2009 YEAR END REVIEW OF MARKETS: COMFORTABLY NUMB

"To the governor of this bank: Never forget that it was created to serve the employer and the working man, the producer and the consumer, the importer and the exporter, the creditor and debtor; all in the interest of the country as a whole."

A reminder written by Benjamin Strong, first Chairman of the Federal Reserve Bank (1913-1928), and always kept in the top drawer of his desk

Markets in 2009 began with trepidation during the first quarter, and finished with a sustained recovery in asset prices for the remainder of the year. Central banks printed, and governments around the world borrowed, unprecedented amounts of money which they injected into their economies to prevent catastrophic collapse. As one of our favorite global investment strategists commented, it was the same as administering financial heroin to a stricken victim or strung out addict. And while markets are presently comfortably numb from these injections and attempting to recover, the real challenge will be to manage the withdrawal. Ultimately, the overleveraged economies will struggle to regulate the dosage as they operate in a stupor of slack demand and oversupply. Healthier, younger economies should be able to distance themselves from these recovering addicts.

Summary returns for 2010 are reviewed below:

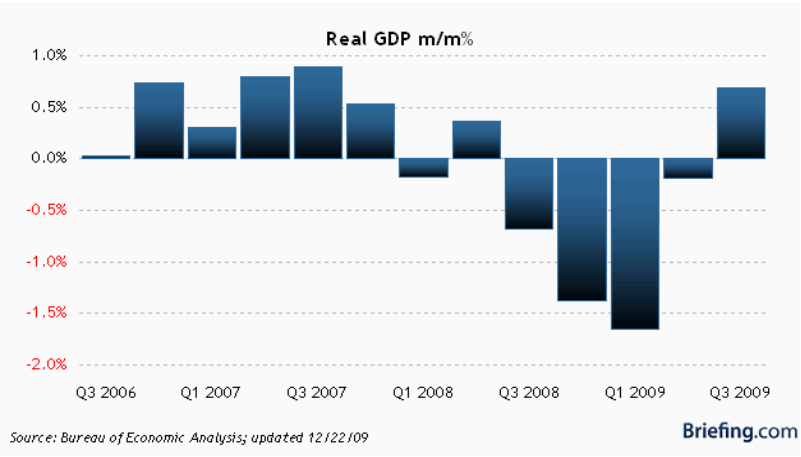
	2009	Last 3 Years	Last 5 Years	Last 10 Years
S&P 500 Total Return	26.46%	-15.95%	2.09%	-9.12%
Value Line Composite	36.77%	-32.51%	-23.60%	-28.32%
MSCI EAFE	32.46%	-15.80%	21.78%	16.97%
MSCI Emerging Markets	79.02%	17.16%	108.99%	161.95%
Citigroup 5 Year T-Note	-1.39%	24.06%	27.25%	79.93%
Barclays Five Year Muni	7.41%	19.46%	24.62%	66.55%
DJ UBS Commodity Index	18.91%	-11.06%	10.17%	99.12%
CPI	2.91%	7.20%	13.68%	28.54%

All returns are cumulative, not annualized

Stocks recovered much of their value versus bonds, but are still well off their highs of 2007-8. The "lost decade" of the "oughts" produced a negative return for US stocks (S&P 500 / Value Line Composite), but was a winner for emerging markets and hard assets like commodities, despite the epochal crash of 2008.

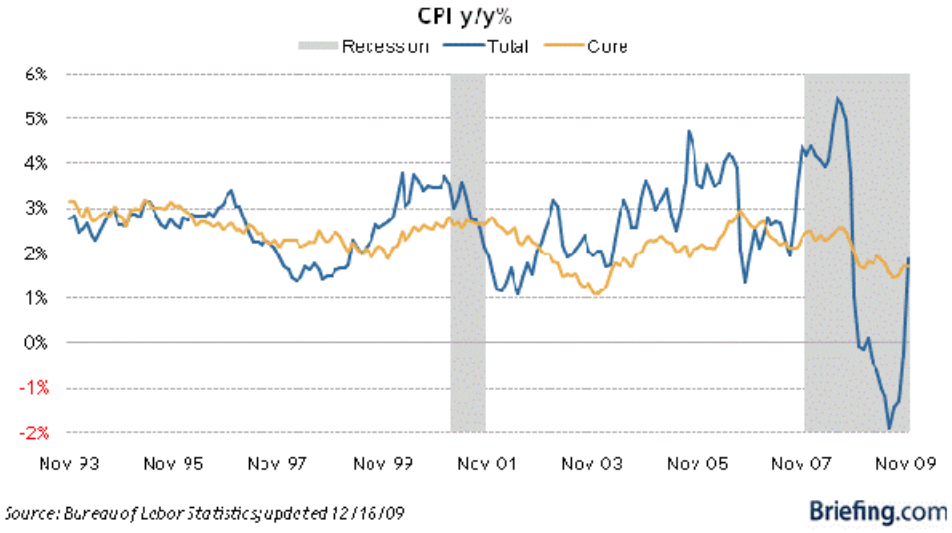
Macroeconomic Outlook

GDP bottomed during the first quarter of 2009, and is trying to recover. Q3 GDP was up at an annualized rate of 2.2%:

