
MARKET OUTLOOK 2010

- Our market outlook for the past six months has included the following assertion: ***"We believe that investors should be prepared for two things: a) the continuation of the stock market rally well past expectations and b) another sell off of some magnitude sometime in the near future."*** **We maintain this near term outlook.** Fundamentally, more "green shoots" of economic recovery become evident each month. Yet, the economy remains buffeted by considerable headwinds. This tension will persist for the foreseeable future. On balance, however, there is ample justification for a growing sense of optimism.
- At present, cash represents the most difficult asset class to manage. Principal protected/insured deposit accounts and money markets pay virtually **zero**. This situation forces investors to seek alternatives for current income. A strategy that involves extending maturities increases interest rate risk. This risk becomes more pronounced to the extent the Fed accelerates its program of removing stimulus from the system. Investors can choose to lower credit standards, although we recommend against such an approach. **What to do with cash????!!!**
- One beneficiary of low interest rates has been the stock market (**see chart on page 5**). We believe that implicit Fed policy **"encourages"** investors to reduce risk aversion as a means of reinvigorating capital investment. As the cash and money markets normalized, yields began a rapid descent from last year's extreme levels. This has penalized investors that seek to remain in cash and has forced many to seek alternatives.
- During Q4 2008, there was a compelling investment opportunity represented by high grade corporate bonds (**see chart on page 6**). This condition existed because investors abandoned risk assets for the "safe haven" status of Treasuries. Spreads widened to extremely attractive levels and offered investors the opportunity to "lock in" high yields.
- Spreads (i.e., nominal yields) on corporate bonds are no longer as attractive as they were in November 2008. We, therefore, recommend investors diversify and seek **yield** opportunities in the stock market (**see table on page 7**).

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- We believe the focus of the markets in 2010 will be on the Fed and other central banks as to when they remove monetary stimulus. On [pages 8 - 12](#), we develop our case for when/if these authorities take action. The [chart on page 9](#) provides current market expectations of higher Fed Funds as implied by the futures markets.
- Low rates of resource utilization are an indirect way of describing the labor market ([see chart on page 11](#)). As consumption remains 70% of US GDP, the weak condition of our labor market suggests a long, gradual economic recovery. It also suggests inflation, at least for the consumer, should remain subdued.
- If one includes the “under employed” with the actual number of unemployed, economists estimate the “true” unemployment rate to be close to 17.5%. That would mark the worst labor market since the 1930s. Many industries continue to post operating rates in the 60 – 70% range (i.e., capacity utilization). Under “normal conditions”, aggregate capacity utilization below 80% is considered “non-inflationary”. Thus, the Fed argues that inflation is not a huge concern at the moment because our economy is operating well below capacity. This is another way of describing the “output gap” – the difference between actual GDP and potential GDP.
- We believe both macro and fiscal policy will be geared to reversing the trend in unemployment in 2010 ([see chart on page 12](#)). The long term costs might be high, but political forces will likely align to enact more job creating legislation. We should note that, as unemployment is a lagging indicator, **it is highly likely that the economy will demonstrate sustainable growth before a meaningful increase in net new job creation.**
- There has been much discussion of the weakening of the Dollar this year. We believe it is advisable to examine dollar trends from a longer term perspective. The Dollar, in fact, has been weakening since 2002 ([see chart on page 15](#)). There was a sharp Dollar rally in 2008 related to the financial crisis as investors sought safe havens and liquidity. This rally seems to have been a short term correction in a much longer term (i.e., secular) trend of Dollar weakness.

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- There are many negative implications of a weakening Dollar. At its simplest, a weakening Dollar implies that US standards of living have remained stagnant or, perhaps, declined. Currency strength indicates the opposite. Thus, growth among trade partners has come at the expense of the US – a form of wealth transference. Interestingly, this long term trend of Dollar weakness has **not** generated much consumer inflation ([see chart on page 14](#)). Inflation has been present instead among various asset classes. The increasing value of various asset classes supported greater amounts of leverage. That cycle created the credit bubble which burst in 2007.
- The argument for the inevitability of inflation resulting from Dollar weakness is monetarist. The monetarist approach to economic policy believes that growth of the money supply will inevitably result in rising prices. The equation for general equilibrium in the monetarist school argues that $P * Y = M * V$. P is the price level (inflation). Y is the volume (i.e., quantity). The two combined is GDP. M refers to money supply. V is the velocity of money (i.e., turnover). It is without question that M has exploded in size. However, V is currently negative. When V collapses, it suggests that the money multiplier is quite low. As a result, GDP has not grown as much as one would expect given the expansion in the money supply. Moreover, the explosion in size of the money supply has not yet resulted in rising prices.
- Whereas inflation expectations have increased from this past Spring's deflation scare, they have only recently returned to levels that existed pre-Lehman (i.e., the long term trend line) ([see chart on page 16](#)). The worry among market participants is that expectations for inflation will continue to increase, affecting behavior and market performance. Thus, the key to the market will be the timing of actions by central banks to remove stimulus in order to pre-empt inflationary developments. Note how Australia, Canada, and other nations have already begun this process while the ECB is currently discussing it.
- On [pages 17 – 18](#), we present strategies for hedging inflation risk (to the extent some of these pressures accelerate). On [pages 19 – 21](#), we offer some general investment recommendations and present our long term investment themes.

