Baldwin Investment Management, LLC

BEWARE OF GREEKS BEARING GIFTS…….

The first quarter of 2010 was a period of market "churn". Fresh from vaulting new heights in the previous nine months, most markets moved sideways from January through March, making little progress. Some pundits have argued that consolidation was only to be expected after the Olympic result of 2009. In fact these seers have posited that markets around the world needed some "base building" before launching another move up. The prognosticators of a less ebullient hue expectedly declared the rally dead. Problems loomed large. Contagion (remember that word from 2008) was set to spread again and this time from a corner of the world not often thought about in the canyons of Wall Street – GREECE. But Greece was not the only problem unnerving investors in Q1. There were also fears of China tightening monetary policy and a stubborn U.S. unemployment rate. So let's examine each.

When the Euro was being designed as the currency for the Euro zone member countries, Greece was/is part of that group of European nations considered the "soft economic underbelly" of the union (i.e. Portugal, Ireland, Italy, Greece and Spain aka PIIGS). These were the countries that had historically run with current account deficits and more debt on the balance sheet than the "hard" economic countries like Germany and the Netherlands. In fact, it was a bit of "a shoehorn" affair to get Greece and its compadres accepted to the Euro club because there was worry in the hard currency camp that one day some "weak sister" would have to get bailed out. During the first 10 years of the Euro's existence, as the world grew, lots of budgetary infractions of the Euro club rules were ignored or covered up by economic growth. Statistically speaking, Greece, with the help of some investment banking hocus-pocus remained a Euro member in good standing. But statistics and their attendant models "…are like bikinis: what they reveal is suggestive, but what they conceal is vital", according to Aaron Levenstein, late professor at New York's Baruch College. Greece has always had to struggle to comply with the Euro rules. So when the "meltdown" of 2008 occurred, Greece was left on the beach and as Warren Buffet has opined, "….when the sea rolls out from the shore, we all see who is swimming naked". Now Greece is not an economic power of such standing that it itself could threaten world economic order if it defaulted. However, the contagion theorists started to worry aloud that if Greece "went down the tubes" others like Spain would not be far behind and thus the whole Euro zone was threatened.

The Euro zone is enough of an economic power that if it were damaged, world growth would be sharply impaired. So as Greek and Spanish and Portuguese bond prices started to plunge, other Europeans gathered to devise a "support mechanism". Leaders from Germany and France have publicly stated that their countries would step into the breach to support Greece. So far, nothing concrete in the way of specific plans for a rescue has been mooted. But merely verbal support has so far been sufficient to calm investors. Greece has successfully recently sold a new issue of bonds, as have the Portuguese. We believe that Europe has invested too much in the creation of the Euro and the Euro zone to let it come asunder. Also, German and French lenders have a big exposure to Greek credit. In fact, German loans to the PIIGS represent 19% of German GDP. Thus, there will be support and Greece will go away as an issue for investors. However, this recent contretemps we think appropriately underscores the inherent weakness of the Euro zone, particularly vs. America. No doubt we have economic/political problems in the U.S. But we would rather be investors in slower growing American companies than in even slower growing European ones. In short, we would be "long" the dollar vs. the Euro.

During the first three months of the year, the Chinese raised reserve requirements for Chinese banks a couple of times. They have yet to increase interest rates. Raising reserve requirements effectively restricts the amount of money a bank can lend and this is exactly what the Chinese banking authorities wanted to accomplish. They wanted to slow loan growth in China so as to "rein in" the economy. Cooling off the economy is not the same as "killing it". The Chinese absolutely want and need to have their economy grow so as to provide employment opportunities for their citizens. High unemployment means political unrest and potential loss of political power for the Communist Party – something they will not allow. Why slow the Chinese economy and why did the authorities choose raising bank reserve requirements as the tool to accomplish this? Well, the Chinese economic engine is growing mighty fast for an economy of its size (for example, the U.S. GDP grows 2% - 3% annually, usually) and nobody thinks it a good idea for Chinese growth to careen out of control and allowing for rampant inflation. Hiking interest rates was not considered the "right tool" to get the job done, because raising interest rates would have made the Chinese Yuan more attractive and put upward pressure on the currency. The Chinese want to keep their currency stable vs. the dollar – but want to slow the economy. So, hiking reserve requirements seemed to "fit the bill". The "doom and gloom" types immediately extrapolated the hiking of reserve requirements to increasing interest rates and "killing" of the Chinese economy – one of the engines of world growth this past year. So far the Chinese economy is growing at a very healthy pace of approximately 10%. Further, there are some slight hints of inflation, which the authorities want "to nip in the bud". Therefore, one might think that the Chinese would be applauded for their preventative actions instead of their actions being cited as cause for investor worry. We believe that the Chinese will continue to responsibly slow their economy – but allow enough growth to further help propel the world's economy.

U.S. unemployment is always a lagging economic indicator, but during Q1 various seers chose to ignore that fact and worry aloud that unemployment remained too high and would abort the recovery. Companies do not hire or rehire people until management is comfortable that the future is brighter than the past. Before any hiring gets done, existing staff are worked harder and as a result productivity increases. Profits rise and productivity levels off, prompting the need for more workers – and hiring begins. This is always the way out of every recession and it will be no different this time. Already we have seen a drop in the unemployment rate to 9.7% from 10.2%. The rate will continue to drop in 2010.