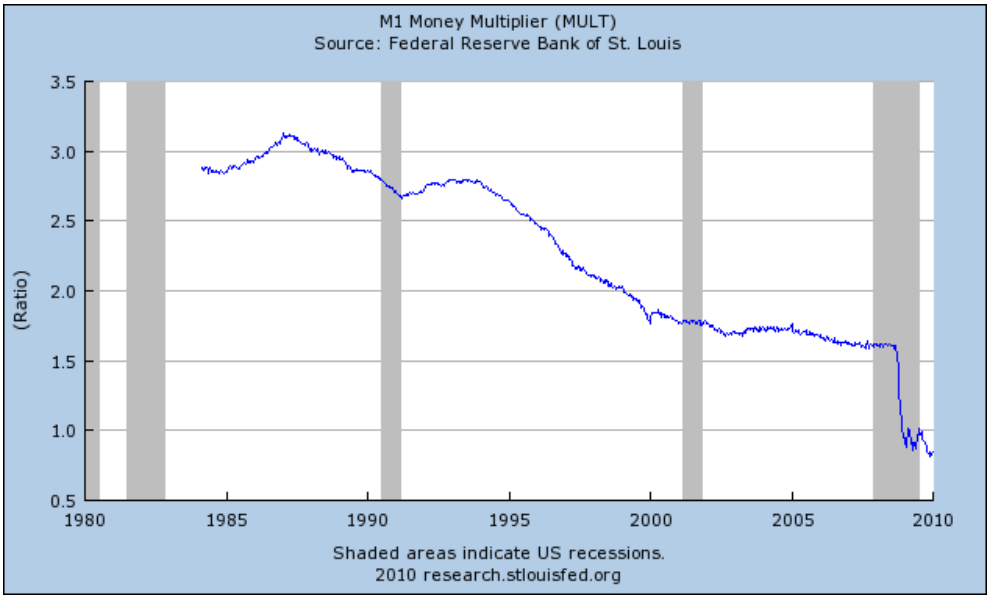


This is a shockingly low rebound given all the government stimulus applied. What is the "something else" that will get things moving again? The classic tool of cheap money (0% interest rates for savers) is impotent. Government spending through TARP, cash for clunkers etc. is a short term, finite exercise. Our view is that an overleveraged economy must reduce its debt burden through increased savings over a very long adjustment process to restart demand. This basic economic principle means consumption will decline until a point of equilibrium is reached, and the accumulated savings will then provide fuel for reignition. Therefore, investors should expect lower normalized GDP growth. We look for a low 2% trendline versus the 3.5% that has characterized much of the last three decades.

On the inflation front, CPI fell throughout the year but has recently rebounded to annualized rate of 1.8%.



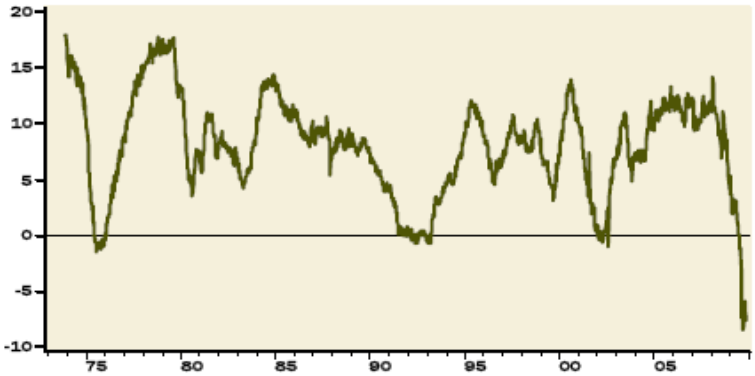
Concerns about deflation seem to have fallen by the wayside, as most prognosticators fret over an imminent eruption of inflation due to the massive expansion of the US money supply since 2008. However, until that excess money gets used (credit expansion occurs; i.e. loans are made), there will not be much pressure on prices. (In technical terms, until the money multiplier rises to increase velocity, the economy will limp along.) This very important measure is illustrated below:



As we have long held, credit is the grease that lubricates the economy and causes increases in real demand. The current abysmal state of the lending market is shown below:

