



Economic Recovery: Flying Into A Headwind

Roughly one year ago, the global financial system and capital markets were in significant disarray as a result of the bursting of the housing price bubble in the United States. Massive liquidity injections by our Federal Reserve Bank averted a depression and stabilized the financial markets, but the ensuing recovery is less robust than one might have hoped and still characterized by 10% unemployment. Although the stock and non-Treasury bond markets recovered after making lows in March 2009 (table below), important unresolved questions remain about the future course of the U.S. economy.

STOCK AND BOND MARKET RESULTS TAILWIND REPLACED BY A HEADWIND?

	First 9 Months	4th Quarter	Year 2009
S& P 500 Stock Index	19.3%	6.0%	26.5%
Salomon Medium-Term Treasury Bond Index	-0.9%	-0.6%	-1.5%
Merrill Lynch 5 to 10 Year AA-AAA Corp. Bond Index	21.1%	1.8%	23.3%
Merrill Lynch 3 to 7 Year State Muni G. O. Index	6.6%	0.2%	6.8%

One reason the economic rebound has been somewhat anemic to date is that it is taking place within the context of continued consumer debt reduction. When consumers were continually monetizing home price appreciation through low cost refinancing and spending the net cash “take out”, the economy had a growth tailwind of roughly 1%. That game has clearly ended, and consumers are struggling to reduce debt balances and debt service costs to manageable levels. We believe this behavioral change coupled with a difficult job environment has put a damper on growth.

The typical signs of recession transitioning to recovery such as a turnaround in indus-

trial production, renewed inventory building, and a decline in the rate of job losses have all evidenced themselves as expected. The distinctive characteristic of this economic cycle, however, is that it was precipitated by excessive mortgage debt accumulation on the back of a price bubble, and it will take time for that over-indulgence to be corrected. The recovery to date also has been reliant on a much larger than normal amount of government stimulus, which cannot be sustained indefinitely.

As a result, we are not looking for the typical “big rebound quarter” in real GDP growth that normally follows a severe contraction, and we are forecasting a below trend up-cycle this time around. Our belief is that after 3 or 4 quarters of 2 - 4% growth, the economy will settle into a period of 1% - 2% growth, below the 3% long-term historic trend.

STOCK MARKET STRATEGY FOR 2010

Another unique characteristic of this recession, which officially began in December of 2007, is how well corporate America managed to maintain profitability in the face of sharply declining revenues. When orders and sales started to decline in 2007-2008, companies responded quickly by cutting capacity and laying off workers. Outside of the financial sector, aggregated profit margins and returns on capital have remained above long term averages despite the shrinking economy. Corporate America actually made large gains in productivity in the second half of 2009, a remarkable achievement in the midst of a recession.

This is one factor that encouraged us to hold, and in some cases add to, equity positions when the news environment was most bleak last spring. Even cyclical companies exposed to global construction and mining cycles were committed to making positive earnings at the bottom of the cycle. Our strategy was to limit our exposure to leveraged balance sheets, but to buy manufacturing companies where we had confidence in the management teams.

Our strategy for equity holdings has now changed at the margin. In summary, we are much more sensitive to the recent corporate performance and the outlook for revenues because our 2010-2012 economic forecast is modest and earnings generated primarily through cost cutting are not generally highly valued. We are paying more attention to companies that either have maintained above average sales growth through this difficult period or have been able to surround their “products” with related “services” that enhance their basic growth rate going forward.

INFLATION FORECAST CRUCIAL FOR BOND MARKET OUTLOOK

The most recent inflation data reported by the Labor Department shows consumer prices up 1.8% versus one year ago. The so-called “core” consumer price index that excludes food and energy prices is up 1.7% over the same period. We believe the reason that inflation pressures are so well contained in the face of unprecedented monetary expansion is that there is significant unused capacity coupled with the highest unemployment rate in 26 years. Cost push inflation is just not on the horizon.

The most recently released Federal Reserve Board minutes stated: “A few members noted that resource slack was expected to diminish only slowly” and observed that it “might become desirable at some point in the future to provide more policy stimulus by expanding the planned scale of the Committee’s large-scale asset purchases and continuing them beyond the first quarter, especially if the outlook for economic growth were to weaken or if mortgage market functioning were to deteriorate.” (Emphasis added.)

We are keenly aware that monetary ease will have to be withdrawn at some point, and we follow each speech on this topic by Chairman Ben Bernanke with great interest. Our assessment at present, however, is that the current United States situation has more parallels with the Japanese experience over the last 20 years than it does with a Latin American style inflation cycle. Ten year government bond rates in Japan are 1.3% today after years of quantitative easing and negligible short-term rates. A key data series to monitor is the volume of lending by banks; if the Fed prints money but the banks do not lend it out, then the inflationary impulse is limited. Inflection points in bank lending, employment and capacity utilization will be key to our bond strategy going forward.

ETM’S, TIPS AND BABS -- PIECES OF THE BOND MARKET PUZZLE

Accordingly, we are willing to take maturity risk in municipal and taxable bond portfolios, but we have a distinct preference for high quality / low credit risk. In the municipal bond market, we have added to our escrowed (ETM) and pre-refunded U.S. Government backed bond positions in addition to tax-exempt bonds backed by “basic services” like water-sewer, highway and electric revenue bonds. We have generally avoided bonds backed by port facilities, airports, convention centers and the like which tend to be more economically sensitive. We think it is almost inevitable that individual income tax rates will be raised once the economy is on firmer ground, and municipal bonds should respond positively when that happens.

Taxable bond portfolios generally sold straight U.S. Treasury holdings when risk aversion drove yields to very low absolute levels in early 2009. We have, however, maintained a position in TIPS as a hedge against inflation if our forecast proves to be too optimistic. During early 2009, we replaced Treasury and callable Agency holdings with high-grade corporate bonds in the ten year maturity range and many of these issues have appreciated nicely as demand for corporate bonds has improved.

We have also found good relative value in “Build America Bonds” (BABS). These are taxable bonds issued by tax-exempt entities like local governments where the interest payments are subsidized 25% to 35% by the Federal Government. These bonds have favorable credit characteristics, in our opinion, and have become a part of our taxable bond strategy.

ADDITIONAL THOUGHTS

The Securities and Exchange Commission requires that we annually offer to send you an updated copy of our form ADV, like the one that was given to you before the incep-

tion of our business relationship. If you would like one, please send us a written note to that effect because the SEC requires two-way documentation of all requests.

Despite being pleased with the progress our managed portfolios made in 2009, we recognize that there is still work to do and a difficult environment ahead. We take the responsibility of managing your money seriously and we appreciate your confidence in our judgment and methodology.



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