

POLITICAL, ECONOMIC AND CAPITAL MARKETS REVIEW & OUTLOOK FOR 2010

Summary

- 2010 will be politically contentious; active role of federal government in domestic economy will continue.
- Growth in emerging economies will drive global economic growth and trade.
- Following a dramatic rebound in 2009, capital markets will be subdued in 2010.
- Globally diversified portfolios are a favorable strategy in current environment.
- Investment in multinational corporations and corporate bonds offer value for investors.

Political Commentary

In 2010, we anticipate a world that will be experiencing significant stress. Much of this stress will emanate from global economic struggles. Still, we anticipate that these tensions will be primarily expressed in the political arena.

At the beginning of 2009, the United States, along with the rest of the world, was caught in the most severe financial crisis in modern history. Central bank authorities, regulatory agencies, and the new Obama Administration came forward with bold measures to address the crisis. These government measures were effective in avoiding global financial collapse and restored a basic level of faith and functionality in our financial systems. The ills that brought about the crisis, however, have not been cured. The trend that we experienced in 2009 of the federal government taking an active role in the economy, assuming responsibility for troubled corporations and financial institutions, will continue in 2010.

In our annual Review and Outlook for 2009, we expected that the initial enthusiasm for the new Obama Administration would wane over the course of the year. Indeed, towards the end of the year, the U.S. Congress was engaged in heated debate over health care reform. Ultimately, the Obama Administration was successful in getting legislation enacted by both houses of Congress. Politically, however, the Administration's goals of greater bipartisanship were unsuccessful. While the ultimate outcome of the reform legislation remains unknown, the U.S. will experience an era of renewed partisanship.

In 2010, the Administration will likely want to continue with major domestic reforms, including in the areas of education, immigration policy and financial regulation. However, these reform efforts will be partially undermined by the deteriorating political environment. In addition, in the

context of a sluggish domestic economy, political focus will likely turn more towards economic policies, designed specifically to increase employment and stimulate growth.

U.S. Government efforts in these areas will be constrained by the large national debt and budget deficits, creating additional tensions. Also, state and local governments will continue to be severely squeezed by constricted budgets. Governments will be caught in the tension between the need to raise revenues, and the difficulty of doing so in a weakened economic environment.

These domestic political tensions will have a mixed impact on the economy and the markets. The federal government will view stronger economic activity as the most effective way to address the issues of budget deficits and unemployment. At the same time, government actions, though well meant, will result in higher costs and regulatory constraints on business. Overall, though, the government's efforts will be to stimulate economic growth, business activity and employment. This will benefit the financial markets.

In 2010, the global political arena will be filled with tensions as well. According to Daniel Franklin in the Economist's *World in 2010*, "China will be central to just about every global issue in the coming year, from the economy, to climate change and nuclear diplomacy."

In our view, the overriding emphasis of global political tensions in the coming year will be the deep conflict between militant fundamentalist groups and western capitalist societies. This conflict can be seen in many areas around the world: war in Afghanistan; military tensions in Pakistan, Yemen and Somalia; ongoing conflicts, such as that between the Israelis and Palestinians; civil unrest in Iran; terrorist incidents throughout the Middle East, as well as in the United States, Europe and Southeast Asia. These conflicts are not easily addressed. At the forefront, the U.S. government has chosen to step up its fight against the Taliban and to establish a stable, democratic government in Afghanistan. The outcome of these initiatives will be uncertain.

In 2010, we think that the main focus of this conflict between western capitalist societies and militant fundamentalists will be seen in the escalating tensions regarding Iran and its intent to develop nuclear technology. The current regime in Iran has demonstrated its unwillingness to abandon its nuclear development program. The United States has been working to build international support for sanctions against Iran in response to this defiance. Israel is standing by, nervously monitoring the effectiveness of these steps. Meantime, the current regime in Iran is currently experiencing significant threat from internal social unrest.

We anticipate that these tensions will escalate in 2010. They may lead to a unilateral strike by Israel against Iran's nuclear facilities during the year. Such an action would likely be highly destabilizing in the Middle East, as well as divisive within the United States and elsewhere. The political tensions over Iran's nuclear capabilities will be played out alongside ongoing terrorist incidents and conflicts throughout the Middle East and elsewhere around the world. These global political tensions will be economically disruptive and will add to instability in the investment markets.