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WHERE ARE WE NOW?

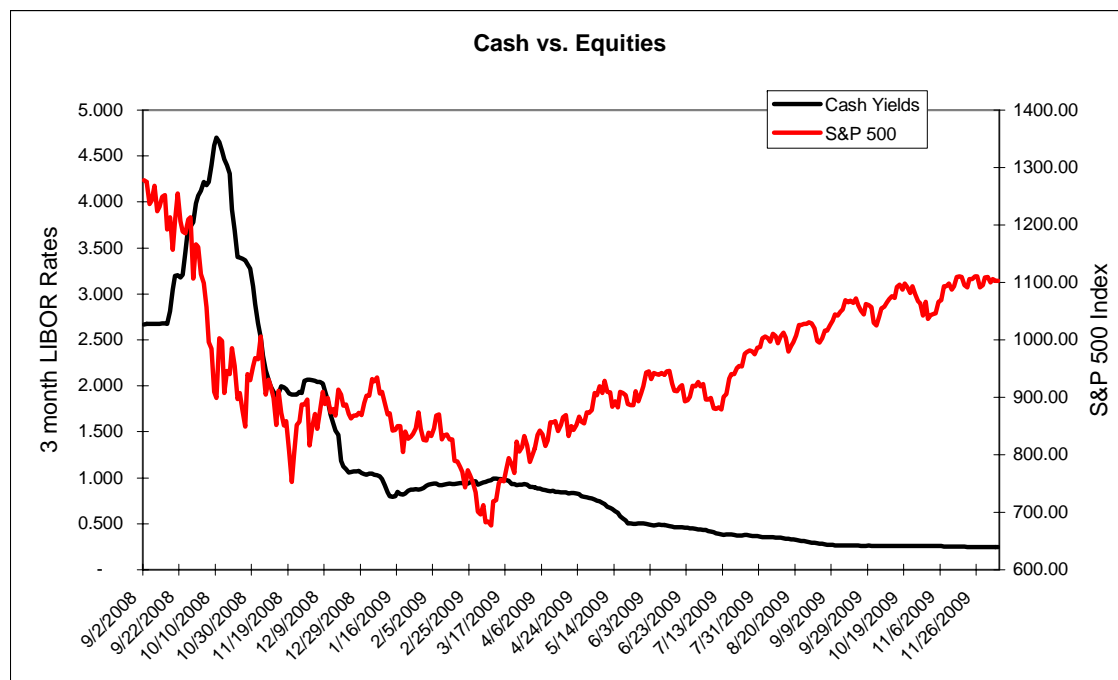
- Credit markets have returned to pre-Lehman levels (i.e., September 2008).
- Stock markets are approaching pre-Lehman levels.
- Economic indicators continue to suggest gradual improvement.
- However, banks are hoarding cash.
- Emerging markets – the first to decline; the first to recover. Now, **market leaders**.
- Dollar rallied from May 2008 – March 2009 (crisis period); Dollar has returned to weakening trend which began in 2002.

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ANYTHING OTHER THAN 0.10% !!!

