FVCM

U.S. Market Report

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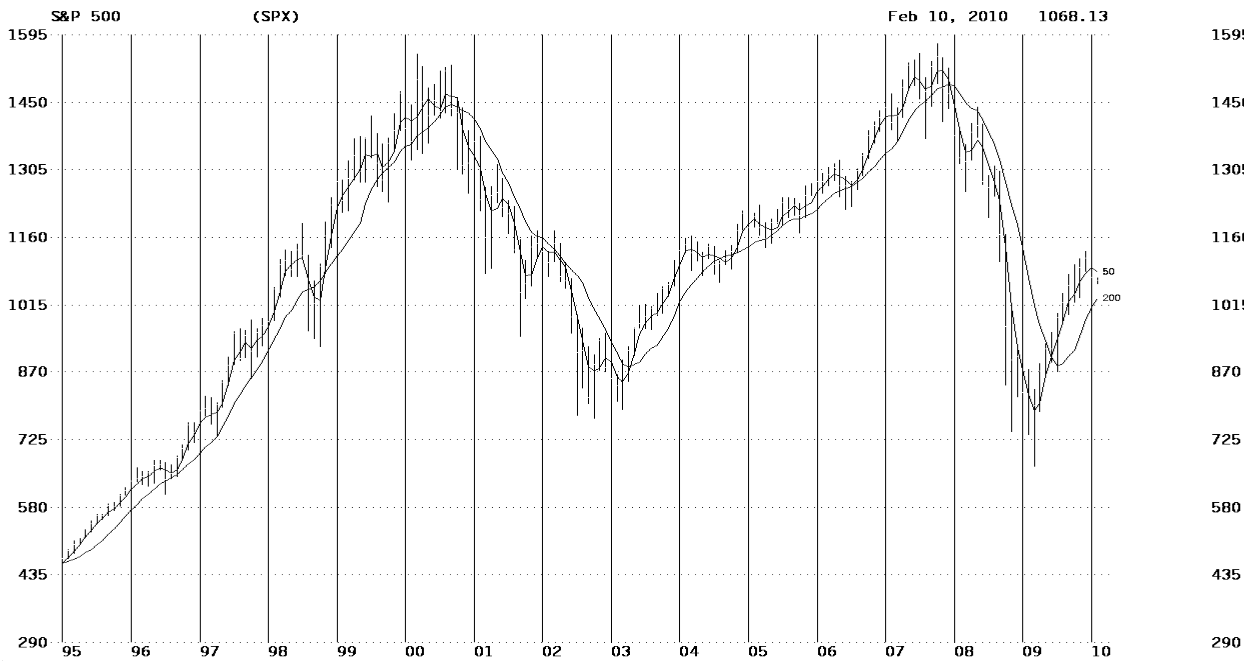


