AR SCHMEIDLER & CO
INVESTMENT ADVISORS
A Hudson Valley Bank Company

The Outlook

Aug 12, 2009

As of 8/11/09		
Index	**Market Value**	**YTD % Change**
Dow Jones Industrials	9241.45	5.3%
S&P 500	994.35	10.1%
Nasdaq Composite	1969.73	24.9%

As circumstances have evolved over the past year, the underpinnings of the global financial system have strengthened in many respects. **Although the global economy is far from out of the woods, the unprecedented commitments of central banks and governments around the world to backstop financial institutions, stimulate growth and avoid deflation at any cost have, for now, taken the worst case scenarios of last fall off the table.** Led by the resurgent strength in emerging markets, as well as inventory rebuilding, stronger than expected corporate earnings and the gradual recovery of consumer confidence, the global economic outlook is stronger today than many economists predicted just months ago.

Nevertheless, global imbalances remain. The US is reaching a tipping point in its ability to continue financing its deficit spending. At its current trajectory, the US will be challenged to meet its longer-term obligations and the sheer volume of treasury bond issuance threatens to overwhelm investor demand and further weaken the dollar. The US consumer is also in need of significant balance sheet repair. **The US, and to some extent much of the developed world, will need to undergo substantial deleveraging that is likely to suppress economic growth for several years.**

At the same time developing economies in Asia and Latin America are undergoing rapid industrialization, which in absolute scale is the greatest the world has ever seen. This industrialization has been led by the “BRIIC” countries (Brazil, Russia, India, Indonesia and China), which have a combined Gross Domestic Product (GDP) of $9.4 trillion (15% of the world’s total) and a combined population of 3.1 billion people (46% of the world’s total). The BRIIC countries have grown to become significant economic powers, yet still have considerable growth prospects as reflected in their low GDP per capita, highlighted on the table below. To put this in perspective, if over the next decade the BRIIC countries were to grow at 7% annually, they would double their GDPs per capita (to roughly $6,000, or just over half the level of Mexico) and add approximately $10 trillion to global GDP.

GDP Per Capita Comparison (2008 IMF data)

	World	**Developed Economies**		**Developing**		**BRIIC Countries**					
		US	EU	Taiwan	Mexico	Brazil	Russia	India	Indonesia	China	**Total**
GDP (billions)	$60,690	$14,265	$18,394	$393	$1,088	$1,573	$1,677	$1,210	$512	$4,402	**$9,372**
Population (mm)	6,706	307	491	23	108	192	142	1,167	230	1,332	**3,063**
GDP Per Capita	***$9,050***	***$46,859***	***$37,463***	***$17,040***	***$10,235***	***$8,197***	***$11,807***	***$1,068***	***$2,246***	***$3,315***	***$3,060***

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Therefore we see two forces competing for investor attention: the concern over the structural health of developed economies versus the opportunities emanating from the industrialization of emerging countries. This second force is presenting significant opportunities in the form of profitable, undervalued companies who are benefiting from emerging market demand for their products. Moreover, the weakening US dollar is presenting opportunities for producers of tangible assets such as oil, gold, agricultural commodities and industrial materials, which continue to rise in dollar terms. **Our investments are positioned to benefit from these forces, as well as other important investment areas where we expect capital to flow, as described further below.**

Global Economic Imbalances

Much of the global growth of past years proved to be based on an unsustainable framework. Emerging markets led by China built up their manufacturing and export infrastructures to sell cheaper products to an insatiable western consumer. The savings rate of the US consumer declined from 12% in the late 1970's to less than 0% in 2005 when consumers began raiding their savings and home equity to support higher spending lifestyles. At its peak, consumer spending accounted for over 70% of US GDP, compared with less than 40% for China. The manufacturing base of the US has also contracted. Over the last 10 years alone, manufacturing jobs in the US declined by 5.5 million to 11.8 million or 32%, while government jobs grew by 10% to 22.5 million. However, government efforts to stimulate the US economy have amounted primarily to mere patches on state, municipal and consumer spending shortfalls. **The US remains overly dependent on consumer spending to drive its economy. With taxes expected to rise, the US is simply not creating the environment needed to jump-start productive economic activity.**