CHART 2: BANK LENDING CONTINUES TO CONTRACT

United States: Commercial Banks: Loans & Leases in Bank Credit
(year-over-year percent change)

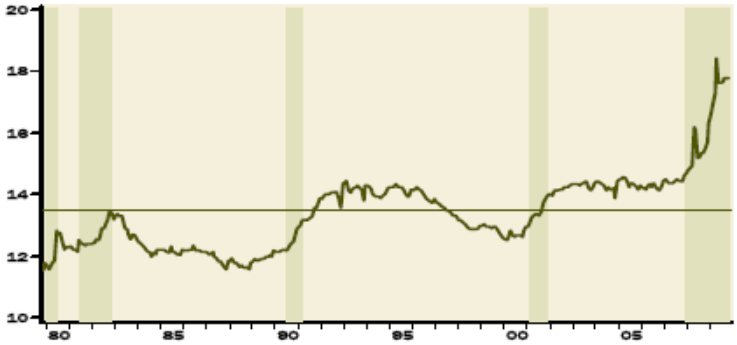


Source: Haver Analytics, Gluskin Sheff

Government spending remains the primary motor for the US economy. With the midterm election coming up and the Federal Reserve likely to delay any withdrawal of monetary stimulus (i.e. short rates will stay at 0% and continued purchases of mortgages and other impaired assets will continue), the government remains the only source of "organic" growth in the US economy. This public sector "demand push" command style economy is reasserting itself into the personal income structure, as transfer payments to individuals from the government (i.e. welfare checks) move sharply higher:

CHART 1: HANDOUTS NOW ACCOUNT FOR ALMOST ONE-FIFTH OF PERSONAL INCOME

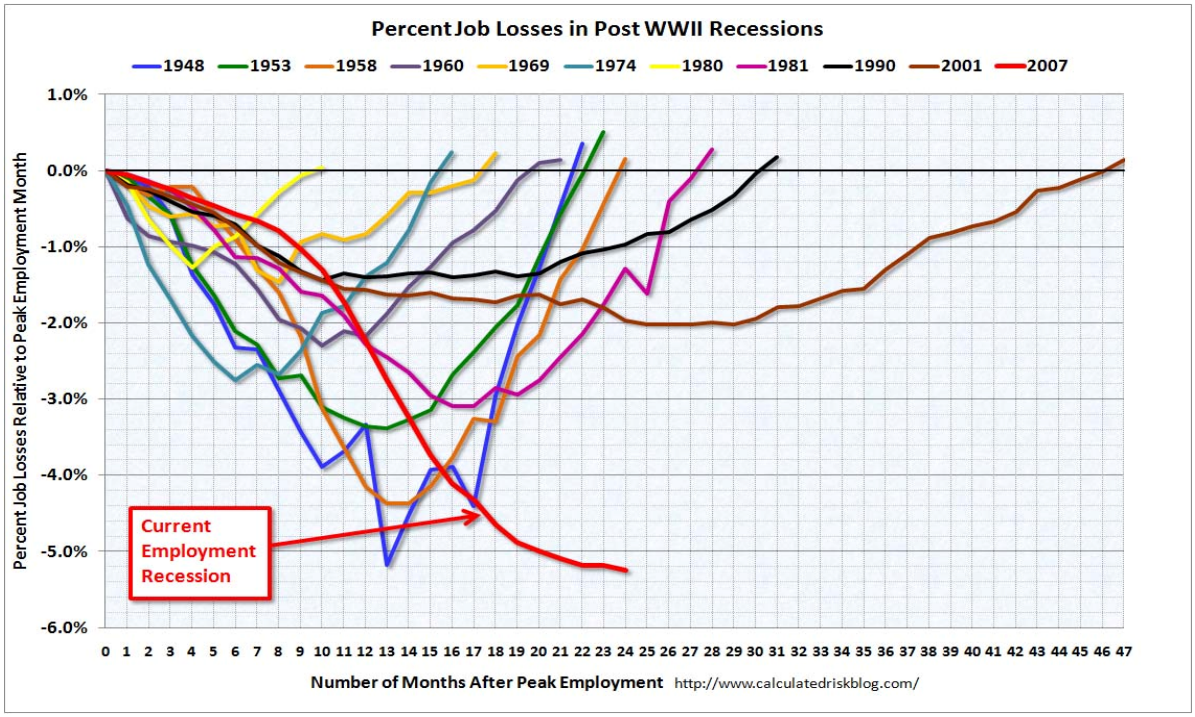
United States: Personal Current Transfer Receipts as a share of Personal Income
(percent)



