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## QUARTERLY REVIEW AND OUTLOOK

Well, three more months have passed and evidence of economic recovery has broadened, equity markets have remained resilient, and the important corporate credit arena has shown definite signs of returning to normalcy. Yet, for investors, the dilemma continues: Can our economic upswing be sustainable and vigorous enough in the face of large federal, state, and local deficits, likely persistent high unemployment, the prospect of new and higher taxes, and the uncertainty about future moves by our Federal Reserve?

Our position is: “Yes” to sustainability, and “Maybe” to vigor. As noted in previous letters, the amount of liquidity pumped into the major economies during the past twelve months is unprecedented. And, the collective impact has moved from stabilization to stimulation. While we believe central banks will undertake policy actions to reduce or offset this liquidity over the longer term, the flow-through has not yet had its peak effect on economic activity broadly. Recovery in the developed economies is not yet firmly anchored, and we think that key policies will continue to be accommodative for most, if not all, of 2010, particularly in light of difficult employment conditions and prospects.

Consumer confidence and activity are very sensitive to employment trends and opportunities; and, we expect that it will take more than just a flattening of unemployment to rekindle broad-scale consumer spending enthusiasm. Which means that our economy will be much more dependent on high levels of government expenditures and programs, a rising level of exports, and an extended rebound in industrial employment and spending for inventory restocking and capital projects.

We certainly have ample evidence of increased government willingness to spend, and there are nascent signs of improving business confidence and an upturn in new order trends in our manufacturing sector. Exports are also showing some encouraging gains, partly because of currency relationships, but importantly, because a number of emerging nations’ economies are experiencing stronger internal growth with rising demand for consumer, industrial, and technology products, components, and systems.

The upturn in equity prices since early March has been impressive and very welcome. While a portion of the rise undoubtedly has been the result of relief that the prevalent end-of-the-world fears were not realized, an equally important factor was the increased understanding that many businesses had prepared for and had quickly adjusted to the very difficult operating and financial conditions. These actions have reduced operating and overhead expenses sharply, with the result that profit margins and employee productivity have been maintained at impressive levels. If, as seems increasingly probable, sales revenues begin to gradually increase over the next four quarters, earnings growth could be surprisingly good. If so, this would trigger a boost to employment and new capital investments.

So much for the good news that could sustain economic growth and support a positive outlook for equities and corporate debt securities. There are, however, risks and impediments that have the potential to impact investor confidence and moderate the slope of recovery in our economy. While we currently are giving more weight to the present and incipient positive factors, we are highly sensitive to the hazards.

Foremost, in our minds, is the likely sluggish pace of consumer spending during the next twelve months. With employment trends and the housing sector both very cloudy and debt levels still high, our economy may be lacking a traditionally potent growth component. Other concerns which require attention include the projected and long-lived government deficits, the as-yet unknown costs and impact of possible new energy and health care programs, the uncertain outlook for tax policies at all levels and the resulting effect on business capital decisions, and the longer term potential for a new inflation spiral caused by the vast amount of global liquidity injected in the past year.

All in all, we believe a positive tilt is still justified based on the likelihood of rising corporate earnings and cash flow, a larger contribution from government stimulus programs in 2010, gradual strengthening of most global economies, few serious inflationary pressures in the near term, and a healthier world credit environment. Obviously, markets have recognized the improved backdrop and outlook and now appear fairly valued in the aggregate. As is often the case, however, a generalized view may miss numerous specific exceptions and opportunities.

In the fixed income arena, we continue to feel that good quality, intermediate maturity corporate and agency issues offer attractive total return potential. The pickings here are not as ripe as they were six to nine months ago; but, relative to Treasuries, they still stand out. Amongst the equity sectors, our focus is still on technology and infrastructure providers which have strong product dominance and well-established international market presence. Health care is facing potential changes and pressures, but there are unique companies which offer cost-effective products and solutions and should be future beneficiaries. Finally, there are a number of well-managed and strongly capitalized companies that will experience positive earnings leverage as economic and industry conditions strengthen or which offer exposure to very promising secular global opportunities such as agriculture and energy.

At this time, we are maintaining a moderate level of cash reserves. While this liquidity should provide a modest cushion in the event of temporary downside market volatility, our primary objective is to establish or increase portfolio exposure to certain international markets or sectors. It is increasingly obvious that these areas offer above-average profit opportunities for the longer term because of strong demographic trends, rising living standards, and significant potential for resource development and infrastructure build out. Discipline and patience are required, and diversification will be essential.