

# HUDSON ADVISOR SERVICES, INC

## OUR VIEW OF THE MARKETS

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

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We were interested in a recent opinion column in *The Wall Street Journal* by Charles Schwab: "Low Interest Rates Are Squeezing Seniors." His article demonstrates a major quandary in the current financial period. The hangover from the equity market crash of 2008 remains strong. Most individual investors are still shunning the stock market. The result is an unprecedented \$7 trillion sitting in cash investments. But, there is a big problem. With interest rates so low, the earnings on this stockpile of cash are somewhere between pathetic to paltry.

The search for other avenues to investment return explains the recent boom in the fixed income market. While investments in stock mutual funds have been anemic, money has poured into bond mutual funds. The hunger for yield drove demand for corporate, U.S. Government, and municipal tax-exempt bonds in the last quarter.

At Hudson Advisors, we are astutely avoiding this bull market in bonds. As former bond traders, we are too familiar with the concept of "duration" – meaning simply that the more long term the bond, the greater the risk associated with increases in interest rates. So, let's use some common sense. Interest rates are at a historic low point. The only path from here is for rates to increase in the years ahead. All those current buyers of bonds are looking at a big hit to their portfolio values.

As described in recent newsletters, our focus now is the equity markets. The rationale is pretty straightforward. It is a matter of alternatives. Cash investments earn next to nothing and bonds are too volatile. In contrast, the risk of equity investing is largely behind us and the opportunities for reward are good as we go forward. We are counseling our clients to be patient. Stock investing is still fraught with pitfalls. Seeing results can take time but we are confident of our capability to pick stocks that serve the best long-term interests of our clients.

### MARKET TRENDS

The accompanying table summarizes stock and bond market results for the first quarter of 2010. The bond market was clearly positive in the quarter. Meanwhile the stock market demonstrated that its advance can still be halting and somewhat uncertain.

**Equity Markets:** Stocks began the year well as the rally of 2009 showed promise of continuing. By mid-January, however, troubles appeared. The market turned nervous over a combination of events: uncertain economic policy in China, the Greek debt crisis, and political gridlock in the

U.S. By mid-February, the Dow Jones Industrial Average had fallen below 10,000 – and was down over 5% for the year. However, those concerns soon abated, and the mood of the market rapidly improved. The Dow rose steadily for the rest of the quarter and ended with a gain of 4.8%-- the best first quarter performance since 1999. The renewed rally seemed to be spurred largely by the growing view that economic recovery in the U.S. and globally would be sustainable and ongoing.

Other market indexes were even more positive. The S&P 500 index was up 5.4% for quarter. The Nasdaq Composite index improved 5.7%, reflecting the ongoing interest in the technology sector. The best performer for the quarter was the Russell 2000 index of small company stocks with a gain of 8.8%.

**Fixed Income Markets:** The bond markets in the first quarter clearly benefited as investors seemed eager to put cash to work. Concern over the inevitability of higher interest rates was strangely muted. Corporations rushed to sell both investment grade and high-yield bonds – and there was enough investor appetite to absorb it. Both investment grade and high-yield corporates also performed well in secondary market trading.

Meanwhile, the market for U.S. government bonds remained strong despite high levels of debt issuance. The Treasury sold over \$600 billion of debt in the first quarter – versus \$450 billion in the preceding quarter. Nonetheless, pricing remained virtually unchanged. The 10-year Treasury yield stood at 3.837% at the end of the quarter versus 3.834% at the end of 2009.

### THE OUTLOOK

**The Economy:** The stock market rebound in February and March clearly was tied to the economic outlook. There are obvious signs of a broadening to the recovery and talk of a "double dip" recession has pretty much disappeared. The consensus forecast is that U.S. GDP will grow by more than 4% in 2010.

### MAJOR MARKET INDEXES

	1 Q Total Return*
Dow Jones Industrials	4.81%
S&P 500 Index	5.41%
Russell 2000 Index	8.85%
NASDAQ Index	5.68%
Barcap Intermdt. Govt./Credit	0.97%

\*Total Return Includes Reinvested Dividends.