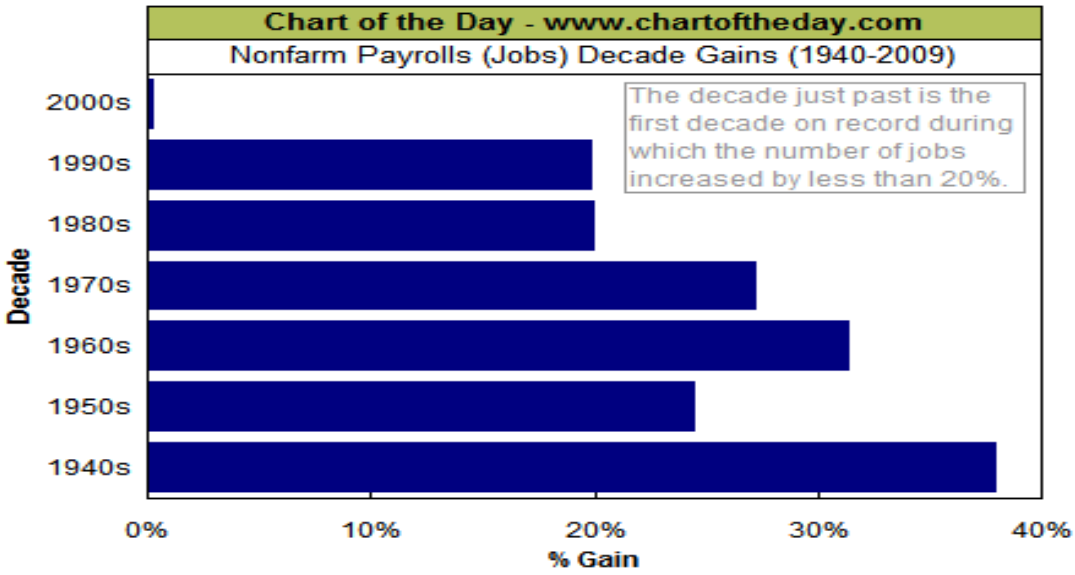
Shaded region represent periods of U.S. recession.
Source: Haver Analytics, Gluskin Sheff

Unemployment remains highly problematic, and is sure to become a political hot potato in the 2010 re-election campaigns. The latest jobs report ("non-farm payrolls") was down 85,000, but is being touted as an aberration in an otherwise improving job market. The statistics suggest otherwise. The "household" survey, which reflects small business activity, showed a loss of 589,000 jobs in December. The "U6 Report", which includes those discouraged workers who are no longer seeking employment, recorded a national unemployment rate of 17.3%. Jobless benefits have been extended for the fourth time to a record 27 weeks.

The constant focus on month to month changes obscures long term patterns. In this recession, there has been no turnaround in job creation versus prior rebounds, and the extended nature of this downturn is unprecedented:

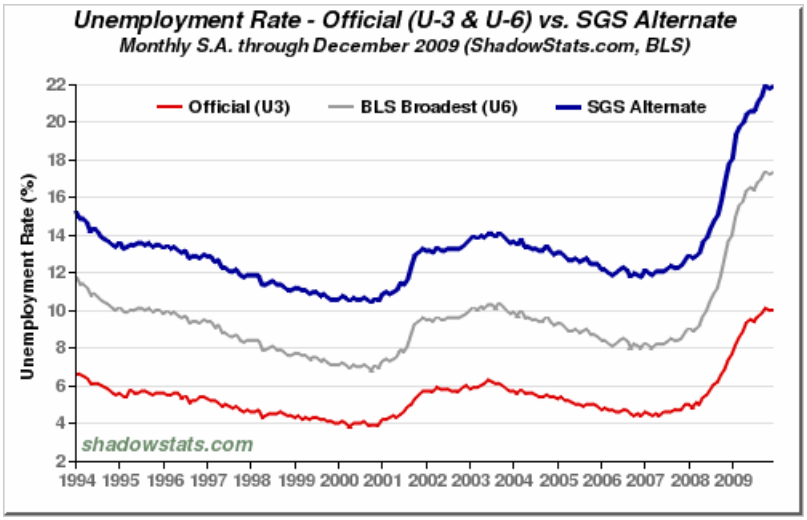


There has also been little net job creation in the US over the past 10 years:



To compound matters, the Bureau of Labor Statistics (which compiles the unemployment data) has changed formulas over the years so that the current 10% unemployment rate is sanitized and massaged to mask the real situation. We recommend a visit to www.shadowstats.com for a clear eyed and unvarnished

presentation of the true state of the economy. Here is a comparative graph showing the "official" rate versus the "real" (SGS Alternate) rate of 22% unemployment:



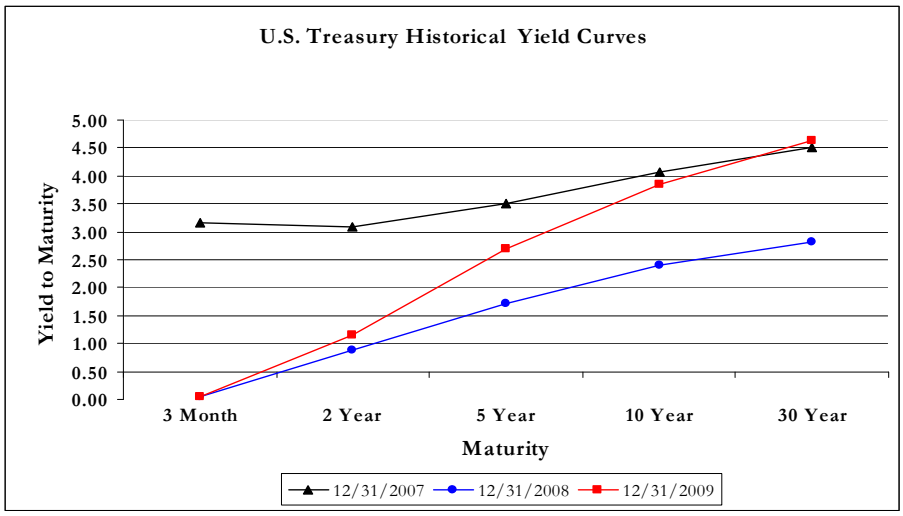
This all spells "downscaling" for the US economy, and is about the clearest evidence we can find that consumption/demand is in for a long dry spell in the US. We think the 1930's playbook will be revived, as the government will embark on a massive jobs program that is certain to be on the agenda as election year legislation rolls out. Growth will come from overseas economies which do not exhibit these income suppressing trends. (In India, for example, GDP expanded by 7.9% in the latest reporting period, leading most economists to upgrade their forecasts. IT powerhouses like Infosys are boosting staffing by over 20%, but they can't find enough qualified people at home, and so are "offshoring" to other countries to meet booming demand.)

The distressing state of the US economy and our elected officials / political system was recently flogged in a bold statement from PIMCO's Bill Gross that got a lot of play among professional investors: "What has become of the American nation? Conceived with the vision of liberty and justice for all, we have descended in the clutches of corporate and other special interests to a second world state defined by K Street instead of Independence Square. Our government doesn't work anymore, or perhaps more accurately, when it does, it works for special interests and not the American people. Washington consistently stoops to legislate 10,000-page perversions of healthcare, regulatory reform, defense, and budgetary mandates overflowing with earmarks that serve a monied minority as opposed to an all-too-silent majority. You don't have to be Don Quixote to believe that legislators – and Presidents – often do not work for the benefit of their constituents: A recent NBC News/*Wall Street Journal* poll reported that over 65% of Americans trust their government to do the right thing "only some of the time" and a stunning 19% said 'never'. What most politicians apparently are working for is to perpetuate their power – first via district gerrymandering, and then second by around-the-clock campaigning financed by special interest groups. If, by chance, they're ever voted out of office, they have a home just down the street – at K Street – with six-figure incomes as a starting wage.

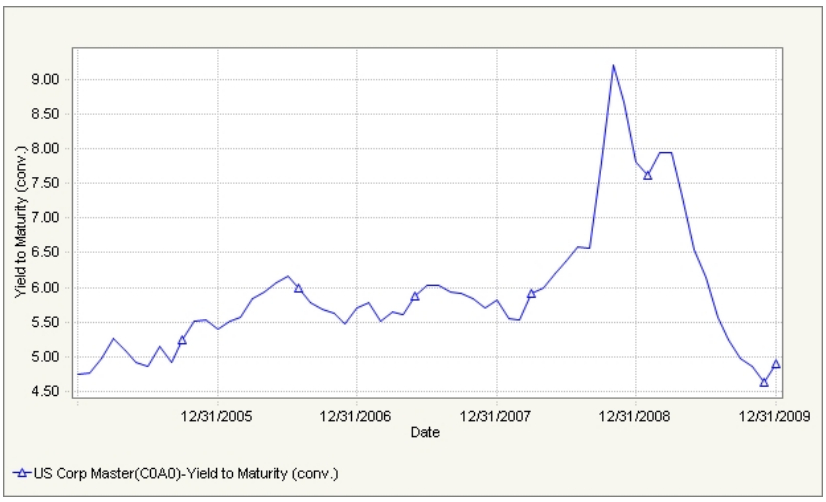
What amazes me most of all is that politicians can be bought so cheaply. Public records show that combined labor, insurance, big pharma and related corporate interests spent just under $500 million last year on healthcare lobbying (not much of which went to politicians) for what is likely to be a $50-100 billion annual return. The fact is that American citizens have never been as divorced from their representatives – and if that description fits the Democratic Congress now in control – then it applies to Republicans as well – past and present. So you watch Fox, or is it MSNBC? O'Reilly or Olbermann? It doesn't matter. You're just being conned into rooting for a team that basically runs the same plays called by look-alike coaches on different sidelines. A "ballot box" pox on all their houses – Senators, Representatives and Presidents alike. There has been no change, there will be no change, until we the American people decide to publicly finance all national and local elections and ban the writing of even a $1 check for our favorite candidates."

