

Market Watch		4Q09
12/31/09	Value	Return
S&P 500 Index	1,1115.10	6.0%
DJIA	10,428.05	8.1%

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Summary and Conclusion

Estabrook's U.S. stock market outlook for the year now beginning envisions further advancement over the next twelve months but a more erratic and smaller percentage appreciation than the 26% S&P500 gain experienced in 2009. The major positive factor in 2010 appears likely to be a sharp recovery in corporate earnings from the prior year's level. The largest inhibiting factor is the fact that the S&P500 already is priced slightly more than 15 times our estimate of 2010 earnings, a level that is within a normal range in contrast to the sharp undervaluation that was apparent a year ago.

Looking toward the period beyond the new year, our view still holds that S&P500 earnings will reach an annualized rate of \$92 within the next twenty four months. This provides a two year price target 25% higher than the index's current level.

Therefore we regard the U.S. equity market as still offering considerable longer term attraction.

Strong Earnings Gains In Prospect

Although it is only slightly apparent in recent earnings reports, most large U.S. corporations achieved sharp cost reductions in 2009. This implies that as revenues begin to recover with continued economic growth in 2010, margins and income are likely to exceed sharply current consensus estimates. Our view is that the cost reductions have been particularly successful in the Industrials sector including railroads, and manufacturers of machinery, machine components, and electrical equipment.

We are emphasizing this sector in our strategy.

As the year progresses, other industries including oil and gas, materials, information technology, and financial services, should demonstrate their own benefits from cost cutting.

Economic Outlook

The current economic recovery in the U.S. is slower in pace than could be reasonably expected in the aftermath of the sharp 2008-2009 recession.

In our opinion this is caused by a combination of factors including:

- 1) consumer caution in response to the steep 2008 rise in unemployment
- 2) business concerns regarding higher taxes and a more adversarial regulatory environment both which inhibit hiring
- 3) continued deleveraging by debt-burdened consumers and businesses.

These restraints will be offset to a moderate degree by the forward momentum from very expansionary monetary policy through 2008, complemented by the continuation of the Obama administration's \$787 billion fiscal stimulus spending program of which only about one quarter was disbursed in 2009.

We anticipate real GDP growth in the U.S. of 3.0% to 3.5% in 2010 following a decline of about 2.8% to 3.0% for all of 2009. The 2010 rise in consumer spending is expected to be notably below that of the composite growth rate with business spending and an upturn in housing investment from very depressed 2009 levels providing a larger than usual share of the renewed growth. We further expect that export demand for industrial equipment and raw materials from North America to markets in the Asia/Pacific region and, to a smaller degree, South America, will grow faster than real GDP in the U.S. in the new year.

Our strategy has been to emphasize investments well-positioned relative to these expected trends.

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Strategy and Stock Selection

The economic outlook just described is biased to the upside from that set forth in our previous 2009 quarterly outlooks. Therefore, our strategy shifts at this outset are most accurately described as adjustments to positions that have appreciated above target weightings in individual accounts.

We have reduced some holdings in iron ore mining where positions have risen above target weights. The same comment applies in securities dealers holdings.

In energy, Estabrook has shifted holdings more toward North American natural gas production, distribution, and processing toward oil field service companies.

As previously mentioned our firm considers the potential earnings leverage in industrials to be especially attractive. We continue to commit new money to manufacturers of machinery, fluid power equipment, truck drive train components, pumps, compressors, process controls, electrical products and automotive turbochargers.

Underweighted sectors include consumer discretionary, consumer staples, and health care. In financial services we are gradually adding to an underweight position toward a level nearer to the weight of the benchmark index.

Our estimates for S&P500 earnings on a GAAP core basis are: 2009 - \$62, 2010 - \$75, 2011 - \$85, and 2012 - \$92 compared to \$46 in 2008.

As value managers, our strategy will remain focused on building portfolios whose composite earnings per share outpaces the gains described above while purchasing at below market price to earnings multiples.

Fixed Income Strategy

Daniel S. Oh – Fixed Income Director

Over the past quarter, we have seen the fixed income markets further normalize. Investment grade corporate bond yields continued to trend downward from 4.85% to 4.73%¹ as spreads over treasuries tightened. During this same period, we saw a dramatic increase in treasury yields as government programs have been lifted and the economy has stabilized. During the quarter, 10 year bond yields have risen approximately 50 bps to 3.84%. We are forecasting additional increases in treasury rates over the next quarter and continue to favor TIPS and corporate bonds over treasuries. In addition, we recommend that clients stay in the intermediate to shorter part of the yield curve in anticipation of higher rates.

As we enter 2010, the fixed income market will be focused on the movements of treasury rates. Federal Reserve actions and the termination of government support programs will be the main drivers of higher rates. Thus, we believe the extraordinary liquidity and deficits that remain in place will result in 10 year yields as high as 4.50% over the next year. We recommend that clients remain defensive and minimize duration risk.

In a rising interest rate environment, we believe treasuries will underperform both TIPS and corporate bonds. As treasuries are fully exposed to increases in yields, we favor products that offer spreads that will offset some of the negative price action. We continue to favor TIPS over treasuries as breakevens will increase with inflation and will partially counteract increases in yields. We also like corporate bonds as the spread over treasuries should tighten as corporations continue to improve balance sheets and increase profitability. In particular, we believe there is value in sectors such as insurance, banks, and brokerages. These sectors have not fully normalized and offer attractive spreads. Currently, these sectors provide additional yields over treasuries ranging from 200 bps to 250 bps.

This year should prove to be challenging as we expect yields to increase. We believe that TIPS and corporate bonds offer better value than treasuries in this environment. In addition, we continue to prefer bonds with shorter maturities to minimize the impact of higher rates.

1.Data from Barclays US Investment Grade Corporate Bond Index

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