



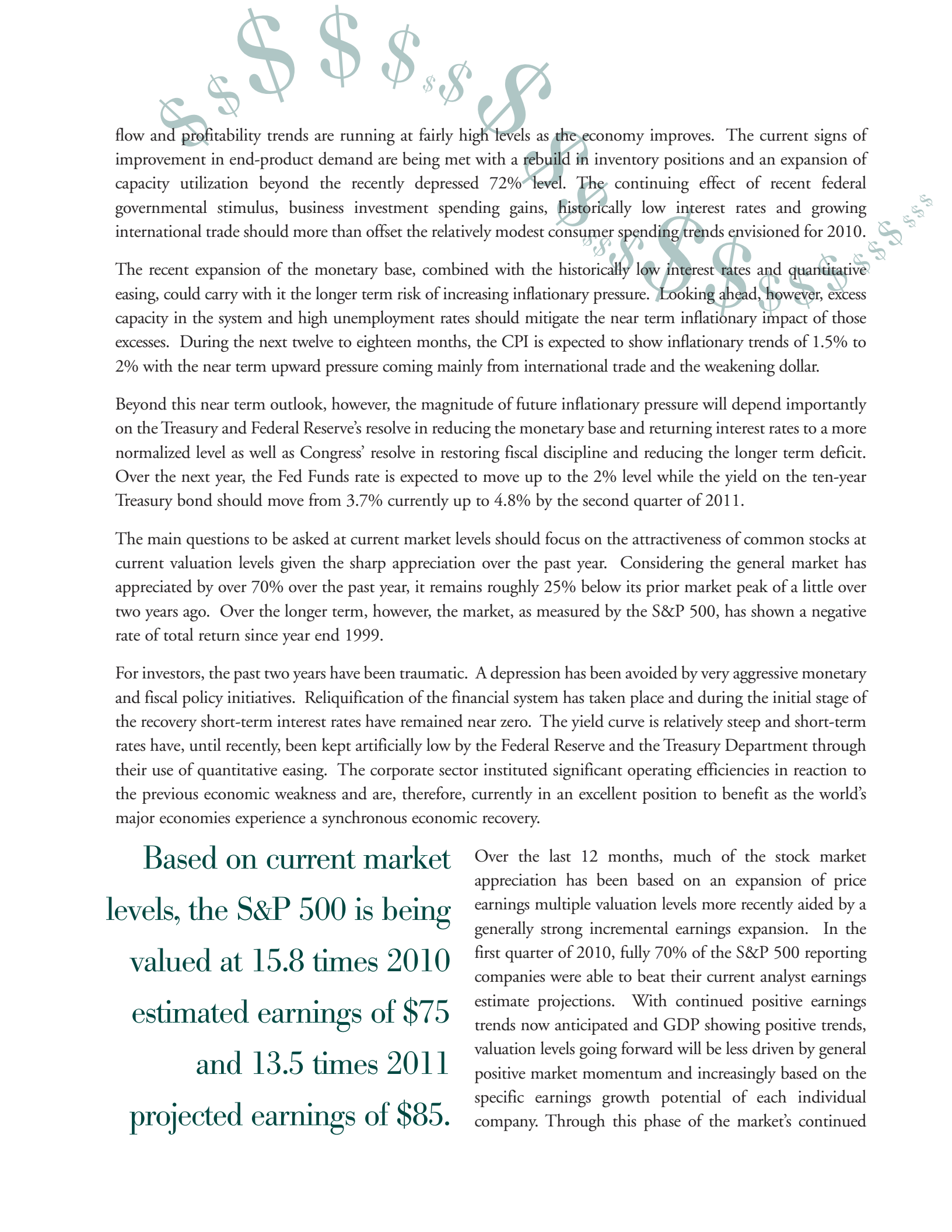
ECONOMIC OVERVIEW

# Spring marks the one year anniversary of the end of what has become known as the “Great Recession”.

The economy bottomed in the second quarter of 2009 and turned positive in July of last year. The initial economic recovery was relatively weak and largely the result of an unprecedented level of fiscal and monetary stimulus that was applied to the economy by the Treasury, the Federal Reserve and Congressional legislation. Looking back at the governmental actions that were taken in late 2008 and early 2009 now, one can question the wisdom and longer term implications of some of the fiscal, monetary and legislative initiatives. The net result of these actions, however, was crucial in unfreezing the financial system and setting the stage for the economic recovery.