Bonds

In 2009, corporate bonds performed exceptionally well, rising 15% or so, while high-grade government bonds were flat to slightly negative. The yield curve steepened with short rates firmly anchored at close to zero. Long rates rose meaningfully as market participants anticipated significant new issuance from the US Treasury:



The panic that gripped investors last year drove yields up on corporate and other "risky" bonds to unprecedented levels, allowing them to snap back hard once the panic subsided:



Source: Merrill Lynch

It is clear that risk appetite has returned to the bond market, as huge issuance and take-up of well regarded issuers dominated the last half of the year. However, tainted paper (mortgage and asset backed securities) has virtually no "bid". We do not see any natural buyer for now for these securities except the Fed, so it is unlikely that support for this market will be withdrawn anytime soon. If the economy does not gain traction, then corporates may also give back some of their gains.

Another notable feature of the bond market is the record steepness of the yield curve, especially between 10 and 2 year Treasuries (3.7%-.9%=2.80%). Any weakness in stocks will see these bonds rally, especially 5-10 year maturities, producing a "flatter" curve and healthy returns for these "risk-free" instruments.

In the US, a further deterrent to recovery is the rapidly deteriorating fiscal condition of state and local governments, whose tax receipts have plunged 13% over the past three quarters, the worst decline since

1963. California has already requested federal "bailout" monies (actually the "Governator" says it's a more equitable re-distribution of dollars submitted to DC by the Golden State). Estimates are for an even worse showing in 2010, and it is a certainty that many others will join the handout line. DC is in no position, and voters are in no mood, for more bailouts, so we expect a steady reduction in services. Libraries, parks and recreation, and schools will be particularly hard hit. Essential services like water and sewer, and police, fire, and health care should fare better. Municipal bonds are bearing the brunt of market concerns, with many yields double what equivalent maturity Treasury Notes bring. We favor only shorter maturities because the municipal finance crunch is only beginning, and higher yields await 3 to 5 years out. Increasingly scarce pre-refunded or escrowed to maturity municipal bonds (100% backed by US Treasuries) are even more attractive as they offer tax free income with no credit risk.

Globally, the focus in bonds will be how investors adjust to the torrent of new sovereign debt hitting the market. 2009 was a year of record bond issuance by the US Government, with $2.1 trillion in new Treasuries sold. 2010 financing needs are estimated to increase to $2.4 trillion. And, while borrowing costs (interest rates) for the US are at an all time low, returns for Treasuries were the worst since 1973, at -3.7%. The same situation exists in the UK, Japan, and many Eurozone countries (Greece, Italy, Spain, etc.). The need for fiscal belt-tightening is staring squarely in the face of continued spending programs as governments embrace a Keynesian solution to the persistent downturn. We expect the bond vigilantes will police the worst offenders (Greece for now) by hiking interest rates (risk premiums). Formerly risk-free issuers like the US Treasury are seeing the effects, as credit default swap spreads--the cost of insuring against default--have risen from virtually nothing to around 40 basis points. In Europe, high quality corporate bond issuers now have lower insurance costs than sovereign nations. On the other hand, those countries that operate in surplus mode and are debtor friendly will likely be rewarded. Although it won't happen instantly, the long run adjustment is beginning, and formerly "gilt-edged" government issuers are going to have to compete for increasingly scarce investment dollars with healthier ascendant issuers like Brazil and Canada.

There is also the very large issue of the willingness of a nation/people to repay the debts incurred in their name. Recently, the *Economist* wrote about the debt-imploded nation of Iceland: "There are many ways to decide whether to repay your debts but a national referendum is surely a first. That is what is going to happen in Iceland after its president refused to sign a bill paying €3.8 billion ($5.5 billion) to the British and Dutch governments over 15 years. Given that a quarter of the Icelandic population has signed a petition opposing such payments, it is not difficult to imagine how such a poll will turn out. 'Vote for lower incomes' is not going to be a very popular slogan. And the Icelanders will only be the first. Around the world governments have assumed the debts of their private sectors. That is an easy commitment to make in the short term. Paying the money back is another matter. If the debt is large enough, the result will be years of austerity. Electorates will choke at the cost." In Argentina, already eight years into their sovereign debt default, we now have the extraordinary spectacle of the President demanding the resignation of the Central Bank head because he refused to pay down a portion of the national debt. Art Cashin of UBS finishes the spot on analysis: "The reason this discussion is important is the level of sovereign debt around the world. The rescue of the financial system was achieved by transferring mountains of debt from private to sovereign hands. When it comes time to begin paying down that debt, will the populace willingly bear the burdens and sacrifices needed? Or, will they vote to default or elect officials willing to default?"

