

Economic and Social Outlook: *January 2010*

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Looking Back on 2009

After the tremendous run we've had in the stock market it's hard to remember how the world felt when we sat down a year ago to write the January '09 Outlook. So we went back and re-read the piece. Having done so, we'll borrow from Kierkegaard and offer "Fear and Trembling" as an apt summary of sentiment at the time.

Investors had just suffered their worst year in the stock market since the 1930s. Comparisons to and predictions of another Great Depression were commonplace. Panic was so widespread that short-term US Treasury bills actually had a *negative yield* in December of '08. That is, investors were paying the US Government to lose them money because they were confident it would be only a small and predictable loss.

Against that backdrop our economic and market forecast a year ago may have struck some as Pollyanna-ish. Last January we suggested the worst of the recession would be over by the end of the then-current first quarter. We estimated the economy would begin to expand by the third or fourth quarter and that stocks would begin to recover about six months before the economy did. As it turns out, all of those things came to pass.

Consistent with our outlook for recovery we said a year ago that we were shifting our portfolios' emphasis to stocks in the consumer discretionary and technology sectors. Our reason for the move was that these shares tend to rise in anticipation of economic recovery earlier than stocks in other sectors. For 2009 the three best sectors of the US stock market were technology (+60%), materials (+45%) and consumer discretionary (+39%).

In our April Outlook last year we said the nascent rally that had begun in early March looked to us like the real thing. That is, it looked like the start of a new bull market rather than another false, bear-market rally that would fail. And, in fact, March 9 did mark the absolute low for the vicious bear market that had savaged investors since late 2007. From March 9 through December 31 of last year, the S&P 500 rose 65%.

All in all, we got a lot right about 2009. But market forecasting is in some ways easier coming out of a bear market. Bear markets and the recovery from them display highly consistent patterns due to a) predictable herd behavior by investors, b) predictable interventions by central banks and other governmental agents, and c) the predictable effects of those interventions on the economy. All this was writ large in 2009.

Looking Ahead for 2010

The harder part of market forecasting comes in less extreme periods when such highly predictable behaviors are no longer driving the story. That's where we are now. A few things do, however, seem likely to us.

First, in 2010 stocks won't keep the pace set during the rally of 2009. Stocks always "front-load" returns coming out of a bear market—the big gains come early. We had our snapback rally and forward returns should moderate.

Second, the US economy probably expanded during the fourth quarter of 2009 at around a 4.5% pace. That's respectable and should lead to net positive job growth in the US sometime in the first quarter.

continues on reverse

Major Market Performance 2009

	4th Quarter 2009% chg.	2009 % chg.
Dow Jones Indus. Average	8.10	22.68
S&P 500 (large cap)	6.04	26.46
S&P 1000 (small/mid cap)	5.43	33.48
S&P 1500 (all cap)	5.96	27.25
NASDAQ	6.91	43.89
Barclays State G.O. Muni Bond	-1.37	9.09
Barclays Gov/Credit Intermediate Bond	0.31	5.24



Looking Ahead for 2010 (cont'd...)

Third, the economy should continue to expand throughout 2010 and do so at about a 4% rate (this estimate is above consensus). With 60% of the federal economic stimulus money yet to be spent, very low interest rates greasing the wheels of commerce, overall job growth about to return, and the foreign markets we sell into growing at a relatively faster pace, the US economy has plenty of fuel to keep the engines of growth turning.

Confirming this view is our old friend the yield curve, which is steeply positive with short-term interest rates much lower than long-term rates, a condition that historically is highly predictive of economic expansion ahead.

Fourth and lastly, US corporate profits will surge 30% or more in 2010 as pared-down cost structures (= low labor costs) let a big chunk of expanding top-line revenues fall straight to the bottom line.

The Crystal Ball Grows Cloudy

So, if the US economy expands, jobs return, and profits surge in 2010, shouldn't US stocks likewise do well? Probably. But remember that stocks price in expectations for the economy and profits six to twelve months out. The huge rally from March through December last year already priced in a lot of good news for 2010. How stocks do over the *next* twelve months has as much to do with 2011 as it does 2010. Here the crystal ball grows cloudy.

As has been widely noted, the economic recovery both here and abroad is largely the result of massive government intervention, the stimulative effects of which will wane as we move toward year end. The real question for investors now is: What do global economies look like in six to twelve months when left to their own devices?

Goldilocks Goes Global

We think there are three possible answers to this question: too hot, too cold and just right.

Once government stimulus wanes, if the economy is too hot then inflation picks up and the central bank must raise rates to cool things down. If the economy is too cold it risks lapsing back into recession and new government stimulus measures are needed (the politics of which must be assessed). If the economy is just right it has enough steam to keep growing but not too much to risk inflation, so the government can stand down.

