NOESIS CAPITAL MANAGEMENT

A REGISTERED INVESTMENT ADVISOR

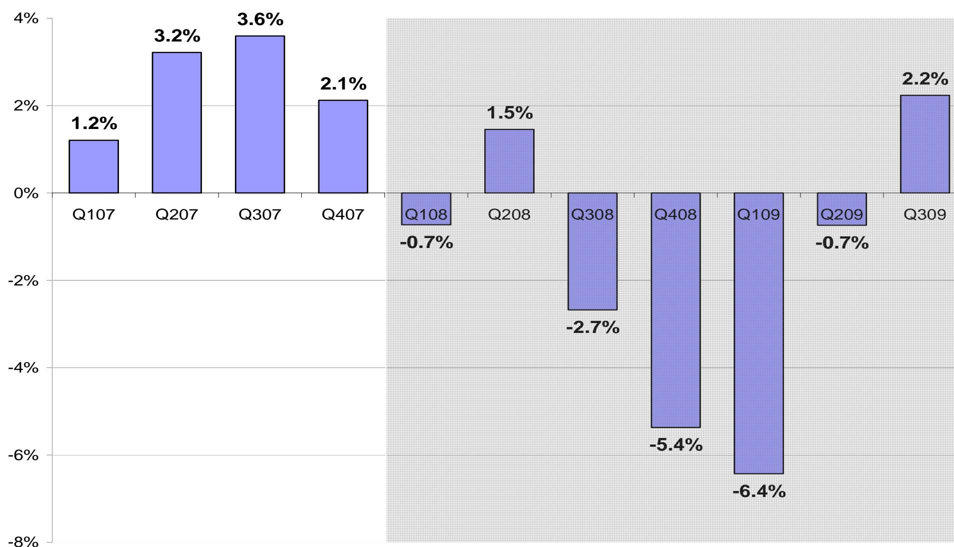
January 15, 2010

Dear Client:

Happy New Year!

We are relieved that the unprecedented economic downturn appears to be behind us. By now, most economic indicators, leading or coincident, have already shown a strong recovery. Based upon this data, we should be out of the Great Recession. (See Chart 1)

Chart 1: Real Gross Domestic Product (GDP)



Note: Grey area indicates recession period.

We expect economic growth to be strong in the coming quarters driven mainly by the impact of massive monetary and fiscal stimulus, gains from net exports and expected spending increases from corporate America, which have extremely low levels of inventory and overdue facility upgrades. However, there still remains a high level of uncertainty marked by a considerable amount of disagreement among investors and economists about the inflation outlook over the next few years. Many analysts believe that inflation will remain low as long as the unemployment rate remains well above its natural rate. Others believe that large-scale stimulus and budget deficits could eventually push inflation up substantially.

Guiding the economy to a healthy recovery is tricky. Take Japan's experience over the past two decades as an example. Japan was misdirected by premature signs of economic recovery and tightened its fiscal policy before demand was strong enough to sustain a recovery. This led to entrenched deflation. Our own economic challenges could be even more daunting than Japan's twenty years ago and will require every ounce of wisdom from our government and central bank. Many other developed economies face the same dilemma.

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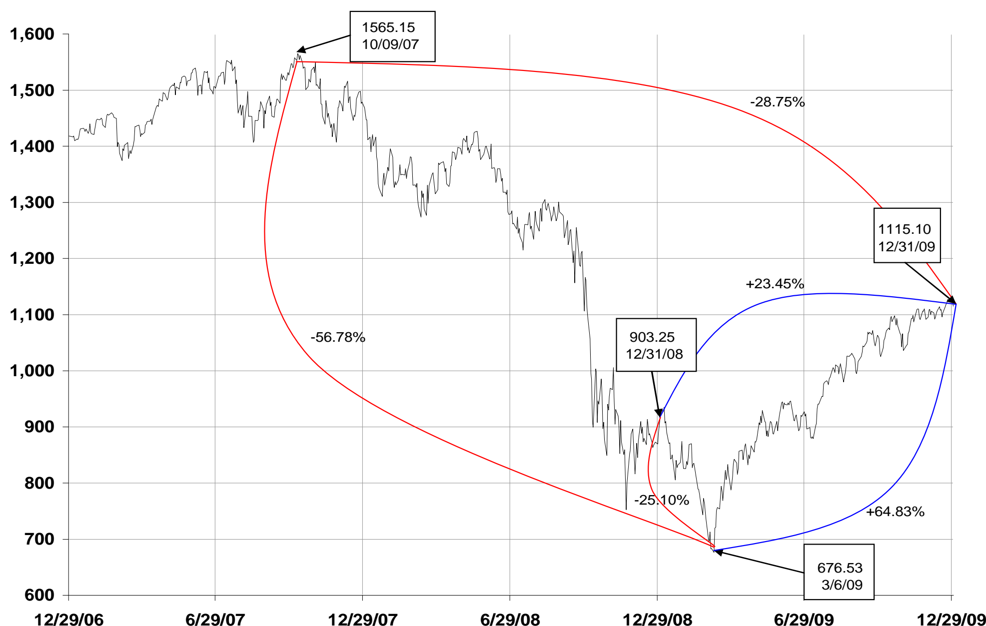
Despite a bumpy start, the equity markets enjoyed a strong rebound in 2009 from the downturn which started back in October 2007. The S&P 500 Index was down 25.10% in early March 2009, but finished the year up 23.45%. For the entire period (10/9/07 to 12/31/09), the S&P 500 Index declined 56.78% from the top to the bottom and rebounded 64.83% afterward. The Index still is 28.75% below its peak. (See Chart 2)

