



Investors often have a great deal of difficulty navigating the early stages of an economic recovery.

A leap of faith regarding future economic growth and corporate profitability is always required.

Concrete signs of improvement are usually slow to emerge, and the market has historically moved upward well in advance of the actual recovery. Future growth is always uncertain, fear is often palpable, and investors can become increasingly lost in the cacophony of disparate opinions broadcast 24 hours a day.

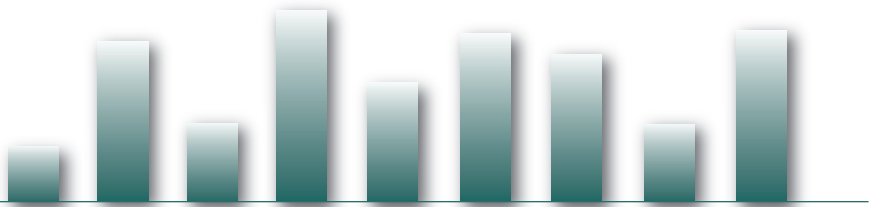
The situation becomes much more challenging coming off one of the worst economic downturns since the Great Depression of the 1930s. Real estate prices have taken a big hit, unemployment has topped 10%, the Federal budget deficit is unprecedented, and the political climate is extremely uncertain. In light of all these uncertainties, however, the stock market was still able to mount one of the most impressive rallies in modern financial history.

In light of the myriad headwinds, it would be easy to believe that it couldn't get any better than this. That, in our view, would be very short-sighted. History has shown that periods of stress in the corporate world always yield longer-term benefits. Corporate managers grow introspective, with a great focus on cost control and efficiency improvements. At the same time, the successful companies in which we invest do not scrimp on research and development and product innovation. In other words, excesses are purged while setting the stage for strong profit performance in the future.

It is admittedly difficult to maintain perspective during these periods, but perspective is an absolutely essential ingredient for successful investing. Despite the numerous negatives – of which we are all constantly reminded by both the mainstream and financial press – we believe we are only at the beginning of a sustainable upturn in the worldwide economy. Given that equity market valuations are relatively attractive, especially when considered relative to other financial instruments, world stock markets should follow economic growth.

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ECONOMIC OUTLOOK



The economy, helped by massive monetary and fiscal stimulus and inventory rebuilding, finally began to grow again in the third quarter of last year. Gross Domestic Product grew 2.2% in the period, following a decline of 6.4% and 0.7% in the first two quarters of the year, respectively. That strength carried into the fourth quarter with GDP growth of about 5.7%, bringing the full-year tally to about -2.5%. Clearly, most of us want to forget 2009...and 2008 for that matter!

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As we look toward the rest of 2010, we believe the economy will continue its modest improvement, gaining increased momentum through the balance of the year. Businesses are becoming more confident, sales have stabilized in many sectors of the economy, and pent-up demand should become more and more of an issue as time marches on. A good example of this is automobile sales. For the fifteen years through 2007, 16.5 million automobiles were sold, on average, per year. In 2008 and 2009, Americans purchased only 13.2 and 10.4 million units, respectively. It is only a matter of time before a replacement cycle kicks in, returning sales to more normal levels.

But for now, most Americans are focused squarely on retrenching their finances, forgoing most big-ticket discretionary items and focusing on debt reduction and savings. This is nothing new, as discretionary consumer spending first turned down in 2007, at about the same time housing markets began their dizzying descent.

The good news is that housing prices seem to have stabilized in most areas of the country, thanks to tax breaks, low mortgage rates, and a lack of new homes being built. Housing affordability has increased dramatically as a result. The bad news is that housing prices have stabilized at much lower levels, leaving a great many homeowners underwater on their mortgage and decreasing their overall confidence about their economic well being. Exacerbating this problem is stubbornly high unemployment, rising energy prices, and the prospect of an increasing tax burden.

It is important to note that we have experienced similar problems in the past, and while it takes time to work off the ill effects of past excesses, economic growth always returns. Through its massive fiscal and monetary intervention, the government has helped us avoid a much deeper recession, and the policies in place should also help restore sustainable economic growth.

Studying the historical economic data, one thing becomes apparent: unemployment is a lagging indicator. Accordingly, while many fret (as they should) about continued high unemployment, the leading indicators – temporary employment, for example – are beginning to support the view that the worst is behind us. While construction spending continues to be weak for obvious reasons, the service sector is now doing much better and manufacturing is recovering as well.