So, what's been good thus far in 2010? Fourth quarter 2009 results bested Street estimates with nearly three-quarters of the companies in the S&P 500 beating projections and estimates for 2010 were increased. Corporate America seems in pretty good health. Dividends are again growing. Companies are also getting more aggressive on the mergers and acquisition (M&A) front. ExxonMobil has agreed to buy XTO Energy; Schlumberger has signed a deal with Smith International; MetLife is buying a huge chunk of AIG as is Prudential of Great Britain. Stanley is acquiring Black and Decker; Phillips Van Heusen has made a bid to buy Tommy Hilfiger and Air Products has made a hostile play for Airgas Inc. There is a lot of money working the M&A halls. Capital investment is now showing "signs of life" after quite an hibernation. Orders for durable goods are on the upswing and inventories are doing somewhat better. Inflation is nearly non-existent. As a result, interest rates are low and we would project them to stay low at least until employment rises smartly. Brazil, China, India and numerous other parts of Asia, South America and Africa have continued to record substantial economic growth which generates trade and fosters growth in the developed world – including the U.S.

It always seems to be necessary that there is a "wall of worry" for Wall Street to climb. Sunny days, when everyone is of one happy mind, are not conducive to up markets. If every investor agrees that the direction is up, then it is probably the case that every investor is already invested and there is no one left to buy to drive markets. There needs to be a difference of opinion for markets to advance. There must be sellers for the buyers to have inventory to buy. We like it when people worry. Out of uncertainty comes opportunity. We thought year end equity prices were not outrageous. Since there has been little stock price progress during Q1 and corporate earnings were better than expected with brighter outlooks for 2010, we still think equity values around the globe are reasonable.

PREDICTIONS FOR 2010	COMMENTS
1) The world will grow with China leading the way	Yes – China starting to "rein in" growth
2) Global inflation will still not be a problem	Yes – still quiescent most everywhere with some whisper of deflation In Japan
3) The dollar will have bouts of strength – but will still melt during the year	Certainly having one now especially vs. the Euro due to fear of "contagion"
4) The Euro will lose strength versus the dollar	Yes - because of the fear of "contagion"
5) The Chinese renminbi will appreciate in value	Not yet – but international pressure for appreciation of the yuan grows
6) Commodity prices will go up across the board	Mixed bag – some industrial commodities (iron ore) yes; some agricultural (corn) no
7) U.S. Treasury prices will decline	Not yet as the fed continues to promise low interest rates
8) There will be more merger & acquisition activity	Yes – in numerous industries corporate chiefs are loosening purse strings
9) U.S. equity prices will advance	So far, a bit positive – but a churn for most of the quarter
10) Foreign markets (especially emerging markets) will rise	So far, a bit positive – but a churn for most of the quarter

A FINAL THOUGHT

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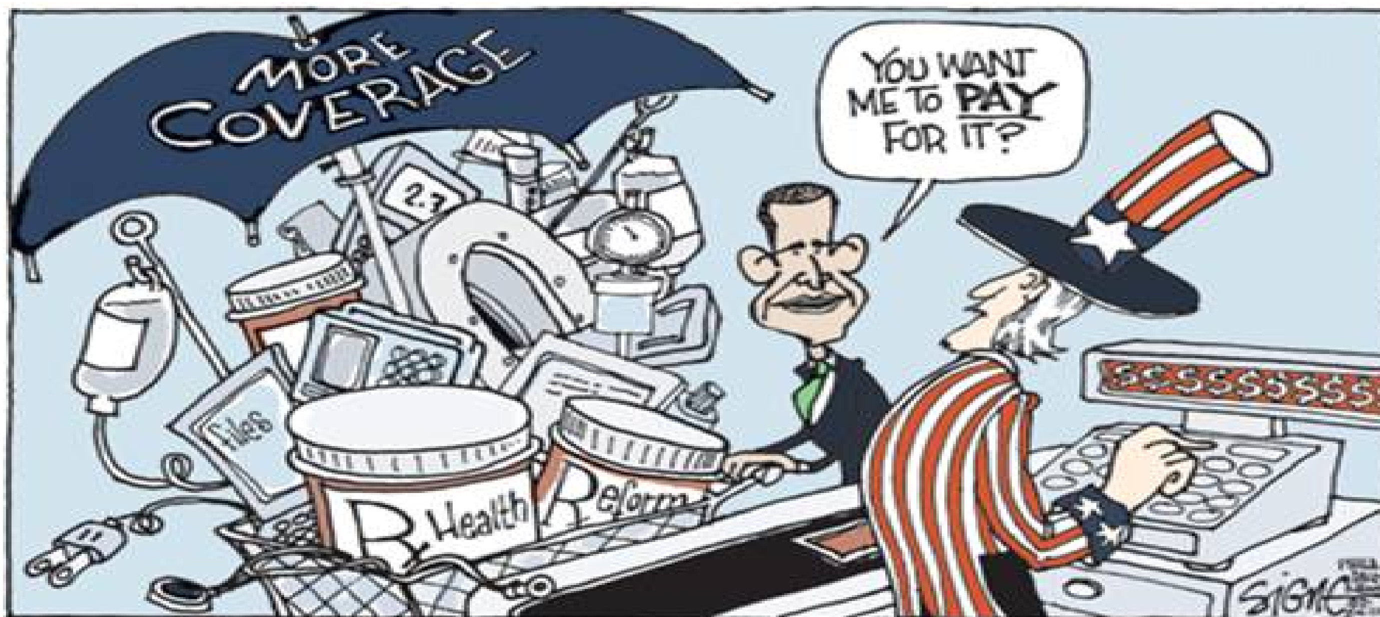

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