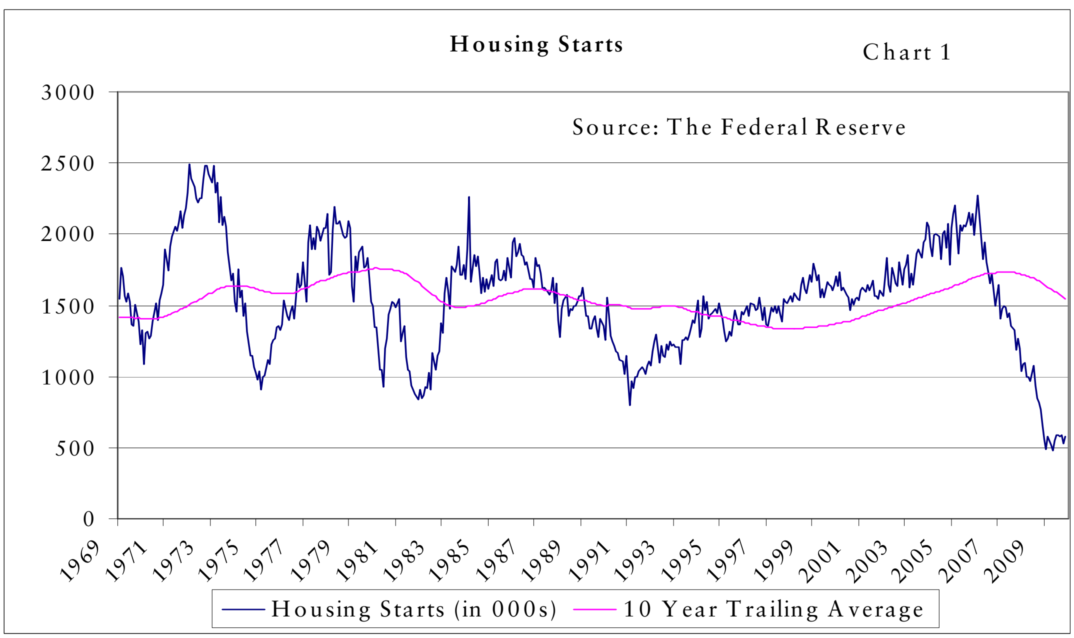
REVIEW

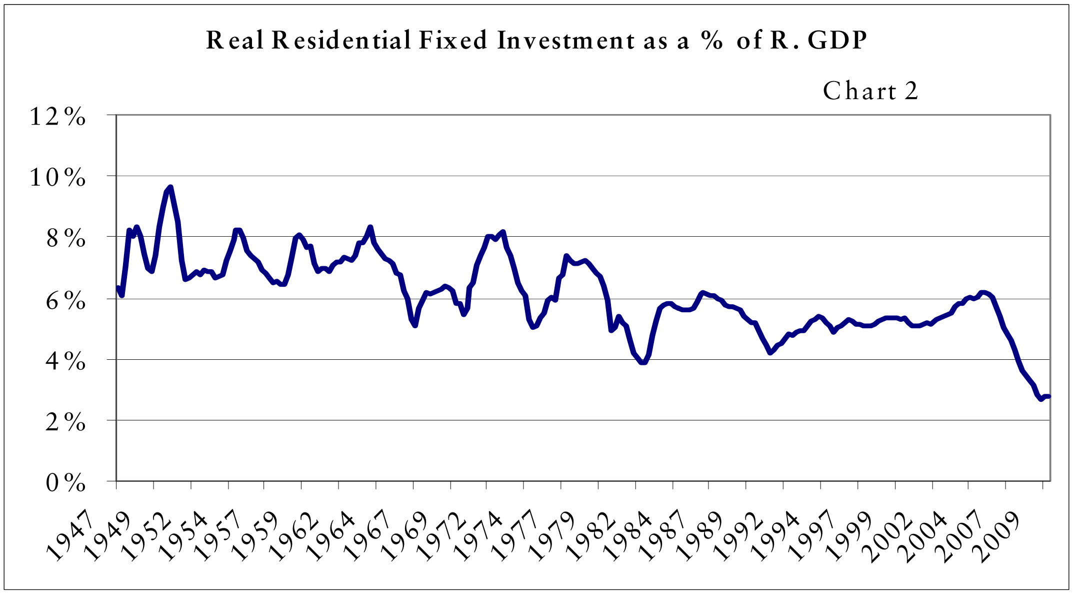
Our Bullishness on stocks last year paid off as the S&P 500 returned more than 26% to investors. As we had anticipated, most analysts and economists had become too pessimistic. Both GDP forecasts and earnings estimates have been trending upward for several months. More recently, stocks have pulled back about 7% due to concerns including the debt situation in Greece, actions by Chinese authorities to reign-in bank lending, and other factors which lead to questions about the sustainability of the global recovery. However, we see this pull back as a normal move in the context of a Bull Market. While there are certainly areas of concern, most of which involves self-inflicted damage by the political class, we think the indicators point toward a continued upward trend in economic growth, corporate earnings and stock prices over the next year.

