

## ESTABROOK CAPITAL MANAGEMENT LLC

First Quarter 2010

Market Watch 03/31/10	Value	1Q10 Return
S&P 500 Index	1,178.10	5.4%
DJIA	10,927.07	4.8%

George D. Baker, CFA  
Director  
Portfolio Manager

*"We continue to maintain a near fully invested position in the equity portions of portfolios in recognition of the strong probabilities that the current economic recovery still is at a relatively early stage and that corporate earnings in companies with cyclical leverage to the level of economic activity are responding as envisioned."*

*-George D. Baker, CFA*

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### Summary and Conclusion

In the quarter just ended, the U.S. stock market, using the S&P 500 index as a proxy, has provided about half of the total return we forecast for all of 2010 in the previous edition of this letter. This condition, when viewed in the context of the superior relative performance of the materials and industrials stock groups, implies that corporate earnings are improving at a pace at least as fast as consensus expectations. We therefore continue to maintain a near fully invested position in the equity portions of portfolios in recognition of the strong probabilities that the current economic recovery still is at a relatively early stage and that corporate earnings in companies with cyclical leverage to the level of economic activity are responding as envisioned.

Even with this reassuring aspect of the current outset, rebalancing of stock positions and vigilance toward the possibility of setbacks remain requirements in our view. We have trimmed appreciated positions in natural gas and mining equities when price gains have taken positions above target levels.

The major risk to our outlook for the next three to five years has become political. Rapidly escalating entitlement expenses are an increasing tax threat to income from marketable securities in the 2013 to 2020 time frame. How much discipline elected officials will exercise in containing this problem remains uncertain.

We are leaving unchanged our current outlook that the S&P 500 will provide a total return of about 10% in 2010 and 25% to 30% over the 2010 to 2013 time frame.

### Corporate Earnings on Track

This firm has contended for the past three quarters that 2010 would witness corporate earnings that proved to be materially stronger than expectations held at the beginning of the year as a result of sharp efficiency improvements undertaken in response to the preceding recession. First quarter 2010 reports are still pending as of this writing but indications from recent management announcements, particularly at industrial manufacturing companies, suggest that this expectation is beginning to be fulfilled. Our outlook holds that this will continue to be the case throughout 2010 but vary widely among different industry groups.

Our estimates for S&P 500 earnings are now \$75 to \$80 for 2010, \$85 to \$90 for 2011, and \$94 to \$102 for 2012. We believe it is prudent to use ranges at this point because an increasing number of U.S. companies are taking charges against earnings due to new future benefit obligations on retiree prescription drugs as a result of recent legislation. However, even if the low end of our 2012 estimate is achieved, an assumed S&P price to current earnings ratio of 14 in 2012 yields an index target level about 12% higher. This combined with another 5% in dividends over that time suggests a combined return of 17% over 21 months. We feel three observations are noteworthy in regarding this prospect: 1) It suggests that much of the cyclical appreciation potential in this recovery has been realized. 2) The potential returns in prospect for equities are still more attractive than those being offered in the bond market. 3) If the higher end of the 2012 earnings estimate is attained, combined two year returns should reach about 23% as opposed to 17%.

### Economic Outlook

Estabrook continues to expect 2010 to witness real GDP growth in the U.S. in the 2.5% to 4.0% range with 3.75% being the most likely case. The first half of the year is expected to experience growth above

trend due to inventory restocking after significant drawdowns in 2009. Anticipation of higher taxes on both businesses and individuals should restrain growth in the second half of 2010 and in 2011.

Over this same time frame we expect inflation to be 2% to 3% as stated by the GDP deflator with labor costs remaining benign but industrial commodity price increases eventually filtering through into finished product prices for consumer durables and consumables derived from crude oil.

We further expect U.S. official unemployment to remain stubbornly high moving below the 9% level only late in the fourth quarter of 2010 or in 2011.

### **Portfolio Strategy**

Since the second quarter of last year Estabrook's portfolio strategy has been based on two fundamental tenets:

1) Overweight oil and, as the fall of 2009 approached, natural gas related investments. 2) Apart from energy stocks, emphasize those equities representing companies with an above average responsiveness in earnings and revenues to economic recovery.

The latter principle led to extensive exposure in railroads, materials, mining, machinery, truck parts, aircraft components, and electrical equipment companies. The energy emphasis was moderated only slightly in the first quarter with slight trimming of overweight long term positions in natural gas. We also reduced exposure to consumer staples because of the below average cyclical leverage in that sector while adding still to industrial manufacturing. More recently we have begun adding exposure to our underweight position in information technology, focusing on component suppliers for new investment.

We believe our strategy has been successful and expect to continue to employ a deliberate incremental approach.

### **Fixed Income Strategy**

Daniel S. Oh – Fixed Income Director

During the 1<sup>st</sup> quarter of 2010, fixed income markets continued to rally as the Barclays Intermediate U.S. Government/Credit Index finished the period with a return of 1.543%. Investors chased after yield, shying away from nominal treasuries and reaching for spread in credit products. Investment grade corporate spreads tightened another 25 bps to 147 basis points over treasuries. Corporate credit spreads continued to compress as investors reached for yield by going down the credit spectrum and into sectors providing the widest spreads. The sectors with the best spread performance included insurance, REITs, financial services, and consumer non-cyclicals. The sustained tightening of credit spreads helped to offset the volatility in treasury rates. Although 10 year yields only moved 1 basis point lower over the quarter, the market was quite volatile. At the end of 2009, yields were at 3.84% but declined to as low as 3.56% in early February as fears over sovereign risk emerged with problems in Greece. For the last two months of the quarter, treasuries traded in a tight range as inflation data continued to remain benign and sovereign risks subsided. Over the last week of the quarter, yields backed up a staggering 20 bps as the treasury auctions were met with weak demand, specifically from foreign investors. 10 year treasuries ended the quarter at 3.83%.

We recommend that clients continue to minimize duration risk and remain defensive towards a higher rate environment. We also continue to believe 10 year yields will increase over the year and could reach as high as 4.50%. We favor spread products over nominal treasuries and believe there is value in sectors with the widest spreads. These sectors include REITs, insurance, banks, and financial institutions. We remain constructive on the financial sector as we like the fundamentals of the space but are monitoring the proposed financial legislation in Congress. Overall, the market technicals for continued spread tightening remain intact as fund flows continue to enter the space and investors reach for yield. We believe our investors should be focused on spread products such as corporate bonds to offset the foreseeable backup in rates.

#### *1.Data from Barclays US Investment Grade Corporate Bond Index*

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