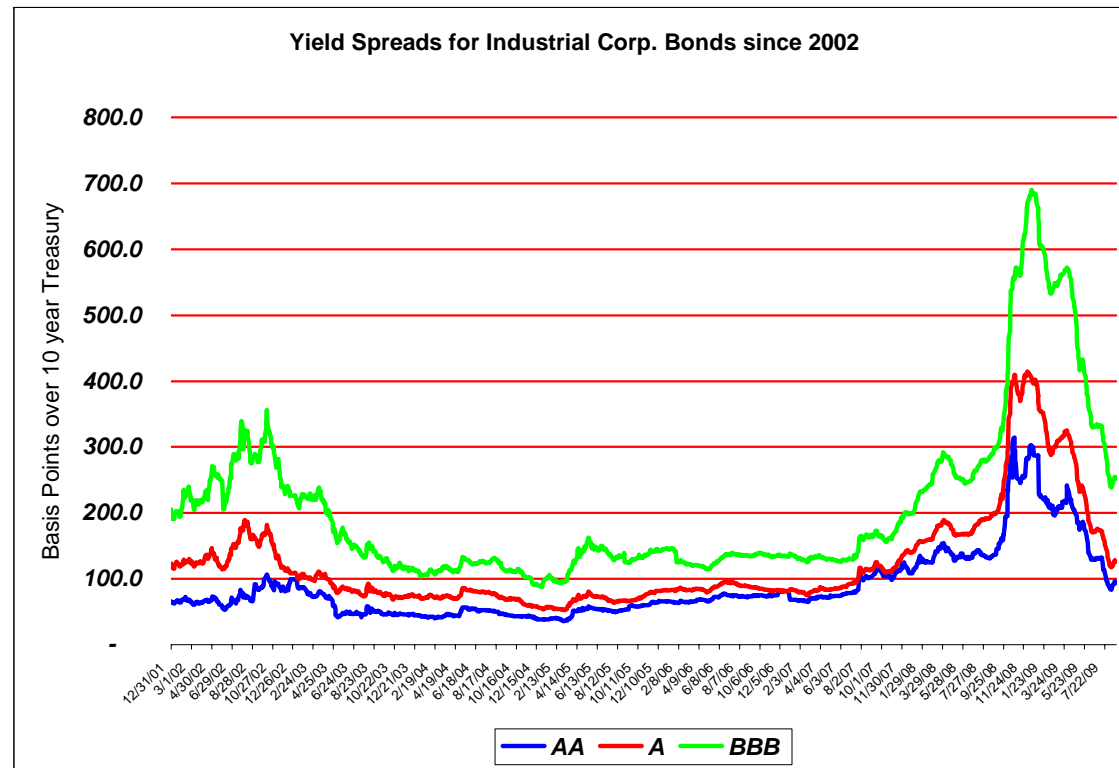


- Note how the near 5% level on 3 month LIBOR was an indication that demand for cash far exceeded supply. The prevailing sentiment in Q3 2008 was that **“cash is scarce and, therefore, precious”**. Today, 3 month LIBOR is 0.255% -- an indication that **cash is abundant**. Excess cash (i.e., liquidity) has sought greater returns in other asset classes, namely the capital markets.

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SPREADS ON CORPORATE BONDS HAVE "NORMALIZED"



- In yet another sign of “normalized” markets, corporate spreads have fallen from the crisis levels of last Fall.

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LOOK FOR YIELD IN THE STOCK MARKET

- For some of these companies, the dividend yield is higher than the yield on their bonds. This is a rare occurrence. Either the market has mispriced the stock or has mispriced the bonds. In any case, the yields currently available on the common stock represent an attractive sector from which to derive current income.

Company	10 year Bond Yield*	Dividend Yield*
AT&T	4.80%	6.05%
Verizon	4.77%	5.94%
Duke Energy	4.80%	5.72%
Dominion Resources	4.60%	4.76%
Merck	4.13%	4.17%
Florida Power & Light	4.35%	3.60%
Lockheed Martin	4.36%	3.22%
Kellogg	4.12%	2.80%
Procter & Gamble	4.01%	2.79%

* as of 11/25/09

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WHEN DOES THE FED ACT?