ECONOMICS

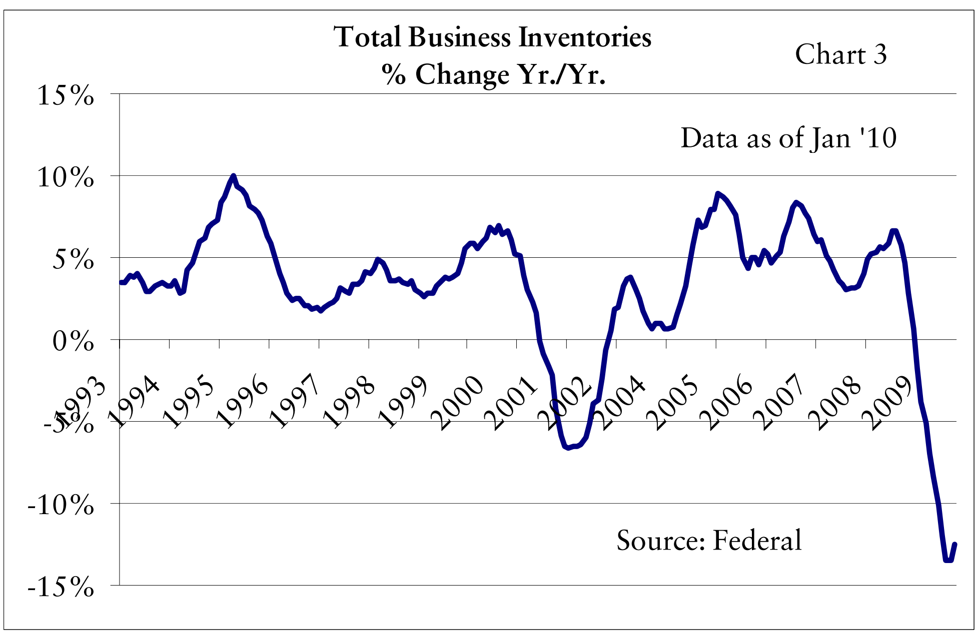
Real GDP is expected to continue to expand at a good rate despite continued softness in some areas of consumer demand and rising taxes. Real GDP was initially reported to have expanded at a 5.7% annualized pace in the 2009 fourth quarter. While that figure may be revised a bit lower as final adjustments are made for net exports and other factors, the final number is still likely to show a good rate of growth. The figures are starting to benefit from some stabilization in the housing sector as well as business inventories. It's not that growth to housing or inventories has yet resumed, it's already enough that they don't continue to freefall and drag down the overall growth figures. Looking ahead, the U.S. is expected to experience real GDP growth at about a 3.5% rate in 2010 and a 2.5% rate in 2011. Such growth figures are low compared to what would typically be expected after coming out of such a significant recession, but there are likely to be considerable drags to growth including a rise in marginal income tax rates, higher capital gains and other taxes, and more onerous regulations on business activity.

We do not expect the housing sector to be a meaningful area of growth for many years to come, but it is also not expected to be a heavy drag as it has been over the past couple years. Chart 1 below shows the stunning decline in new housing starts. Recently, the inventory of unsold homes has been declining and the level of new housing starts has stabilized at about half a million per year. Chart 2 below shows how new housing went from slightly more than 6% of GDP at the recent peak, down to the current level of about 2.5% of GDP. This obviously has been a dominant factor in the recession. The US population is now growing at only about a 1% rate and, with plenty of unsold homes still available, we don't expect either of those charts to start bouncing back up anytime soon. Nonetheless, the overall economy can still show good growth as long as housing is not declining further.

