NOESIS CAPITAL MANAGEMENT

A REGISTERED INVESTMENT ADVISOR

January 15, 2009

Dear Client:

By far the best thing about 2008 is that it is over. The U.S. economy is thirteen months into a recession that began in December 2007, according to the National Bureau of Economic Research, the official tracker of recessions. The current recession seems likely to last longer than those ended in 1975 and 1982, both of which lasted sixteen months and were the longest since 1933.

This downturn was triggered by the subprime mortgage fiasco and the subsequent collapse in homebuilding, with a buildup of inventories of unsold homes and severe weakness in sales of existing homes. The sharp decline in residential construction impacted related industries such as building materials, heating, plumbing, air conditioning and other components, plus appliances, furniture and so on.

Unavoidably, the job market was hit hard, with unemployment rising throughout most of the year and a grim prospect that this will continue into 2009. The deterioration in housing and employment was accompanied by serious problems in the financial system. Following some high profile disasters and rescues, such as AIG and Bear Stearns, the failure of Lehman in mid-September had the most severe and frightening effect, causing the short-term credit market to virtually cease functioning.

The Lehman collapse was followed by a dramatic response from the Treasury Department with the support of the Fed. This resulted in passage of a $700 billion rescue package (TARP) for the financial system, with about half of this amount remaining to be allocated. A portion of this will be used as part of the bailout of U.S. automakers, with the balance available for other purposes. In addition, the Fed announced intentions of using over $600 billion to ease conditions in the mortgage market, quickly causing a drop of more than 100 basis points in conforming mortgage rates and a strong increase in refinancing applications. There have also been reports that the Federal Home Loan Bank might be used by the government to apply additional downward pressure on rates. With housing the weakest part of the economy, these actions could be helpful in relieving the downward pressure created by problems in this industry. The Fed also announced that it will "employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability." This means, of course, that enormous amounts of additional monetary stimulus could be used.

In addition to aggressive actions by the Fed and similar actions by the European Central Bank and other central banks in countries such as the U.K. and China, the new administration has appointed a group of experienced nominees for key economic positions who are regarded as supporters of aggressive government intervention to stimulate the economy. Moreover, the incoming Obama administration is preparing a

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stimulus package said to be in the $600 to $700 billion range and widely believed to possibly be as high as $1 trillion or more.

While many significant questions remain unanswerable at this time, the combination of the Fed lowering its target interest rate on Fed funds to nearly zero combined with other extraordinary stimulus actions by the Fed relating to monetary policy, could have a favorable effect on the economy. This, in addition to the aggressive fiscal policy of the incoming administration, including tax cuts, provide a valid basis for becoming hopeful that economic growth will resume later in 2009.

The consensus of economists surveyed by The Wall Street Journal believe the economy will continue to contract until mid-2009 and then start growing again at a moderate rate. They expect the unemployment rate to rise to over 8% by year end. Estimates we have seen anticipate declines in real GDP of about 5% in the fourth quarter of 2008, followed by declines of 3% and 1%, respectively, in the first and second quarters of 2009. Modest second half growth is possible but likely to be slower than normal, with full-year 2009 GDP probably down 1% to 2%.

This conforms to the minutes of last month's Fed meeting, released January 6, 2009, when they predicted further economic deterioration, with a slow recovery beginning in the second half of this year with unemployment rising significantly into 2010. This would be consistent with past business cycles, when the unemployment rate continues to rise after the economy has turned because employers continue to tighten until they see clear evidence of improvement.

We should bear in mind that in previous business cycles equity markets normally began to recover before the economy hit bottom and we are hopeful that this pattern will be repeated in the current cycle. We continue to carefully monitor our core holdings, most of which have strong balance sheets, sound business models and healthy prospects. A few fell short of these expectations due to the present business environment, with the result that four positions were sold in the fourth quarter. Conversely, two positions were increased and three stocks, as mentioned below, were added to our core holdings.