At the same time, developing and emerging economies continue to experience strong GDP growth. These nations are working to raise living standards for vast numbers of people by investing heavily in their productive capacity and infrastructure. China in particular, as the world's largest creditor and surplus nation, is able to fund these growth initiatives on the back of historic global financial imbalances and a treasury flush with accumulated and still-growing foreign reserves. **With over $2.1 trillion in reserves at latest count and a continuing trade surplus, China can maintain this investment and stimulus for a long time if they choose to. However, China and other developing economies will ultimately need to stimulate domestic consumer spending to build more balanced and self-reliant economies.**

Two Approaches to Economic Stimulus

The $787 billion American Recovery and Reinvestment Act passed by Congress in February amounts to just over 5% of 2008 GDP; however, this amount is spread over roughly 3 years, with only $185 billion expected in 2009 and $399 billion in 2010, or approximately 1% and 3% of GDP, respectively. Of the total amount committed, less than one-fifth (approximately $150 billion) is dedicated to infrastructure and energy investment. A significant portion of the remainder is comprised of transfer payments, such as aid to the states for Medicaid, unemployment and job training assistance. **These payments do not represent incremental "stimulus" as much as "substitution" for holes in state, municipal and household spending. Another way to think of them is as the "transfer" of indebtedness from states, municipalities and consumers to the federal**

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government. These aspects of the stimulus appear to be one-time in nature, without much of the "multiplier effect" or longer-term productivity enhancements we would have expected from greater investment in infrastructure, telecommunications, the energy grid or clean energy alternatives. What makes this a particular misfortune is the desperate condition of US infrastructure, which the American Society of Civil Engineers 2009 Report Card graded a "D" with a five year investment need of $2.2 trillion. With unemployment continuing to grow and now expected to potentially exceed 10%, we should also not be surprised to see a second stimulus package emerge at some point if the economy does not begin to improve.

In contrast, China's stimulus package represents nearly 13% of their GDP and is heavily concentrated on productive investment. Of the $586 billion committed, approximately $220 billion is for public infrastructure development (railway, road, irrigation and airport construction), $145 billion is for post-earthquake reconstruction in Sichuan and another $135 billion is for rural and sustainable development and technology advancement, for a total fixed asset investment of over $500 billion, or nearly 12% of GDP. By comparison, the US fixed asset investment of $150 billion represents approximately 1% of GDP. China's stimulus plan has already been credited with lifting anticipated GDP growth prospects, which were recently revised upward for 2009 by the IMF to 7.5% up from its 6.5% estimate in April. **China's infrastructure plan has also helped to "prime the pump" for other markets as high demand for steel, copper, iron ore and other raw materials have boosted the growth outlook for resource-rich exporting countries such as Australia, Canada and Brazil.**

Complementing the two approaches highlighted above, over 700 policy initiatives have been announced around the world since the start of the economic downturn. These have included stimulus programs, tax incentives, industry bailouts, interest rate cuts, lending programs, loan guarantees and quantitative easing (printing money), among others. The majority of this spending is targeted for the second half of 2009, 2010 and 2011. The size and scope of these coordinated actions are without precedent. **It is important to note that over 40% of the combined revenues of S&P 500 companies are generated outside the US. As such, many companies stand to benefit from global policy initiatives regardless of the ultimate success of US efforts.**

The Importance of Perspective

Not all that long ago, it appeared as though the stock market was heading into a summer correction amid increasing punditry talk of "green shoots" turning to "yellow weeds." The better-than-expected earnings reports of recent weeks and strengthening emerging market growth has shifted the market's focus to the positive for the time being. **Nevertheless, it is a fair question to ask how the lingering risks facing the economy compare with those of last summer.**

