2009 …. It Started Ugly but Ended Strong

2009 turned into a remarkable year for investors. After a rocky start the stock market had one of its best rallies ever. For the year the S&P 500 advanced by 26.5% ending with a solid 6.04% advance in the fourth quarter. **Our accounts ended the year solidly ahead of our benchmarks, and we are quite pleased given our conservative approach to have slightly outperformed our benchmarks in the strong final quarter of the year.**

A steady stream of improving economic news confirms that the recession is over. The massive fiscal and monetary response by governments around the globe did its job but not without costs. Unfortunately the primary condition -too much debt- that brought our economy to its knee has not been resolved increasing risks for investors. However, the ownership of the debt has changed from private to public hands. The Federal Reserve saved the financial system via capital injections, guarantees, asset purchases and liquidity provision and now owns over $1 trillion dollars in mortgage-backed securities and agency debt. Total U.S. debt (Government, corporate and consumer debt, however, it does not include a few trillion in "off balance sheet" financing, contingent unfunded pension plans for corporate and state and local governments, or unfunded liabilities of the U.S. government for such items as Medicare, Social Security and other programs) is roughly $53 trillion, a level unprecedented in our history.

The problem for investors is that it is going to be hard for the economy to wean itself off government support. Private sector deleveraging has barely begun. The Federal Reserve puts total household debt, including mortgage debt, at about $13.7 trillion, or 125% of annual after-tax income, a burden that many economists believe will take several years to pare down to what they see as a more sustainable level of 100%. The Fed's exit strategy is tricky. Withdraw support too soon and risk a double-dip recession, or continue to run high deficits and risk a public debt and currency crisis. Either way investors will have to deal with large deficits, heavy public debts and stubborn unemployment for the foreseeable future.

An interesting condition currently is the divergent outlooks for large corporations versus small businesses. Big companies have lots of cash and access to credit. According to a Wall Street Journal analysis, the 500 largest nonfinancial U.S. firms held almost $1 trillion in cash and short-term investments which is one of the reasons why we are emphasizing ownership of large, high-quality stocks in our portfolios. The credit environment is much different for small firms who largely rely on bank loans. Lending by U.S. banks plunged by 2.8% in the third quarter, the largest drop since at least 1984 and the fifth consecutive quarter in which banks have reduced lending, the Federal Deposit Insurance Corp. reported. Struggling small businesses do not bode well for a swift fall in the jobless rate either. Companies employing fewer than 50 people accounted for a third of net gains in employment between late 2003 to late 2007, according to the Bureau for Labor Statistics, but 45% of job losses since the recession began.

The biggest surprise coming out of the downturn has been the performance of the emerging economies. Many forecasters expected the emerging economies to crumble as consumer spending in wealthy nations slowed. However, blessed with strong balance sheets and significant local demand emerging economies, especially China, carried out massive stimulus programs that have helped the world economy recover. Currently in Asia, consumer spending is picking up, businesses are showing profits, and unemployment rates are falling in most of the region. And unlike the West, consumers have low debt levels and banks are expanding credit rather than shrinking it. China and its neighbors may be the economic driver the global economy needs to get through the rough times.

The challenge for investors is that the range of possible outcomes for the economy and stock market is wide. We don't believe this is a time to be too aggressive. Our biggest concerns revolve around the debt issue described above; however, this condition could persist for quite a long time before the financial markets revolt. We also fear that strong corporate profit growth this year will prove transitory, especially for cyclical businesses, if the strength is due to government support which is not sustainable in the long term. **Therefore, we are maintaining our strategy of emphasizing steady-growth businesses, with strong balance sheets, healthy dividends, attractive valuations and exposure to emerging economies.** If investors have learned anything it should be that corrections can happen quickly with not a lot of warning. Therefore, we think it is prudent after a tremendous rally to hold some cash and high-quality fixed income as a hedge to have available to invest during any pullbacks.

The investment landscape is even murkier than usual. Therefore if you have any questions, please feel free to contact us. We look forward to an exciting 2010! As always, thank you for trusting your portfolio to our care.

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