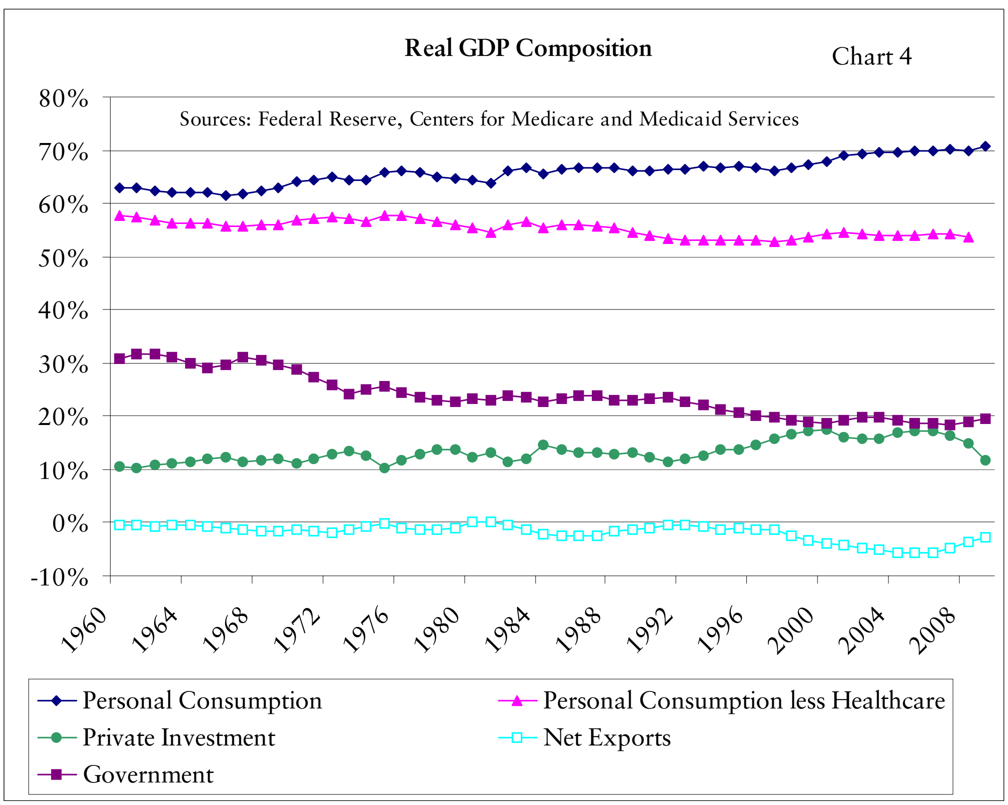




Inventories have also been a big drag on economic growth but are now starting to become a major contributor. Businesspeople were obviously as scared as former US Treasury Secretary Hank Paulson says he was during the recent financial crisis. Not only did businesses decide to layoff lots of workers, they also made deliveries with existing inventories instead of through new production. As seen in Chart 3, the decline in inventories has been quite stunning and was a major factor in the negative GDP growth of 2009. Businesses do not even have to add to inventories in order to get a positive contribution to real GDP growth. All that has to happen is that the decline in inventories slows. This is what happened in the 2009 fourth quarter when the inventory adjustment actually added more than 2% to GDP growth. In the near future, businesses are expected to start increasing production and rebuild inventory levels. This is the normal course of economic recoveries. In 2010 and 2011, we can expect inventories to start rebounding and employment should rise as new orders help fear to dissipate.