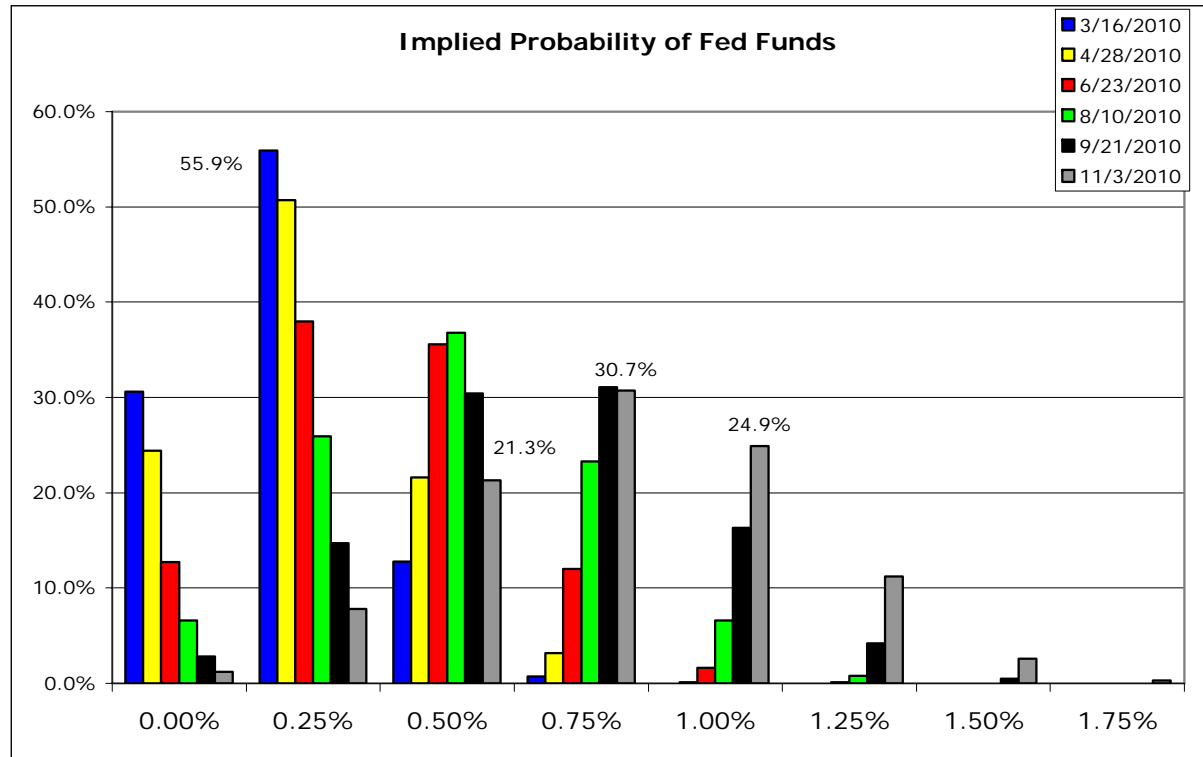
- From Statement (11/4/09): the Federal Reserve will maintain its policy rate (0 – 0.25%) for “**an extended period**”.
- **Justification**: “low rates of resource utilization, subdued inflation trends, and stable inflation expectations.”
- **Interpretation**: the Fed is more concerned about ensuring the economic recovery than the long term inflationary implications of recent policy actions.
- **Risk**: timing of their “exit”.

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WHEN DOES THE FED ACT? CURRENT MARKET EXPECTATIONS



Implied Probability of Fed Funds, as of December 7, 2009.

- At present, the market believes there is a 50% probability that the Fed will initiate a series of gradual 0.25% Fed Funds rate increases beginning June 2010.

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WHEN DOES THE FED ACT? OUR EXPECTATIONS

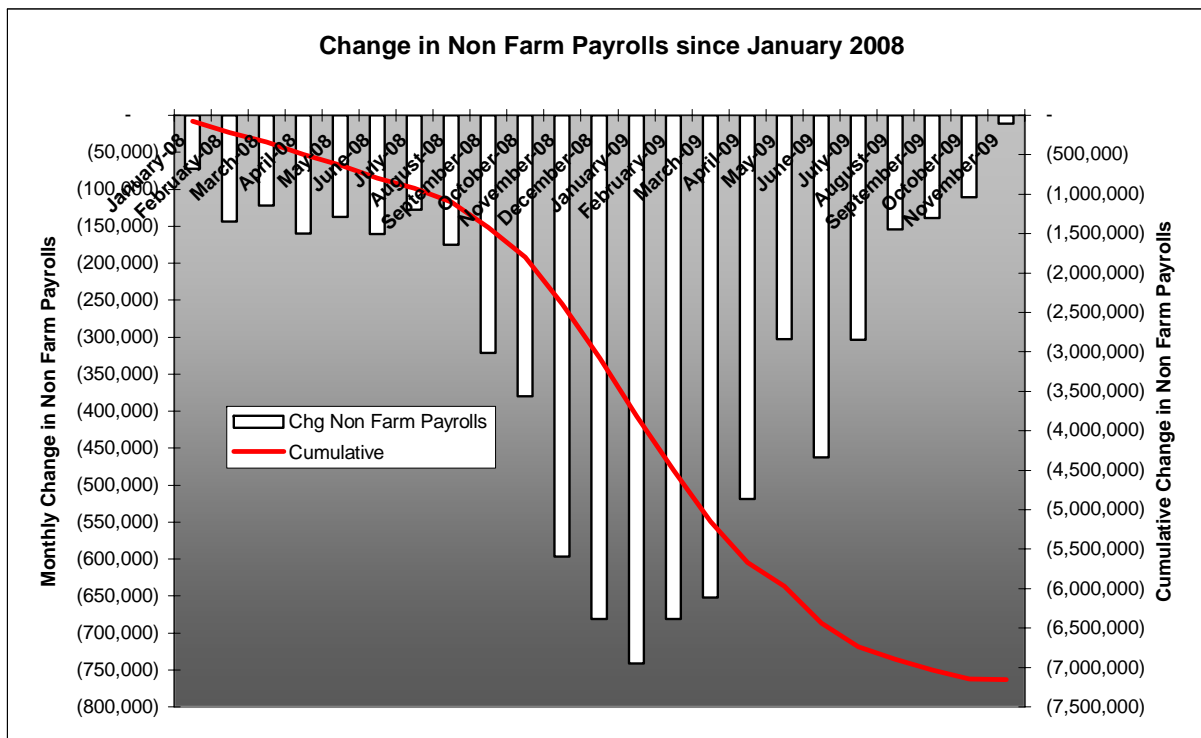
- We anticipate the Fed will maintain low rates until job creation becomes evident. Key barometer is the Unemployment Rate.
- Fed's policy response is asymmetric: aggressively respond to recessions; gently slow down economies/markets.
- At this point, the Fed is more likely to be late rather than early in terms of removing stimulus.
- At some point, consumer inflation could become a problem. For now, the Fed wants to ensure the economic recovery continues.

