

Ipswich Investment Management Co., Inc.

4th Quarter 2009 Newsletter

“Individual and commercial deposits should not be allowed to fund financial engineering but rather lending, which is a proven highway for sustained economic growth.” - EHJ

January 15, 2010

As we enter 2010, we see renewed economic growth in most parts of the world ranging from 1% to 10%. Never before have we witnessed such a broad but disparate global recovery. Here in the U.S., we should expect GDP growth of 2.5% this year. Growth in real estate and consumer sectors will remain sub par and domestic banking remains fragile as the effects of last year's wealth destruction linger on. Meaningful progress in attacking the two major domestic problems of 10% unemployment and record public sector deficits will likely remain elusive unless there is a renewal of economic incentives to lift the rate of private sector job creation. Additional direct government stimulus targeted to lower the unemployment rate will prove to be counter-productive in the long term. Government at all levels needs to follow the examples of the private sector in executing structural reforms that significantly reduce the cost of delivering services or by eliminating programs that are duplicative or redundant.

Corporate response to the unprecedented 50% decline in global trade between the third quarter of 2008 and the first quarter of 2009 was swift: immediately reducing breakeven operating rates, liquidating excess inventories and shrinking balance sheets with the result that cash levels remained high enough to finance renewed economic growth in the last half of 2009. Higher unemployment from these actions did cause collateral damage by adding to the unemployment rate; however, the corporate capital base has been preserved and with it the resources to create sustained job growth. Continued lack of adequate commercial lending by banks will retard small business growth, whereas the larger corporations will sidestep banks and tap the corporate bond market for mid and long term capital.

Thus we begin 2010 with renewed growth expectations, rising levels of confidence and increased investor appetite for risk. The pace of the U.S. recovery will be well supported by strong growth in Asia. Any fragility in the recovery rests with the banking sector which to date has been long on rhetoric and short on structural and capital reforms. Meaningful changes are needed now to prevent future misallocations of capital in the system. Individual and commercial deposits should not be allowed to fund financial engineering but rather lending, which is a proven highway for sustained economic growth.

THE MARKETS

The vast improvement in investor sentiment and corporate results has moved the markets back into a zone of reasonable valuations. The first phase of the recovery historically produces the highest percentage of profit margin expansion and normally the best period of stock market returns. The 14% stock market return since the beginning of the third quarter of 2009 (up 60% from the March low!) is consistent with historic norms. We expect continued earnings gains in the range of 9-12% for 2010 against a background of continued low inflation and below real market interest rates and dividend growth of 3-5%. This should translate into stock market returns of 7-12% for all of this year. Any market disruption or sharp increase in volatility will likely be caused by an unexpected change in Fed policy, a sudden renewal of inflationary expectations or the appearance of new systemic risk tremors. We believe the odds are about one-in-three that any of these events will happen. Thus we continue to hold to our strategy of favoring stocks over bonds with emphasis on large cap multinationals and overweightings in energy, materials, industrials, technology and financials, excluding U.S. banks. We continue to be cautious on consumer non-durables, autos, real estate and small caps. Our health care exposure favors the large cap non-U.S. multinationals. Fixed income exposure favors U.S. Treasury TIPS and 3-5 year corporates rated AA or better over straight Treasury debt or long dated corporates.

A LOOK INTO THE DECADE AHEAD

Before we peer too far into the future, let's look back on the half dozen or so defining economic events of the last decade. In no particular order of importance, these events are worthy of note because of their long-term effects:

- The maturity of the Euro and with it the world's third reserve currency where its growth has been largely funded by the disuse of the U.S. dollar.
- The globalization of financial markets brought to fruition largely by advancement in global technology platforms and occurring faster than the ability of governments to regulate them.
- The economic and social consequences of global warming and the political process that is attempting to overtake science in determining the road we follow.
- The extraordinary global advancement of the internet.
- The likely evolution of new disruptive technologies and the changes they will bring to economic matters and social and public policy processes.
- The extended exuberance in financial markets that created asset bubbles in 2002 -Dot.com and 2008 - Sub prime mortgages & real estate.
- The collapse of the long wave consumer debt cycle in 2009.
- Lastly the coming of age of the major Asian economies into post emerging markets: China-India-Indonesia.

We will comment on each of these events in future letters.

The last shall be first: The most predictable long-term influence for the next decade will come from the new post-emerging market status of China, India and Indonesia, where the combined population will soon exceed three billion. China will continue to achieve long-term GDP growth of 8-10%, India 7-9%, and Indonesia 6-8%. Savings rates will run well over 20% and new job requirements are likely to exceed 750 million in the next 10-12 years. Chinese growth will be split between domestic development and export growth, primarily in Asia, while India will continue to grow internally with at least 75% of its GDP domestically oriented, and Indonesia is likely to fall midway between its two larger neighbors.

This means the U.S. will continue to decline as a factor in world economic growth. Its global contributions must focus more heavily on growing innovation in technology and medicine while marketing the increased productivity from these sectors on a global basis. The influence of the U.S. dollar will continue to decline and it is quite likely that we will see the creation of a fourth global reserve currency in Asia before 2020. This has important long-term implications for our domestic economy and fiscal structure -- most of them not being positive. Asia will focus on Asia, thus it is delusional to think that continued Chinese purchases of U.S. Treasury bonds is an accommodation to us; this will be a policy driven by China's own current needs. When and if their needs change, so will the current policy.

As always, please let us know if there have been any changes in your financial situation or your investment objectives that we should know about. Please feel free to contact anyone on our team if you have any questions or concerns. Thank you and Happy New Year!

Sincerely,

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