- Recovery is still over the horizon, however.
- New, broad-scope economic patterns will form as a result of consumers and corporations deleveraging while government spending accelerates.
- A long-term impact of government stimulus will likely be renewed inflation.
- Fixed income investors can find attractive near-term opportunities in non-Treasury sectors, most notably short-term corporate bonds.
- Equity investors can prepare for recovery by identifying companies that generate free cash flow, have limited need for credit, and are well situated to take advantage of the emergent economic patterns.

TIM's Current Catalysts for Positive Change

Through independent research, we study individual companies and the secular environments in which they function. Our research process identifies companies that exhibit certain key attributes and also possess a catalyst for positive change in company cash flows and growth rates. These catalysts may be specific to a company or industry – such as a change in company management or strategy – or they may be associated with secular trends.

As of May 2009, our secularly defined catalysts for positive change are:

<ul style="list-style-type: none">• Infrastructure Spending	Government spending to rebuild and expand highways, mass transit and the power grid – after years of underinvestment – is slated to increase dramatically.
<ul style="list-style-type: none">• Government Funding	Announced targets of government spending include better health care record-keeping and information sharing, improvements in education and life sciences.
<ul style="list-style-type: none">• Environmental Sustainability	Government, consumers and businesses desire environmentally friendly, cost-efficient sources of energy or means of production.
<ul style="list-style-type: none">• Productivity Enhancement	Cost-conscious consumers, reduced consumer spending and rising costs in an inflationary environment will squeeze corporate profits, forcing businesses to find ways to generate more output per dollar invested.
<ul style="list-style-type: none">• Mobile Lifestyle Ubiquity	Tools that allow business and individuals to connect to each other or to information anywhere, anytime, are in growing demand.
<ul style="list-style-type: none">• Beneficiaries of Industrialization	Industrialization is a global, multi-decade trend.

¹Standard & Poor's Corporation. Based on earnings estimates for constituents of the Standard & Poor's 500 Index, January 2008 through April 21, 2009.

²Source: Reuters/University of Michigan, April 2009. The University of Michigan Consumer Sentiment Index is published monthly by The University of Michigan. The index is normalized to have a value of 100 in December 1964.

³Source: International Monetary Fund, November 2008. "What Happens During Recessions, Crunches and Busts?" Stijn Claessens, M. Ayhan Kose and Marco E. Terrones. Based on review of recessions in 21 Organization of Economic Cooperation and Development (OECD) countries, 1960-2007.

⁴Source: The Wall Street Journal, March 2009. Based on data from Case-Shiller.

⁵Source: fabiusmaximus.wordpress.com. "A Picture of the Post-WWII Debt Supercycle"

⁶Source: Bureau of Economic Analysis, May 2009.

⁷Based on closing values of Dow Jones Industrial Average at 3/8/2009 and 5/18/2009.

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