RECENT PURCHASES

<u>Baxter International Inc. (BAX)</u>

Baxter is a global medical equipment company. The firm operates three divisions: 1) BioScience (accounts for 41% of total revenue) – treatments for hemophilia and other bleeding disorders; 2) Medication Delivery (38%) – intravenous products to deliver fluids and drugs; and 3) Renal (20%) – treatments for end-stage renal disease. Baxter is considered among the most defensive names in the industry. More than 57% of its revenue is generated from overseas. Baxter's BioScience business focuses on protein deficiencies with large overseas exposure, which have low dependence on

Medicare/Medicaid payments and limited opportunity to reduce usage or substitute alternatives. Its Renal business specializes in dialysis, which has little room for patients to reduce/quit/delay therapy. Its Medication Delivery represents most of the ancillary products relating to a long-term hospital stay and/or surgical procedure.

Genentech (DNA)

Genentech, based in San Francisco, CA, is the world's second largest biotechnology company. Approximately 56% of the company is owned by Roche Holdings. Key products include: the flagship cancer drug Avastin ($2.30bil in 2007); Rituxan for blood cancers and immunology ($2.29bil); and Herceptin for breast cancer ($1.29bil). Genentech primarily sells its pharmaceutical products in the U.S., while Roche sells overseas. Genentech is a fundamentally solid company with high margins, high returns, solid balance sheet, low competitive threats, and sustainable growth (or even earnings acceleration) through new late-stage pipeline products as well as multiple indications for existing products. Last July Roche offered to buy the remaining 44% stake in Genentech for $89 per share. Genentech's Board rejected the offer maintaining that the price offered substantially undervalued the company.

PepsiCo Inc. (PEP)

PepsiCo is a global beverage and snack producer with a diversified portfolio of strong brands, including Pepsi-Cola, 7-UP, Mountain Dew, Gatorade, Tropicana, Lay's, Quaker, Doritos, Lipton and Aquafina. Its revenue mix between beverages and snacks is close to 50/50 with Frito-Lay holding a dominant position in the snack-chip market domestically (58% market share) and internationally (30% market share). PepsiCo has paid close attention to changing consumer tastes and developed/acquired new products to meet the demand. For example, the firm purchased Tropicana and Quaker Oats (including its Gatorade brand) and was early to enter niche segments like ready-to-drink coffee, energy drinks and fitness water. As a result, while it is second to Coca-Cola in carbonated soft drinks, PepsiCo is the leader in non-carbonated beverages in most of its markets. The company continues to benefit from its global expansion, generating 44% of total revenue from overseas, up from 32% in 2001. We believe that this trend supports a sustainable double-digit long-term earnings growth rate.

FIXED INCOME UPDATE

During the fourth quarter, the 3-month Treasury Bill slipped from 0.90% to 0.11% and the 10-year Treasury Note declined from 3.85% to 2.25%. Currently, there is strong demand for risk-free income securities, which is partly responsible for yields moving to such low levels during the quarter. The Fed cut the federal funds rate target to between 0% and 0.25% in December, the lowest target in its history, and suggested that it would stay there for "some time." Year-over-year headline inflation, measured by the consumer price index, was 1.1% in November, down from 5.6% in July 2008, which also impacted yields. Inflation is expected to turn negative for much of 2009.

The possibility of deflation has become more of a concern to policymakers and, as a result, they are implementing policies to minimize the risk. For example, the Fed has started buying corporate bonds and mortgage backed securities issued or guaranteed by Freddie Mac, Fannie Mae, and Ginnie Mae. This should reduce the spread between the long term risk-free interest rate and the 30-year mortgage rate. The Fed also has indicated that it would purchase long term treasuries in order to keep long term risk-free interest rates low. This would be intended to have inflationary implications and reverse the deflation prospects. Thus far, it has not been necessary. However, if a deflationary spiral occurs, aggregate demand and prices of goods and services could be eroded. We believe that the Fed's current action will make an occurrence less likely.

In the current environment, we are buying senior bonds from durable businesses with strong balance sheets and exceptional profit margins. We recently purchased America Movil 5.5% bonds due 2014 at a discount to par. The company is a wireless services provider in Latin America with over 172 million customers, but serves a potential market of over 790 million people.

We are glad to have the past year behind us and look forward to a more prosperous and stable 2009. We are always available to discuss your portfolio and/or address any questions.

Sincerely,

Richard M. Brown, CFA
Chief Investment Strategist

Our most recent Form ADV, Part II is available upon request