MARKET OUTLOOK

YHB Investment Advisors, Inc.

OCTOBER 2010

The stock and bond markets performed extremely well in September and in the third quarter. September saw its best monthly stock market gain since 1939 and the quarter saw the best quarterly gain since 1935. Bond prices also rose as interest rates continued to decline.

The Federal Reserve initiated a program of Quantitative Easing (QE) in March 2009 after having reduced short term interest rates to zero. Early in this year's third quarter, the Fed announced it would maintain a steady level of easing and late in the quarter the Fed said it stood ready to expand the program—"QE 2." QE is an untested method of monetary stimulus whereby the Fed buys U.S. Treasury and mortgage backed securities in the open market. This direct intervention in the bond markets resulted in higher bond prices and lower yields. It also resulted in a significant expansion of the money supply. However, because of the slow economy, the unwillingness of banks to lend, and business' reluctance or inability to borrow, the increased money supply did not flow into the real economy but rather was retained in the financial markets further driving up security prices.

Although the longest recession since the Great Depression was recently declared to have technically ended in June 2009, unemployment remains high and the fundamental economic outlook is highly uncertain as the rate of growth is well below what would be expected after such a deep contraction. Looking into 2011, businesses and consumers are faced with unprecedented unknowns which are holding back investing, spending, and job creation. These uncertainties include the following: final federal income tax rates for 2011; new costs and regulations from the implementation of the new healthcare law; ongoing surprises from the recently passed financial reform legislation; economic impacts from new environmental regulations; repercussions from needed reductions in consumer and government debt; struggles in the domestic housing market; fallout from the outcomes of the mid-term elections in November; questions around euro-zone financial stability and growth; and mounting signs of protectionism which will hurt world trade. This very high level of uncertainty will most likely result in continued, above average price volatility in the markets. On a positive note, profits are growing and inflation is low. Corporations are in excellent shape to hire new workers when they are ready. Not only are their balance sheets strong but they have been able to borrow new money at historically low interest rates. Many companies are using these funds to increase dividends, to buy back shares, and to boost capital spending (i.e., reinvesting in their businesses by purchasing or upgrading equipment). We are also seeing a rise in mergers and acquisitions.

Even in a volatile market environment, there are attractive areas to invest as outlined in our recent newsletter entitled "Investment Themes for a Changing Investment Environment." Therefore, we will continue a cautious but opportunistic approach to investment management emphasizing balance, diversification, and portfolio strategies that stress the preservation of principal while at the same time taking advantage of market opportunities to purchase securities at appealing prices.

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