HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows June 2011

One of the major global money management firms gave this title to its third quarter investment outlook: "Challenging times for riskier assets." Their definition of riskier assets includes equities.

Well, yes indeed these are challenging times. And yes, equity investing is characterized by considerable risk. But what is the alternative? The other asset classes are decidedly more unattractive. Cash is safe, but offers no return in the current interest rate environment. And as our clients know, we have no attraction to fixed income given the interest rate risk. We think the investor fascination with U.S. Treasuries in recent months is simply foolish.

We were not surprised by the "blah" performance of equities in the past quarter. We predicted in our April commentary that the best months for equities in 2011 had occurred in the first quarter and that the remainder of the year would be difficult. Much of our concern is rooted in the unresolved structural problem of the federal deficit. That concern has been compounded by the sluggishness of the economy and the uncertainties over sovereign debt in Europe.

So, we are left with no choice but to manage our clients' equity portfolios as best possible through these challenges. While the market outlook is frustrating, we have confidence in our strategies. We have long emphasized stable, diversified companies with strong dividend policies.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first half of 2011. Following a strong first quarter, and a positive April, stock prices declined for six straight weeks, making for a mostly negative second quarter and eating into the year-to-date gains. Meanwhile, the fixed income markets did extremely well as investors returned to their bond buying ways. Despite the issues of the federal deficit, and the inherent interest rate risk to long-term maturities, investors flocked to the perceived (in our view mistaken) safety of U.S. Treasuries.

Equity Markets: The equity rally during the first four months of the year reversed itself in early May. After climbing to over the 12,800 level, a three-year high, the Dow Jones Industrial Average spent the next six weeks in a painful rout driven by the macro concerns over the outlook for the economy and the government debt problems in the U.S. and Europe. The Dow fell below 12,000 before recovering in the final two weeks of June to end at 12,414. Overall, the Dow was up 1.42% for the quarter and ahead 8.59% for the year. The story was less bright for the other major indexes – which all had slightly negative numbers for the quarter – eating into their first quarter gains. The S&P 500 was up 0.1% for the quarter and was ahead 6.02% for the year. The Nasdaq Composite was .27% negative for the quarter and ahead 4.55% for the year. The Russell 2000 index was down 1.61% for the quarter and ahead 6.21 % for the year. Foreign stocks significantly lagged with the MSCI EAFA advancing only 4.98%

Fixed Income Markets: As investors shunned the stock market, they returned to bonds with curious enthusiasm. During the month of May, stock mutual funds saw outflows of over $5 billion while nearly $20 billion flowed into taxable bond funds. U.S. Treasuries were the major beneficiary. The yield on the 10-year Treasury note, which moves inversely to price, declined from 3.57% in early April to 3.16% at the end of the quarter. Prices of both corporate high-yield and investment grade bonds also rose moderately. The investor comfort with bonds was assisted by the perception that the Federal Reserve will keep interest rates low for the foreseeable future as long as the economy remains sluggish. This perception exists even though the program of monetary easing known as QE2 officially ended on June 30.

MAJOR MARKET INDEXES

	2QTotal Return*	YTD Total Return
Dow Jones Industrials	1.42	8.59
S&P 500 Index	0.10	6.02
Russell 2000 Index	-1.61	6.21
MSCI EAFA	-0.72	4.98
Barcap Intermdt. Govt./Credit	2.12	2.47

THE OUTLOOK

The Economy: The hesitation in the equity markets stems clearly from signs that the economy is sputtering. The U.S. economy had been expected to grow 2.2% in the first quarter. Instead, when the numbers were reported, growth in the quarter was only 1.8%. Unemployment remains stubbornly above 9% -- and the monthly reports on new job creation are consistently disappointing. Inflation remains officially low, as recorded by the Consumer Price

Index, but those reports do not accurately capture the rise in food and fuel prices. The U.S. consumer is struggling and that creates a significant drag on economic growth. The housing market remains in recession – which also dampens consumer confidence and spending. Moreover, economic slowdowns in Europe and Asia suppress export demand.

As expressed in our April commentary, the Federal deficit is a problem without resolution in sight. Despite some political theater, we do believe the Congress will extend the national debt ceiling. That action will avoid crisis – but the fundamental structural problem will remain unaddressed. As a result, the further capacity of the Federal government to stimulate the economy is limited. Adding to the problem is the fiscal stress of state and local governments which are actively cutting spending and jobs. Part of the problem with the monthly job numbers is that gains in private sector jobs are being offset by loss of public jobs. In short, the economy will continue to limp along – not slipping back into recession – but lacking the vigor to create improvements in the key areas of employment and consumer confidence.

The Market: Despite the litany of economic woes, a bright spot is corporate earnings which as reported for the first quarter grew 18% over the prior year period. Company balance sheets remain healthy and merger and acquisition activity is strong. Like all analysts, we will be watching closely the reports on second quarter earnings. While some news may disappoint, we expect overall earnings to have a positive cast.

Corporate earnings will be the buttressing force for the stock markets. Barring some new catastrophe - like the meltdown of the European debt problem – we expect the market to improve moderately for the remainder of 2011. There will be periods of volatility and rockiness. But we think it quite likely for the major market indexes to close the year with gains in the high single digits.

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 60% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and 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 central to our strategy. 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: We are interested in companies with products and services for the demands of an aging population. .

CONSUMER STAPLES: Companies that provide the necessities of life are good dividend payers in the current market.

UTILITIES: Gas and electric companies are a conservative stock pick that also pay good and regular dividends.

BASIC MATERIALS: This sector benefits from the infrastructure development in the emerging market 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 prefer to keep the non-equity portion of client portfolios in cash. To assist return, we have been putting some monies into instruments which have upside potential linked to performance of the equity markets – albeit with a cap that allows a guarantee of the principal invested.

Dow Jones U.S. Sectors
(Percent Change for One Year, Ending March 31, 2011)

Sector	Change	Sector	Change
Oil & Gas	**11.73%**	**Consumer Services**	**9.71%**
Basic Materials	**3.30%**	**Telecommunications**	**6.29%**
Industrials	**9.26%**	**Utilities**	**8.58%**
Consumer Goods	**7.98%**	**Financials**	**-0.23%**
Health Care	**14.22%**	**Technology**	**2.67%**

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