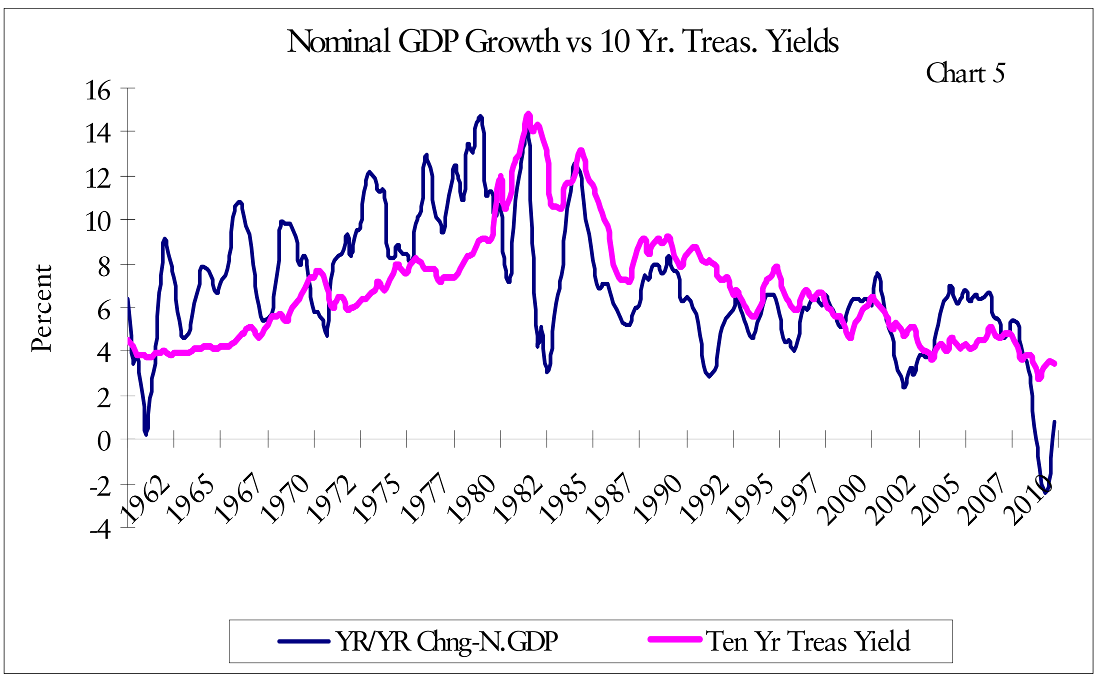
Business investment and net exports are expected to provide an increasing contribution to growth in 2010 and for years to come. It is our thesis that the financial crisis and the "Great Recession," as it is being called, marked an end of a secular trend whereby *individuals* in the US were willing to absorb capital flows from abroad. A nation's capital account, by definition, is the reciprocal of the current account, which includes a trade surplus or deficit. Countries that run trade deficits import capital, and those that run trade surpluses export capital. The US importation of capital and the corresponding trade deficits permitted low interest rates and easy credit that helped entice people to spend heavily on housing and consumer durable goods during the past cycle. However, in essence, the zeitgeist has changed. For the near-term at least, Americans have become much less willing to borrow and spend even at very low rates of interest. And longer term, while the American population is aging, such trends are much more pronounced in other major exporting nations in Europe and Asia. Those nations have heretofore been net savers and capital exporters. However, as those nations are increasingly populated by retirees, they are likely to become capital importers and run trade deficits while the US shifts toward capital exportation and trade surplus'. Net exports have been a positive contribution to US growth in recent quarters (again see Chart 4) and we think net exports may continue to rise within a secular trend. A corollary to this thesis is that U.S. manufactures will perform very well as net exports rise and production essentially shifts from the aging populations abroad to the relatively younger and growing population of the U.S.



