Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

January 2010

2010: Good News, Bad News

> We forecast that global GDP growth will be 4.4% in 2010…
> Our team projects growth will be led by China at 10.1%,
> while U.S. GDP growth will be 3.2%.
>
> BofA Merrill Lynch Global Economic Research, 2009

> The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance.
>
> Cicero, 106 B.C. – 43 B.C.

2009 was one for the history books. As Warren Buffet said, "We were really looking into the abyss." He went on to say: "I felt that this is something like I've never seen before, and the American public and Congress don't fully understand the gravity of the problems." The global financial meltdown reached the panic stage in September 2008 with the failure of Lehman Brothers and the run on a prominent money market fund on September 16th. Without timely U.S. government action guaranteeing money market deposits, increasing FDIC insurance, injecting capital into the banks through TARP, and taking over AIG, Fannie Mae and Freddie Mac, it is likely that a systemic financial collapse would have occurred. Even with dramatic government intervention and enormous monetary and fiscal stimulus, the worst recession in decades was unleashed with the U.S. economy shedding more than 7 million jobs. All of this led to one of the worst stock market sell-offs in the last century. The chart below tells the story:

Chart of S&P 500
October, 2007 - December 31, 2009

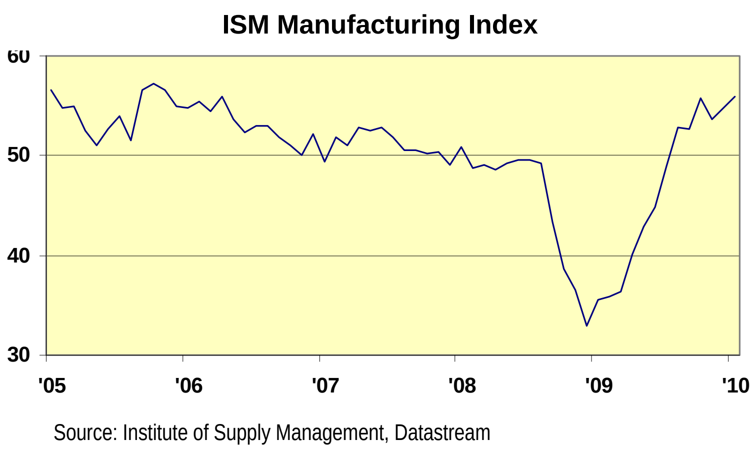
Source: Bloomberg

The S&P 500 Index dropped 57.7% from its all time high in October, 2007 to its March, 2009 low. Then, as investors sensed that Washington would not nationalize banks nor intervene excessively in the U.S. economy, the stock market rebounded robustly, producing a 67% rally in the S&P 500 from its low point to the end of the year. What terrifying volatility! It was a roller coaster ride straight from hell for many investors.

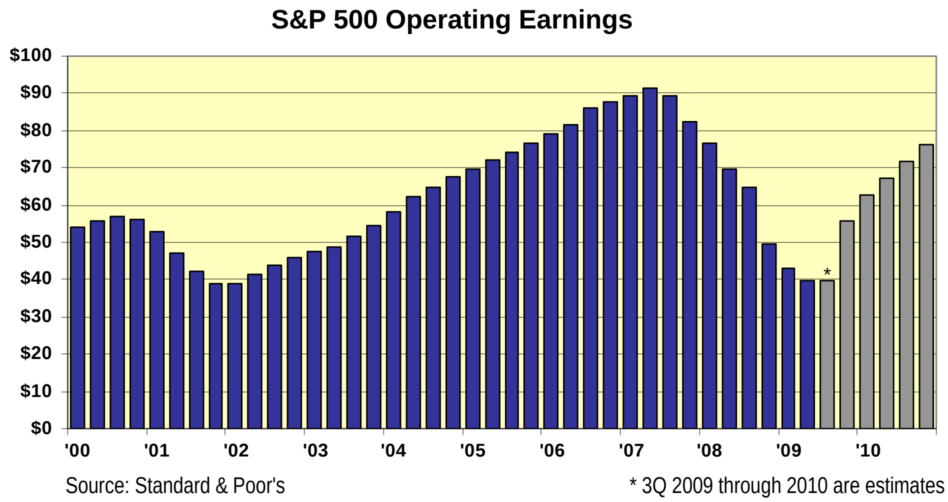
The Good News: Signs of a Healthy Economic Recovery