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JOB CREATION REMAINS THE KEY TO FUTURE ECONOMIC GROWTH AND FED POLICY

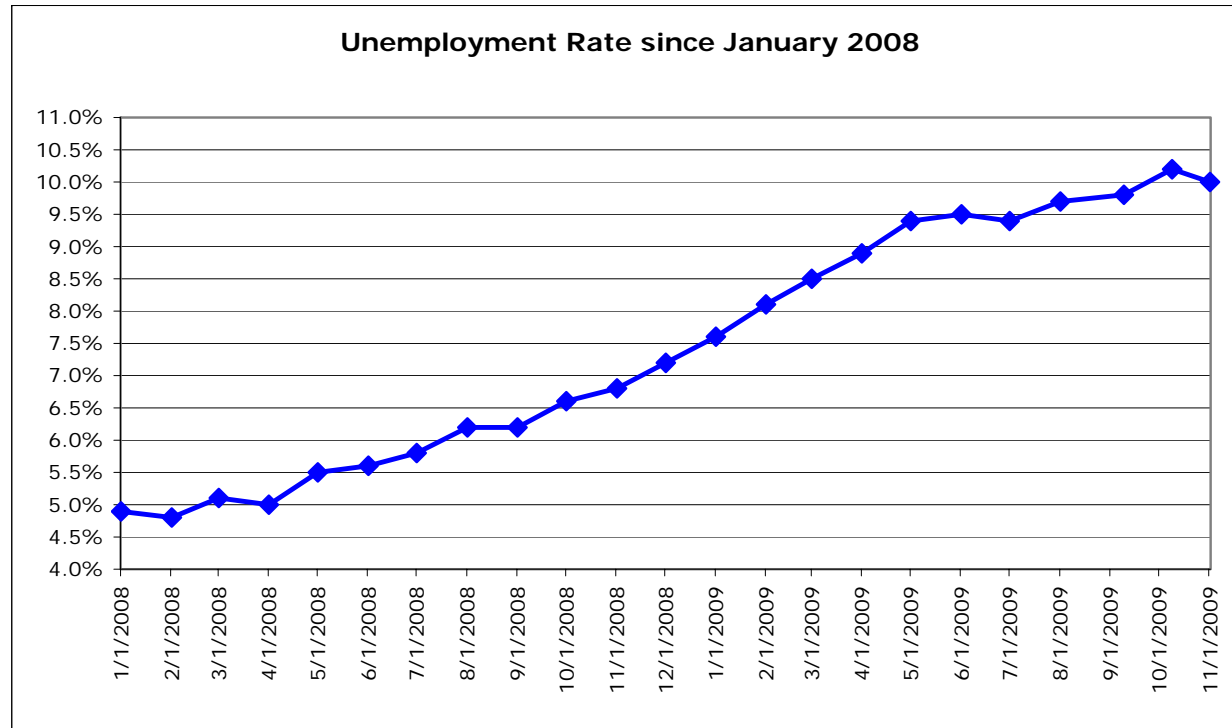


- The red line (right axis) is the cumulative number of jobs lost since January 2008 – a figure approaching 7.5 million. The bars (left axis) are the monthly non-farm payroll figures.