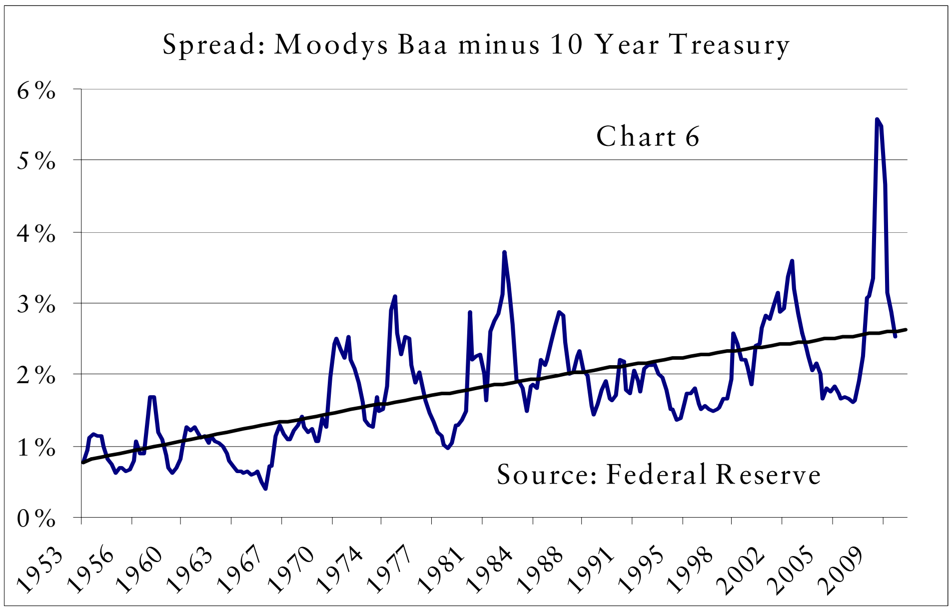
While we think this will be a "normal" recovery, economic growth is likely to change form: Increases in personal consumption will likely make less of a contribution than in the past. It is fashionable to say that Americans excessively spent on homes, automobiles and other consumer items, but Chart 4 tells a rather different story. It is true that Personal Consumption has trended upward in recent decades from just over 60% of GDP to more than 70%. But at the same time, spending on Healthcare has increased from about 6% of GDP to more than 16% of GDP, while spending on everything else declined relative to GDP. Part of this phenomenon reflects sharply rising manufacturing productivity and the fact that people can, for example, purchase an automobile with a much smaller portion of their income than was necessary in 1960. But it also obviously reflects rising preference for healthcare. It doesn't seem that this transition is likely to change as the US population, like nearly everywhere, ages. And it looks to us that so-called "healthcare reform," in the sense of a government nationalization of the sector, will not happen in the foreseeable future. Americans want fast access to MRI's, hip replacements, coronary bypass surgery and all the other healthcare services which they see as being endangered by too much government control. A Canadian or UK type system is unlikely in the US. At the same time, spending on housing, automobiles and other consumer goods is likely to continue to shrink as a proportion of GDP. These are not likely to be the growth industries of the future.

INVESTMENTS

Fixed income as an investment class is relatively unappealing. Bond yields, like inflation, are largely a function of the growth in nominal spending. Bond yields have been trending lower since the early 1980s and ten year US treasury yields are now down to about 3.7% (see Chart 5). Given that year-over-year growth in current dollar spending (i.e., nominal GDP) has recently been somewhere between -2.4% and only slightly above zero, there is very little upward pressure on either inflation or bond yields. Therefore, it seems unlikely that bond holders will suffer major capital losses from rising yields in the very near future. However, Central Banks worldwide have been doing much to bolster spending and there has been evidence of improvement. In our judgment, a yield of 3.7% on ten year treasuries, even if we assume yields are stable and there are no cap losses, is not very appealing. Furthermore, if the Fed and other central banks get some traction and spending rises, we could see yields rising—perhaps late in 2010 or in 2011.



Neither are corporate fixed income securities appealing. The spread on yields between corporate issuers and the US treasury spiked during last year's recession as concerns grew about the ability of businesses to repay their debts. However, as shown in Chart 6, corporate spreads have narrowed significantly and have now come back down to the long term trend line. With the Baa spread over treasuries down to about the 2.5% range, corporate bonds are no more interesting as investments then 10 year treasuries.