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While significant concerns remain, there are key differences, as summarized in the chart below:

The macro backdrop, 2008 vs. Current

	Mid-2008	Current
Financial System:		
Major Institutions	- Lehman / AIG failures	- Large financials "too big to fail" - Fed backs $12 trillion in liabilities
Capital Markets	- Frozen	- Banks raise billions to re-capitalize - TARP/TALF introduced
Money Markets Funds	- Noted money market fund "breaks the buck"	- Accounts temporarily insured; liquidity restored
FDIC Insurance Limits	$100,000	$250,000
	Uncertain government commitment	*"We will do whatever it takes"*
LIBOR (3-Month):	4.10%	0.62%
30-Yr Mortgage Rate:	>6.00%	~5.25%
Fiscal Stimulus:		
US Plan	~$152 billion (2008 plan)	**$787 billion** (targeted primarily at 2H 2009 / 2010)
Global Initiatives Announced	~67 (through Aug '08)	> 700 (Aug '08 - Present) - China announces **$586bn** stimulus - Several other nations announce a total of **$1,100bn+** in stimulus
Monetary Policy:		
Fed Funds Rate	2.75%	0.0 - 0.25%
US Quantitative Easing	None	$300 billion (initial commitment)
Economic Indexes:		
University of Michigan Consumer Sentiment	57.6	66.0
Purchasing Managers	38.9	48.9
Corporate Earnings:	Substantially below consensus expectations	~75% of companies beat consensus estimates
S&P 500:	**1435** (May 2008)	**997** (~30% below 2008 highs)

These improvements in the financial and economic underpinnings of the US have not corrected the long-term imbalances we face. **However, they do reflect and have resulted in greater stability (at least for the time being), which we believe creates an environment where asset classes will not be as closely correlated and the inherent undervaluations of select businesses become more fully recognized.**

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Investment Implications

Despite the economic concerns discussed above, we continue to identify profitable, undervalued companies with strong franchises, solid balance sheets and proven management teams that are positioned to benefit from powerful global trends. Even with the recent market rise, the opportunity remains to invest in these businesses at a significant discount to the valuations they have garnered over the last several years or decades. With an estimated record $7 trillion of cash currently "sitting on the sidelines" earning minimal returns, investors have begun to recommit to equities to benefit from the dynamics discussed above.

Our focus continues to be investing in the beneficiaries of where global capital will flow over the next 24-36 months. The portfolios are built primarily with North American-based companies and select American Depository Receipts (ADRs) that will benefit from emerging economy growth without the political and capital market risk of investing directly in foreign markets. **Due to their strategic importance and attractive valuations, many of these companies offer the additional benefit of being well-positioned to participate in future industry consolidations.**

The equity and balanced portfolios are positioned for the appreciation of real assets against most currencies, a weaker dollar and continued growth in the emerging economies. **In response to emerging market infrastructure investment, we see opportunities in companies with significant international sales in the areas of energy (oil), food (fertilizer and seeds) and infrastructure (steel, iron ore, and copper). To protect against further weakness in the US dollar, we continue to invest in gold and silver companies whose operating profits and cash flows would expand appreciably in response to any price rise in the underlying metals**. In a rapidly changing world, the need for countries to focus on national security provides targeted opportunities among defense companies.

Our introduction of technology companies in recent months reflects our view of the needs of companies and governments to increase their productivity in both the developed and emerging economies. Finally healthcare companies, many of which were abandoned by the stock market due to concerns over the outcome of healthcare reform, are now trading at historically low valuations with strong balance sheets, high dividend yields, and in many cases, improving fundamentals. With respect to fixed income securities, we continue to focus on shorter-term maturities among investment grade issuers, although we will selectively target longer-term maturities of good credits offering attractive total returns.

As we stated in our last Outlook, we believe that a two-tiered market can develop whereby the beneficiaries become standout opportunities for returns irrespective of broader market performance. This continues to be a time for thoughtful investment security selection in a more complex global environment.