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POLICY FOCUS IN 2010: LOWERING UNEMPLOYMENT



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LET'S DISCUSS THE DOLLAR

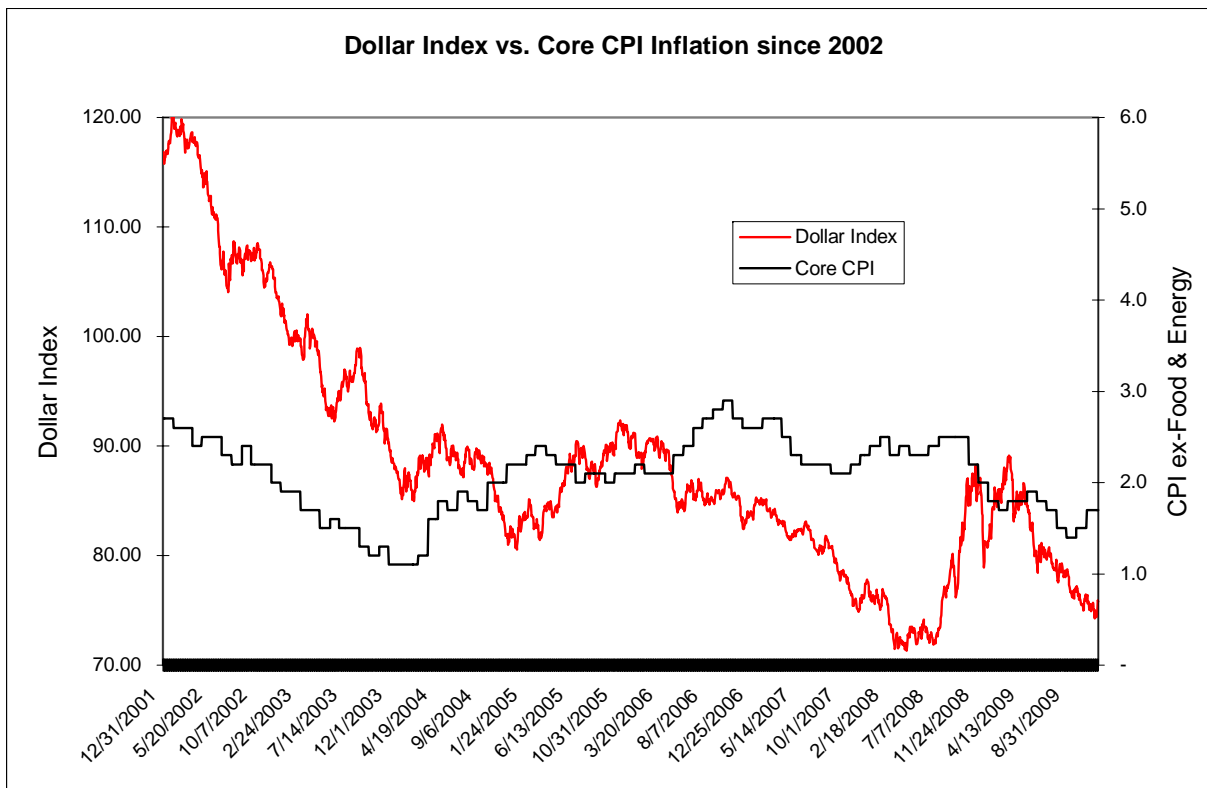
- Expansion of monetary base has contributed to the renewed weakness in the Dollar.
- Weakening Dollar has facilitated growth in US exports.
- Dollar is serving as funding currency for “global carry trade” as speculators invest on leveraged basis in higher return markets.
- Dollar weakness has boosted values of commodities.
- Dollar weakness has **yet** to generate consumer inflation.
- Dollar weakness is contributing to inflation in multiple asset classes.