Equities

In the US, the sector scorecard for 2009 was a mirror reversal of 2008's dreadful returns:

Technology	59.92%
Basic Materials	45.23%
Consumer Discretionary	38.76%
S&P 500	***26.46%***
Industrials	17.27%
Health Care	17.07%
Financials	14.80%
Energy	11.29%
Consumer Staples	11.20%
Utilities	6.80%
Telecommunications	2.63%

Source: Standard & Poors

Operating earnings for 2010 are currently estimated at $77 per share, an increase of 36% over 2009. This "consensus" view is very optimistic given the sluggish performance of US GDP and employment, and leaves little room for error. In fact, earnings growth of 30%+ has never occurred with nominal GDP at 4-5%. Only a very strong "V-shaped" recovery can justify current stock prices. And, since PE multiples are already at elevated levels (20-25X depending on projected forward earnings), investors cannot count on multiple expansion to increase values. Only a real and sustainable uptrend in earnings can validate and sustain current levels.

The wild card is that "hot money" continues to chase stocks as momentum carries prices higher. Remember that as the Internet bubble rose, investors discarded any notion of fundamental valuation, buying stocks at highly elevated prices for almost two years (Cisco Systems at one point traded for over 100 times earnings and was briefly the largest company in the world by stock market capitalization). So it is quite possible that stocks continue the march higher in 2010 and overshoot on the upside. We know how this movie ends however, and are prepared for sudden and sharp declines in prices that inevitably result from a reversal of momentum, especially one that is aided and abetted by the "carry trade" (borrowing on a sliver of equity in dollars at near 0% and buying anything going up in value).

On the positive side, a significant increase in mergers and acquisitions activity is occurring, and tremendous amounts of "dry powder" are looking for a home away from low yielding cash alternatives. In November, Warren Buffett's Berkshire Hathaway made an "all-in wager on the economic future of the United States" by launching a tender offer for Burlington Northern Santa Fe Corp. at a 31% premium to its prior day close. More of these high quality companies with significant "economic moats" may be put into play this year (Kraft's current pursuit of Britain's Cadbury fits this mold).

Thematically, we continue to favor the international arena, and especially those companies that produce what is needed most by the fast growing consumer sector in the newly "emerged" economies. Agricultural oriented and food investments look to have especially robust futures. It also appears that, after a long period of underperformance, high quality US large cap companies are set to resume their winning ways. Amongst the shifting mosaic of investment opportunities, investors will also need to factor in the heavy hand of government regulation and higher taxes (i.e. how will a higher tax on dividends and capital gains affect stocks, how will utility companies stay profitable with a mandated carbon tax, how do health care providers compete with new and restrictive guidelines etc.).

The Continuing Housing Conundrum

What happens in the housing market has an enormous impact on the US economy, and it is funded through the issuance and securitization of loans into "MBS" (mortgage-backed securities), which used to be purchased by the private sector. Activity is hyper-sensitive to rates, which are rising. Mortgage rates were up a quarter-point in December from record sub-5% lows in 2009, and now stand at four month highs. Investors are obsessing over the Fed's exit strategy in March when it plans to stop purchasing mortgage-backed securities. The Fed now holds an unbelievable $909 billion of mortgage paper on its balance sheet, and has purchased 73% of the mortgages securitized by Ginnie Mae, Fannie Mae and Freddie Mac. Adding in US Treasury purchases, the government has bought over $1 trillion of mortgages. In short, the US housing market has been nationalized, and these guarantees are never likely to be paid back in full, leaving a permanent bill for future generations. The Fed, in its infancy, was guided by a principled and thoughtful Chairman, Benjamin Strong, who would recoil in horror at the gross manipulations and distortions of the economy that these actions have wrought.

More despicably, in the still of the night as Christmas Eve approached, the US Treasury announced that it was unilaterally overriding the Congressionally approved cap of $400 billion on mortgage guarantees, and would henceforth offer UNLIMITED financial support for Fannie Mae and Freddie Mac for the next three years. We think large creditor nations (China, Japan, Singapore etc.) forced the US to buckle under to protect the value of their enormous MBS holdings. They know that the rising foreclosure wave is going to further impair these packaged housing loans. So we now have an open-ended and wholly unlegislated complete bailout of the US housing market which will saddle the US with untold hundreds of billions of more debt. And, apparently, the US Congress is going to roll over and play dead with respect to fiscal powers that the Constitution enumerates to it and it alone, as luminaries like Barney Frank merrily chirped away on CNBC that this action by Treasury was OK with him. Now even the US Congress has gotten comfortably numb, but this time from the unceasing incursions of an unelected bureaucracy. We are shocked that the major media and most investors have remained silent at this gross hijacking of the US Constitution. The rule of law lies in tatters.