Corporate balance sheets look relatively strong. Fears over major problems in the commercial real estate market have not materialized. Most significant, employment is stabilizing. Employers added over 160,000 jobs in March, an encouraging sign, even though the unemployment rate for the month stayed at 9.7% as new workers entered the job market and people who previously had quit the labor force returned.

Despite the positive signs, we are cognizant that recovery from the Great Recession will be frustratingly slow. By some estimates, it may take the economy a full decade to replace the 8 million jobs lost in the recession. The housing market remains deeply troubled and also will take years to repair itself. Given this outlook on jobs and housing, consumer spending will be restrained compared to recent decades. Most concerning to us at Hudson Advisors is the fiscal prognosis for the Federal government. The cost of the economic stimulus has been enormous and the current Federal deficits are not sustainable. Inevitably, we expect taxes to increase -- thus crowding out consumer and business spending in future years.

**The Market:** Given the mid-term economic view, our forecast for the equity market indexes is to show upward movement for the rest of 2010. We expect the market to hold and build upon the first quarter gains. Corporate earnings reports are positive and support equity valuations. While less spectacular than 2009, we expect the indexes to end 2010 in positive double digit territory.

For 2011 and beyond, we are more cautious. One major reason is the problem of federal deficits. The other big uncertainty is how the economy and markets react once the Federal Reserve starts to adjust monetary policy and raises interest rates. Thus, while strategically bullish on equities, we are also tactically defensive when making long-term stock choices for our clients.

## OUR STRATEGIES

**Asset Allocation:** For clients investing new money, and who have a growth orientation, we recommend 65% allocation to equities. This percentage is our maximum historic allocation, but is the right posture in the current investment terrain. Because of our caution on bonds, most of the remaining 35% would be in cash or short term bonds.

**Preferred Equities:** Our main focus for long-term stocks reflects the underlying investment philosophy of Hudson

Advisors. We are looking to find undervalued, large cap companies with strong balance sheets, sustainable cash flows, and credible business models. As always, we like companies that pay attractive dividends. Our sector preferences include:

**TECHNOLOGY:** Most technology companies have next generation products in development and consumers seem highly willing to keep their personal computer and communications equipment up to date.

**ENERGY:** Despite ongoing political turmoil in the Middle East, the long-term imbalance between supply and demand creates profit benefit in production and exploration companies. This is true of the large, integrated energy companies and the specialized companies such as deep sea drillers.

**MATERIALS:** This sector is well priced and benefits from infrastructure investment in the emerging nations.

**CONSUMER STAPLES:** Companies that provide the necessities of life are good dividend payers in the current market – and will gain value as the economy improves. We especially like international companies such as General Mills that benefit from the growing middle class in emerging countries.

**CONSUMER DISCRETIONARY:** As the economy stabilizes, more affluent consumers will resume purchase of luxury goods.

**FINANCIALS:** We like selected financial companies – such as those with strong investment banking divisions.

Dow Jones U.S. Sectors (Percent Change for One Year)			
Oil & Gas	0.02%	Consumer Services	9.86%
Basic Materials	6.18%	Telecommunications	-4.96%
Industrials	9.83%	Utilities	3.30%
Consumer Goods	6.28%	Financials	10.21%
Health Care	3.87%	Technology	1.67%

**Fixed Income:** Our view on the interest rate risk to bonds prices should be clear. Thus, we are avoiding most fixed income securities and holding the non-equity portion of client portfolios in cash. For clients who want income, we like short term tax-exempt bonds – but avoid the mutual funds and invest in individual municipal issues.

### William Hudson, Jr. & Jeremy Hudson

4445 North Hwy A-1-A, Suite 233 • Vero Beach, Florida 32963 • (866) 8HUDSON  
237 Main Street, Suite 600 • Buffalo, New York 14203 • (866) 3HUDSON

### William Hudson, III

112 Mission Drive • Gaithersburg, MD 20878 • (301) 840-2071

### David Burrows & Elizabeth Kisen

Two Sound View Drive, Suite 100 • Greenwich, CT 06830 • (203) 302-3530

[www.hudsonadvisors.com](http://www.hudsonadvisors.com)