Whether measured in its duration of nineteen months or its peak to trough decline in GDP (Gross Domestic Product) of 3.9%, the Recession was the worst economic downturn since the Depression of the 1930's. Following the rapid economic deterioration that extended through the first half of 2009, positive GDP growth returned in the third and fourth quarters of last year with gains of 2.2% and 5.6% respectively. For the full year 2009, the United States economy reported a decline in GDP of 2.5%. During the first quarter of 2010, GDP growth came in at 3.2%. Consumer spending reported a gain of 3.6% during the first quarter representing the strongest quarterly comparison in three years. Business investment spending was very strong with a gain of over 13% coming off what had been very depressed levels experienced over the preceding eighteen months. The 3.2% GDP gain reported for the first quarter actually occurred in the face of a decline in overall governmental spending during the period, as a 3.8% drop in state and local spending more than offset the modest 1.4% increase in federal spending.

For the remainder of 2010, the domestic economy is expected to show continuing gains in the area of 3.5% to 4% as consumer spending trends continue to show gradual improvement from first quarter levels. Business investment spending growth should remain strong. Corporate balance sheets in the non-financial sectors have remained strong throughout the recession and cash



flow and profitability trends are running at fairly high levels as the economy improves. The current signs of improvement in end-product demand are being met with a rebuild in inventory positions and an expansion of capacity utilization beyond the recently depressed 72% level. The continuing effect of recent federal governmental stimulus, business investment spending gains, historically low interest rates and growing international trade should more than offset the relatively modest consumer spending trends envisioned for 2010.

The recent expansion of the monetary base, combined with the historically low interest rates and quantitative easing, could carry with it the longer term risk of increasing inflationary pressure. Looking ahead, however, excess capacity in the system and high unemployment rates should mitigate the near term inflationary impact of those excesses. During the next twelve to eighteen months, the CPI is expected to show inflationary trends of 1.5% to 2% with the near term upward pressure coming mainly from international trade and the weakening dollar.

Beyond this near term outlook, however, the magnitude of future inflationary pressure will depend importantly on the Treasury and Federal Reserve's resolve in reducing the monetary base and returning interest rates to a more normalized level as well as Congress' resolve in restoring fiscal discipline and reducing the longer term deficit. Over the next year, the Fed Funds rate is expected to move up to the 2% level while the yield on the ten-year Treasury bond should move from 3.7% currently up to 4.8% by the second quarter of 2011.

The main questions to be asked at current market levels should focus on the attractiveness of common stocks at current valuation levels given the sharp appreciation over the past year. Considering the general market has appreciated by over 70% over the past year, it remains roughly 25% below its prior market peak of a little over two years ago. Over the longer term, however, the market, as measured by the S&P 500, has shown a negative rate of total return since year end 1999.

For investors, the past two years have been traumatic. A depression has been avoided by very aggressive monetary and fiscal policy initiatives. Reliquification of the financial system has taken place and during the initial stage of the recovery short-term interest rates have remained near zero. The yield curve is relatively steep and short-term rates have, until recently, been kept artificially low by the Federal Reserve and the Treasury Department through their use of quantitative easing. The corporate sector instituted significant operating efficiencies in reaction to the previous economic weakness and are, therefore, currently in an excellent position to benefit as the world's major economies experience a synchronous economic recovery.

**Based on current market levels, the S&P 500 is being valued at 15.8 times 2010 estimated earnings of \$75 and 13.5 times 2011 projected earnings of \$85.**

Over the last 12 months, much of the stock market appreciation has been based on an expansion of price earnings multiple valuation levels more recently aided by a generally strong incremental earnings expansion. In the first quarter of 2010, fully 70% of the S&P 500 reporting companies were able to beat their current analyst earnings estimate projections. With continued positive earnings trends now anticipated and GDP showing positive trends, valuation levels going forward will be less driven by general positive market momentum and increasingly based on the specific earnings growth potential of each individual company. Through this phase of the market's continued

growth, the markets' overall price earnings multiple valuation expansion begins to slow and individualized earnings potential becomes the driving factor behind further market gains. We will continue to focus on high quality firms with strong balance sheets and global footprints that will benefit from the continuing economic recovery both domestically and internationally.



While the equity markets have shown a negative total return since year end 1999, the fixed income market as measured by the Barclay's Government/Corporate Intermediate Bond Index has recorded a positive total return of over 80%. Over the past few years, the bond investor has been the beneficiary of a benign near-term inflationary outlook, a flight to safety in an environment of dramatic stock market declines and the current Federal Reserve and Treasury policies fostering financial reliquification. With the recent policy of quantitative easing now at an end, the initial increase in the Federal Funds rate should be expected before year's end. As both short and longer term interest rates begin to move up and longer term inflationary concerns overtake the investors' desire for safety, the current historically low level of interest rates should begin to rise and produce a gradual migration of marginal cash flow from the bond market to the equity market. In this environment, the relative performance of the bond market should begin to weaken in relation to equities.

