Market & Economic Recap: 12/31/09 – 9/30/10

Economy Sluggish, Corporate Profits Standout

Fourth Quarter 2010

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The equity markets so far this year have been somewhat of a roller coaster. The first quarter was marked by a follow-through of the 2009 recovery largely on expectations of an improving economy. The second quarter witnessed a sharp sell-off as economic developments began to suggest a meaningful slowdown, including talk of a double-dip recession. Despite continued economic sluggishness in the third quarter, equity markets here and abroad rallied sharply with the S&P 500 Stock Index rising 10.72%. The 2010 market summary through September 30th, both domestically and globally is listed below:

Quarterly Returns (Price Change Only)

2010 Period	S&P 500 Stock Index	S&P Global Market Index (Developed)
Quarter Ended 3/31/10	4.87%	3.29%
Quarter Ended 6/30/10	-11.86%	-12.75%
Quarter Ended 9/30/10	10.72%	13.44%
Year-To-Date	2.34%	2.28%

Source: Standard & Poor's

Several factors are notable regarding the September and the third quarter equity results:

- The September gain in the S&P 500 Stock Index was the best showing for this month since 1939.
- The September advance was exceptionally broad with 483 of the S&P 500 components advancing and only 17 showing declines.
- The third quarter market advance was worldwide with all 45 developed nations' markets showing solid improvement, 27 of which had double digit gains.
- All ten of the S&P 500 Stock Index economic sectors participated in the quarter with the best performing sectors (telecom, materials, consumer discretionary, and industrials) being the most economically sensitive. The following table summarizes the results:

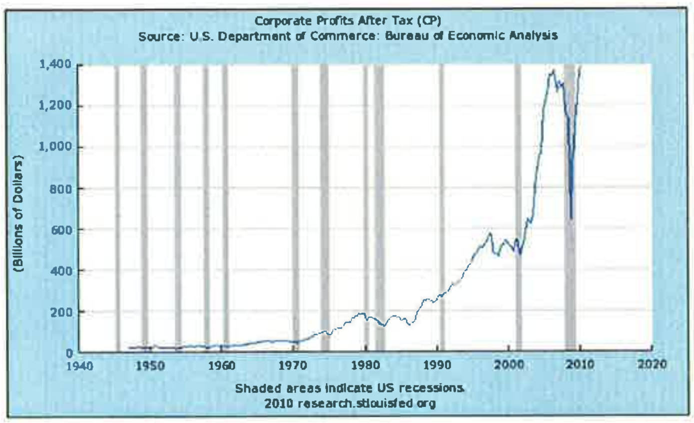
Monthly Returns Through September 30, 2010

S&P 500 Economic Sectors	Month	3-Month	YTD
Energy	9.14%	12.30%	-2.48%
Materials	7.53%	17.24%	1.20%
Industrials	11.20%	13.65%	11.45%
Consumer Discretionary	11.00%	14.72%	12.10%
Consumer Staples	5.38%	9.76%	5.09%
Health Care	8.82%	8.22%	-2.34%
Financials	5.98%	4.06%	-0.31%
Information Technology	12.11%	11.50%	-0.77%
Telecommunication Services	7.93%	19.10%	6.02%
Utilities	2.59%	11.11%	0.87%
S&P 500	8.76%	10.72%	2.34%

Source: Standard & Poor's

Many investors are asking "why the disconnect? Why are stock prices showing solid gains, worldwide, yet economic activity continues to be lackluster?" We believe there are several sound reasons to account for the renewed buying interest.

- The second quarter was rife with predictions of a double-dip recession. While the third quarter statistics were lackluster, in many cases they were better than generally feared, allaying recession concerns. Investors began to accept a slower, but still respectable GDP growth rate (2.0% - 3.0%) versus the 3.0% to 4.0% previously thought possible.
- Reinforcing this belief was the Federal Reserve's pronouncements that it would take additional steps, if necessary, to maintain growth. This allowed investors to focus on stock valuations which are still low by historical standards – particularly given the low level of interest rates.
- The overall world GDP growth rate continues to show strength exceeding our domestic economy by a large margin. This will benefit large U.S. corporations with sizeable international operations which is a growing component of the S&P 500 Stock Index.
- In our view, the most important factor is that corporate profit growth has been, and continues to be, exceptional since net income after taxes troughed in the second quarter of 2009. The following chart shows aggregate corporate profits after tax through the second quarter of 2010:



