

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

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We believe ourselves to have a fairly good track record as prognosticators in this quarterly commentary. But we did not envision the events of the second quarter. The oil rig explosion in the gulf, the “flash crash” on May 6th, uncertain economic policies in China, the crisis in the Euro zone, and new concerns about the U.S. economic recovery erased the gains in the equity markets and left the major market indexes negative for the year.

The situation is frustrating. We invest money for individual clients based upon a long-term view. Yet, the market now is dominated by large institutions – with their formula-driven strategies – that react with a trading mentality to the events of the day. We watch in dismay on many afternoons when those trading formulas send the market tumbling just before the closing bell. We regard some of this behavior to be as irrational on the negative side as the euphoria of the technology bubble a decade ago.

Despite this frustration, we still believe that equities are important and attractive long-term asset class for our clients. The companies we like are fundamentally sound. Stock prices are extremely well-valued right now. The reward will come eventually. So, we advise our clients to keep calm and hang in there. Meanwhile, we are prepared for some more clobbering in the months immediately ahead.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first half of 2010. Since mid April, stock prices have been hammered. The gains of the first quarter disappeared and all the major equity indexes are now in negative territory for the year. Meanwhile, the bond market is a mixed story. The fascination with both investment grade and high-yield corporate bonds seems finally to have ended. But investors are flocking to the relative safety of U.S. Treasuries.

Equity Markets: The equity rally that showed such promise in March reversed itself with fairly sudden drama in mid April. After climbing to over the 12,500 level, the Dow Jones Industrial Average spent the last 10 weeks of the quarter in a painful rout. The so-called “macro” concerns about economic outlook and government fiscal

Capacity seemed to pound the market daily. The Dow ended the quarter at 9,774 – a drop of over 10% for the three-month period – and was negative 5.0% for the year.

The story was similar for the other major indexes – which all had rallied in the first quarter. The S&P 500 was 6.65% negative for the year on June 30 and the Nasdaq Composite

was 7.05% negative for the year. The most resilient equity sector was small stocks with the Russell 2000 index being down just 1.95% for the year.

Fixed Income Markets: Both the corporate and U.S. Government fixed income markets had enjoyed a strong rally since the end of 2008. Starting in late April – as concern over all those macro issues took hold – U.S. corporations encountered a hard time borrowing. New debt issuance ground to a halt and investors pulled money out of riskier high yield, or so-called “junk” bonds.

As investors turned highly defensive, U.S. Treasuries seemed to be the safest haven. (The propensity to hunker down was also reflected in the increased interest in gold as an investment.) The yield on the 10-year Treasury note, which moves inversely to price, was 2.96% by the end of the quarter versus 3.84% at the start of it. The two-year note yielded .63%, down from 1.03% three months earlier. Demand for Treasuries was high despite the Government’s intention to borrow over \$1.3 trillion in 2010 – including \$300 billion issued in the second quarter.

THE OUTLOOK

The Economy: The markets are sending a clear signal: Investors believe the fragile economic recovery is in trouble, both in the U.S. and globally. The evidence for this concern is certainly widespread. Job growth is anemic. The latest monthly report showed just 83,000 private sector jobs created in June – an improvement over recent months – but not sufficient to make a dent in high levels of unemployment. Consumer confidence is weak and retail sales are sluggish. The housing market is stuck in a slump that shows scant signs of improvement. Credit availability from banks remains tight. To fuel the fears is the specter of a sovereign debt crisis that threatens to overwhelm some national governments.

Having expressed this litany of woes, let us be clear on one point. At Hudson Advisors, we do not believe the U.S. or

MAJOR MARKET INDEXES

	2H Total Return*	
Dow Jones Industrials	-5.00	
S&P 500 Index	-6.65	
Russell 2000 Index	-1.95	
NASDAQ Index	-7.05	
Barcap Intermdt. Govt./Credit	4.56	

*Total Return Includes Reinvested Dividends.

global economies are headed for a “double dip” recession. Such events are historically rare and have been caused by fundamental mistakes of government policy. We do not see that probability in this situation, especially in the U.S. The Federal Reserve will not move prematurely to tighten money. Despite the concern over the deficit, the President and Congress will not make an abrupt switch from fiscal stimulus to fiscal constraint. We also take comfort from the fact that most corporations have quite healthy balance sheets and cash reserves. This burgeoning private sector surplus will help to stabilize the economy.

So, yes, the Government and big corporations have capacity to avoid another round of recession. But can they effectively promote continued growth? The answer to this question is murky and, thus, the financial markets are nervous. There is strong likelihood that we will see a prolonged period in which the economy just drifts along – neither shrinking nor expanding. It seems perhaps we have downshifted into a permanent stall.

The Market: Given this economic view, we honestly do not know what will happen to equities for the remainder of 2010. The market would need some major good news to enjoy a bounce back to positive territory. At the same time, we believe the market overreacted to the recent spat of bad news. Thus, perhaps the worst of the decline is over. The best bet is that the market will trade narrowly at its present level.

More long term, we remain typically optimistic. We are encouraged that the stocks in the S&P 500 are trading at a price/earnings ratio of about 13.5 times 2010 estimates compared to an historical P/E around 16. From that perspective, this is a good time to buy stocks for clients who can wait to hold them for future year gain.

OUR STRATEGIES

Because of the economic and market outlook just expressed, our current investments strategies are tactical for the period immediately ahead.

Asset Allocation: For clients investing new money, we recommend 55% allocation to equities, 20% to short term bonds, 10% to cash, and 15% to alternative investments.

Preferred Equities: We remain focused on undervalued, large cap companies with strong balance sheets, sustainable cash flows, and credible business models. For the immediate term, companies that pay attractive dividends

are critical to our strategy. Why take the interest risk that accompanies 10-year Treasury notes when you can earn the same 3% return with a generous dividend company like Coca Cola? Our sector preferences include:

TECHNOLOGY: Most technology companies have next generation products in development. Both consumers and corporations seem to recognize the need to keep their computer equipment and communications systems up to date.

HEALTH: The impact of the new health care bill is still being analyzed and understood. However, one clear impact is that access to health care will increase and we are interested in companies with products and services that can meet this new level of demand.

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

Fixed Income: Our clients are certainly familiar with our ingrained caution on long-term bonds. We are not swayed by the recent rush to Treasuries. Eventually, in future years, interest rates will rise and all those buyers will take a large hit to their portfolio values. We may be contrarian to the current market sentiment, but for us good dividend paying companies are a safer haven than the interest rate risk attached to long term bonds. For this period, we are keeping client monies in maturities under two years.

Dow Jones U.S. Sectors (Percent Change for One Year)			
Oil & Gas	-13.53%	Consumer Services	-3.10%
Basic Materials	-10.59%	Telecommunications	-11.60%
Industrials	-3.23%	Utilities	-8.06%
Consumer Goods	-3.84%	Financials	-4.50%
Health Care	-8.81%	Technology	-10.25%

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