



INVESTMENT STRATEGY UPDATE

December 28, 2009

2010 -- THE YEAR AHEAD

Wow, what a ride, this year just past. Now we look ahead, but in order to divine the future, we must first attempt to understand how we got to where we are today. The U.S. economy was already in recession, even before the now infamous collapse of Lehman Brothers in September of 2008. The nation's orgy of debt and consumption, along with the substantial over-investment in housing, was taking a serious toll. The residential real estate bubble had burst. Banks were tightening credit, unemployment was rising, and the consumer was retrenching. While we had been expecting a protracted period of deleveraging, we had also hoped the process would be orderly. But, that was not to be.

The demise of Lehman unleashed a near freefall in U.S. spending and production. And given the highly leveraged, globally intertwined banking system, the fallout spread rapidly. Stock markets plunged worldwide. Banks stopped lending, and consumers and businesses stopped spending. The global economy was shutting down. In response, central banks and governments around the world undertook massive rescue operations, flooding their economies with money and sponsoring huge stimulus programs. In hindsight, they had little choice.

And so it was that, amidst widespread fear of financial Armageddon, the world's stock markets bottomed in March of 2009, in what can only be viewed as a classic selling climax. Following that, investors began to refocus on the prospect of future growth, and stock markets rallied once again. Fortunately, the massive stimulus efforts took effect and most of the world's economies started to recover, including our own. The huge central bank reflation efforts also resulted in a substantial reservoir of excess liquidity – over and above what their economies were able to deploy. Thus, in an environment of very low interest rates and few practical investment alternatives, stocks continued their rise, eventually ending the year with substantial net gains.

So, what now? The U.S. economic outlook is positive, but the expected rate of growth is mediocre. And with the huge rally in U.S. equity prices, stocks can no longer be considered “too cheap.” Also, while the private sector is continuing to deleverage, one cost of the financial rescue was an enormous increase in public-sector debt. Government stimulus efforts were justifiably huge, but now, the key policy challenge going forward will be how central banks and governments, particularly our own, manage their exit strategies. When, and how quickly, the liquidity punch bowl is removed, will likely be the key to U.S. financial market performance in the year ahead.

With that in mind, what follows is our outlook for 2010. We remind you, however, that while we are attempting to forecast the future, our continued investment success in these volatile times will depend much more on our ability to interpret and adjust to trends and events, as new information becomes available.

The Economy

Economists' forecasts for 2010 are primarily clustered into two camps. Those in the smaller but more visible camp believe that while there has been enough stimulus to bring the system back to life, the boost has not been sufficient to ignite a self-sustaining economic expansion. In this camp, they contend that the underlying damage to consumers and businesses has been so deep that once the effects of successful stimulus programs, such as "cash for clunkers," have worked through the system, the economy will fall right back into recession mode – the so-called "double dip."

Economists in the larger camp (the one to which we find ourselves most drawn) suggest that, while a double-dip recession is unlikely, there are major structural impediments to the rate of future growth. Thus, following a couple of relatively strong quarters resulting from the restocking of inventories and some pent-up consumer demand, the economy is likely to settle into a prolonged period of subpar growth. The rationale for this position is that in the aftermath of such a huge credit overshoot, lenders and borrowers will have little choice but to continue repairing their balance sheets, thereby spending and investing at less-than-normal levels. They also note that, going forward, the economy will be constrained by increased regulation and the tax hikes scheduled in 2011.

There is, of course, a third possibility, that of an anti-consensus positive growth surprise. For one thing, given the depth of the inventory correction, restocking could be significant. For another, companies have been especially aggressive in paring labor costs and pulling back from capital spending. The result is that, even with the modest economic rebound experienced to date, U.S. corporate productivity has been outstanding. Corporate balance sheets are in excellent condition, as well. The weaker dollar and strengthening global economy should combine to provide a boost to U.S. manufacturing activity, as should the very probable rebound in global capital spending. In this scenario, an improved manufacturing environment should eventually lead to a noticeable pickup in hiring and serve to buoy consumer confidence and spending. Readers should note that economic growth does not need to be exceptional to have positive implications for the stock market. It just has to be better-than-expected.

The U.S. Federal Reserve Board and central banks around the world had little choice but to aggressively reflate. But as a result, most now find themselves balanced on a policy tightrope, with the risks of economic stagnation on one side, and future inflation and another asset bubble on the other. Most central bankers have stated their intentions to pull back from their highly stimulative policies as developments allow. Those decisions will be crucial to the economic and investment outcomes.

Inflation and Interest Rates

Many clients have expressed concern about the outlook for inflation and interest rates. Their worries are understandable. The Federal Reserve Board has injected a huge amount of liquidity into the system. Furthermore, the combination of reduced revenue and the enormous total funding of public-sector stimulus programs has led to burgeoning government debt, with little evidence of any credible deficit-reduction strategy.

