HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows
Volume 45 October 2010

We were reminded recently of a famous essay written in 1920 by the English economist Arthur C. Pigou. His title was: "The Giant Error of Pessimism." His thesis was that investors hold back until too late in the market cycle – and ending up paying a significant cost.

Too many investors in the current market are forgetting the "lessons of history" and should google Professor Pigou's essay of 90 years ago. In the third quarter just completed, individual investors put $88 billion into bond funds and withdrew $43 billion from stock funds. The apparent rationale is to avoid risk and look for safety.

At Hudson Advisors, we are contrarians in this market. In our view, the greater risk lies in the bond market and the opportunity is with equities. The fascination with bonds is a mistake. We saw a recent quote from the manager of a major investment company that we liked: "I think those investors reaching for bond yield without understanding the risks are going to pay a price down the road." Yes, exactly right.

One analyst called the recent quarter "quirky." Despite the preference of individual investors for bonds, the stock market also rallied strongly at the end of the quarter. In fact, it was the best September for stocks since 1939. The quirky part was that the surge for stocks was driven largely by hedge funds – which operate within their own investment paradigms not usually reflective of broader market sentiment.

Nonetheless, we welcomed the September stock rally. It helped give some comfort to our clients. We have been positive on equities for over a year. Yes, it can be a challenge to explain and support our viewpoint but, we are confident in our strategies and eventually our clients will see the benefit. We are determined to protect our clients from the costs of excessive pessimism identified so many years ago by Professor Pigou.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first three quarters of 2010. In a roller coaster story, the stock market in the third quarter reversed the losses of the second quarter and is now about where it stood at the end of the first quarter. Meanwhile, the fixed income markets performed well as investors clamored for both safety and yield. Prices rose on both high yield and investment grade corporate bonds and on Government bonds.

Equity Markets: The "quirky" part is that stocks seemed to benefit in the third quarter from the same underlying trends that hurt them in the second quarter.

The driving force is the sluggish recovery of the U.S. economy. Recognition of the big picture economics caused stocks to tumble in May and June. Now, however, many professional money managers expect the Federal Reserve to pump new money into the struggling economy. This expectation encouraged institutional investors to jump back into equities. The Dow Jones Industrial Average gained 10.4% for the quarter, a complete reversal of its second quarter loss. It now stands 5.57% positive for the year.

The pattern was similar for the other major indexes. The third quarter rally reversed the second quarter decline. The S&P 500 was 3.89% positive for the year on September 30 and the Nasdaq Composite was 4.38% positive for the year. The strongest and most resilient equity sector in 2010 has been small stocks with the Russell 2000 index being 9.12% positive for the year.

Fixed Income Markets: Both the corporate and U.S. Government fixed income markets have experienced a sustained rally since the end of 2008. Concerned about equity market volatility, and discouraged by paltry returns from money market funds, they placed over $375 billion into bond mutual funds last year and $230 billion thus far in 2010. Demand for bonds is stronger than supply and prices have risen. The effect has been to drive yields, which move inversely to prices, gradually lower. In the last quarter, high yield corporate bonds returned 6.5%, investment grade bonds returned 4.9%, and 10-year Treasury bonds returned 2.7%.

THE OUTLOOK

The Economy: The economic story is mixed. Fears of a double dip recession have receded. The Federal Reserve has indicated clearly its intention to pump enough money into the economy to prevent a renewed slump.

Nonetheless, economic growth is anemic. At one point, many economists were forecasting U.S. economic growth of 4% for 2010. Those forecast were obviously too cheery.

Unemployment is stubbornly high. The housing market remains in a slump that may take several years to correct.

MAJOR MARKET INDEXES

	3Q YTD Total Return*
Dow Jones Industrials	5.57
S&P 500 Index	3.89
Russell 2000 Index	9.12
NASDAQ Index	4.38
Barcap Intermdt. Govt./Credit	7.44

*Total Return Includes Reinvested Dividends.

Consumers are cautious and choosing to save rather than to spend. The GDP growth for the second half of 2010 is not expected to get much above 2.5%. Looking to next year, expectations for GDP growth have dropped to a median forecast of 2.5% in September from 2.9% in June, according to Bloomberg's monthly survey of economists.

Some bright spots do exist. Corporate earnings are strong, which creates the possibility for a pick-up in private sector hiring and capital spending. Some indicators suggest a comeback of consumer confidence. At minimum, the situation is stable, or to quote one economist: "There is a black cloud overhead, but the worst is not yet to come."

The Market: We do not expect the equity market to rally much further in 2010. The fourth quarter should show some modest gains which will allow the indexes to end the year somewhat above the current levels.

Our view for 2011 is more optimistic. At some point in the next 12 months we expect to reach an inflection point at which the appeal of bonds finally diminishes and the logic for attraction to stocks takes more permanent hold. Here are our reasons:

- With strong earnings, corporations have record levels of cash in their coffers. We expect they will start ramping up purchases of their own stocks, and choose to increase dividend payments.
- With bonds so expensive, individual investors will eventually realize their returns are not worth the flight to perceived safety. The two-year Treasury note is returning under 2%. Why accept that return when an equity investment can pay over 3% -- possibly bolstered further by dividends?
- The stocks in the S&P 500 are trading at a price earnings/ratio of about 13 – which is historically cheap – and makes for intelligent long-term buying.
- The elections in November may clarify some of the present uncertainty about the future direction of federal tax and regulatory policy. Improved clarity on these issues will assist corporations and individuals to make expenditure and investment decisions.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 60% allocation to equities, 15% 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. As expressed, companies that pay attractive dividends are critical to our strategy. Our sector preferences include:

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.

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 mutual funds --which provides exposure to the economic expansion in the emerging market countries. We also like international companies such as General Mills that benefit from the growing middle class in emerging countries.

Fixed Income: We have already 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. Once the Fed moves to tighten money, which eventually it will when the economic outlook strengthens, the spike in interest rates will happen quickly. Thus, we are keeping client monies in maturities under two years.

Tax Liens: As an alternative to bonds, we recently have moved to put some client monies into municipal tax liens – which involve the collection rights to unpaid property taxes. We have invested in a partnership that buys these tax liens at auction in the state of Florida. We hold the liens for a 30-month period – during which they pay clients about a 10% annual return. We regard this as an attractive earning with minimal risk. We may soon expand our program to the states of Colorado and Arizona.

Dow Jones U.S. Sectors (Percent Change Year to Date 9-30-10)

Oil & Gas	**1.23%**	**Consumer Services**	**0.15%**
Basic Materials	**1.45%**	**Telecommunications**	**0.83%**
Industrials	**0.28%**	**Utilities**	**0.71%**
Consumer Goods	**0.24%**	**Financials**	**0.83%**
Health Care	**0.04%**	**Technology**	**-0.09%**

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
Potomac, MD • (301) 840-2071 • bhudson3@hudsonadvisors.com
David Burrows & Elizabeth Kisken
Two Sound View Drive, Suite 100 • Greenwich, CT 06830 • (203) 302-3530
www.hudsonadvisors.com