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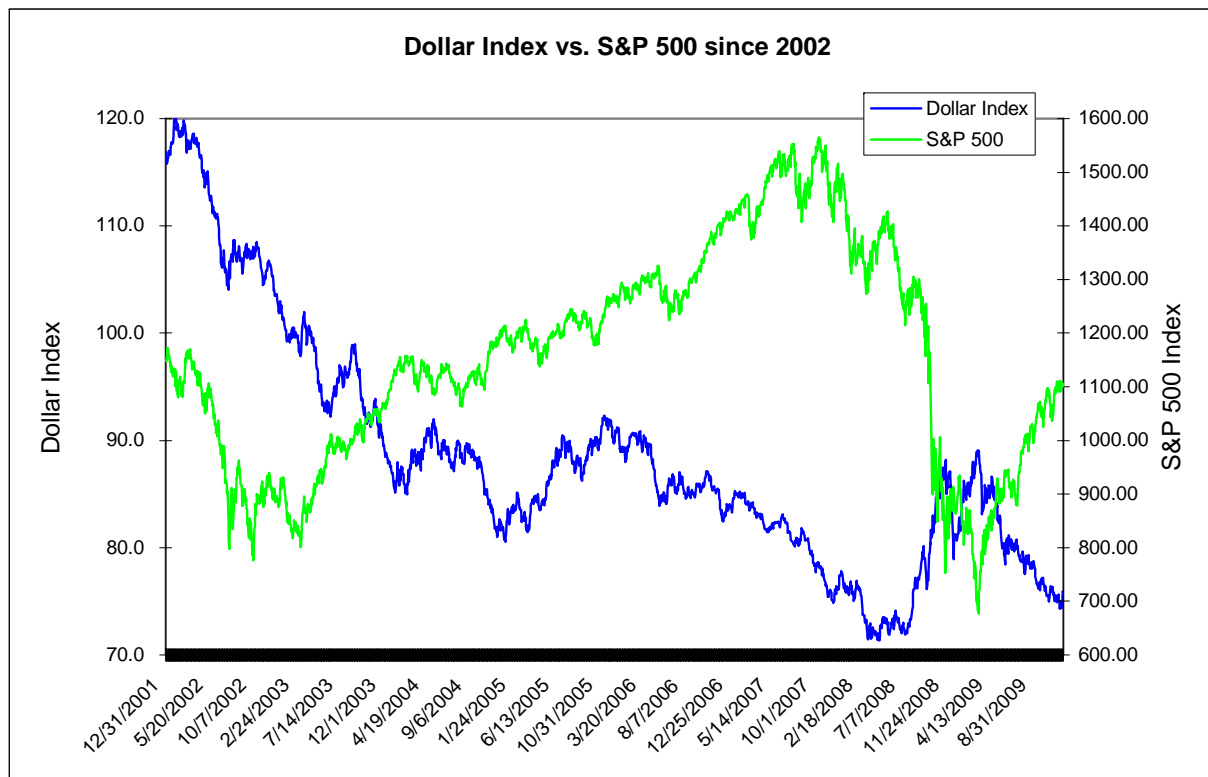
DOLLAR BEAR MARKET SINCE 2002 , YET INFLATION HAS REMAINED STABLE



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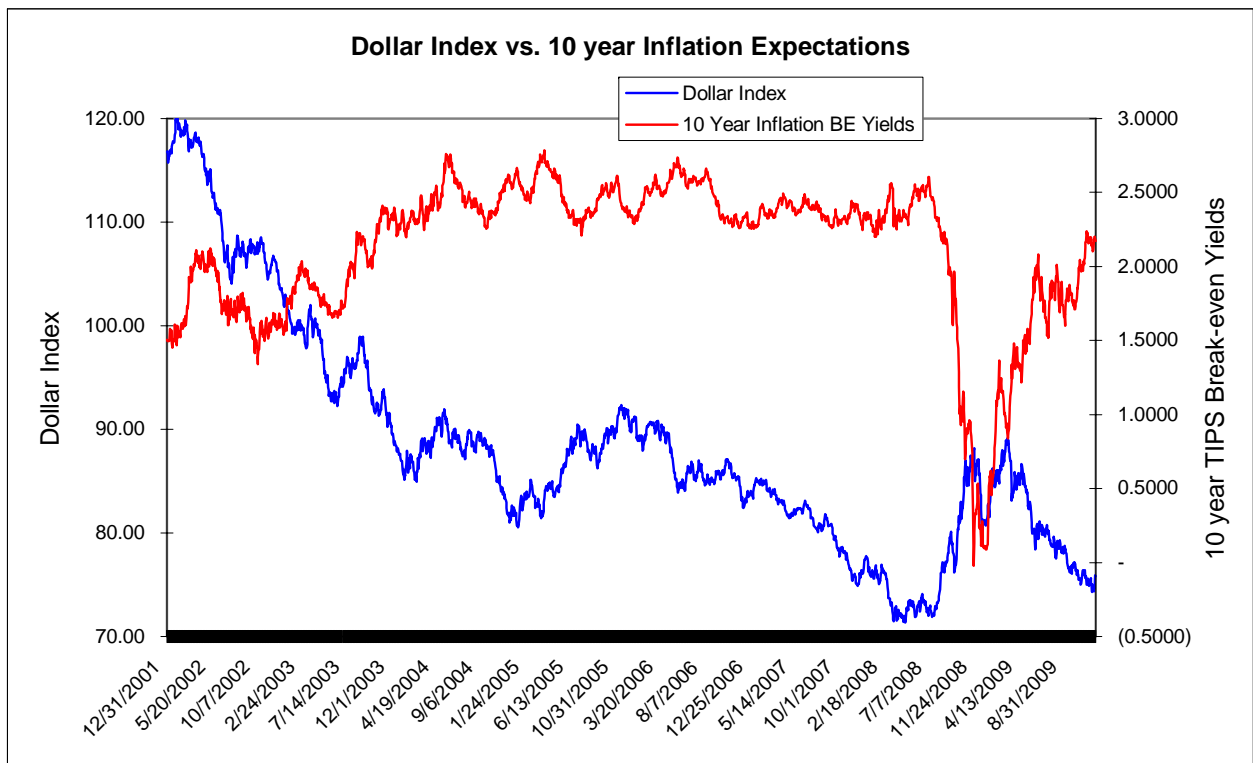
DOLLAR WEAKNESS HAS SUPPORTED EQUITY PRICES