Economic Review and Outlook

2009 was a year marked by extreme reversal in fortunes in the global economy. The economy started the year in the midst of the worst downturn since the Great Depression. However, after massive government interventions, recovery began during 2009.

Global economic recovery will continue in 2010. We believe that growth in selective emerging economies will lead the world in renewed global growth. This year, we anticipate moderate world GDP growth. We continue to see deflationary pressures in developed economies. To support economic recovery, we think central banks will maintain low interest rates. However, we also see inflation of asset prices in 2010, driven by these low interest rates. Competition for resources between emerging and developed countries also threatens inflation in commodity prices.

The economies of the U.S. and Europe are no longer in recession. Replenishment of depleted inventories, low inflationary pressures and low interest rates will help sustain growth in the first half of 2010. Exports as well should continue to aid the economic recovery.

Yet, recovery will proceed slowly and haltingly. These economies are currently hindered by high unemployment, low consumer confidence, heavily leveraged bank balance sheets and the potential for further substantial loan losses. Until unemployment begins to significantly improve, consumer spending will remain weak. In addition, tight bank credit will hinder not only consumer spending, but also expansion of businesses too small to access the capital markets.

Furthermore, additional government stimulus spending within the U.S. and Europe is unlikely given substantial deficits. Indeed, strained state and local government finances in the U.S. may be a further hindrance to U.S. economic recovery.

On the other hand, selective emerging economies will provide stimulus to sustain global growth. Some economies, specifically those in Eastern Europe and several Latin American countries, will struggle as problems continue for key trading partners. In other economies, however, stronger recovery is emerging, particularly within Asia, the Middle East and Africa. In these regions, financial systems avoided the worst of the credit market turmoil. Now with the ability to expand credit, combined with low consumer debt, private consumption in these economies is rising. Moreover, governments in these regions generally have relatively low levels of public debt, giving them the wherewithal to provide stimulus if needed. Indeed, China brought forth a large government stimulus package in 2009, and it has the capability of doing so in 2010.

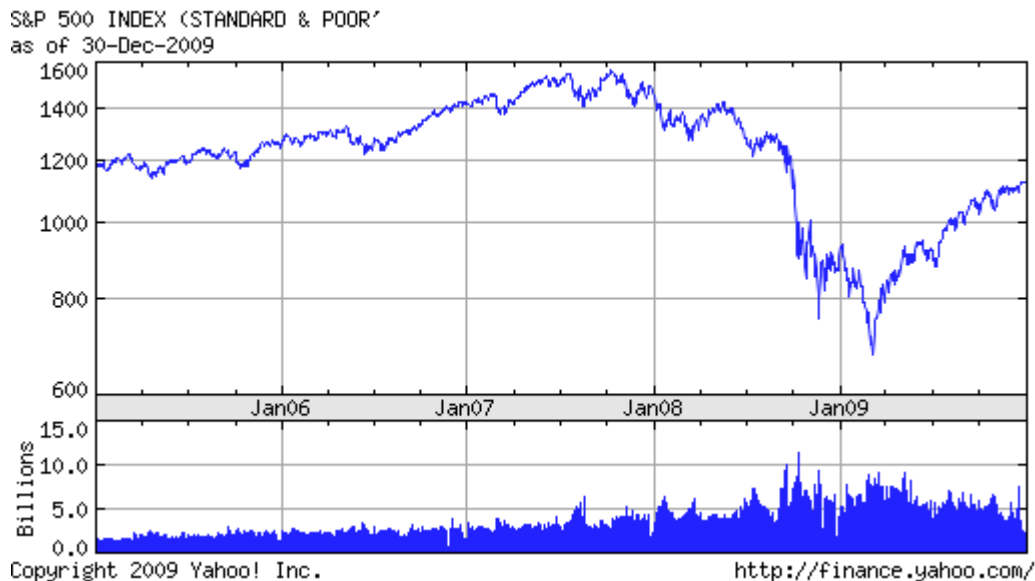
In our view, demands of growth in these emerging economies will drive global trade. Within Asia, a number of countries have completed trade deals to liberalize trade in the region. Exporters, including providers of commodities and multi-national corporations, will likely benefit from stronger global trade.

