FBB CAPITAL PARTNERS

4520 EAST-WEST HIGHWAY · SUITE 450 · BETHESDA, MARYLAND 20814 · TEL 301-657-8870 · FAX 301-657-0866
WWW.FBBCAPITALPARTNERS.COM

October 9, 2009

Dear Clients and Friends,

In our recent conference call (we hope you were able to tune in; if not, a recording is available on our website, www.fbbcapitalpartners.com), we referenced an old Chinese proverb, which says,

To be uncertain is to be uncomfortable, but to be certain is to be ridiculous.

The obvious point, despite the very strong recovery in both stock and bond prices, is that a great deal of uncertainty remains with regard to actual economic activity. The recent data points on employment were dismal, with first-time jobless claims running at greater than 500,000 a week, and the unemployment rate nearing 10% (and much higher, if certain adjustments are made to the official government figures.) Credit card defaults and delinquencies continue to grow as well, and foreclosures remain at elevated levels. This data suggests the consumer is struggling to pay bills, and with the consumer representing upwards of 70% of US GDP, the economic outlook is cloudy at best.

Yet the notion is contradicted by positive comments from high-end retailers (makers of famous brand silk ties associated with the 1980s "greed is good" days on Wall Street, luxury-label leather handbags, silver trinkets in powder-blue boxes, etc.), who report surprisingly robust sales figures around the globe; by marginally better-than-forecast corporate earnings figures; and to a large degree by the sudden widespread availability of *capital* flooding the markets.

Earlier this year we mentioned a decline in investment-grade corporate bond yields, a sign that money was leaving the "safe haven" of Treasuries and money markets and seeking riskier opportunities with higher return potential. That flow of capital has continued, at a surprisingly rapid pace, with even "junk" bonds being bid higher and yields falling fast. Similarly, the influx of capital is pushing stock prices higher now that the economic waters appear less choppy than they were in the spring.

Normally we would be concerned about inflation in this type of capital environment, but disinflationary pressures largely offset this concern, at least in the near term. In particular, wage growth will not likely be a source of inflation as long as the jobs picture remains bleak. Also, excess manufacturing capacity is at elevated levels, keeping product prices low until sales growth resumes.

Of course, there is inflation of a different sort going on now – financial asset inflation. While we benefit from higher prices for stocks and bonds, we also grow concerned that prices might be getting ahead of economic reality. Stocks seem "fairly" valued to us, neither cheap nor overpriced, based on our forecast of 10% to 15% operating profit growth next year, and using historical price/earnings ratios as a guide. We do know that Wall Street's estimates currently exceed our own, so there may be a period of volatility if the Street's numbers prove too optimistic. That said, we think the likelihood of more stable, long-term growth is increasing, even if that growth comes at a lower level than we've seen in the past. Similarly, bonds may come under pressure if inflation returns sooner rather than later, or if the Federal Reserve begins to moderate its current easy-money policies (which we expect to happen beginning early next year.)

In short, the economic picture is stabilizing but consistent strength remains elusive, and securities prices seem to adequately reflect the up- and downside possibilities. Also, given the possible economic headwinds (ongoing deleveraging, the likelihood of higher corporate and individual income taxes, health care reform, cap-and-trade legislation), there are many reasons to be uncomfortable with the near-term outlook. The implication for investment portfolios is to maintain a somewhat defensive bias, with an emphasis on security selection, balance sheet quality and relative value.

Sincerely yours,

Mitch Schlesinger

SUSAN BREAKEFIELD FULTON · MITCHEL B. SCHLESINGER, CFA
SANDRA A. KINGSLEY, CPA, CFA · DAVID W. MALMGREN, CFA · STEIN A. OLAVSRUD, AAMS, CMFC
KATHLEEN M. HASTINGS, CFP, CLU · MAGGI M. KEATING, CFP · MICHAEL J. MUSSIO, CFP