Corporate earnings are expected to rebound from the depressed levels set during the recession. As seen in the table below, revenues and operating earnings for the S&P 500 declined sharply in 2008 and 2009. Much of the decline was due to a sharp downturn in sales by energy companies and other cyclical businesses. The banks were also big contributors to the decline in operating earnings and the spike in "special charges" in recent years. For 2010 and 2011, our expectation of moderate growth in revenues may turn out to be too pessimistic. Our forecast for revenue growth would still leave sales below the peak level set in 2008. Most of the earnings improvement is not expected to come from sales growth. Instead, profit margins as a whole are expected to rebound as the cyclical businesses bounce back to more normalized levels. Furthermore, the very low inflation environment has put great pressure on businesses to control costs. Margins have been in a long-term uptrend thanks to the efficiencies businesses have been striving toward thanks to the disinflationary pressures. We expect that to continue.

S&P 500 Revenues and Earnings

	Revenue	Operating Earnings	Special Charges	Net Earnings	Operating Margin	Net Margin
1987	373.84	19.31	1.81	17.50	5.2%	4.7%
1988	408.19	27.65	3.90	23.75	6.8%	5.8%
1989	461.15	24.46	1.59	22.87	5.3%	5.0%
1990	509.08	23.22	1.88	21.34	4.6%	4.2%
1991	512.57	19.03	3.06	15.97	3.7%	3.1%
1992	523.64	22.75	3.66	19.09	4.3%	3.6%
1993	527.22	26.54	4.65	21.89	5.0%	4.2%
1994	552.06	31.28	0.68	30.60	5.7%	5.5%
1995	598.41	37.71	3.75	33.96	6.3%	5.7%
1996	616.43	41.18	2.45	38.73	6.7%	6.3%
1997	640.40	45.08	5.36	39.72	7.0%	6.2%
1998	634.51	44.49	6.78	37.71	7.0%	5.9%
1999	663.21	50.88	2.71	48.17	7.7%	7.3%
2000	712.28	56.34	6.34	50.00	7.9%	7.0%
2001	732.41	45.17	20.48	24.69	6.2%	3.4%
2002	675.93	48.13	20.54	27.59	7.1%	4.1%
2003	695.36	55.55	6.81	48.74	8.0%	7.0%
2004	777.70	66.99	8.44	58.55	8.6%	7.5%
2005	871.58	76.29	6.36	69.93	8.8%	8.0%
2006	945.17	88.17	6.66	81.51	9.3%	8.6%
2007	1,013.57	86.23	20.05	66.18	8.5%	6.5%
2008	1,061.28	68.63	53.75	14.88	6.5%	1.4%
2009(E)	933.93	64.52	18.09	47.71	6.9%	5.1%
2010(E)	971.28	80.51	14.29	68.71	8.3%	7.1%
2011(E)	1,059.07	92.00	15.00	77.00	8.7%	7.3%

Source: Standard & Poor's Corp, Thomson Baseline, F&V Capital Management, LLC

The first year off the bottom of a recessionary Bear cycle is often the best, but we think further gains are likely in 2010 and 2011. The S&P 500 is currently trading at about 13 times the 2010 estimate of 80.51 for operating earnings and 15 times the more conservative net earnings. At this still relatively early stage of the recovery and with inflation running below 2% and not expected to rise anytime soon, such P/E multiples are quite modest. Our model still has the fair value of the S&P 500 at about 1250, or some 17% above current levels. It would not be unreasonable in our view to expect equities to return somewhere in the 7% to 10% range during the 12 months ahead. This makes stocks look quite attractive compared to the fixed income alternatives.

Near term, we wouldn't be shocked to see stocks drift slightly lower before regaining traction, but such market timing is not particularly scientific. The S&P 500 has drifted lower to the current level of 1068 after hitting 1150 on January 19th. We think stocks are nearing oversold levels and will get support before they hit the 200 day moving average of 1022, which is about 4% below current prices. Between now and then, we would be putting cash into stocks in anticipation of a coming rebound. Naturally, we think longer term holder should ignore these potholes and hold on for the general upward movement that we think is likely.

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