Capital Markets Review & Outlook

2009 was a dramatic year in the investment markets. In the United States, the extraordinary declines in the final quarter of 2008 continued into the new year. At the end of February 2009, the broad based Standard & Poor's 500 stock index had fallen an additional 18%. From that level, however, the market reversed course sharply and climbed over much of the balance of the year to end with a gain of 27%.

Returns in foreign markets followed a similar pattern, and were even stronger. Emerging market stocks had particularly high returns. The Brazilian Bovespa stock market index, for example, more than doubled from its beginning of year value. Weakness in the U.S. Dollar vs. foreign currencies for much of the year contributed to returns on foreign stocks.

Note, however, that these strong returns in 2009 only partially offset declines of 2008. Equity markets in general remain well below their peak levels attained in the fall of 2007.



In the fixed income arena, in response to the global financial crisis, U.S. treasury security yields at the beginning of the year were at historic lows. Domestic monetary authorities reduced short term interest rates to nearly zero. Over the course of the year, yields on Treasuries increased, leaving them with low single digit returns for the full year. Yields on corporate bonds, however, declined over the year from their initial high levels. Total returns were in strong double digits. High-yield “junk” bonds were particularly rewarding. The Merrill Lynch High Yield Bond index was up over 50% in 2009. Returns on foreign bonds varied, but were generally favorable due to the relative weakness of the U.S. Dollar.

At the start of 2010, we are relieved that the severe threats to the global financial system at the height of the crisis have been allayed. The recovery in the investment markets in 2009 has helped to restore faith for investors. On the other hand, recovery is only partial.

We believe that we are currently in a work-out phase. The impact of the financial crisis will be ongoing. Some financial institutions, corporations and other organizations will never recover. Other entities have been permanently changed. In particular, we believe that the heightened role of government in the economy and the markets is a critical component in our current investment analysis.

In general, the investment outlook at the start of 2010 is tepid. In the developed world, economic growth expectations for the coming year are low. Government budget deficits will put constraints on fiscal measures to boost activity. Heightened regulatory controls will increase costs on business. Therefore, corporate profits will be modest. Moreover, interest rates will remain at low levels. Returns on fixed income investments will be muted, at best.

The major area where we see investment opportunity is in developing markets around the world, such as China, Brazil and India. Economic growth in these countries has remained vigorous. They will likely continue to increase their share of global economic activity in the coming years. At the same time, we note that the investment markets have responded to their favorable outlook, and that risks associated with those markets are also high.

With regard to the equity markets, throughout 2008 we maintained a defensive posture. At the start of 2009, we adopted a more neutral approach, and moved to take advantage of that over the course of the year. We favored emerging market stocks. For 2010, we are maintaining a neutral posture. We suspect that the strength in the markets in 2009 will continue into 2010, but that over the course of the year economic sluggishness and ongoing resolution of financial system structural problems will retard further significant gains in the stock markets.

We are not, however, negative on equity investments. A key component in our analysis is the impact of Federal Reserve Board interest rate policy. In our view, a great deal of the strength in the stock markets in 2009 was attributable to the Fed's 0% interest rate policy. In 2010, in the absence of any strong rebound of economic activity, we anticipate that the Fed will maintain low interest rates. Faced with essentially no return on cash and money market holdings, investors will continue to find common stocks attractive. The equity markets will be sensitive to political events and short term unexpected events. So long as the Fed keeps rates low, however, we do not expect any sustained decline in stocks.

With regard to fixed income investments, we think that any significant declines in interest rates from current levels, which would boost bond returns, are unlikely. In the context of an overall low investment return environment, we see some value in intermediate, investment grade corporate bonds. In general, however, prospective return on bonds in all sectors is modest.

Summary & Strategy for 2010

In summary, we anticipate a year of political tensions. Economic growth in developed economies will resume, but be muted. Developing markets, however, will likely experience ongoing solid growth. In this context, we believe that returns on investments overall are not enticing. Nevertheless, equities should hold up reasonably well, and may well fare better than fixed income investments. Cash holdings will likely provide little return due to low interest rates.

We are maintaining globally diversified portfolios for our clients. We believe that selected investments, such as common stocks of multi-national corporations and corporate bonds, offer benefit for investors. We are also seeking out opportunities in the areas of alternative energy, education, or other special situations that we think will generate above-average returns.

Overall, however, we anticipate moderate investment returns in the year to come. On the other hand, we also see an environment in which investment risks, as well, are now greatly diminished.

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