The Bigger Picture and Outlook for 2010

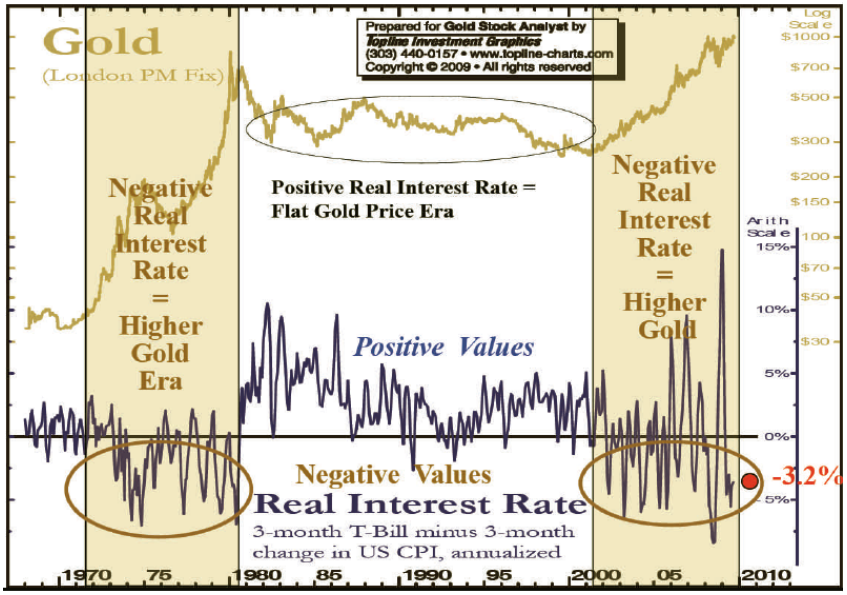
Recently, and on the same day, China announced that they would raise their short term interest rates, and Japan proclaimed that they would pursue a weaker Yen policy. These actions are part of a coming period of currency adjustments in which countries will compete to have the lowest/most competitive currency to drive exports and thereby soak up excess domestic labor which might otherwise prove destabilizing. Most people call this a "beggar thy neighbor" policy. It will be a gradual but relentless process, as the whole world seeks growth/full employment in a demand starved world.

Some countries, like Venezuela, may overtly and dramatically devalue their currency (Chavez took the Bolivar down over 40% this past week). Besides the loss in purchasing power, these actions will serve to reinforce the notion that paper currencies ("fiat money") are inherently unreliable as a long term store of value. And, while the US Dollar will undoubtedly continue to serve near term as the world's global reserve currency, we expect to see continued diversification into oil, gold and other hard/productive assets.

In addition, protectionist measures look set to increase. The year end decision by the US International Trade Council citing state-subsidized Chinese steel exports as harmful to US producers follows on the same ruling for imported tires, and is indicative of rising inward looking and nationalist sentiment which has proven to be so harmful in the past.

Gold and precious metals will remain the destination of choice for skittish investors and governments globally. In November, India purchased 200 metric tons of the yellow metal in one of the largest sales ever by the International Monetary Fund. An all time high if $1,226 per ounce was recorded in December. And, while supply currently exceeds demand, it is vulnerable to a pronounced and sustained period of rising purchases.

More importantly, gold performs extraordinarily well in periods of negative real interest rates (when inflation exceeds T-Bill rates), which is where we are now:



Source: Gold Stock Analyst

Negative real rates incentivize investors to hold gold, both because of the low opportunity cost and the very strong correlation between ultra-low rates and the eventual onset of inflation. Because this environment is the same in many advanced economies, there is a growing mass of buyers that can now easily access the bullion market through exchanged-traded funds, electronic vault holdings, and outright metal purchases. While a period of consolidation would not be unusual, we think much higher prices are in store as investors realize how poorly paper currencies serve as a store of value, particularly given the explosion in debts (liabilities) which stand little chance of being retired in most investors' lifetimes.

In sum, the reflation of asset prices during the past year is a work in progress that must be monitored diligently. It is unclear how much more stimulus can be applied by governments worldwide to get their economies moving. Volatility has collapsed, and investors have been numbed into a warm zone of security. These are precisely the times when extra caution is warranted. A global orientation and a capital protection mindset may be an investors' best friend in 2010.

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January 15, 2010