And yet, we consider it unlikely that inflation will become a meaningful problem over the next year or two. With high unemployment and plentiful unused manufacturing capacity, there is little direct cost pressure. Also, the fact that China and other recently emerged nations are continuing the march of industrialization almost ensures a further intensification of global competition. So until the economy begins to pick up steam, the Fed will not feel pressured to raise interest rates. That, and the fact that there is little household demand for funds, should serve to keep interest rates low for many months to come.

Still, we do not favor long-duration fixed income investments at this time. With very low current interest rates, there does not seem to be much potential for bond market capital appreciation. Yet at the same time, there is a substantial risk of higher interest rates longer term that would be associated with a lack of political will to trim our rising deficit.

We anticipate that the Federal Reserve Board will gradually raise short-term interest rates and slowly remove excess liquidity from the system, perhaps beginning during the second half of 2010. But this nation must also take action to put its fiscal house in order. The U.S. government has emerged as the major borrower in the world. It is crucial that we develop a credible strategy for reducing the deficit, or the financial markets will eventually rebel. Failure to undertake corrective action would likely have the consequence of higher inflation, and perhaps lead to an all-out dollar rout and an eventual decline in U.S. living standards. Unfortunately, with high unemployment, an aggressive social-spending agenda, and mid-term elections scheduled for late 2010, it is difficult to be optimistic on this front.

The Stock Market

2009 turned out to be an unexpectedly positive year for the stock market. The risk of a total financial meltdown had passed by late spring, and the avalanche of rescue liquidity had to go somewhere, so stock prices surged. But as we enter the new year, stocks are no longer undervalued. So again, the question is, where do we go from here?

Our opinion is that the stock market is somewhere in the transition period between the liquidity-driven portion of the bull market and the next phase, which should be more a function of earnings growth and fundamental improvement. While we continue to expect stock prices to grind their way higher over the coming months, the next leg of the advance will likely be more selective, more volatile, and consequently, more challenging.

These are tough times for America and it is easy to get bearish on the outlook. There are myriad risks, and we cannot help but worry, as well. However, we also recognize that doubts and concerns are common emotions following a recession. If anything, the risks are very well publicized by the financial press and, therefore, are probably largely discounted in current valuations. The combination of low inflation and accelerating growth is very positive for stocks, and we suspect that large numbers of individual and institutional investors remain underweight equities relative to their benchmarks. In addition, with returns on cash near zero, stocks continue to look attractive relative to the alternatives. So for now, our continuing strategy is to buy on dips.

The bottom line is that we think the stock market should continue to perform well during the early portion of 2010. When the world's policy makers embark on the next tightening cycle, reduced liquidity may serve to limit further stock market progress. But, we think that event is at least two or three quarters away.

Longer term, visibility is fairly low. We suspect that we are in a multi-year environment for stocks which may turn out to be much like the second half of the 1970s. A very big decline in 1973-74 was followed by a significant rebound in 1975. Then began a several year period of alternating cyclical bull and bear market fluctuations, with little net progress overall. During the 1970s, the Dow Jones Industrial Average seemed stuck at the 1,000 level. Now we are in a period of consolidation around Dow 10,000, setting up the base for the next secular advance. But, the start of that advance is probably still a few years away. On a positive note, while the general indices made little progress during the latter '70s, it turned out to be an excellent period for well-considered sector and stock selection strategies. Astute investors profited handsomely.

Conclusion

Financial innovation, deregulation, and the greatest credit overshoot in modern times all combined to boost economic activity during the last two decades. But, as a nation we lost control, and the very things that served to foster growth severely broke down. Necessarily and appropriately, policy makers took drastic measures. The system was rescued, and most of the world's major economies started to grow again during the second and third quarters of 2009. Nonetheless, the deleveraging process and its resulting consequences will be ongoing. Domestic credit growth will be considerably slower going forward, and thus, so too will be economic growth. Increased regulation and higher taxation will place further impediments on future growth.

Still, the U.S. economy is healing, and we anticipate modest growth in 2010. The global economy will expand as well, and Corporate America is in fine shape to benefit from that. As such, we expect reasonable earnings growth this year, particularly from those firms with meaningful international exposure. Furthermore, liquidity remains abundant, and U.S. stocks, if no longer cheap, are also not excessively valued. While volatility is likely to increase, there are still few practical alternatives to stocks. Our expectation is for

moderately positive equities returns for the year as a whole, but we believe they will exceed the returns produced by cash, bonds, or real estate.

Our world is changing, the emerging markets have emerged and the U.S. is no longer the primary driver of the global economy. With the rapid industrialization of China, India, and other nations comes great opportunity. Hundreds of millions of people around the world are rising into the middle class and consuming accordingly. In order to prosper during this evolution, we must embrace free trade and globalization. We must also bolster our educational standards and foster the creativity and entrepreneurial spirit that has made this nation so great. And, we must not overtax or over-regulate. Within reasonable bounds, the chaos of competitive markets can still be a beautiful thing.

As a final note, we wish all of our friends and clients peace, joy, health, and prosperity in the new year and for many years to come.

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