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INFLATION EXPECTATIONS ARE "NORMALIZING"



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WHAT **IF** INFLATION ACCELERATES?

- Inflation damages the value of all financial assets.
- Bonds will suffer in terms of principal value.
- Expect tangible assets – e.g., precious metals; commodities – to perform well.

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HOW TO HEDGE INFLATION RISK

- Treasury Inflation Protected Securities (TIPs).
- Gold, precious metals, and other commodities.
- Non-Dollar markets such as international equities and bonds.
- Shorten duration of bond portfolios.
- Re-allocate away from interest sensitive equity sectors (e.g., financial services) and toward defensive sectors with pricing power (e.g., health care; utilities; staples).

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GENERAL RECOMMENDATIONS

- Invest in large, high quality companies that pay attractive dividends.
- Buy/hold high grade corporate bonds.
- Buy/hold high grade tax-free municipal bonds, especially if tax rates rise, as expected.
- Invest globally: high quality multi-nationals (both US and foreign based); faster growing, natural resources-based economies (e.g., Brazil; Canada; Australia; China).
- Hedge inflation risk with TIPS and weak Dollar risk with Gold.

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OUTLOOK

- Risk/liquidity rally will likely continue into 2010. When does it end/reverse? When the central banks begin to aggressively remove excess liquidity.
- Stock market performance should continue to outpace economic recovery.
- Markets are vulnerable to a) reversal in Fed policy; b) unwinding of fiscal/monetary programs; c) valuation concerns; d) sudden increase in risk aversion resulting from credit “scares”; e) regulatory reform and pending legislation.
- Both inflation and interest rates should remain low in 2010.

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LONG TERM INVESTMENT THEMES

Financials: selective inclusion of certain franchises with solid balance sheets and sustainable business models. We feel it is important to maintain limited exposure to this sector, but we do not advocate complete avoidance. Mohamed El-Erian of PIMCO believes that bank business models, in a world with substantially less leverage, will resemble those of utilities – i.e., negligible growth potential; low valuation; restrictive capital structures; attractive dividend yields. Fundamentally, the sector is unlikely to experience demonstrable improvement absent massive consolidation.

Energy: the collapse in crude prices could discourage exploration and production, as it did in 1998. Long term, this dynamic renders the sector attractive as supply shortages will facilitate prices to rise over time.

Agriculture: We favor investment opportunities along the entire “food chain”: hybrid seeds; fertilizer; equipment; processing; storage. Driven by commodities prices, this sector is also prone to occasional price spikes that render valuations unjustified.

Water: perhaps the most important environmental and economic issue facing the world. We believe investment in all aspects of water development -- irrigation; sanitation; delivery; purification – are vital.

Alternative Energy: until a particular type of energy source becomes prevalent, we favor a “basket” approach using diversified ETFs. However, we feel that this sector, too, represents an important long term investment allocation.

Global Infrastructure: much hinges on the continued rapid expansion and build out of emerging Asia, particularly China and India. We believe many US companies are well positioned to provide the resources necessary for the Eastern hemisphere to improve its standard of living.

Tax-Free Municipals: given US fiscal pressures, we anticipate higher tax rates in the future. High quality tax-free municipal bonds could provide a stable source of income with attractive nominal, as well as taxable equivalent, yields.

International: no economy will be immune from a global slowdown, but we feel certain countries are better positioned long-term than others. Brazil, in particular, has the potential to become both an agricultural and an energy superpower.

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