AR SCHMEIDLER & CO
INVESTMENT ADVISORS
A Hudson Valley Bank Company

The Outlook

December 2009

As of 12/28/09		
Index	**Market Value**	**YTD % Change**
Dow Jones Industrials	10,547.08	20.2%
S&P 500	1,127.78	24.9%
Nasdaq Composite	2,291.08	45.3%

As 2009 comes to a close, investors should be both opportunistic and highly selective in their portfolio construction approach heading into 2010. Central to our investment outlook is the clear separation of those companies and nations benefiting from the need to rebalance the global economy. For equity investors, the focus for portfolios should be on thoughtful security selection with an emphasis on the beneficiaries of industry consolidation, a secular weakening of the U.S. dollar, the recent rally not withstanding, and continued emerging market growth as well as high quality companies with strong balance sheets and rising dividend yields. After a strong year in the markets, we urge fixed income investors to keep their maturities relatively short and to be cautious as we see an increasing risk of sovereign debt downgrades, record Treasury issuance and rising interest rates impacting bond returns.

At the present time, the global economy is being driven by the developing nations where billions of people are experiencing rapid industrialization and rising living standards. While the developed economies must reduce the leverage in the system with consumer and government debt at historically high levels, many U.S. corporations with strong balance sheets, growing earnings and cash flow are well-positioned to benefit. Corporate productivity has risen as many companies used 2009 to refocus their businesses and lay off workers at a record pace. There are many American corporations whose foreign revenues represent 40 to 50 percent of their total revenues that are important beneficiaries of global growth and whose share prices do not adequately reflect these dynamics. For these companies, there is the potential benefit of participating both in overseas growth and any further devaluation of the U.S. dollar as foreign earnings are translated into more dollars.

This year the equity and bond markets experienced a broad-based rise fueled by aggressive and globally-coordinated fiscal policies and central bank initiatives to restore capital markets after the financial collapse of 2008. While many professional investors participated in the strong market move since March, many other market participants sat idle while holding record levels of cash earning little or no return. The reasons for this included a loss of confidence in the markets and concerns about owning stocks after a decade of near-zero returns for the market indexes. As discussed in our last Outlook, the U.S. economy will continue to face significant headwinds as we move through 2010. With much of the

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previously announced stimulus hitting the system in the first two quarters, ARS believes that we will see continued separation of those companies that are positioned to benefit from the global forces described above from those that will continue to struggle.

Global Growth, World Currencies and Inflation

We are witnessing the largest transfer of wealth in history from the developed world to the developing world, as the U.S. has gone from the largest creditor nation to the largest debtor nation. Two major themes standout: the developed world must reduce its debt, which instead continues to increase, while the developing world is increasing its currency reserves and economic power. In the developing economies such as China and India, the challenge remains to manage the delicate balance between strong growth through external consumption via exports and internal social needs for their more than 2.5 billion people. Looking at China, which is industrializing rapidly, consumers represent only 35% to 40% of the economy and have a high savings rate. As millions of people enter the middle class this is having a profound impact on global demand for a wide range of products and scarce resources.

Bearing in mind that China has been dependent on exports due to an underdeveloped domestic economy and the U.S. has been dependent on imports and an over-debted consumer, a rebalancing of these two conditions has been necessary for a long time. Since China has been so dependent on its exports for growth, it has been reluctant to revalue its currency for fear of damaging its export business. Moreover because its currency is pegged to the U.S. dollar, as the dollar has declined it has put competitive pressure on other Asian countries' exports.

We have written often in this past year's Outlooks about the need to rebalance the global economy, but it is important to remember that this is a multi-year process. Three weeks ago Vietnam devalued its currency in order to be more competitive with China. Central banks know that their respective economies require cheap currencies for their exporters to compete with China. Central banks cannot trust each other not to devalue their respective currencies to achieve these ends. Since currency reserves reside in paper money (fiat currency) which has no backing, Russia, China, India and others have sought to protect their purchasing power under these circumstances by various initiatives including gradually converting some of their currency reserves to gold.

