H.M. Payson & Co.

ESTABLISHED 1854

RESEARCH NOTES

MAY 21, 2010

BULLS, BEARS AND PIIGS

As the stock market continues its rapid decline from the recent highs of mid April, spurred by fears over a Euro contagion and the potential effects on our nascent economic recovery, we thought it appropriate to reiterate our positive view of high quality US stocks. We hold this belief in spite of the current concern over the fate of the European Union and the ominous predictions of falling financial dominos from Greece to the countries linked under the unfortunate acronym of PIIGS (Portugal, Ireland, Italy, Greece, Spain) to the United Kingdom and then across the Atlantic to our shores. The current market decline has also been abetted by stubbornly high unemployment and a recent downtick in the leading economic indicators.

We are mindful of the uncertainty that further turmoil in Europe might engender, which is not healthy for markets. We have commented frequently on the long term consequences for the dollar of our own government spending policies, and we suspect we will be hearing much more about currencies in general for the foreseeable future. Our position has been that the progress of the economy has not justified the magnitude of the recovery in the stock market from the lows of March, 2009. Couple these factors (among many others) with the full market valuations of last month (after an uninterrupted advance from the February lows to the mid April highs and some sort of pullback seemed inevitable). Unfortunately, as starkly illustrated by the "flash crash" of May 6, 2010, these things can happen in a hurry. With Asian markets retreating along with Europe's and many commodities selling off as well, money is rapidly leaving riskier assets for the safety of U.S. Treasury securities and cash.

With the US market down roughly 10% from the April highs the question becomes: what now for US stocks? It will come as no surprise to our long term readers to hear that, in the short run at least, we don't know. Based on our return projections for various asset classes over the next five years, top quality US stocks have the best total return potential. We define top quality as companies with strong balance sheets, stable profit margins, good free cash flow and above average dividend growth. However, we maintain this view in the context of our otherwise cautious outlook for returns in general. At the end of March, our return projection for large cap stocks was 6% annually over the next five years. While this is hardly overly optimistic, it was in sharp contrast to our projections for negative returns for most fixed income assets and small cap and emerging market stocks. Our current valuation work leads us to hold to this projection for large cap stocks, particularly in light of the current retreat in the market.

It is difficult, but very important, to cling to valuation disciplines in chaotic markets as a major crisis dominates the headlines. As the complacency of April has been replaced by the volatility today, we believe there are emerging opportunities. We will offer our current thoughts in more detail in the upcoming Perspectives. As always, we encourage you to contact us with any questions about your account.

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