HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows Volume 49 October 2011

The one positive comment that we have about the 3rd quarter is that it is now over. There is a well known saying that "when the United States sneezes the world catches a cold." After the events of 2008 and the 3rd quarter 2011, we believe a revision of this saying should read; "when Greece sneezes the world catches a cold".

In the beginning of the year, we were cautiously optimistic that the economy was starting to recover but we were still concerned about the debt overhang that had been transferred to government balance sheets after the 2008 market crash. In the 3rd quarter, these sovereign debt issues derailed the stock market recovery and all equities sold off regardless of their business fundamentals. While there is a possibility that we may enter another recession, we believe it still makes sense to own equities given their valuation and dividend yield. In particular, we like "basic need" dividend paying stocks like consumer staples, health care, energy, material, telecommunications, and utility stocks. Many of these sectors have held up better in the recent sell off but any company with a hint of cyclical or regional exposure has sold off regardless of its business profits. However, we will continue to allocate a portion of our portfolios to these equities given their higher yield compared to bonds and their ability to be profitable now and in 2008.

So, okay, sticking to that story has not been so easy this year. We listen to all the dour chatter on CNBC. We watch the market gyrate daily, driven heavily by program trading from large institutions. We watch investors flee stocks for the perceived safety of U.S. Treasuries. Occasionally, we have a moment of doubt: "Do we still believe what we are saying?" But those moments pass. We are confident of our core strategies and we focus on making them work as best possible in these adverse markets.

We think the investment herd overreacted in recent months. Recent domestic data suggests the U.S. economy will not slip into another recession. We do not think the crisis of 2008 is about to repeat itself. We appreciate our client loyalty – and we thank you for your trust. We take seriously the responsibility to reward your trust. We are not running from equities – but we are cautious and defensive. Our job is to find stocks that can weather through this period of turbulence and put our clients in a position for long-term gain.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first three quarters of 2011. The decline in equity prices which began in the second quarter continued and accelerated in the third quarter. It was the worst quarter since the beginning months of 2009. Meanwhile, the fixed income markets did extremely well. Bond prices, especially U.S. Treasuries, soared to near historic levels. The dominant investor sentiment was to find somewhere thought safe to hide for the moment.

Equity Markets: The most common word used to describe equity investors in the third quarter was "spooked." Indeed, the news just all seemed negative and frightening. Developed economies struggled to gain traction and talk of a renewed recession was prevalent. U.S. and European leaders appeared unable to address the problems of government debt. The developing economies also indicated stress, with even China showing signs of slowing and analysts debating whether the Asian giant faced a "hard" or "soft" landing. In reaction, U.S. investors yanked over $70 billion from stock mutual funds.

The Dow Jones Industrial lost over 1,500 points in the quarter -- a decline of 12.1% -- and was off 5.7% for the year. The story was worse for the other major indexes. The S&P 500 lost 14.3% for the quarter and was down 10.0% for the year. The Nasdaq Composite was 12.9% negative for the quarter and behind 9.0% for the year. The Russell 2000 index took the worst beating – a drop of 22.1% for the quarter, leaving it down 17.8 % for the year.

Fixed Income Market: The flight from equities seemed driven by a sentiment that just said get somewhere safe and live to fight another day. For many investors, that safe place was U.S. Treasuries. The yield on the 10-year Treasury note, which moves inversely to price, declined from 3.16% in late June to 1.71% at the end of September. This was the lowest yield since the 1940s. With inflation at over 3%, investors were accepting an effective loss out of fear that stocks were more threatening. The rush to Treasuries occurred despite the political stalemate in Washington over the fundamental issue of the federal deficit and the action by S&P to downgrade U.S. Government debt. (We do note that 10-year yields have moved back above 2% in early October). Investors also showed interest in some of the safest sectors of the corporate bond market such as utilities. In contrast, there was little interest in high-yield, or junk, corporate debt – which faced an aversion similar to stocks.

MAJOR MARKET INDEXES

	3QTotal Return*	YTD Total Return
Dow Jones Industrials	-12.55	-5.37
S&P 500 Index	-13.87	-8.68
Russell 2000 Index	-21.87	-17.02
NASDAQ Index	-12.91	-8.95
Barcap Intermdt. Govt./Credit	2.39	6.65

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: Much of investor response in recent months has been to see every piece of news in the most negative context. At Hudson Advisors, we certainly recognize all the causes of worry. But let us explain why we believe the markets have overreacted. The U.S. economy grew at annualized rate of just over 1% in the first half of the year. Most analysts see a slight bounce in the second half with the possibility of a 2% growth rate. The September jobs report gave some support for this view. The economy added over 100,000 jobs – and the previous flat growth in August was revised upwards to 57,000. Unemployment remains over 9%, but at least there is some sign of life. There have been other rays of hope in data on manufacturing and purchasing activity and increased consumer credit. Moreover, the Federal Reserve had indicted its intent to keep interest rates at current low levels through 2013. We accept that the economy will have slow and anguished growth in the next several years. But we do not foresee the much feared "double dip" recessions.

Let us even stretch to say something positive about political leaders in the U.S. and Europe. In Washington, there is obviously no agreement on how to contain the federal deficit. But at least both parties accept that something needs to be done and we do not rule out some conceivable progress from the Super-committee on deficit reduction. In Europe, we do not see consensus on the long-range issues in the Euro-zone. But we believe leaders will patch together some temporary ways to avoid a fiscal meltdown with global repercussions.

The Market: The hopeful news for the stock market is that corporate earnings are healthy – with second quarter year-on-year growth of 19%. Looking forward, outlook statements are constructive, balance sheets are healthy with high levels of cash, and profit margins are resilient despite the sluggish macroeconomic picture. The result is that stock prices are reasonably valued.

We also think it possible that the market has now priced in the most pessimistic economic scenarios. We think the market will stabilize for the next several quarters in its current range. We do not expect much of a rally – but we do not expect the 3Q rout to continue unabated. We also think the market will react positively to any good news.

Asset Allocation: For clients investing new money, we continue to recommend 60% allocation to equities and the remaining portion to cash, laddered bonds with a short overall maturity range, and alternative investments.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Given the economic and market uncertainties, we are defensive in our equity selections. We look for companies that can withstand the current turbulence. Companies that pay attractive dividends are central to our strategy. Our sector preferences include:

INDUSTRIALS: Certain companies in the auto industry, such as Ford, and the aviation industry, such as Boeing, represent good value and promising future outlook.

HEALTH CARE: 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.

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

FINANCIALS: Interestingly, certain regional and super regional banks have good value as the result of low risk profile and conservative balance sheets. We are avoiding larger international firms that may have exposure to the Euro-zone problems.

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. We also continue to buy municipal tax lien certificates to add income for certain client portfolios.

Dow Jones U.S. Sectors
(Percent Change for YTD, Ending September 30, 2011)

Oil & Gas	**-13.01%**	**Consumer Services**	**-5.39%**
Basic Materials	**-27.01%**	**Telecommunications**	**-6.42%**
Industrials	**-16.02%**	**Utilities**	**5.87%**
Consumer Goods	**-2.88%**	**Financials**	**-23.29%**
Health Care	**-0.03%**	**Technology**	**-8.12%**

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