Economic & Market Update

December 31, 2010

The global economy and financial markets provided some challenges for investors during 2010, but fortunately it turned out to be a rewarding year. Among the more prominent headline events were the European sovereign debt crisis, an economic soft patch in the middle of the year that had many wondering if we would slide back into recession, quantitative easing (QE2) by the Federal Reserve, the beginning of monetary tightening in China, and strong trends in commodity prices with oil finishing the year above $90 per barrel. There were also periods of consternation among investors that temporarily interrupted the upward trend in stock and bond prices. In the end, however, continued economic progress in domestic and world Gross Domestic Product (GDP), sharply improving corporate earnings, and lower trending core inflation enabled almost all asset classes to end the year with positive returns. It was not easy, but it turned out well.

One factor that is consoling to investors is an environment that has a degree of consistency and certainty. While the headline developments noted above kept investors off balance and skeptical at times during the year, overall they were less important than the broader, more basic economic trends. We took the opportunity to look back to our appraisal letter of one year ago and found several assumptions about the outlook for 2010. We repeat them here, for in our opinion they still apply to the outlook for 2011.

» The U.S. and world economies have entered a period of sustained economic recovery that will last for several years at least.

» The rate of growth in the recovery will be subpar compared to previous recoveries from deep recessions.

» The unemployment rate in the U.S. will decline slowly.

» Inflation will remain dormant for the intermediate term at least.

» Interest rates may drift higher as the recovery gains strength but will not rise dramatically.

These assumptions should still be a fair characterization of unfolding economic events over the next few years. Adjustments to the assumptions are all salutary. For instance, the economic recovery which is now six quarters old will most likely turn into an economic expansion in the first quarter of 2011. This means that GDP will have recovered to an all-time high, and the expansion's duration may be more than several years. As noted above, core inflation rates (ex food and energy) continue to trend lower leading to the assumption that inflation will remain dormant for longer than the intermediate term. While the trend in bond yields did seem to reverse in the fourth quarter, we expect yields to be contained in a low range until inflation shows signs of being a problem.

Against the larger backdrop there are certainly plenty of things to worry about. We do not discount the importance of the longer-term issue of mounting U.S. government debt burdens, cutbacks by state and local governments, the fact that the European debt crisis just will not go away, fears that Federal Reserve policy will eventually lead to inflation, and the prospect that currency wars will erupt in the face of intense

world competitiveness. All of these issues have an important bearing on the overall level of confidence that is so important to the ongoing health of our domestic economy, and ultimately the stock and bond markets. Nor should we omit the fact that our housing industry, one of the largest segments of our economy, is mired in what might be called a depression.

Many are wondering how in the face of these worries in 2010 the stock market managed to have another strong year. There are many Wall Street adages that have some validity. One is: "the market has to climb a wall of worry." It seems contradictory that worry would help fuel market advances, but the truth is worries traditionally create good buying opportunities because they have driven the market down. Consider the unemployment problem. Yes, some 10% of our workers are unemployed. If the economy continues growing, the unemployment rate will decline, although slowly. The time to be invested is during the journey from high to low unemployment. Those who wait to buy when unemployment is low and things seem rosy will be less rewarded than those who participate along the way to lower unemployment. Also, there is the oft cited "don't fight the Fed." This one certainly has validity because liquidity is the lifeblood of any market. If the Federal Reserve is employing expansive monetary policy there is excess liquidity in the financial system, and it always works its way into the stock market. With QE2 underway the Federal Reserve is definitely in an expansionary mode. It is no coincidence that the stock market began its latest rally phase concurrent with the announcement that the Federal Reserve was considering QE2.

Adages aside, as we view fundamental conditions in the stock market we are encouraged. We are focusing on several factors. First, we do believe the economic expansion has sustaining power, although at a less than average rate of gain compared to other post-recession periods. Second, within this recovery the performance of corporate America has been remarkable. Earnings grew at a rate of almost 40% last year and are expected to expand further this year. Profit margins are now at some 91% of their all time high in 2006. Furthermore, non-financial companies are sitting on over $1 trillion of cash equivalents which can be employed on behalf of shareowners. Third, we believe the valuation of stocks is reasonable. Based on estimated earnings of $93 for the S&P 500 in 2011, the market trades at just about its historical average price- to- earnings ratio. Other valuation methods that take into account the overall environment including the level of interest rates and inflation indicate extreme value in stocks. Either way it is hard to make a case for overvaluation of stocks unless the economy were to collapse suddenly. Of course there is the possibility of an unexpected event, but that is always a risk for investors.

In summary, we believe the path of least resistance for stocks is upward. Importantly, this is a multiyear view. Stocks are volatile instruments and are always subject to temporary correction. This is certainly a possibility today considering the extended move of the last four months. Some investors are perhaps overly optimistic, and when sentiment becomes too strong, the market often goes the other way. But longer term investors who recognize the inevitability of such swings in sentiment will keep focused on the basics of economic growth, corporate earnings, and valuation. If these are all in reasonable ranges, then one should maintain an invested position for the longer-term.

Speaking of the possibilities of market corrections, the bond market suffered one of its own in the fourth quarter. Bond yields backed up rather sharply as the yield on the ten-year U.S. Treasury note rose from roughly 2.5% to 3.5% in a short period of time. Investors quickly began worrying about future inflation as a result of QE2, and the supply of new bond issues tended to overwhelm the market. Late in the fourth quarter yields began to stabilize and recover, and we believe this trend is likely to persist.

Like stock investors, bond investors should also keep focused on basic fundamentals. In our opinion, if one restricts bond investment to highly-rated, high-quality issuers, there is one overwhelming factor to

keep an eye on: inflation. One of the highest correlations in all of finance is the trend of bond yields to underlying inflation. A bond investor simply must get it right on inflation. Here our level of conviction is high. It is a fact that the world faces a shortage of demand, and inflation is more a product of demand than any other factor. As long as the world has more capacity to produce goods and services than it does to consume them, there will be no room for a general inflation. Yes, commodity prices can inflate, and there can be pockets of inflation around the world, but a general inflation where there is price pressure across the board is almost impossible to sustain in the face of shortage of demand. As noted earlier, we expect inflation to remain dormant for some time, thus bond yields should be contained within a reasonable range around current levels. Investors will do well to remember the diversifying ability of bonds when matched with equities. Bonds are more stable because they have an ultimate maturity which promises return of capital, and they produce a higher level of income, another stabilizer of the return pattern.

Best regards.

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