It is noteworthy that developing nations continue to increase their industrial capacity. At the present time, global capacity exceeds global demand for many products. For example, U.S. industrial production is well below maximum capacity and there is enormous slack in the labor force. Consequently the risks of near-term inflation should be low. However in 2010, the U.S. government will require $3.5 trillion to refund the federal debt and finance the federal deficit which equates to an average of $67 billion per week. So while near-term inflation should not be an issue, longer-term inflation could be a problem. It is vitally important that the Federal Reserve not raise interest rates any time soon if it does not wish to damage the economy, risk a double dip recession and add further to the federal deficit. If rates in general were to rise prematurely, it would be damaging to the nascent economic recovery and compound the difficulties facing state and local government budgets already struggling to meet their needs including education, unemployment, pension and medical benefit obligations.

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Brief Comments on the U.S. Economy

Since U.S. growth will be more muted than in the past when it was supercharged by vast amounts of credit, investments linked to global growth should be beneficiaries of the outlook we foresee for 2010 and beyond (see discussion in our November 2009 Outlook). While the latest unemployment figures for the U.S. indicate that the aggressive pace of layoffs by businesses during the early part of this year has subsided, the current level of unemployment, including those who have dropped out of the labor force through discouragement, nevertheless leaves the employment situation for the U.S. in quite poor condition. We remain mindful of the other possible risks to the outlook through potential policy errors including tax, trade and regulatory changes as well as the always present geo-political events. As a consequence of a heavily indebted consumer, consumer behavior has become more cautious and spending patterns have reverted to increased savings and debt reduction instead of increased spending and debt expansion. Because the U.S. economy is so heavily consumer driven (approximately 70%), government budgets at all levels are in deficit. Under these conditions it does not appear realistic to expect banks to once again be aggressive lenders, nor should we expect consumers to be aggressive borrowers. Since these conditions had fueled U.S. growth in recent decades, it will take time for the economy to achieve a sustainable level of economic activity.

Portfolio Implications and Opportunities

Since our inception in 1971, the investment philosophy has been and remains to purchase the most assets, cash flow and earnings for the fewest dollars. We view the stock market as a medium of exchange through which dollars are exchanged for ownership shares in businesses. The focus should be on those companies whose cash flows, earnings, and assets are priced below the cost of acquiring them if the entire corporation were to be purchased. For longer-term investors the stock market should not be used for short-term speculation, but rather to make serious investments in businesses with the ultimate goal of building capital and preserving purchasing power. As we enter 2010, we believe portfolio allocations should be strongly favoring equities over fixed income and cash.

Equity portfolios should include the companies that own, produce and distribute the increasingly rare materials needed for global growth and infrastructure development, such as oil, copper and iron ore. Companies with significant global sales exposure, and those that raise productivity or living standards are important areas of emphasis for client portfolios. In 2009, we built positions in select technology companies that are poised to benefit from the product upgrade cycle as well as agricultural companies enhancing food production for the growing needs of the world's population. American multinational corporations with high and rising dividend yields represent important investments under current circumstances as cash earning virtually nothing seeks a meaningful rate of return. We are investing in particularly attractive opportunities in the out-of-favor pharmaceutical sector, where world-class franchises are trading at their lowest P/E multiples in history despite having solid balance sheets, strong cash flow generation and dividend yields of up to 5.5%.

For fixed income investments, investors should weigh the desirability of realizing the capital gains that have accrued to date versus holding to maturity and losing the premiums over

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par. Municipal investors should consider the impact of the challenges of state and local governments on the potential for credit downgrades on their municipal holdings. In general investors should be sensitive to the risks of holding bonds with long-term maturities.

While 2008 was certainly a difficult year for the global economy and the markets, 2009 has marked the beginning of the recovery. Significant work remains and progress will not always be in a straight line, but we remain excited by the opportunities we see. As 2009 comes to a close, we would like to express our appreciation to our clients for the trust and confidence they have placed in us.

We at A.R. Schmeidler extend our warmest wishes to our clients and readers for a very healthy and happy New Year.

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