Source: Federal Reserve Bank of St. Louis

Despite a somewhat stagnant economy, corporate profits through June 30, 2010 have climbed to new all-time highs (nearly $1.4 trillion, at an annualized rate). Third quarter earnings reports, so far, are exceeding analyst expectations. Much of this improvement is attributed to the draconian cost-cutting measures many corporations have implemented during the recession.

The next chart depicts actual and estimated operating earnings per share data for the S&P 500 as a whole and by economic sector for selected periods with estimates for the balance of the year and 2011:

Operating EPS Change

	Q3 2010 Over Q3 2009	Q4 2010 Over Q4 2009	2009 Over 2008	2010 Over 2009	2011 Over 2010
S&P 500	31.20%	27.18%	14.87%	45.62%	13.62%
Consumer Disc.	16.22%	3.60%	107.90%	57.37%	11.61%
Consumer Staples	1.44%	3.17%	6.90%	4.90%	10.39%
Energy	44.09%	43.52%	-66.11%	104.68%	15.61%
Financials	181.79%	170.54%	120.68%	251.27%	18.09%
Health Care	6.42%	16.69%	7.89%	9.80%	12.56%
Industrials	36.46%	12.52%	-32.86%	22.47%	12.83%
Info. Tech.	35.87%	13.36%	8.41%	43.51%	13.42%
Materials	18.35%	29.08%	-12.40%	70.34%	27.70%
Telecom. Services	15.90%	30.64%	-12.06%	11.63%	3.70%
Utilities	8.80%	10.57%	-6.07%	10.77%	2.70%

Source: Standard & Poor's

In addition to strong profit growth, the corporate balance sheet has never been more liquid with the Federal Reserve reporting nearly $2 trillion in cash and short-term investments. This extreme conservative posture is a direct result of the severity of the past recession. The important conclusion from this is that at some point this hoarding of liquidity will be mobilized, resulting in a dramatic impact on the economy. It is already manifesting itself in share buyback programs and increased dividend payments. As confidence in the recovery builds, capital spending and new hiring will take hold.

Finally, the issue of stock valuation is favorable. At current prices, the S&P 500 Stock Index is trading at 12.8 times estimated 2011 earnings per share. In the past 25 years this index, on the same basis, has traded as high as 28 times est. EPS (1999), as low as 9.4 times (2009), and has a mean of 15.6 times. The current valuation represents an 18% discount to the mean multiple in this period.

Conclusions:

We believe this analysis is still consistent with the investment scenario we outlined in our last quarterly commentary and, as such, are repeating our conclusions from that publication:

While unemployment, consumer confidence, and housing continue to be restraints on the economic recovery, and will continue to receive press scrutiny, we believe the underpinnings of the current expansion are sound. We think the most likely scenario going forward is a slower than normal expansion in the area of 2.5 - 3.0% GDP growth over the foreseeable future. That is respectable but not robust. The advanced economies will continue to go through the deleveraging process and how long this takes is an unknown. However, this should lay a foundation for solid investment returns from the equity markets, particularly relative to fixed income alternatives. The investment areas which we think offer the best 3 - 5 year return potentials are as follows:

1. Large capitalization, U.S.-based companies with a growing international exposure. Our preference is the growth side of this arena but there are also many good opportunities on the value side. Both will benefit from emerging nation growth.
2. Mature, large capitalization firms, with above-average dividends and the ability and history of increasing the dividend rate annually. We believe there will be P/E ratio expansion with this group as competing interest rates remain low.
3. Energy (oil, natural gas, etc.) and commodity (steel, aluminum, chemicals, etc.) oriented companies. While commodity prices in general have weakened during the recession, we believe it is only a matter of time before demand begins to outstrip the world's productive capacity, resulting in higher prices.

Our client portfolios are presently well-represented in these areas but we will continue to evolve the accounts to reflect changing opportunities.

David J. Szatkowski, CFA
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