HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows   Volume 46   January 2011

We revisited our commentary in this newsletter one year ago. We were strategically bullish on equities and highly cautious on the bond market. How correct was this prognosis?

On equities, we were perhaps too tempered in our viewpoint. We cautiously predicted the potential for a maximum 10% gain in the major indexes. The year obviously ended with better results. We did not foresee the capacity of national governments and central banks to stimulate their economies and boost the financial markets to the extent which occurred in 2010.

On bonds, the fixed income markets also enjoyed a good year as result of fiscal and monetary policies. We sometimes felt challenged to defend our avoidance of long-term bonds investments. Significant to us, however, was the decline of the bond market in the fourth quarter. Many investors seemed to catch on to our concern that bond prices are too vulnerable to the ultimate return of inflation and higher interest rates.

Looking to 2011, our basic viewpoint is vindicated and unchanged. We remain strategically optimistic on equities. The combination of gradual economic recovery and improved corporate earnings will be good for stock prices. We even are willing to say that 2011 may turn out as positively as 2010. On bonds, our aversion to the long-term risk is firm. In contrast to many analysts, we do not foresee recovery from the recent rout in the fixed income markets and think 2011 might bring further decline.

We certainly understand the problem of the structural deficit in the federal budget. Yes, the current level of federal borrowing is unsustainable. There will need to be reconciliation in future years for the U.S. to remain economically sound. For 2011, however, the economy still needs the crutch of fiscal and monetary support. So, for the year ahead anyway, we can be fairly rosy on equities – while cognizant of issues to be resolved down the road.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the full year 2010. The stock market suffered in the first half over various concerns about the economic recovery – but crested strongly in the second half on the back of government interventions. Meanwhile, despite the fourth quarter reverse, the bond market showed positive results for the full year.

Equity Markets: The stock market ended 2010 strongly despite some bumpy periods. The first quarter was positive but the second quarter was a bust as the economy seemed to sputter, Europe encountered its crisis over sovereign debt, and oil spilled into the Gulf of Mexico. Then, however, the Federal Reserve moved aggressively with its policies of quantitative easing. The market recovered strongly and then boomed in December upon renewal of the Bush era tax cuts.

The Dow Jones Industrial Average ended the year 11% ahead and the S&P 500 index ended 13% ahead. Even more impressive was the technology-laden Nasdaq Composite – which gained 17% for the year. But the most interesting result was the Russell 2000 index of small stocks, which surged 25% based upon the expectation of improved credit access for small business. Technology, heavy industrials and consumer discretionary stocks were strong performers. Interestingly, however, many Blue Chip large cap names lagged in 2010 – suggesting their catch-up potential in 2011.

Fixed Income Markets: For most of the year, investors seemed to perceive Treasury bonds as a safe haven. But then in the fourth quarter the concerns about future price vulnerability emerged forcefully and investors pulled money out of bond funds. Treasuries of all maturities lost nearly 3% in total return during the final months of the year, according to Barclays Capital indexes. Nonetheless, they were still ahead over 5% for the full year. Meanwhile, many investors, hungry for return, flocked to speculative high-yield (or junk) corporate debt and emerging market debt in 2010.

MAJOR MARKET INDEXES

	2010 Total Return*
Dow Jones Industrials	14.06
S&P 500 Index	15.06
Russell 2000 Index	26.85
NASDAQ Index	16.91
Barcap Intermdt. Govt./Credit	5.89

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: The economy does remain stubbornly sluggish. Impediments to higher growth rates are powerful and include excessive unemployment, depressed housing prices, and still high levels of consumer debt. Nonetheless, we expect the economy to show gradual improvement in 2011 – with GDP increasing somewhere in excess of 3%

We share the viewpoint for 2011 that some economists describe as: "not too hot, not too cold, but just about right." In this scenario, economic growth is enough to gradually bring down the unemployment rate. Inflation will remain subdued and the Federal Reserve will keep interest rates at their current historically low levels. Emerging markets continue to provide certain types of export demand. Tax rates are stabilized for the period immediately ahead. Corporate profits look set to increase decently again. All in all, it is a moderately attractive story.

The Market: The scenario described above is positive for stocks. Most significant is the widespread consensus among analysts that corporate profits are on the rise. As a result, the S&P 500 index is valued at about 13 times projected 2011 profits – quite low by historic standards. Equity valuations are extremely attractive right now. This assessment is especially true for many large cap stocks which have lagged technology and small cap stocks during the market run-up over the past two years. Moreover, many of these large companies are using their ample profits to boost dividends and to repurchase shares

Moreover, we expect 2011 to see a continuation of the fourth quarter trend in which investors became less enamored of bonds and turn their attention to equities Thus, on balance, we have reasonable confidence in the forecast that equity markets will record gains similar to those posted in 2010. This forecast is especially true for the Dow Jones 30 and the S&P 500 with their large cap names.

OUR STRATEGIES:

Asset Allocation: For clients investing new money, we recommend 60% allocation to equities, with a focus on large-cap global companies with strong balance sheets, sustainable cash flows, and credible business models. As expressed, companies that pay attractive dividends are critical to our strategy. For the reasons stated, we believe these companies will do well in 2011.

Preferred Equities: We remain focused on undervalued,

ENERGY: The basic supply/demand imbalance will drive profits in this sector. ExxonMobil is an example of a company long overdue for increased investor attention.

TECHNOLOGY: As stated in previous quarters, we like technology companies that 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 CARE: The combination of policies that improve access to health care and the demographics of an aging population make this sector attractive.

MATERIALS: This sector is well priced and benefits from infrastructure investment in the emerging nations.
INTERNATIONAL: For most clients, we continue to recommend about a 15% share of their equity investments be in international equities, including emerging market countries.

Fixed Income: We have clearly expressed our cautions on bond investing in this climate. The investment return is weakening and we firmly believe in the risk of rising interest rates to longer-term maturities. Even if the Fed does not move to tighten money in 2011, investors are now grasping the future risk. We would not be surprised to see the yield on the 10-year Treasury, which moves inversely to prices, climb to 5% this year – from its current level at about 3.5%. We are keeping our client fixed income exposure to shorter term bonds and cash.

Dow Jones U.S. Sectors
(Percent Change for One Year, Ending 12-31-2010)

Oil & Gas	**17.46%**	**Consumer Services**	**21.99%**
Basic Materials	**29.45%**	**Telecommunications**	**11.59%**
Industrials	**23.68%**	**Utilities**	**3.27%**
Consumer Goods	**16.23%**	**Financials**	**10.93%**
Health Care	**2.52%**	**Technology**	**11.57%**

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