Historically, it's only on the "just-right" scenario that stocks continue their upward trajectory. On the too-cold scenario profits fade and with them, stock prices.

On the too-hot scenario, central banks raise interest rates, the economy cools, and you end up in the same place with profits and stock prices flagging.

Over the past two years economies around the globe contracted and then recovered in a synchronized fashion. Going forward their paths will likely diverge as their governments' stimulus measures wane. Japan and Europe look set for sluggish or no growth with a risk of deflation (too cold?). The US should have moderate growth with contained inflation (just right?). And emerging economies like India and China are probably going to overheat with inflation becoming a problem (too hot?).

What We're Doing

If we're right and the US economy finds the sweet spot of just-right economic growth as it moves into 2011, then US stocks should continue to rise through the year with a hiccup (a 5% to 10% decline) likely somewhere along the way. If Japan and Europe are sluggish and China and India overheat, then the US stock market could also be the blue-ribbon winner among global markets in 2010.

If all of the above proves true, then the winning formula *within* the US stock market will be to emphasize companies whose revenues come more from the domestic economy (where just-right growth continues). That would make technology shares relative underperformers in 2010 and healthcare shares, for example, outperformers.

And if all of *that* were to happen, then 2010 will be both a winner and a mirror image of 2009 for stock investors.

One advantage of this view is its contrarian nature. The overwhelming consensus among investors today is that emerging markets are the place to be in 2010 and therefore technology will once again be a leading sector.

For our part, we humbly acknowledge that our view has many moving parts, any of which may frustrate expectations. As we said above, at this point in the cycle the crystal ball is necessarily cloudy.

Still, we think our view has merit. So we're dialing back portfolios' foreign-sales exposure, specifically our emphasis on technology shares, and dialing up exposure to companies with more domestic sales such as those in the healthcare sector. As ever, we'll be keeping a careful eye on events as they unfold.

Farnum Brown
Chief Investment Strategist

Social Advocacy Highlights

After three years of trying to operate within the censorship requirements imposed by the Chinese government – including blocking results related to the Dalai Lama and the Tienanmen Square Massacre – **Google** announced on January 12th that it would stop complying with Chinese demands. Trillium as a founding member of the Global Network Initiative – a multi-stakeholder organization intended to promote freedom of speech and privacy protections on the Internet--has pushed the Company for years to do more to protect freedom of speech around the world. We are extremely encouraged by this critically important step by Google, which marks a watershed moment in corporate social responsibility.

Lincoln Electric Company agreed to implement our proposal to expand its employee non-discrimination policy to cover sexual orientation and gender identity/expression.

The **Securities and Exchange Commission** (SEC) announced a reversal in policy that will allow shareholders to resume filing resolutions that ask companies to discuss the risks associated with climate change, toxic chemicals, rising health-care costs and other significant social and environmental issues. Under the Bush Administration, the SEC had developed policies that restricted shareholders' ability to press corporations on these issues. Trillium has been a leader in pushing the SEC to reverse the Bush-era restrictions. In September, Jonas Kron of Trillium spoke directly with the SEC about the issue. We are encouraged by the SEC's reversal of these policies and renewed support of shareholder advocacy for greater corporate transparency and accountability.

In December, after earlier dialogues with management stalled, Trillium sponsored a shareholder resolution at the restaurant chain **Chipotle Mexican Grill** asking for a report on progress toward reducing pesticide use at the supplier level. Serving "Food with Integrity" defines Chipotle's mission, yet few standards or protocols exist to address pesticide use. Soon after filing the resolution, Chipotle informed us they will publish a sustainability report in the next 12 months that will include strategies to promote reduced pesticide use. Trillium and co-filers Calvert Investments and Green Century Capital Management applaud management's action. We will keep the resolution on the proxy, however, pending a written agreement from the company.

Trillium joined a coalition of investors, representing almost \$200 billion in assets under management, in issuing an Investor Statement urging corporations to ensure their buying practices are not fueling conflict and human rights abuses in war-torn Democratic Republic of the Congo (DRC). The statement asks companies to identify where raw materials in their products originate and take steps to ensure **conflict minerals** from the DRC such as tin, tantalum and coltan are not entering their supply chain.

In the fall, Trillium co-sponsored a shareholder resolution at **Whole Foods Market** calling upon the company to implement a by-law change that would require the position of board chair to be filled by an independent member of the board. Subsequently, Whole Foods' controversial CEO, John Mackey, resigned his position as board chair. We have withdrawn the proposal and will be meeting with the new board chair to press to make the separation of positions permanent.