HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows Volume 41 October 2009

In talking with clients lately, we frequently find ourselves using the term "cross currents." It has become the catch phrase of the moment. The economic and financial news is filled with divergent and sometimes confused trends. The economy is recovering and the financial system has stabilized. BUT, and we put emphasis on that word, the path forward is jagged. This recession was caused and prolonged by structural problems in the economy. Recovery will take time and we are not free of further patches of bad news.

The challenges of operating in an environment filled with cross currents are apparent. In our last newsletter, in July, we said the equity markets would be "range bound" for the remainder of the year – meaning they would churn around and move basically sideways. However like most other market professionals, we were surprised, not unpleasantly, as stock prices traded at the top of our projected range for the year. Who would have predicted the best third quarter performance since 1939?

Despite the cross currents, our view on the equity markets has become more strategically bullish. The logic is pretty straightforward. The risk of a downward adjustment is minimal. We believe the recent gains in the market will hold. The prospect of further advance is strong. More important, investors have few attractive alternatives. Holding cash has no financial reward. Bond prices are at great risk in the foreseeable economic scenarios. In contrast, the risk of equity investing is largely behind us and the opportunities for reward are good.

At Hudson Advisors, we are restoring our more traditional asset allocation for client portfolios, with an increased weighting to equities. Despite this strategic view, we remain tactically cautious. Not all stocks will do well in the period ahead. Some companies will not perform to support their run-up of value in the last seven months. The gulf between winners and losers may widen. Our job is to pick the winners and we believe our current sector preferences both protect our clients and give them the likelihood of respectable to attractive portfolio returns.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the third quarter of 2009. The stock market virtually galloped as the economy overall showed signs of stabilizing, and as corporate profits exceeded expectations. It steamrolled concerns about consumer debt, high unemployment, and lagging home prices.

Meanwhile, bond prices also rallied at the signs of economic recovery – although that trend is filled with notes of future caution.

Equity Markets: The rally in the third quarter was strong and consistent – continuing the pattern that took hold after the market's low point on March 9. The Dow Jones Industrial average is up 48% from its March 9 low and is now ahead more than 11% for the year. The S&P 500 index is up 56% from its March low and ahead more than 18% for the year. Nonetheless, both indexes still remain well beneath their record levels set in October 2007. The Dow is still off 32% from that high point and the S&P 500 is off 32%. This situation supports the view that further growth opportunity exists.

Technology stocks and small cap stocks were even stronger performers in the third quarter. The Russell 2000 index gained over 20% in the quarter and is now ahead nearly 22% for the year. The Nasdaq index of technology stocks added to its consistent 2009 advance and is now ahead nearly 35% for the year. – reflecting the relatively strong balance sheet of technology companies.

Fixed Income Markets: The bond markets in the third quarter clearly benefited as investors seemed eager to put cash to work. Most interesting was the appeal of high-yield, or junk, corporate bonds. Despite their risks, junk bonds gained 15% during the quarter and have gained a record 48% in 2009. Investor desire for return also benefited investment grade corporate bonds which gained over 8% for the quarter.

Meanwhile, U.S. government bonds seemed to overcome, for the moment, the concerns about future inflation and the question of continued interest from foreign central banks. The yield on the benchmark 10-year Treasury note was 3.3% at the end of the quarter – versus 3.5% at the end of June. Bond prices move inversely to their yields. The overall Treasury asset class gained 2.1% during the quarter, according to a BofA Merrill Lynch index that tracks price changes and interest payments.

MAJOR MARKET INDEXES

	YTD Total Return*
Dow Jones Industrials	13.49%
S&P 500 Index	19.26%
Russell 2000 Index	22.43%
NASDAQ Index	34.58%
Barcap Intermediate Govt/Credit	4.92%

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: Guarded optimism is gradually replacing excessive caution in terms of economic recovery. The recession appears to be ending -- and we should see slightly positive GDP growth in the fourth quarter. The massive federal stimulus is having a positive impact. The economy is still shedding jobs, but at a slower pace. Durable goods orders, home sales, and industrial production have all been better than expected. Corporate earnings reports are largely positive. The Federal Reserve will keep interest rates low for the immediate future. We see no prospect for the so-called "double dip" recession.

Of course, to the theme of cross currents, serious problems remain. Unemployment will remain high even as the economy recovers. Most analysts do not expect employment to reach its pre-recession level for several years. Many U.S. jobs -- such as in the auto industry -- are permanently lost. Consumer spending will remain constrained as households seek to reduce debt and build savings. Most fundamentally, the federal deficit is a long-term drag on the economy. To some extent, we have borrowed money to avoid disaster now -- putting today's needs ahead of tomorrow's growth. While the GDP will turn positive, we expect economic growth to be restrained in comparison to the last two decades.

The Market: As indicated, our view of the equities market is constructive. Significant assets remain in money market funds, but investors will grow impatient with nominal returns. Confidence in stocks will continue to build. Valuations are reasonable despite the rally of recent months, and we expect that corporate earnings will surprise on the upside. Companies have maintained profitability through cost reduction, but revenues will improve along with the economic recovery.

We do not expect the market to sustain the growth seen in the third quarter. However, we anticipate the major indexes to climb gradually in the fourth quarter and the first quarter of 2010. In fact, we expect the market to stay positive throughout 2010 within a trading range. We see little likelihood for the market to lose ground again in the next 12 months. As expressed, the upside potential for stocks is more powerful than any downside risk. Yes, there will be days when disappointing news on job creation or consumer spending will create a temporary retreat. But those issues have been analyzed and understood -- and should not impede a general market advance.

OUR STRATEGIES

Asset Allocation: In the last year we have maintained a conservative asset allocation for clients investing new money: 50% to equities, 40% to cash and fixed income, and 10% to alternative investments. Given our improved outlook on the stock market, we are increasing the equity component to 60% and reducing the cash/fixed income allocation.

Preferred Equities: Our focus remains on large cap companies with good balance sheets and credible business models. We strongly favor companies that are diversified internationally with a presence in emerging markets. Demand from the growing middle class in Asia and Latin America will help compensate for sluggish consumer spending in the U.S. As always, we also look for companies with attractive dividend payments. Our sector preferences include:

TECHNOLOGY: Stocks in this sector are performing well. Companies have healthy balance sheets, and innovation continues to generate new products that almost compel consumers to upgrade and remain current with their computer and communications technology.

ENERGY: The growth potential in this sector is strong as the world economy improves. The long-term imbalance between supply and demand will keep profits attractive in production and exploration companies.

RETAIL: Although hit hard by the recession, this sector will see rising stock values as the economy recovers. We particularly like the low-cost retailers that appeal to budget-conscious consumers -- because household spending will remain cautious even with an improved economy.

FINANCIALS: The troubles in this sector are well known -- and issues remain. But, like retail, the upside potential is now attractive. Banks are working through their problem assets, net interest margins are positive, and balance sheets are improving. Stock values should rise.

INTERNATIONAL: For most clients, we continue to recommend about a 15% share of their equity investments be in international mutual funds --which provides exposure to the economic expansion in the emerging market countries.

Fixed Income:. Our caution on bond investing is now intensified. As indicated, the price of the federal stimulus of the economy is inflation in future years. The long period of low interest rates will inevitably end as the Federal Reserve at some point switches monetary policy to fight inflation. This situation makes long-term bonds entirely too risky. We strongly urge clients to invest only in bonds with maturities of less than five years.

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