Let us turn now to the coming year, as wise investors focus on leading indicators rather than looking backwards, which is like driving a car while staring into the rearview mirror. The stock market typically rallies some months before the economy turns up, and this was the case again last year. The stock market rally began in March, while the U.S. economy staggered through the second quarter of 2009. Then in the third quarter, GDP rose 2.2%. Economic forecasters are predicting U.S. GDP growth of 4-5% during the 4th quarter of 2009. In order for unemployment to drop below its current level of 10% (15 million unemployed), GDP in the U.S. has to grow at 2.5% or more, as several million new workers join the labor force each year. For 2010, economists see continued economic recovery in the U.S. They are, however, divided between those who see lackluster growth for the year of 2% or less, and those who forecast robust growth of 4-5%, arguing that history has shown that the more severe the recession, the faster the economy snaps back. This analysis has worked over the past 50 years but was not the case during the Great Depression, when the economy rebounded nicely during 1933-1935 but then shrank again until World War II. Economists are also divided between those who believe that the way to get the economy growing robustly again is for even greater government stimulus (deficit spending) and those who hold that the greater the government's share of GDP, the lower the economic growth and the higher the embedded jobless rate. Both schools of economists, however, do forecast U.S. and global economic growth in 2010.

A reliable predictor of economic behavior in the U.S. is the ISM manufacturing index. This is a monthly index released by the Institute of Supply Management which tracks the amount of manufacturing activity. If the index has a value below 50, it tends to indicate a recession – especially if the trend continues over several months. A value above 50 indicates the likelihood of economic growth. The chart below shows this index over the previous five years and its recent rise above 50:

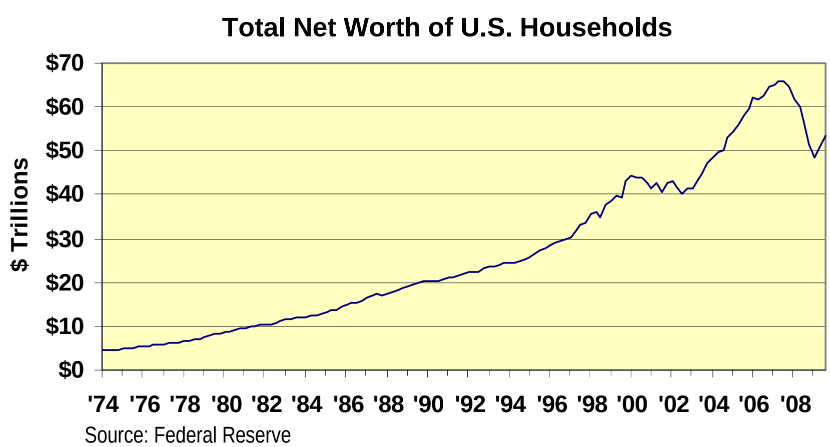


Economic forecasters build their case for 2010 economic growth in the U.S. on other factors as well. These include indicators such as the sharply positive yield curve, the likelihood of expanding inventories, a continuation of the Fed's policy of easy money, and further fiscal stimulus. This positive scenario leads most stock market analysts to forecast a rising tide of U.S. corporate earnings in 2010. Corporate earnings peaked in 2006/2007, when the operating earnings of the S&P 500 reached approximately $90. Both top-down macro forecasters and bottom-up equity analysts are predicting 2010 S&P 500 operating earnings in the $70-$75 range, as shown in the following graph:



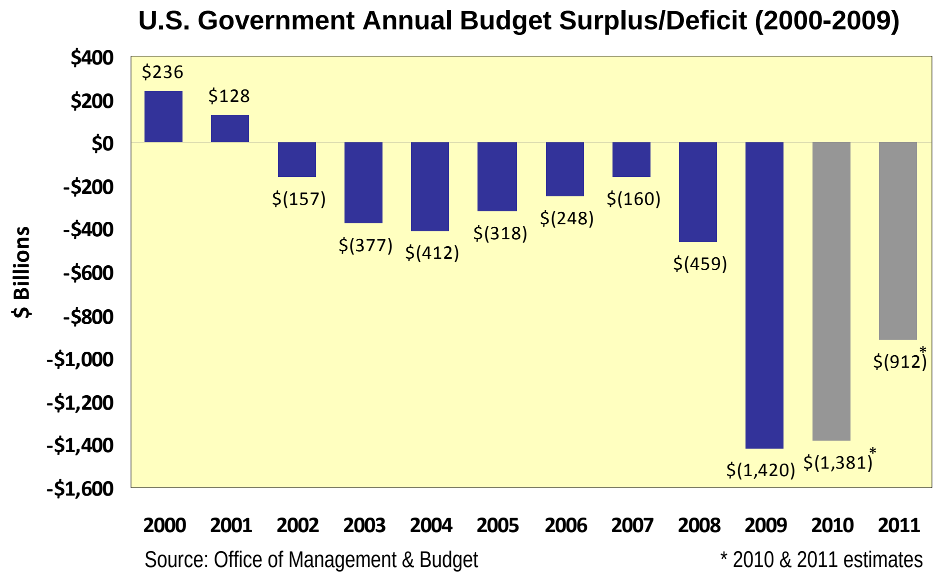
Some investors wonder if U.S. corporate earnings can recover quickly in the face of high unemployment, which should keep the consumer (already under pressure from an excessive level of debt) from increased spending. Others reflect on the possible damage to the economy by excessive regulation from Washington and the probability of higher state and federal taxes. A third potential problem is tight credit for consumers and small businesses, as banks have tightened lending standards, continuing to write off bad loans. These are real concerns that bear close scrutiny.

At Bradley, Foster & Sargent, Inc. we favor the robust growth scenario because of the key indicators in the above paragraph as well as several other factors. The first is that the Case-Shiller Housing Price Indices show that housing prices have turned up in many cities around the country. Secondly, foreign sales represented more than 48% of all the revenues of the S&P 500 in 2008 (up from 32% in 2001). Thus, the prospects for larger U.S. firms depends as much on the health of the global economy, which will likely show strong growth in 2010, as on the U.S. economy. Finally, the net worth of U.S. households rebounded nicely during 2009, as the stock market rallied and housing prices stabilized. The chart below shows this upturn in total net worth of U.S. households last year which should encourage consumers to loosen their wallets as the year progresses:



The Bad News: The Federal and State Governments

Investors' overriding concern is the enormous deficits which face both our federal and state governments. Collectively, the state governments need to close a $180 billion deficit in 2010. Unlike the federal government, the states are not permitted constitutionally to run budget deficits for longer than a year; they must find ways to balance their budgets. Most of them will end up combining higher taxes and fees with lower spending to balance their budgets. The size of the 2009 federal budget deficit and the projected 2010-2011 deficits are unlike anything that the U.S. has ever seen in peacetime. The largest peacetime budget deficit, as a percentage of GDP, was 6% in 1983. The 2009 budget deficit/GDP ratio was 10%; the ratio for 2010 and 2011 is projected to be 9.5% and 6.5% respectively. The chart below tells the story of a nation living beyond its means:



This enormous deficit leads investors to worry that Washington will raise taxes, damaging the nascent recovery, rather than cut spending. Investors also worry about who will buy the flood of government debt and the cost of servicing the debt once interest rates return to normal levels. Many believe that this huge deficit will cause the U.S. dollar to weaken further (increasing the cost of energy and food) and ultimately reignite inflation.

Investor Game Plan for 2010

Recently James Grant, editor of Grant's Interest Rate Observer, quoted the following bon mot by English economist Arthur Pigou: "The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant." This mindset describes the behavior of many investors in the U.S. stock market during the past year. Since March, even with the stock market enjoying a remarkable rally, U.S. investors have removed a net $22.7 billion from U.S. stock mutual funds. This behavior suggests that the stock market still has some room to run before it peaks. This sentiment is reinforced by the stock market's valuation. The P/E on the Dow Jones projected 2010 operating earnings is currently 13.6. Even with the many macro-economic and political uncertainties, a return to the market's historic average P/E ratio of 15 would lift the Dow to 11,710 – 10.5% higher than its current level of 10,610. This could well happen even if the stock market remains in a long term, secular bear market. This leads us to re-emphasize the need to preserve capital. Active management – not passive index funds – is still the watchword. Taking short and long term profits is appropriate. A strong weighting in quality U.S. multinational firms, which can take advantage of stronger GDP growth in selected countries abroad, and a weaker dollar should be helpful in 2010. Investing in international stocks (and some emerging markets) is still a good hedge against the problems faced by the U.S. Finally, a healthy weighting in assets such as energy and mineral stocks as well as fixed income instruments such as TIPs may prove to be a good hedge against the inflation which may result from the huge monetary and fiscal stimulus programs. In summary, we believe that investors can find ways to make money in 2010, but it will pay to be nimble.