INVESTMENT STRATEGY
APRIL 2010

During the first quarter the market underwent an 8.2% correction, but quickly snapped back to achieve new highs by quarter's end. Despite this resiliency, the media continues to try to convince investors that both the stock market and the economy are ultimately doomed because of the lack of job growth. The common belief is that unemployment will stay high for at least several years and 8%+ unemployment will become the 'new normal.' As consistent market participants over the past few decades, we are again amazed by the level of disbelief in the strength and sustainability of the current economic and market recovery. Ironically this "wall of worry" has been a key element in every bull market over the past thirty years.

Although this negative view is currently popular, there are many reasons to believe otherwise, including signs that job growth will likely come sooner than later. One of the best leading indicators for future job growth is an increase in the number of temporary workers, which has been slowly trending upwards since September and is up 5.1% since December. It is highly unusual to have the number of temporary workers continue to increase at that rate after the Christmas holiday. In addition, company layoff announcements are at a 3-year low and new job openings increased 7.6% in the latest month. We have also seen unemployment duration starting to trend down and industrial production numbers turned positive in 2010.

Further, we have seen positive consumption numbers which should drive employment demand. Consumer spending was up 3.5% in January compared to one year ago. Non-defense capital goods orders, excluding aircraft, were up 9.1% in January, the first time this statistic has been positive since August 2008. Orders drive manufacturing activity, which has steadily increased. The average hourly manufacturing workweek now exceeds the important 40-hour threshold. These factors should increase jobs at least marginally in the short-term.

With clear signals that we have turned the corner from job destruction to job creation, it is only natural to ask how the economy will replace the approximately 8.5 million jobs that have been lost since the beginning of the recession. It is widely accepted that the banking and housing sectors will not employ as many people as they once did. We view this as a long-term positive, especially with regard to banking. However, as always, pundits completely underestimate the creativity and innovativeness of U.S. small business entrepreneurs who create new products, new companies, and even new industries during every recession.

So where will the jobs come from? The healthcare sector seems poised to take up much of the slack with elder care as the major driver due to the imminent retirement of the baby boom generation. Another factor is the new healthcare bill and its provisions to supply basic healthcare to the millions of Americans that have largely survived outside the system.

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Finally, we see promise from the field of biotechnology, where it has only been a decade since the human genome was decoded. All of these factors would suggest that the healthcare sector is positioned to grow significantly.

The other major sector of the U.S. economy likely to experience job growth over the next decade is the energy sector. For decades now we have been exporting our energy jobs overseas by importing foreign oil. No matter what the final makeup of our energy mix (nuclear, natural gas, wind, solar, bio-fuel), it seems very likely that there will be more domestic sources resulting in more U.S. jobs. The government is showing some support for nuclear with the approval of billions of dollars of loan guarantees to finance the construction of the first new U.S. reactors in more than 30 years. Meanwhile, the major oil companies view increased usage and production of domestic natural gas as the most likely scenario. Natural gas will likely be used for new power plants to replace coal, but could also provide transportation fuel for trucks, buses, and even cars. We also view this policy as the most rational, since there are large untapped domestic supplies and natural gas is 45% cleaner than coal and 30% cleaner than oil for the same unit of energy. From a jobs perspective, natural gas drilling traditionally takes 5-10 times as many wells to produce the equivalent amount of energy as oil. These jobs would be in the U.S. and we actually have the potential to become a natural gas exporter if commitment to the required infrastructure is made.

As investors, the real question is, “How do we best take advantage of such trends?” In the healthcare sector we have concentrated on three main avenues for investment: diversified pharmaceutical companies, medical device and technology companies, and companies that supply the consumables needed to operate labs, hospitals, and treatment centers. Traditional pharmaceutical companies are trading at extremely low valuations out of fears surrounding looming patent expirations and healthcare policy uncertainties. However, retiring baby boomers and emerging international markets, where modern healthcare is just taking root, should significantly increase the overall market for these companies. Medical device companies may offer the greatest upside. Medtronic, Stryker, Johnson & Johnson, and Abbott Labs provide artificial hips and knees, defibrillators, coronary stents, diabetes monitoring equipment, heart valves, and spinal discs among many other products. The advancement of technology will open new doors for these companies. Healthcare consumable suppliers such as ThermoFisher Scientific, Teleflex, and Kimberly-Clark are positioned to support expanding research and treatment. Their competitive advantages include their distribution networks, technology, ingrained customer relationships, and trusted brands.

With regard to energy, our core holdings include a number of companies that should benefit from an evolving energy policy. ExxonMobil, BP, Chevron, ConocoPhillips, and Apache are examples of companies that explore and produce oil and natural gas and they

represent an important component in a portfolio for dividends and as an inflation hedge. However, as Levi Strauss discovered in California in 1849, providing the picks, shovels, and canvas (Levi jeans) for prospectors was more profitable than competing in prospecting for gold itself. We believe providing the infrastructure for an evolving energy policy will be the best avenue for investment. General Electric is an example of a company that offers a wide range of support to energy companies with drilling infrastructure, pipeline services, and project consulting. GE is also a leading supplier of windmills, natural gas turbines, and nuclear power plants. At the other end of the size spectrum is Dover, which provides a wide array of components essential to land drilling and should benefit greatly from an energy policy with greater emphasis on natural gas. We also own companies such as Emerson Electric and Honeywell that specialize in the management of oil/gas fields, refineries, power plants, pipelines, and wind and solar farms. These two companies also specialize in reducing energy consumption in homes and commercial buildings. Conservation should be a key part of any rational energy policy as it has the most immediate return on investment.

As long-term investors, we are positioned to benefit from these trends as they play out over the next decade. While we cannot predict the economy with certainty, it is our job to look for and understand these trends without succumbing to the inevitable short-term market gyrations. As Warren Buffett stated in an interview on CNBC on October 10, 2008,

> *"I have no idea what the stock market will do next month or six months from now. I do know that, over a period of time, the American economy will do very well and investors who own a piece of it will do well."*

We feel the same way and are not distracted by the media's current focus on near term negatives. We will continue to invest in the quality companies that lead the world in innovation and profitability. We believe these companies represent the best risk-adjusted stock market returns currently available.

Truly yours,

Keating Investment Counselors, Inc.