HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows Volume 36 July 2008

Longtime readers of our quarterly commentary know that often we like to find a quote that summarizes our viewpoint. We did see one analyst, cited in the *Wall Street Journal*, describe the current economic and market predicament as follows: "Earlier this year, people did not recognize all the potholes," he said. "Now they do, and everyone is wondering how we get out."

At the moment, we are part of the "everyone" described above. We are not certain how or when the economy and financial markets will straighten themselves out. In recent months, the problems facing us seem broader, more complex and intertwined, and far more unpredictable.

The housing downturn and credit crunch are lingering. The economic slowdown is likely to persist. Meanwhile, oil prices are spiking and worries about inflation must be balanced with concerns about recession. Forecasts of corporate earnings are declining. Traditional fixes from fiscal and monetary policy are muddled.

At Hudson Advisers, our first mission is always to safeguard client assets. Given the multi-layered economic concerns, our defenses are on high alert. There are few asset classes that give investors the promise of positive return in this environment. Thus, we seek to manage the risks and protect our client monies from the swirl of negative forces at work. We do believe the markets will eventually self-correct – but the way forward is unclear right now. In the meantime, we will act in our role as guardians.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the second quarter and first half of 2008. The equity markets were pounded in the first quarter, seemed to rebound in April and early May, but then saw one of worst Junes in stock market history. Meanwhile, the bond market continued to suffer the impact of the multiple economic and credit worries.

Equity Markets: For stock investors, the second quarter was clearly a time of shattered hope. After wide-scale declines in the first quarter, the major indices rebounded in April and early May as the housing and credit problems seemed to be manageable. But investors were clearly unnerved as that perception eroded and the myriad of additional economic problems emerged. The Dow Jones Industrial Average finished the quarter down 6.85% and 13.38% for the year. The S&P 500 index was also hit hard by its exposure to financial stocks – declining 2.73% for the quarter and 11.91% for the year. In the early days of July, these two indexes slumped even further into "bear market" territory – meaning 20% below their previous highpoint.

The Russell 2000 index of small stocks was more resilient. After major decline in the first quarter, the index was ahead .58% for the quarter – but still down 9.37% for the year. Similarly, the technology sector at least held its ground for the quarter. The NASDAQ composite index was .61% positive for the quarter – although 13.55% negative for the year after a devastating first quarter.

Fixed Income Markets: The multiple concerns over credit quality and economic slowdown have hit hard at the value of fixed income assets. Corporate debt and mortgage-backed securities have declined as investors avoid riskier debt. Even tax-exempt municipal bonds – usually considered a safe credit – are caught up in the turmoil over the uncertain ability of the bond insurers to meet their credit obligations. And Treasury securities, while still considered a haven of safety, were affected by the prospects for renewed inflation and the uncertainty of future Federal Reserve policy. The yield on the benchmark 10-year Treasury note, which moves opposite prices, was 3.97% on June 30 – up from 3.4% at the start of the quarter.

THE OUTLOOK

The Economy: Many analysts are talking about the end of the "Goldilocks era" – meaning the recent years when the economy was neither too hot nor too cold, and inflation was subdued. In fact, we now hear much speculation about whether the economy has headed into a renewed period of 1970's style "stagflation", when growth was anemic and inflation was high.

Our long-term view at Hudson Advisors is not that pessimistic. But our mid-term view of the economy in the next 18 months is not cheery. We fall into the camp of people who foresee a "no recession, no recovery" scenario lasting well into 2009. The economy is currently limping along with about a 1% annualized rate of growth. This situation is most likely to persist.

MAJOR MARKET INDEXES

	2nd Q Return	2008 Total Return*
Dow Jones Industrials	-6.85%	-13.38%
S&P 500 Index	-2.73%	-11.91%
Russell 2000 Index	+.58%	- 9.37%
NASDAQ Index	+.61%	-13.55%
LB Intermediate Govt/Credit	-1.09%	+1.79%

*Total Return Includes Reinvested Dividends.

Some positive forces are at work. Thus, we think it quite possible that we will avoid slipping into recession, defined as two consecutive quarters of decline. The Federal Reserve action in the last year to lower interest rates has helped. Also, the Fed's bold moves after the Bear Stearns meltdown eliminated the worst fears of a collapse of the financial system. The Congressional action to provide a tax rebate has given at least some temporary support to the economy.

But, on the dour side, there are many forces working to forestall any quick return to more normal economic growth. Recent reports suggest greater pain in the housing market and the likelihood of further write-offs by financial institutions. The combination of weak housing equity and tight credit seriously restrains consumer spending. The uncertain outlook for employment trends is also making consumers nervous. For the moment, because of the specter of inflation, the Federal Reserve has taken a pause from additional interest rate cuts. Moreover, we are unlikely to see any further fiscal policy stimulus until the Presidential election is resolved.

For us, the other critical variable in this economic cauldron is the price of energy. Rising oil prices are at the center of our current problem. More expensive energy has the potential to create a cascade of rising prices throughout the economy. The negative impact on consumer spending then raises the risk of the economy slipping into recession. In fact, we are watching oil prices as the key determinant of our economic destiny in the next year.

The Market: Given the economic uncertainties, fear will dominate the equity markets in the months ahead. Investors are not likely to demonstrate confidence until signs of the economic direction become clearer. The earnings reports by major companies in the next few weeks also will determine the mood. On balance, we see little chance for the major market indices to recover their lost ground before the end of 2008. More disturbing, if the oil price situation does create more economic havoc, we could see further market declines this year.

OUR STRATEGIES

Consider the practical consequence of the economic and market confusion described above. Investors are left with few attractive options. Thus, at Hudson Advisors, we have adjusted our normal asset allocation strategies to assume a more defensive posture.

Equity Investments: Despite the beating that equities have taken, we do recommend certain sectors which are likely to hold value in the short- term and offer longer-term potential. Our current preferences include:

ENERGY: Exploration and production companies have profit benefit from the supply/demand imbalance in the energy sector. We are also looking at the traditional alternatives of coal and natural gas.

INDUSTRIALS/TECHNOLOGY: We see value in technology companies and certain industrials that are serving the fast-growing emerging markets. We also like the value in companies that offer productivity-enhancing and power management solutions.

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

HEALTH CARE: Despite recent declines in this sector, we still like companies that serve the needs of an aging population, such as respite care facilities and makers of medical devices.

Fixed Income Investments: The market is too volatile for long-term maturities – but we do utilize short to mid-term instruments.

Alternative Investments: We have maintained a 5-10% allocation to structured notes and diversified hedge fund strategies. More recently mutual funds have been developed to provide the absolute return profile available from traditional alternative products. These new funds allow smaller minimum investments and thus enable us to put reasonable amounts of client monies into these vehicles. The attraction of these funds is that they offer what some analysts call a "turtle strategy" – which means they can do well regardless of which direction the market takes. Thus, they fit into our defensive posture.

Call Writing: We actively engage in writing covered calls in portfolios. As explained in past newsletters, this strategy allows an investor to enhance return on a stock position in a flat to falling market. If you own a stock, you can sell someone else the right to buy it at a higher price. If the stock is likely to stay below the agreed selling price, you keep the call premium paid to you without having to actually sell the stock. This collected premium acts like an extra dividend payment on the stock. This strategy will produce "extra yield" of 4-10% -- thus supporting equity returns in volatile markets.

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
4445 North Hwy A-1-A, Suite 233 • Vero Beach, Florida 32963 • (866) 8HUDSON

David Burrows & Elizabeth Kisken
Two Sound View Drive, Suite 100 • Greenwich, CT 06830 • (203) 302-3530