

December, 2009

## OUTLOOK AT YEAR END

While the year just ending has certainly been less tumultuous than 2008 and has yielded positive investment returns for most asset classes, a sense of unease and doubt still seems pervasive among most investors. There is widespread relief that the financial and economic abyss that was looming has been avoided; and, the improved stability of the world credit markets is acknowledged as a significant achievement. Yet, confidence remains fragile in many sectors and for a variety of reasons. And uncertainty is too often an impediment for financial markets and economic entities.

It is not possible to identify and evaluate each and every concern present today, but there are sufficient prominent ones of a structural nature weighing on prospects for the economy and the markets. Because we have been expressing an increasingly positive posture during the past year, it is important to examine these issues in the context of current market valuations and the seemingly unusual number of contradictory forces at work.

A variety of key "Policy" issues are foremost in the list of concerns for many business leaders and investors. Accommodative monetary policies by our Federal Reserve and other central banks have been instrumental in the stabilization of credit markets and many of the "at risk" world financial institutions. The enormous infusions of liquidity during the past fifteen months have resulted in lowered interest rate structures in most nations along with increased government intervention and involvement in many cases. It would be rare to find any serious investor anywhere who would not express worry about the future policy actions required to begin to withdraw this liquidity and the impact on interest rates and on certain still-weak sectors such as housing, autos, commercial real estate, and consumer durables.

At the same time, many of the developed economies, including the U.S., are facing record fiscal deficits as well as large and rising debt levels. Adequate liquidity is necessary to support the broadened economic growth that will help reduce the cyclical portion of these deficits; but, the structural portion poses a dilemma for monetary policy makers and a political quandary for governments which must consider tax policy options. Economic theory teaches that if excess liquidity stimulus is not reduced, inflation will follow. However, if it is withdrawn prematurely, coupled with meaningful taxation expansion, deflation becomes the more likely outcome.

If these near-cosmic questions weren't worrisome enough, there is increasing evidence of likely well-intentioned, but possibly misguided efforts by various Western governments to introduce new programs or apply new regulations and directives to a variety of economic and financial sectors. While many, if not most, of these initiatives may never be employed, the uncertain costs attendant to them create confusion and cause hesitation and dislocations with many important strategic and tactical business decisions.

While recognizing the worst case potential for the forgoing issues, our current view on these questions of "Policy" is less dire than that of many others. We believe we will begin to see evidence of central bank adjustments throughout 2010, but these actions may be different in each country. This will not be a sign of disarray, but rather each bank taking into consideration the particular strengths and trends in their specific nations accompanied by coordinated communications with other bankers. The overriding objective is to sustain economic recovery and broaden the expansion for all. Tax policies will almost certainly be less coordinated and more varied. It is difficult to predict what the dominant influences in this area will be, but if the goal is to stimulate employment and to increase world trade revenues, then the policies and the strength of the emerging economies will play an important role.

We believe the pace of economic expansion during the next twelve months will be critical and will importantly impact the nature and timing of the policy decisions. It seems quite obvious, at this point, that the developed economic regions are likely to experience rates of economic growth below those of historic recovery periods. Persistent high unemployment, excess productive capacity, reduced capital spending, and fears about possible government restrictions and mandates are seen as the usual identifiable suspects. However, we think there are reasons and factors which support a stronger outlook.

Profits and cash flow are the lifeblood of corporations and are the prime determinants of the critical employment, capital deployment, and expansion policies. As a result of prompt and consistent control of operating costs during the past year, a major cross-section of U.S. companies is now seeing sustained upticks in profitability and productivity. Equally encouraging are the several months of rising orders, production, employment, and inventory rebuilding in the U.S. manufacturing sector. Coincident with these strengthening measures, there have been steady, moderate gains in our exports of goods and services which benefit an ever-increasing number of U.S. firms which have focused on international demand opportunities. The rising level of profits in these important areas will provide the impetus and the means to expand and enhance production capabilities and boost employment in order to remain competitive in global markets.

The consumer and service sectors of the U.S economy are still somewhat sluggish; but, again, there are reasons to expect improvement. Confidence is essential to a sustained and healthy recovery in this broad area, and employment trends are a major influence. We have not yet seen a return to net growth in total employment, but the trend is in the right direction. Given how sharply the cutbacks were in certain areas, and now seeing the rebounds in hours worked and temporary help utilization, growth in employment could resume during the first half of 2010 for many industries. If resolution and greater clarity are achieved relative to proposed health care and energy legislation, the all-important small business sector will likely show increased vigor.

Finally, we think investors are giving insufficient weight to the significant increases likely in infrastructure spending during the next two years and the resultant positive multiplier impact on jobs and consumer spending. While much attention has centered on the initial outlays under the earlier-passed stimulus bill in the U.S., we observe that there are numerous programs here and worldwide that are getting underway to address structural underinvestment in energy, transportation, housing, and production facilities. Spending for these programs in the U.S. and abroad will accelerate in 2010 and extend for several years, offering opportunities for U.S. providers of industrial goods, engineering and construction services, technology equipment and systems, and a wide array of consumer goods.

In total, we think economic progress next year will be a bit disparate: with the developed nations, in aggregate, lagging behind the less-mature regions. The likely uneven growth pattern in the U.S. will cause concern, but we believe the trend will remain positive through 2011. We are not assuming a Pollyanna persona, and we think it would be a mistake not to take seriously the structural issues impacting the shape and the pace of economic progress, particularly in the U.S.

But, it would be equally mistaken not to recognize the development of new and dynamic geographic markets, the widening impact and utilization of technology throughout the world, the changing nature and dimension of consumer needs, and the ever-increasing competitive opportunities for rewarding capital investments. Also, the U.S. continues to display its innate resilience which results from the balance in our private sector, the financial strength of our corporate sectors, and our still-unmatched diversity of entrepreneurship.

Despite all of the economic, financial, and political cross winds, our equity and fixed-income markets have generally performed well, and valuations seem in line with near-term prospects. In the equity arena, we continue to have strong conviction in the longer term opportunities for a diversified group of technology providers, specialized health care companies with well-established product and market niches, and a diverse group of firms positioned to benefit from global infrastructure spending. We still hold positive views regarding certain energy and industrial commodity sectors; and we believe that agriculture offers significant investment potential globally.

Our fixed income preferences are still centered on good quality, intermediate maturity corporate and agency issues. New opportunities are scarce at this time, however, and we may not have the near-term chance to expand holdings in this sector. Our cash reserves are still being held for investment in certain international markets or sectors, when valuations are attractive.