

March 2010

QUARTERLY REVIEW AND OUTLOOK

We are three months into a new year, and it seems as if we never left 2009. The same arguments rage on, and investor attitudes and actions are still highly unsettled and volatile. Economic questions persist about the sustainability and robustness of the U.S. recovery and whether the only thing turning the engine is the fuel from government deficit spending. While pondering the steady flow of economic data, investors have also been confronted by an array of international and geopolitical issues, which have added to the sense of uncertainty. January clearly reflected the prevalence of investor concern as stocks pulled back broadly. Markets have stabilized on balance since then, but money market funds and fixed income investments still seem to be favored choices of many institutional and individual investors.

Like others, we have been evaluating events, trends, risks, and prospects. And, we are maintaining a generally constructive outlook.

There is no way to minimize or dismiss the presence or the magnitude of the government's piece of the action in our economy currently. Policies of our Federal Reserve and Treasury are still important forces impacting numerous sectors, particularly banking and housing. The stimulus program enacted last year is poised to have a significantly greater economic influence this year and next, with positive support centering on engineering, construction, industrial machinery, and certain technology sectors.

Meanwhile, in the U.S. private arena, we see signs of both early and continuing improvement in profits, order rates, capital spending, and employment. While this strengthening is not yet widespread or firmly-enough established, the trend is clearly positive. Importantly, also, we judge the recent increase in stock buybacks, mergers, and acquisitions as evidence of growing conviction within the corporate sector as to business prospects and capital adequacy.

Confidence in our diverse and all-important small business community is still restrained, partly because of bank financing policies and partly because of the continuing uncertainty associated with future tax policies at all levels and with potential costs of health care, energy, and possible regulatory changes. A vibrant economic recovery requires a confident business involvement at all levels; and, the smaller enterprises are the weakest link at the moment.

But, there are some glimmers of upward movement. Recent surveys of bank lending officers show an easing of credit extension policies, which should be of benefit to owners of smaller businesses. If improving employment conditions continue, this will likely spur recovery in consumer spending which would bolster the operating outlook for many concerns. Finally, the rising order rates and operating ratios in many of the important industrial sectors and larger corporations will certainly result in stronger business for their satellite companies and suppliers. A revival of expansion in a broadening section of smaller firms could be a real possibility in the coming months.

As we stated several times previously, healthy earnings growth is the cornerstone for a positive investment environment; and, we believe the fundamentals are supportive of a positive trend through 2011. Stringent cost controls and persistent productivity gains have provided a solid foundation thus far. Improving sales growth spurred by recovering domestic demand, expanding exports, and the return to maintenance of a normal inventory/sales ratio should now become important forces in the quarters ahead.

We are very much aware of the various international events and policies that have proven to be both confusing and disturbing to investors in recent months. As always, some of these issues lend themselves to logical analysis; while others seem to defy rational conclusions.

The integrity of sovereign nation debt liabilities has been a prominent worry since the well-publicized problems of Dubai and Greece and rumors about the repayment capacity of other European nations. Thus far, the threat of financial contagion has been thwarted through the efforts of financially stronger sister states and the adequate functioning of international credit and currency markets. If interest rates remain low and tax revenues in most countries expand along with incomes and profits, deficits should shrink and demand for government securities will be sustained. Maybe, fiscal discipline will follow.

The potential for official moves to tighten monetary policy in various countries has been frequently commented on. Central bankers seem conscious of the substantial liquidity injected in most economies to offset the contractionary economic and financial forces of 2008 and 2009. In particular, recent steps by China to rein in excess bank lending and real estate speculation have raised concerns that China's economic growth will be sharply reduced. The latest indications and reports, however, show a continued strong rate of domestic expansion and uninterrupted demand for foreign imports.

In the category of unfathomable geopolitical dilemmas, Iran's nuclear ambitions and diplomatic intransigence top the list. External pressures and internal dissension seem to have had little effect, and the risk of a major upheaval in the Middle East remains a constant threat. There is no simple or clear cut investment approach to respond to this situation, other than to avoid all direct investments in the immediate area and to maintain a reasonable exposure to energy-related companies in politically stable and secure regions.

Considering all the variables facing investors today, it is probable that the overall mood will remain wary. It would be unrealistic to think an “all clear” flag would ever be raised; and, while it may seem counter-intuitive, an environment of generally low stock market expectations presents good opportunities to focus on industry sectors and companies with the fundamental capabilities to achieve well-above-average results. To that end, we continue to favor information technology, industrial materials, and the beneficiaries of global infrastructure development. Companies that possess proven natural resource assets should prosper as demand rises in emerging global economies. Areas, which should continue to provide steady earnings growth, include specialized health care and consumer goods companies with established international market positions. All are currently attractive on a two-year prospective basis.

The fixed-income sector has recently benefited from investor preference for U.S. dollar denominated assets. While this trend may continue, we believe the best values are in the high-grade corporate and agency sectors; and, we would remain with intermediate maturities. Uncertainty about future tax policies provides ongoing support for tax-exempt securities. But, prudence dictates that close scrutiny be given to each issuing entity with regard to purpose and interest payment coverage.