

THE BUBBLE DECADE ENDS

Most of us are probably tired of the economic bubbles we experienced during the first decade of the 2000s—the tech bubble that imploded in the spring of 2000, the housing bubble of 2006 and the credit bubble of 2008. Most investors were aware that the market’s average return for the past 80 years was around 10%. What most people now understand more clearly is that this average is comprised not of steady returns, but can consist of extremes. The S&P had a negative total return for the decade and performed worse than in the 1930s. The bubbles of the 2000s magnified those extremes. The table below shows the returns for various asset classes over the past year and decade. The quarter was again positive for both stocks and bonds.

INDEX	Q4 2009	1 Year	5 Year	10 Year
Standard & Poor’s 500 Index	6.04	26.47	0.42	-0.95
Dow Jones Industrial Average Index	8.10	22.68	1.94	1.31
Barclay Intermediate Gov/Credit Index	0.31	5.24	4.66	5.93
Merrill Lynch 1-12 Year Muni	-0.10	7.19	4.47	5.56

What opportunities or bubbles may await us in the 2010 decade: U.S. deficits and debt, emerging markets, inflation or deflation? The next decade seems to hold many challenges. Let us hope we learned something over the past 10 years to improve the U.S. and its constituents.

EXAMINING THE E’s

The letter “E” could play an important role in the coming year: Employment, Expectations, Earnings, Exit strategy, Exceptional and Extended. We can start with extended:

“...economic conditions, likely warrant exceptionally low levels of the federal funds rates for an extended period of time.”

-- Federal Reserve Open Market Committee commentary, December 16, 2009

Recent actions will have prolonged, and probably many unintended, consequences for years to come. We cannot simply “undo” the excesses of the late 2000s. Only an extended period of time for healing and better decision-making can lead us back to prosperity.

The government talks of exit strategies from the programs put in place to rescue the economy, but will it happen? The Troubled Asset Recovery Program (TARP) is a good example of the difficulty any attempts to withdraw the stimulus may encounter. Many of the largest institutions

Continued on reverse

that received TARP funds have now paid back the capital they received. The capital came from borrowed dollars and should be paid off when the money is returned. However that does not appear what will happen, as politicians are rapidly dreaming up new programs to be funded with the “found money.” Will the U.S. find the political will to exit its stimulus programs?

Expectations of individuals and corporations regarding employment or the lack of it will shape the economy in the near term. Individuals and corporations need to believe that the future offers adequate opportunities for them to make decisions such as buying a house, investing in a new product line or hiring personnel. If expectations are diminished we would expect a jobless recovery or even potentially another recession.

Earnings of corporations will also play a large role in forming expectations about the future. In the third quarter of 2009, 80 percent of the corporations in the S&P 500 Index reported positive earnings surprises (albeit on lowered expectations) and the next couple of quarters should provide relatively easy-to-beat earnings comparisons. Solid earnings results could reduce some of the anxieties of corporate managers, enabling them to turn positive on increasing employment.

The exceptional efforts engendered by the Federal Reserve and the U.S. Treasury were designed to counter the likelihood of another recession. The Fed Funds rate may remain low for years, as the Fed desires to err on the side of a strong economy (risking inflation) versus a weak one (risking deflation). Some of the extraordinary actions have taken place outside the traditional role of these institutions, which has led to some Congressional pushback. Chairman Bernanke, in an effort to avoid repeating past mistakes, has intensely studied the 1930s and the market dislocations that took place after the removal of certain stimulus measures.

NEUTRAL

Our investment themes of focusing on high quality securities, weak dollar beneficiaries (international stocks/bonds), and a bias toward higher inflation continue to be expressed in our clients’ portfolios. In the past quarter, high-quality stocks and bonds performed better as the market is starting to appreciate companies paying dividends and growing earnings. International equity investments lagged as the dollar rallied in December for only the second month in the past ten. International bonds continued to do well relative to the U.S. Fixed income market, despite the dollar’s strength. Inflation expectations continued to rise as the break-even spread on Treasury Inflation Protected Securities rose to 2.30% from 1.75% at September 30. We continue to recommend a neutral weighting of equities and fixed income versus asset allocation targets.

We are glad these themes are working, and thank you for trusting us to manage your assets.

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