HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows Volume 39 April 2009

We are certainly pleased to see the strong upswing in the equity markets during recent weeks. Like everyone, however, we are uncertain how to interpret the trend. Are we seeing the start of a sustained market recovery? Or is it a so-called "sucker's rally" – a false gain before the market turns down again?

Not surprising, professional opinion is divided. On April 9, we saw a news report that Morgan Stanley had cut its rating on equities from "neutral" to "underweight" – meaning their advice to clients was to sell stock. Despite some positive murmurings about the economy and the rise in stock prices, the bear market is far from over in the Morgan Stanley view. The market will sink to new lows in the months ahead.

On the same day, the research firm, Boston Consulting Group, released a survey of 400 professional money managers. The clear majority saw a positive opportunity for astute stock picking in the current market. Their concern was failure to be aggressive enough to exploit these opportunities.

At Hudson Advisors, our ingrained viewpoint is one of "cautious optimism." Longtime readers of this newsletter will recognize that phrase. But those words need some redefinition in the current environment. Being "optimistic" is relative. We believe that both the economy and financial markets may be at or close to their low points. Unlike past cycles, however, we do not anticipate a quick or normal recovery. We have suffered deep and long-lasting damage. Conditions will start to get better – but that improvement will be slow and frustrating.

Thus, at Hudson Advisors, we remain in a high alert, defensive mode. For client portfolios, our asset allocation model is conservative by the historic standards of this firm. Our first priority is to safeguard our client monies. At the same time, we agree with the viewpoint expressed by the majority of investment managers in the poll cited above. Moving forward, there will be positive opportunities to invest in selected sectors and companies despite permanent changes in the economic landscape.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first quarter of 2009. Overall, the equity markets were a paradox. It was the worst first quarter in percentage terms since 1939 – and the sixth consecutive quarter of decline. Meanwhile, March constituted one of the best months in 50 years. At the same time, the bond market – usually the beneficiary of a negative equity market – was also troubled and uncertain.

Equity Markets: The first 10 weeks of the quarter were brutal. The onslaught of bad economic news kept coming. The Obama Administration seemed to lack a clear strategy to repair the crippled financial sector. The major indexes moved steadily downward. The benchmark S&P 500 index fell from over 900 at the start of the quarter to below 700 in early March. Then, mercifully, hope resurfaced. Certain economic indicators showed what commentators called "glimmers" of hope. The Federal Reserve and Treasury finally articulated a detailed plan to address the problem of troubled assets. The S&P 500 climbed back to 798 by the end of the March – even though it was still down 11.7% for the quarter. The pattern in the other indexes was similar: steep declines, followed by a partial recovery in March. The Dow Jones 30 was down 13.3% for the quarter. The Russell 2000 index of small cap stocks was down 15.4%. The best performer was the Nasdaq Composite – down only 3.1% for the quarter—reflecting the relatively stronger balance sheets of technology companies.

Fixed Income Markets: The bond markets offered little refuge. The multiple concerns over credit quality and economic slowdown hit hard at the value of many fixed income assets. The market for low-rated corporate debt and securitized debt is virtually non-existent. Municipal bonds – usually considered a safe credit –were caught up in the uncertain ability of the bond insurers to meet their credit obligations, and the deteriorating financial outlook of state and local governments. Even Treasury securities no longer offered much comfort. The yield on the benchmark 10-year Treasury note, which moves opposite prices, was 2.7% at quarter-end versus 2.3% three months earlier. Concern is growing about the long-term impact of the Government's massive issuance of debt and the future consequences for inflation. The only bright spot was companies with high credit ratings – who had a busy quarter selling over $200 billion of debt.

MAJOR MARKET INDEXES

	1 Q Total Return*	
Dow Jones Industrials	-12.48	
S&P 500 Index	-11.01	
Russell 2000 Index	-14.95	
NASDAQ Index	-3.07	
Barcap Int Govt/Credit	-0.05	

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: We anticipate the economy to remain in recession for most of 2009. Unemployment is likely to grow higher in the months ahead. Nonetheless, we accept the conventional view that the massive federal stimulus will start to exert some positive effect. The actions of the Federal Reserve have also helped to calm the credit markets. Some of the data on economic activity has begun to stabilize: notably retail sales, consumer sentiment, and housing. While certainly not robust, these indicators are not spiraling downward as they were in the past six months. We think it possible to see some modest growth in the last quarter of this year – certainly in the first quarter of 2010.

But our expectations for the economy in the next several years are restrained. We are not going to rebound to anything resembling "normal" growth as seen in the past two decades. The damage to the infrastructure of the economy is long lasting. It will take years to work through the problem of troubled assets at our major financial institutions. Employment levels will remain weak as companies seek to grow through enhanced productivity. The housing market will even out – but then remain at its adjusted price levels. Reduced access to credit, lower home equity, and concern about lost employment all will keep consumer spending subdued.

Most concerning to us are the limitations to capacity for government stimulus. We cannot borrow indefinitely to achieve prosperity. At some point, the federal deficit must be addressed. The consequence will be higher taxes – not just for the rich – but for the middle class as well. As a practical matter, the Obama tax cut for the middle class cannot be permanent.

The Market: Given this economic outlook, our forecast for the equity markets is obviously cautious. We do think the market is now in the process of testing its low point – or "bottoming out" as the professionals call it. It is quite likely for the market to give up some of its recent gains. By the summer, however, we think stability will be established. We also accept the conventional opinion that the market anticipates economic recovery six months in advance. Thus, we expect ongoing recovery in the second half of the year.

As with the economy, however, that recovery will be slow and painstaking. The major drag on the market will be anemic corporate earnings. Yes, price/earnings ratios are historically low right now – but the normal views of valuation are altered in this environment. With the economy indefinitely muted, corporate earning power is extremely weak.

OUR STRATEGIES

Because of the economic and market outlook just expressed, our current investment strategies are tactical and designed to safeguard client assets in the period ahead.

Asset Allocation: For clients investing new money, our asset allocation remains conservative by our usual standard. As explained last quarter, we recommend 50% allocation to equities, 40% to fixed income/cash, and 10% to alternative investments.

Preferred Equities: Interestingly, as conveyed by the majority viewpoint in the Boston Consulting Group survey, it is possible to find attractive long-term stocks in this market. This is the time for narrow stock picking. We are looking to invest in undervalued companies with strong balance sheets, sustainable cash flows, and credible strategies to take advantage of competitor weaknesses during the downturn. Our sector preferences remain similar to last quarter.

INDUSTRIALS/TECHNOLOGY: The Federal stimulus package will emphasize infrastructure investment – which should create opportunity for certain technology and industrial companies – such as those that enhance productivity and power management.

ENERGY: Despite recent price declines, the long-term imbalance between supply and demand creates profit benefit in production and exploration companies. Natural gas is also attractive.

MATERIALS: This sector is well priced, and also will benefit from the Federal stimulus package.

CONSUMER: Consumer stocks often take the lead when the market recovers. They will be assisted by Federal tax cuts and lower energy prices.

Covered Call Writing: As explained previously, we actively engage in writing covered calls in portfolios. This strategy allows an investor to enhance return on a stock position in a flat to falling market.

Fixed Income: For clients wanting fixed income investments, our preference now is for high quality corporate bonds in the 2-to-5 year range. We are nervous about longer maturities because of the strong possibility of future inflation. That concern also makes us cautious about Treasury securities and we are currently avoiding municipals because tax equivalent yields are below that of high quality corporates.

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