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I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

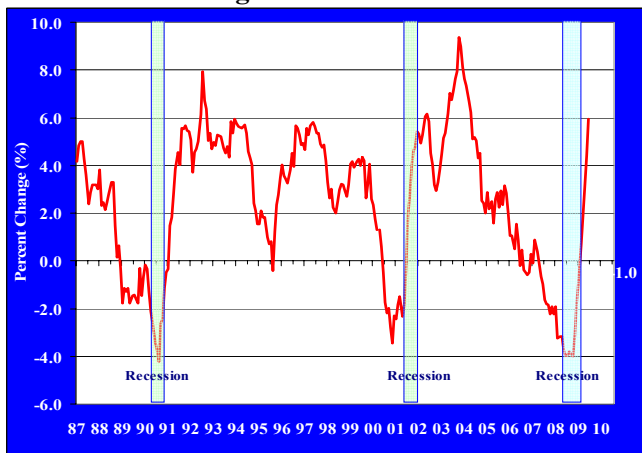
January 2010

THE RECOVERY IS UNDERWAY

And Stocks Should Benefit

Stocks extended their recovery during the last three months, albeit at a decelerating pace from their surge during the prior two quarters. A combination of compressed stock market levels earlier in the year along with increased recognition that the economy is embarking on a sustainable recovery led to the rebound. Confidence in the business outlook has been supported by the rise in the Index of Leading Economic Indicators (Chart I), an upturn in industrial production, a rise in existing home sales, and increased consumer spending. Consumer confidence, while still well below normal, has rebounded from levels earlier in the year that reflected outright despair.

CHART I
Leading Economic Indicators



While the underpinnings of the recovery have been established, its vitality in 2010 will face a number of near-term challenges that should temper growth to the 2.5% - 3.5% range. First and foremost is the

consumer, comprising 70% of the economy. After years of easy access to credit, which facilitated low down payment mortgages, higher credit card balances, and record use of home equity credit lines, households are now going through the painful experience of servicing record high debt levels in an environment plagued by high unemployment rates and sparse wage increases. Reducing debt has taken on a higher priority than acquiring “things”. Economists have termed this process of shedding debt, “deleveraging.” As a result, growth in consumer spending could be sub-par compared to past economic recoveries. Perhaps in 2011 consumer confidence and employment numbers will be strong enough to encourage a more robust pick-up in household spending.

Second, government programs to stabilize the economy resulted in an extraordinary increase in the Federal deficit. The Federal debt is now \$12 trillion. That translates into interest payments in excess of \$380 billion, or \$3,500 per taxpayer per year. Half of that debt is foreign owned, which means that \$190 billion of interest payments is channeled to other economies rather than re-circulating within our own.

Third, our extraordinary debt has also undermined the value of the US dollar in the international markets. Since early March, the US dollar declined 12% on a trade weighted basis. In time, a cheaper dollar can be inflationary as it increases the price we pay for imported goods, such as gasoline, cars, and electronics.

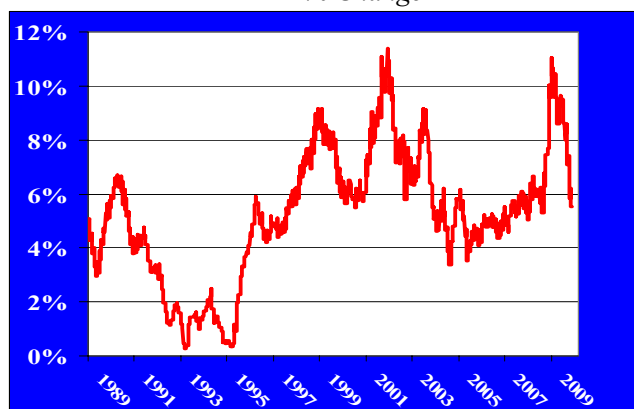
Fourth, inflation fears could cause the Federal Reserve to otherwise raise interest rates more than they would normally, in an effort to protect the value of the dollar and curb rising prices. It could also mean higher mortgage rates on homes, more expensive automobile leases, and higher borrowing costs throughout the economy.

Thus, the combination of a tepid consumer, leakage in the economic system with interest payments to overseas economies, and a reduction in monetary stimulus, should cause the economy to track a more moderate pace than prior recoveries.

INVESTMENT STRATEGY

This presents a challenge for asset allocation in 2010. For the fixed-income sector, some caution is appropriate. While interest rates still remain at extraordinarily low levels, the Federal Reserve has already begun a transition away from monetary stimulus. The pace of money supply growth, which peaked at the beginning of last year at 11%, has now decelerated to half that rate (Chart II). A further abatement in money growth is likely as confidence in the recovery becomes more established. After all, the Federal Reserve cannot afford to let the expansion in the monetary system over the last two years germinate into accelerating inflation rates.

CHART II
Money Supply Growth
Yr-Yr % Change



This could lead to upward pressure on interest rates. Such a phenomenon would curtail investment returns in the fixed-income sector. Thus, such investments should be patiently phased-in, as higher and more attractive yields may become available

later in the economic expansion.

Stocks are likely to extend their 2009 recovery. While year-end prices may seem somewhat extended relative to last year's earnings, markets are forward looking. In 2010, earnings for the Standard & Poor's Index are forecast to rise 25% - 30%, supported by a combination of: 1) revenue growth derived from an overall expansion in business conditions; 2) leaner and more efficient cost structures which permit a higher portion of the incremental revenue to flow to the "bottom line"; 3) stronger growth overseas, especially emerging markets; and 4) the translation of foreign earnings into more dollars than in 2009 due to the decline in the value of the dollar. In summary, stocks should continue to advance as companies benefit from a rebound in the economy and an expansion in profit margins.

CHART III
Potential Price Range for the S&P 500 Index

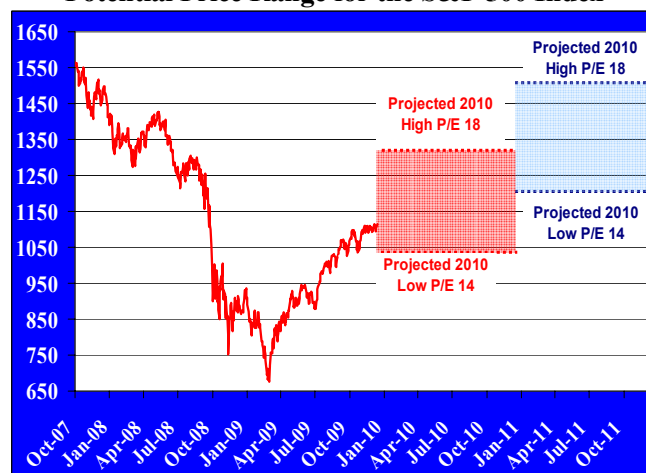


Chart III puts the recovery in perspective, and shows that stocks are still well below their October 2007 peak as we enter the New Year. The projected trading range for the Standard & Poor's Index for 2010 is within a range of 1,039 - 1,336. With last year's close of 1,115, the appreciation potential for 2010 is as high as 20% in contrast to downside risk of 7%. Looking further ahead to 2011, stocks are likely to trade even higher. As a result, it is appropriate to continue to maintain substantial exposure to stocks during this early stage of the economic expansion.