Investment Update

October 2010

M I D D L E T O N & C O M P A N Y, I N C.

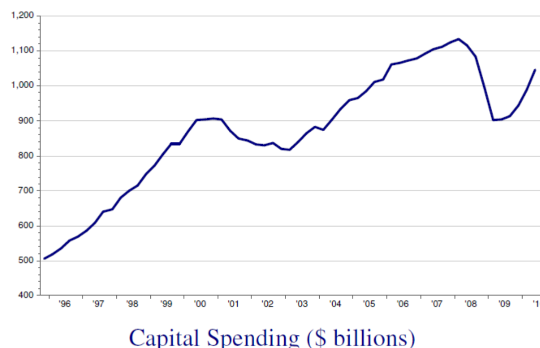
2010 Third Quarter Update

Review: The US stock market rallied strongly at the end of the quarter, finishing up 11.3% as a "double dip" recession became less likely. Bonds, as measured by the BofA-ML Intermediate Bond Index, were up 2.8%, as investors sought the stability of high quality fixed income, despite near record-low yields.

Quarters	***3Q10***	***2Q10***	***1Q10***	***4Q09***	***3Q09***
S&P 500 Index	***11.3%***	***-11.4%***	***5.4%***	***6.0%***	***15.6%***
BofA-ML Int. Bond Index	***2.8%***	***2.9%***	***1.7%***	***0.3%***	***3.3%***

The U. S. Economy: The economic recovery continued in the second quarter, albeit at a slower pace. GDP grew by 1.7% in the second quarter, down from 3.7% in the first quarter. Unemployment claims are below the peak but have not improved appreciably since February. In the past three recessions unemployment claims have, after an initial decline, plateaued at a still elevated level for six to twelve months before resuming a downward trend. We expect claims to follow a similar trajectory in this recovery. Housing starts seem to have stabilized at a 500,000 annual rate, which is well below the peak rate of two million prior to the recession and also below the household formation rate of one million annually. We conclude that while housing will not recover soon because of the overhang of inventory from the boom years, it has stopped being a drag on economic growth. Consumers' balance sheets continue to improve as the savings rate has increased. While this means a slower recovery due to less robust spending, it will make for more sustainable economic growth in the future.

The outlook for corporations is still good. Corporate profits are strong and balance sheets are flush with cash. Domestic business is growing slowly, but exports are growing strongly, up 9.1% in the second quarter. Capital spending, shown in the chart, is healthy, up 17.2% in the quarter, indicating that businesses are resuming investing for the future.



Capital Spending ($ billions)

Because the recovery is fragile, it will be more sensitive than usual to external shocks, such as stock market dips and negative financial news, both here and abroad. This could cause economic data to exhibit short-term weakness. However, the Fed stands ready to supply more stimulus if necessary. Therefore, the likelihood of a "double dip" recession has receded. Our forecast is for continued sluggish growth.

The International Economy: The major countries in the Eurozone have weathered the euro crisis and are growing modestly. While growth dipped in response to the recession in the developed world, the emerging economies of Asia and Latin America recovered quickly and are experiencing healthy expansion. In coming years, we expect at least 60% of global growth to come from emerging economies.

Since the Federal Reserve is holding interest rates down, the outlook for the dollar is flat to down because rates are higher in other parts of the world. This should help exports which are a key part of our recovery.

Stock Market: Stocks are ultimately driven by earnings growth. The trends have been good. For the S&P 500 companies, most of the second quarter earnings reports were better than expected. We expect third quarter earnings to be good but somewhat less robust because of the "pause" in economic growth noted in early summer. More important will be the guidance companies give for the fourth quarter and 2011. The S&P 500 Index is selling at about 13.5x 2011 earnings -- a very reasonable level by historical standards. With a reasonable valuation, good prospects for modest but continued growth and plenty of cash on the sidelines, stocks are attractive.

Bond market: Treasury bond yields are near all-time lows. The recent decline in yields is due to anticipation that the Federal Reserve will begin to buy more government and mortgage bonds, increasing liquidity in an attempt to stimulate the economy. Given the slow pace of the recovery, we expect the Fed to hold short rates at record lows until at least mid 2011. Bond rates are at such low levels that we find them unattractive.

Strategy: We believe stocks will outperform bonds and cash over the balance of 2010 based on attractive stock valuations and good global growth. We still favor stocks with exposure to global growth such as industrials and technology. Despite recent strength, we still feel that direct investments in emerging markets will be rewarding for disciplined investors because those economies have years of strong growth ahead.