Businesses, for the most part, continue to keep their purse strings tight, choosing to spend money on those projects that either have a very good probability of increasing profitability or that will keep their products competitive. Efficiency is the order of the day, and companies are not at all shy about spending money on technological advances that will give them an edge in an increasingly global marketplace.

This last idea – the idea of an increasingly global marketplace – is one of the reasons why we are sanguine regarding the domestic economy. The rest of the world will likely grow faster than the United States, but it is important to remember that we will also benefit from this growth. Corporate America is highly leveraged to growth overseas. As fortunes of foreign economies improve, so do the fortunes of the American citizen.

CAPITAL MARKETS OUTLOOK

From the market highs in October 2007 to the low in early March of last year, the S&P 500 declined 57%. In 2008 alone, the market fell 37%, and that's with the benefit of dividend payments! Overseas markets performed even worse. The March lows probably represented a generational bottom for the market, and thankfully stocks have done extraordinarily well since returning more than 60% in just nine months.

Investors are breathing a huge sigh of relief following such a torrid move, but the focus now moves to future prospects. Have we come too far, too fast?

Although we believe a correction could well be in the cards, short-term market movements are always difficult to predict. We remain confident that the stock market will deliver substantial gains over the next several years. We won't likely see a repeat of 2009, which came off of a panic low and we probably shouldn't have fallen so far in the first place. But measured gains better than the historical average of 7%-9% are probably in store as we continue on a synchronized worldwide economic recovery.

There is currently a "curse on cash." As noted in our most recent quarterly reviews, the Federal Reserve, by keeping short-term interest rates near zero, has been encouraging investors to take on increasing risk. That has worked rather well, obviously, but the very easy monetary policy stance should encourage further gains. Put simply, it is difficult for yield-hungry investors to remain in cash. Stocks and bonds become much more attractive in such an environment.

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At present, stocks are trading at about 15 times 2010 earnings. Although that can't be considered dirt cheap, it is still nevertheless attractive relative to yields of less than 1% on most short-term debt instruments and the 3.6% yield on the ten-year Treasury note. Also remember that stocks offer a dividend yield of approximately 2% and the promise of future growth as the worldwide economic and profit recovery resumes. Furthermore, most non-financial companies boast extremely strong balance sheets as corporations have hoarded capital over the last eighteen months.

Of course, any valuation model is dependent on companies actually achieving and/or surpassing the expectations of future earnings growth that is embedded in these valuation metrics. Given the secular trends in place in the world, combined with the huge improvement in cost structures, we are fairly confident that earnings will surprise on the upside over the next couple of years.

On the demand side, emerging markets continue their substantial growth, and the companies in which we invest participate greatly in this growth. At the same time, corporations have been cutting costs for the better part of the last three years now.

The resulting profit margin improvement was a major driver of stock performance in 2009, and so far fourth-quarter earnings have actually made for good reading. Given the lean cost structure of most American companies, profits should grow disproportionately greater as sales growth finally improves. We've seen this again and again with previous recoveries, and this time should be no different.

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We have been focusing our investment efforts on high-quality companies that will be able to perform well in any economic cycle and participate significantly in the continued global recovery. Our high quality approach has served us well in the latest downturn, and has enabled us to keep up with the major averages throughout the rebound despite an environment that rewarded lower-quality companies.

Turning to our fixed-income strategy, it is important to be cognizant of the risks that accompany a low interest environment. First and foremost, we believe that longer-term interest rates will rise as the economy picks up steam and the government borrows more to finance the fiscal deficit. Accordingly, we have for the most part avoided longer-dated maturities. We believe we will be able to invest at higher coupon yields in the coming quarters.

Next, there is widespread concern about the financial predicaments in which many state and local municipalities currently find themselves. The default rate on municipal bonds has historically been very low, and we don't expect it to rise materially. That said, we do believe that increased selectivity is prudent as governments work through revenue shortfalls and stubbornly high expense growth.

Corporate bonds have enjoyed a remarkable comeback as credit spreads narrowed significantly. We believe there is still some value here, especially with improving profitability. Again, selectivity remains key and we would stay on the short side of the maturity curve.

Final word...

We reinforce our view that security selection will be the primary key to achieving above-average equity returns in the year ahead. Following the financial volatility of the past two years, we believe the market will increasingly reward the stocks of higher quality companies with successful business models that have come through the recent recession with a proven track record.

We want to hear from you!

We invite you to email us at news@davidsontrustcompany.com with your questions, comments, or perhaps propose a topic of interest you would like to read about in an upcoming edition of the Quarterly Review.

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