Based on current short-term interest rates, money market funds provide a current yield of only 0.1%. Adjusting for current tax rates and modest inflation levels, the real return of these assets is actually 0% or slightly negative. By comparison, the general equity market, as measured by the S&P 500, has a current dividend yield of 1.9% and represents an income stream that over the longer term has grown with the inflation rate thereby maintaining the purchasing power of the income stream. In addition, the S&P 500 dividend payout ratio currently represents 28% of the market index's 2010 estimated earnings per share, a level that is well below the longer term average payout of 45%, therefore leaving significant room for improving payout levels.

## CAPITAL MARKETS OVERVIEW

Fixed income has been a difficult path the past two years with volatility, flight to quality and general market frustration at low interest rates. Investors looking for cash flow are once again moving to more risky sectors, such as non-investment grade, mortgage securities and derivatives. The good news is that the willingness of investors to move away from Treasuries, Agencies and investment grade offerings demonstrates a feeling of greater market confidence. The bad news is if we have another global market disruption resulting from the current international turmoil brewing in the European Union there will be several waves of flight to quality investing. Flight to quality always exhibits itself in the form of demand for Treasuries first, agencies when Treasury yields get too low and the US dollar. A strong US dollar puts pressure on the ability of US companies to export goods and services. America is currently suffering from historically high debt levels resulting from government spending and the US government. The government is in a desperate battle to rebalance the scales back to business and consumer spending.

Build America Bonds (BAB) are retaining their allure to a variety of investors. BAB purchases are limited to some very selective names and require a call feature on the issue. The call feature demonstrates the issuer's awareness

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that the federal tax subsidy, as laid out in the America Recovery and Reinvestment Act, is not irrevocable. We want the issuer to have the ability to protect their financial expenditures and call the bonds back to either reissue the debt as a tax-exempt security or identify a new, less costly source of funding. It is also very important that the municipal issuer is being prudent about the total amount of outstanding debt that they can actually carry comfortably and they are not issuing additional debt simply because they have the federal governments approval to do so (like a sub-prime borrower having the ability to borrow in the marketplace, but not the ability to actually pay the debt). An extension of the BAB program would defeat the purpose of the Federal government traditionally shifting the exposure of financially supporting municipal issuers over to the individual investor. Too much debt on the US balance sheet will have a negative longer term affect.

Moody's and Fitch recently recalibrated their credit ratings to a Global Rating Scale (GRS). The theory is that this will realign municipal credit ratings with corporate ratings. The result has been some previously assigned triple-B ratings (such as Puerto Rico and California) have been upgraded to single-A. At the present time our firm has tightened our credit standards on general obligation bond purchases to require a double-A underlying rating, in most cases.

We anticipate volatility and uncertainty will continue in the fixed income markets for the next 2-4 years. Treasuries will experience several flights to quality, of which we can take full advantage. Corporate issuers will slowly reenter the debt market, but steadily in tandem with several of the Federal Reserves liquidity programs rolling off. Thus, increased issuance will initiate a push for higher rates, particularly on the front end of the yield curve. Look for short rates to begin moving up next year as unemployment rates begin to level off. The sooner our European neighbors find footing to stabilize their markets, the sooner we can all move toward more traditional investment returns. There is a light on the horizon.

## AT THE FIRM

We are pleased to announce two recent additions to the Davidson team:

**William J. Rizzo** has joined us as a Portfolio Strategist. Bill will be working with the portfolio managers to deliver expanded product offerings to clients and prospects. He brings with him twenty years of senior level experience in financial analysis, investment strategy and portfolio optimization. With his US Marine Corps background, Bill takes a consultative approach to identify and solve problems. This has guided him in building relationships with nationally recognized institutions and affluent families across the country.

**Philip C. Wagner, CFA** has joined our Investment Advisory team as a Portfolio Manager. Phil will be applying his twenty-four years of experience as a senior investment advisor, wealth strategist and analyst to develop client focused investment strategies. He will be working with the investment team in the areas of security selection, portfolio management and alternative asset manager due diligence. Phil's proven track record of delivering innovative and effective financial advice to individuals and families will be a significant contribution to the team.

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