HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows Volume 42 January 2010

One year ago our commentary was based upon reassurance that the economy was not headed for depression and that our financial system would not collapse. To draw upon a time-tested phase: "Oh what a difference a year makes!" 2009 witnessed an historic surge for the stock market: with the Dow Jones Industrial Average up 61% from its low point in March – a performance not seen since 1933.

Yes, 2009 was a year of zigzagging emotions and events. In our October newsletter, we talked about the theme of "crosscurrents". The basic point was that, despite the pullback from the abyss, and despite soaring stock prices, the view to the horizon is foggy. More simply, as many analysts are saying, we have seen a rebound, but not necessarily a sustainable recovery.

At Hudson Advisors, we are strategically bullish on equities. We are not concerned about any major retreat from the recent market gains. More significant, the alternative assets classes – fixed income or cash – are less attractive because of price risk, in the case of bonds, and paltry returns, in the case of cash. Nonetheless, we are not giddy optimists about the upside potential for equities in 2010. That fog on the horizon is just too thick. The impact of the government's effort to rescue the economy is running its course – and the costs of that rescue effort now must be managed. Can the economy stand and move forward on its own legs? That will be the pivotal question for 2010.

In light of this murky view, we must rely at Hudson Advisors on our traditional care to pick the best possible stocks for our clients. After the excitement of the past two years, our focus is upon the basics that have always served us well: large cap, Blue Chip companies with diversified product and geographic earnings, and established records of attractive dividend payments.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the full year 2009. The stock market suffered in the first quarter with a hangover from all the dire economic and financial events of 2008. After reaching a 12-year low in March, however, the remarkable turnaround began as investors' fear of catastrophe abated and signs of economic recovery emerged. The fixed income markets were also caught up in investor enthusiasm for corporate and mortgage bonds – even though Government bond prices lagged.

Equity Markets: The 2009 performance of the equity markets – especially in the second half of the year – was strong across the board. The Dow Jones Industrial Average was ahead 22.68% for the year. The S&P 500 Index gained 26.46% The Russell 2000 index of small cap stocks was up 27.17%. The best-performing index was the NASDAQ composite – with a 43.89% gain – as the technology sector showed inherent growth potential.

Interestingly, many stocks that had taken the worst hits in 2008 were the same stocks to show the sharpest recovery in 2009. This trend was prevalent in financial, automobile, basic material, and media stocks. For many companies, just the prospect of survival, such as the banks and automakers, aided by the government, caused the stocks to reclaim their value.

Fixed Income Markets: The bond market saw a similar phenomena as traditionally riskier assets drew attention. Investors poured cash into instruments such as "junk" bonds and leveraged loans. Again, with government intervention providing a safety net, the lure of opportunity for high returns drew investors to asset classes that had survived the crisis days of 2008. High-yield and low-rated corporate junk bonds returned 57.5%, according to a Merrill Lynch index. Investment grade corporate bonds returned 20%. Even mortgage-backed securities were positive with a 5.8% return.

Meanwhile, U.S. government bonds fell from favor as issuance surged and fixed income investors looked to other bond classes for profit. The total return index on the benchmark 10-year Treasury bond showed a 9.3% decline for the year.

THE OUTLOOK

Our outlook for the economy, and the impact on the financial markets, can be divided into a mix of positive and negative forces at work. This interplay explains the ongoing theme of "crosscurrents."

Positive Forces: The United States GDP is forecast to be in the 3% growth range for 2010. We see these forces contributing to that growth:

MAJOR MARKET INDEXES

	2009 Total Return*
Dow Jones Industrials	22.68%
S&P 500 Index	26.46%
NASDAQ Index	43.89%
Barcap Intermdt. Govt./Credit	5.24%

*Total Return Includes Reinvested Dividends.

Employment Firming: The worst period of job losses appears to be over. The unemployment rate, although high at 10%, is not likely to increase further. Signs exist that companies are increasing temporary and part-time hiring. The unemployment rate should trend down slowly as the year progresses.

Corporate Earnings: Corporate balance sheets are generally strong and most companies are reporting good earnings for 2009. Much of this strength was achieved with aggressive cost-cutting and, going forward, earnings must be accomplished with increased revenue. We believe this scenario is possible as the economy recovers.

Inventory Levels: Many companies have operated for much of 2009 off existing inventories. For 2010, industry data suggests the need to rebuild inventories, which is an economic stimulus.

Demand from Emerging Economies: We share the general concern about the extent of future demand from the U.S. consumer. However, in the new global economy, demand from the emerging market countries can boost U.S. economic output.

Retail Investors: Most of the market rebound in 2009 was driven by institutions. Small investors are still on the sidelines with enormous cash assets. As the "fear factor" abates, renewing confidence from these investors should assist the market.

Negative Forces: The following issues are likely to create a drag on the economy and market, especially in the second half of 2010.

Federal Deficit: The capacity for additional economic stimulus is limited. By contrast, the large federal deficits are potentially destabilizing and must be addressed – raising the strong potential of higher taxation.

Federal Reserve Policies: The Fed will soon begin to curtail its various programs of support for troubled assets. The reaction of the markets is highly uncertain. Moreover, while no immediate moves are likely, the Fed cannot indefinitely keep interest rates at zero. Some monetary tightening is likely before the end of 2010. Again, the impact is uncertain.

State and Local Governments: These governments, especially the states, are looking at their second year of substantial fiscal distress. The effort to balance budgets is negative for economic demand.

Credit availability: Credit remains tight for both businesses and consumers. Even where borrower demand does exist, loan approval by banks is difficult.

Summary: On balance, given this interplay of positive and negative forces, our 2010 expectations for the market are restrained. We would be pleased to see a 10% growth in the major indexes – although a single digit gain is more likely.

OUR STRATEGIES

Equities: We are looking to invest in undervalued, large cap companies with strong balance sheets, sustainable cash flows, and credible business models. We look for companies that did not participate in the recent rally and whose future market growth is based on fundamentals rather than short-term mispricing. We like multinational companies with diverse revenue streams and international presence. Companies with attractive dividends are highly important – since dividends can account for half of investor return in this market.

Dow Jones U.S. Sectors (Percent Change for One Year)			
Oil & Gas	14.99%	Consumer Services	31.63%
Basic Materials	61.87%	Telecommunications	3.72%
Industrials	22.96%	Utilities	7.62%
Consumer Goods	20.01%	Financials	14.25%
Health Care	19.27%	Technology	62.79%

Fixed Income: We think the recent fascination with risky bond classes was short-sighted and speculative. Some reversal of these price gains is likely. Moreover, the eventual Fed actions to increase rates will have negative impact. Thus, we are giving our clients more exposure to international bond funds with sovereign debt and high grade corporate bonds. These investments are non-dollar denominated – which offers protection against fluctuations in the value of the dollar.

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 Kisken
Two Sound View Drive, Suite 100 • Greenwich, CT 06830 • (203) 302-3530
www.hudsonadvisors.com