

Client Briefing

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After a fairly robust start to 2010, US equity market performance turned slightly negative towards the end of January and into the early part of February. This down period coincided with a brief uptick in the amount of volatility in US equity markets as measured by the Chicago Board Options Exchange Volatility Index. At the time of this writing, however, equity markets appear to have turned around – at least for the time being – and volatility has eased. However, because of numerous economic and geopolitical uncertainties, it is quite possible US equity markets will repeat this pattern throughout 2010 – moving in erratic fits and starts.

There are a number of reasons why we think equity markets might act in this fashion. One of the primary reasons is simply that the US economy now appears to be in an awkward, “in between” stage that, as you would expect, is fraught with uncertainty. On the one hand, the recession most likely ended last summer given that 3Q2009 and 4Q2009 GDP figures were positive (although it has yet to officially be declared over). On the other hand, so far the recovery has been jobless and thus lacking in consumer support. Some economists even worry the US might face a double-dip recession wherein the economy would cycle back into recession before finally and convincingly returning to a period of robust growth.

Any gains or economic growth of late are most likely the result of massive government stimulus programs and an exceptionally accommodating Federal Reserve. However, these stimulus programs should peak later this year. Also, the Federal Reserve is scheduled to begin withdrawing some of its monetary assistance to the US economy by the end of March when it plans to stop purchasing US government debt. Once these debt purchases ease and eventually cease, longer-term interest rates are expected to rise. Already, the yield on the 30-year treasury is about 75 basis points above where it stood at this time a year

ago. Also, the Federal Reserve just announced an increase in the discount rate from 0.50% to 0.75%. The discount rate is the rate the Federal Reserve charges banks when they borrow. In its press release announcing this rate change, the Fed noted “these changes are intended as a further normalization of the Federal Reserve’s lending facilities.”

While it is a positive sign the US economy has recovered enough that the Fed feels it can begin removing some of the extraordinary accommodations implemented over the last eighteen or so months, there is still great concern over what might happen when the US economy no longer receives this same massive level of government support. Can or will the US consumer – a critical driver of economic growth over the last few decades – support strong economic growth in the near future, especially as government support begins to recede? If the US consumer is not able to promote robust economic growth, what, if anything, waits in the wings to serve as a new driver of economic growth? These are just a few of the many questions and uncertainties now plaguing US financial markets. Until we begin to see some clarity on these issues, it is likely that US markets will be fickle and more unpredictable than usual.

As things currently stand, it is fairly unlikely the US consumer will be the sole or even the most powerful driver of economic growth over the near- to mid-term. Rather, many US consumers are still in the midst of deleveraging as they seek to shed additional debt and increase their savings rate. In other words, US consumers are returning to a more normal pattern of spending/saving and away from the aberrant behavior pattern that existed between 2002 and 2007. Additionally, limited access to credit, more restrictive loan terms, and high unemployment will probably dampen consumer activity for months to come.

In short, the US economy now finds itself facing a bit of a conundrum – how can it return to economic

strength when the US consumer is practically on the mat after being hit with a one – two sucker punch (too much debt, falling home values, and high unemployment)? One key to solving this puzzle might lie outside our borders. Perhaps consumers overseas, particularly in China, India, and other emerging economies, are the answer? There is a growing sense that consumers in these emerging economies may soon have the strength to replace the US as a primary driver of not just US but also global economic growth. If this were to occur, the US conceivably would generate additional economic growth and begin to rebuild its economy by once again becoming a major exporting nation.

For this scenario to come to fruition, however, the Chinese government will probably have to revalue the yuan by allowing it to appreciate in value against the US dollar. The yuan is too cheap in relation to the dollar and has been for a while. The Chinese government purposefully has kept the yuan cheap because this makes Chinese goods and services relatively inexpensive for global consumers. Chinese economic growth has been heavily dependent on massive export growth to the rest of the world -- especially to the US. The tide is now turning, however, and US consumers can no longer support massive Chinese export growth. Rather, the Chinese may need to look within and stimulate the Chinese consumer. Also, the US can no longer simply be an importing and consuming nation. Rather, the US must produce more and grow its exports to China and elsewhere. The obvious potential consumers live not only in China but also in India and other emerging nations.

Accordingly, to facilitate this sea change, the US and other governments are calling for China to revalue its currency to a more realistic (higher) valuation against the dollar. There is precedent for such a revaluation – between 2005 and 2008, the yuan rose 21% against the dollar. At this point, the US and Chinese economies enjoy an intensely symbiotic relationship. They both rely heavily on each other and without one the other would suffer greatly. Thus, it seems only a matter of time before China will have to revalue the yuan. Otherwise, China likely will face a tide of rapidly rising inflation as their economy is booming, real estate values are quickly escalating, banks are loaning money like crazy, and the country is already

awash in cash thanks to US monetary policy over the last year. (The US has greatly expanded its money supply in order to fund its stimulus packages. Since China pegs the value of its yuan to the US dollar, its money supply has grown by almost 30%) Some economists predict that, absent a yuan revaluation, China's rate of inflation could reach 10% this year because of this rapid growth in money supply. Of course, it remains to be seen if and/or when the Chinese will revalue their currency.

Another key to solving the US economic puzzle is for Washington to implement a small-business friendly set of policies that will encourage and facilitate growth. As we noted in a prior briefing, small businesses are the economic backbone of our country. If small businesses are not able to grow and prosper, then the health of the US economy suffers. Indeed, small businesses account for about half of US GDP and they are major employers – since the 1990's small businesses created between 60 and 80% of net new employment!

Looking ahead, there are positive signs on the horizon – retail sales are trending in the right direction, inflation remains benign, and industrial production data has been better than expected and up for seven straight months. US exports have been on the rise for the last eight months and housing starts data shows marked improvement over this time last year. However, there are also challenges – the ongoing Iraq, Iran, Afghanistan problems and the matter of sovereign debt (US and overseas) come to mind.

As we have said in recent briefings, uncertainty reigns and likely will do so for months to come. As a result, we continue to apply a conservative and value-oriented approach to equity investing. We look for dividend-paying equities issued by high-quality companies with experienced management and strong balance sheets. We think Procter & Gamble (PG), Emerson Electric (EMR), Microsoft (MSFT), Intel (INTC), Home Depot (HD), Johnson & Johnson (JNJ), Automatic Data Processing (ADP), and AT&T (T) offer investors good value and growth potential. We also look to further globally diversify portfolios by identifying US companies that derive revenue from overseas, high quality foreign companies, and internationally focused exchange-traded funds.

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