

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David. D. Burrows

Volume 35

April 2008

We did enjoy a recent article in *Fortune* Magazine. It described our present economic and financial woes as resulting from the collapse of a “Tinker Bell” financial market – one that depended heavily on borrowed money that now has vanished like pixie dust. “Since the Tink market began tanking, so many shoes have dropped that it looks like Imelda Marcos’s closet,” the article proclaimed.

Amusing? Yes. Entirely accurate? No. In fact, the article reflects part of the immediate problem. By sensationalizing the current economic story, the media is creating a scenario that has the potential to become self-fulfilling. The psychology of fear feeds the cycle of negative events.

At Hudson Advisors, we are served well by our core philosophy and style. We always keep a balanced view. Remember us? We did not jump into the “tech bubble” of the last decade. We did not panic when that bubble collapsed. In the recent years of market growth, we managed client portfolios with moderate risk appetite and emphasis on capital preservation.

At the moment, we do not accept the view of those who prophesize financial apocalypse. Serious problems exist in the housing and financial sectors. But the economy also has areas of strength. Despite its first quarter decline, the stock market actually has signs of resilience. The remainder of 2008 will not be easy. But we are not panicked. We will manage – as we always do – with a prudent mix of optimism and caution.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first quarter of 2008. There was bad news pretty much across the board. The major equity indices took their worst pounding since the 2000-2002 bear market. This time, however, the decline came sharply and more rapidly. Meanwhile, most sectors of the bond market suffered the impact of the multiple economic and credit worries.

Equity Markets: Stock investors were clearly unnerved – or “freaked” in the words of one TV commentator – by the shocks to the financial system and prospect of economic recession. The Dow Jones Industrial Average finished the quarter down 7.6% from where it began the year – its worst quarterly performance in 5½ years. The S&P 500 index was hit even harder by its exposure to financial stocks – declining 9.9% – its worst quarter since 1990. The Russell 2000 index of small stocks, always sensitive

to signs of recession, was down 10.2%. The best stock performer of the 2007 year, the technology sector, gave up much of last year’s gain. The NASDAQ composite index was 14.1% negative for the quarter. Despite the overall quarter losses, the major indices did show some recovery in late March following aggressive interest rate actions by the Federal Reserve. In the first weeks of April, however, declines have continued over worries about corporate profit reports and skyrocketing oil prices.

Fixed Income Markets: Concerns over credit quality and economic slowdown hit hard at the value of fixed income assets. Corporate debt and mortgage-backed securities both showed sharp price declines. Even tax-exempt municipal bonds – usually considered a safe credit – were caught up in the turmoil and suffered losses in price. The problem for municipals was an outgrowth of the problems of the bond insurers and the collapse of the auction-rate securities market. Only Treasury securities, still considered a haven of safety, escaped the chaos. The yield on the benchmark 10-year Treasury note, which moves opposite prices, was 3.49% on April 10 – down from 4.0% at the start of the year.

THE OUTLOOK

The Economy: Much debate exists at present as to whether the economy is already in recession – or headed for recession. There are many negative economic signals. Jobs declined by 80,000 in March – the worst in five years – and unemployment is climbing slowly. The jobless rate is expected to reach 5.5% by later in the year. Consumer spending, which accounts for two-thirds of economic activity, is expected to rise at only an annualized rate of .5% in the first six months of this year – its slowest growth rate since 1991. Besides job losses, consumers are obviously hampered by high oil prices, declining home values, and credit restrictions.

At Hudson Advisors, we expect economic growth to be virtually flat during the first six months of the year. But, when the official numbers are released, we

MAJOR MARKET INDEXES

	Quarter 1 Return
Dow Jones Industrials	-7.00%
S&P 500 Index	-9.44%
Russell 2000 Index	-9.90%
NASDAQ Index	-14.07%
LB Intermediate Govt/Credit	3.00%

believe the economy will avoid recession as technically defined – two consecutive quarters of decline in Gross Domestic Product. Should the economy, in fact, slip into recession, we expect that downturn to be relatively mild and short-lived. We should see signs of positive revival in the second half of the year.

While hardly “optimistic”, this more benign view of our U.S. economic outlook is attributable to several key conclusions:

-- The Federal Reserve has demonstrated that it will do what it takes to provide economic stimulus with lower interest rates. We expect the Fed funds rate to go as low as 1% if necessary. Moreover, the Fed demonstrated in the Bear Stearns crisis that it will take unprecedented steps to maintain confidence in the financial system.

-- American households will soon start receiving tax rebate checks from the fiscal package enacted by the Administration and Congress. These rebates should give a modest boost to consumer confidence.

-- The credit crunch and the housing slump will take some time to work though the myriad issues and arrive at a new state of equilibrium. However, we note that the “crisis” of recent weeks has been a problem of liquidity in the financial system – which the Federal Reserve seems ready to address. Our problems are not primarily an issue of capital quality. Corporate balance sheets remain healthy.

The Market: Given the economic viewpoint expressed above, our prognosis for the equity markets is tempered rather than dire. Actually, considering the shocks to the financial system in recent weeks, equity prices have shown some resilience. Outside the financial sector, many stocks have held value quite well.

We are willing to say that equity prices will not fall much further from their current levels. We find confidence in two facts. First, unlike the “tech bubble” of 2000, most stocks are reasonably priced at present. Second, despite the liquidity problems facing some financial institutions, there are still healthy levels of capital seeking investment opportunity.

The stock market will be uncertain and volatile in the months ahead. Barring some new calamity, however – such as unexpected geo-political event--we think the market will remain at its current levels for most of the year. By the fourth quarter, we even see the chance for some recovery in the major indices – although we are not sure that by December 31 they can recover all the ground lost in the first quarter.

As explained in January, we changed the recommended asset allocation for most client portfolios – increasing by 5% to 10% the cash portion

OUR STRATEGIES

and decreasing the equity component accordingly. Again, we are not panicked by market conditions, but our posture is heavily defensive.

Also, we are concerned about the prospect of changes to federal tax policies on the treatment of capital gains – especially if the Democrats take the White House. Thus, where appropriate, we encourage clients to take capital gains now.

Recommended Stocks: We remain focused on large cap companies that are diversified both internationally and in terms of product lines. We also retain our preference for companies with attractive dividend policies. Among the sectors getting our current attention as having the best potential are:

HEALTH CARE: We continue to like companies that serve the needs of aging populations, such as operators of respite care facilities and makers of medical devices. Biotechnology companies also look interesting again.

ENERGY: Oil companies and refining companies have profit benefit from the supply/demand imbalance in the energy sector.

INDUSTRIALS/TECHNOLOGY: We see value in technology companies and certain industrials that are serving the fast-growing emerging markets.

CONSUMER STAPLES: Companies which meet basic household needs should sustain profit growth even if consumer spending declines for more discretionary items.

FINANCIALS: Despite the broader problems in this sector, some companies remain good investments, including HSBC, JPMorgan, M&T Bank, and Berkshire Hathaway.

Fixed Income Investments: Our cautionary view of fixed income securities as a long-term investment remains unchanged. We are putting the non-equity portion of client portfolios into cash and avoiding longer-term Treasury and corporate bonds. Where client need does justify longer-term bonds, we prefer municipal instruments – which at the current time have unprecedented high rates. Even if clients do not have need for tax-exempt income, municipal rates are now higher than Treasury rates – creating an unusual investment opportunity for the majority of clients.

William Hudson, Jr. & Jeremy Hudson

237 Main Street, Suite 600 • Buffalo, New York 14203 • (866) 3HUDSON

10 Rockefeller Plaza, Suite 604 • New York, New York 10020 • (212) 765-1880