Chart 2: S&P 500 Index



During the down cycle, many investors became overly emotional, losing confidence in the economy and financial markets. A large portion of the population had never experienced an economic downturn of this magnitude. Unfortunately, many investors jumped out of the market at the bottom, sustaining big losses and consequently missed the strong rebound during the past nine months.

We are grateful to have the Great Recession behind us and consider ourselves well-positioned moving ahead. While we are firm believers of long-term investment, we did raise cash to reasonably high levels during this down cycle. By the end of 2008, we felt the market had become extremely bearish and presented a great buying opportunity and methodically began to add more positions into our portfolios such as HSBC, Google, and PepsiCo. As the market further weakened during the first quarter of 2009, we became more aggressive buyers and, at the same time, sold other positions that were no longer consistent with our investment criteria. For example, we purchased positions of Baxter, Fluor and U.S. Oil Fund while we sold Citigroup, Johnson & Johnson and Genentech during this time frame. Since June, we have been purposely quiet as the markets have moved up very rapidly.

There are many lessons to be learned from the cycle and this downturn proved that discipline, in our opinion, is essential to investment success. We also regularly review our investment strategy. However, as long as our investment philosophy is sound, we will continue to be disciplined in implementing our strategies.

At Noesis, we only invest in "first class" companies. Our definition of "first-class" is a company that has an honest management team with a proven track record, high earnings visibility and growth potential, a solid balance sheet and strong cash flow generation. Furthermore, we will not make a purchase unless we believe the margin of safety is high enough to offset any possible downside surprise.

Looking ahead, we continue to believe that equities offer greater opportunity than bonds. The S&P 500 Index is behind its long-term trends, specifically compared to nominal GDP. As such, we are confident that many opportunities exist in the U.S. equity market. We particularly favor global companies due to the current high growth environment existing in many emerging markets versus the high level of uncertainty present in much of the developed world.

RECENT PURCHASES

Praxair (PX)

Praxair is one of the largest industrial gas suppliers in the world. Its products include atmospheric gases such as oxygen, nitrogen, argon, and rare gases, and process gases such as carbon dioxide, helium, hydrogen, electronic gases, specialty gases, and acetylene. Praxair serves approximately 25 industries around the world including health care, petroleum refining, aerospace, and chemicals.

The industrial gas industry is a "behind-the-scene" play for the energy, environment and emerging markets. Praxair's products are crucial for its customers to meet the tightening environmental regulations because these products help to increase energy efficiency and reduce CO2 emission. The growth and industrialization in emerging markets also lead to a steady increase in industrial gas demand.

FIXED-INCOME UPDATE

Short-term interest rates, measured by the 3-month T-Bill, moved lower during the quarter to 0.06%, and long-term interest rates, measured by the 10-year Treasury Note, moved higher during the quarter to 3.85%. The yield curve spread, the difference between the long-term rate and the short-term rate, is historically wide (see Chart 3), suggesting that short-term interest rates could move higher in the coming quarters as the economy continues to recover.

The year-over-year rate of growth of the Consumer Price Index (CPI) has turned positive from being negative since February 2009. Many floating rate securities have coupons that are linked to the CPI. These securities have become more attractive because their cash flows have increased.

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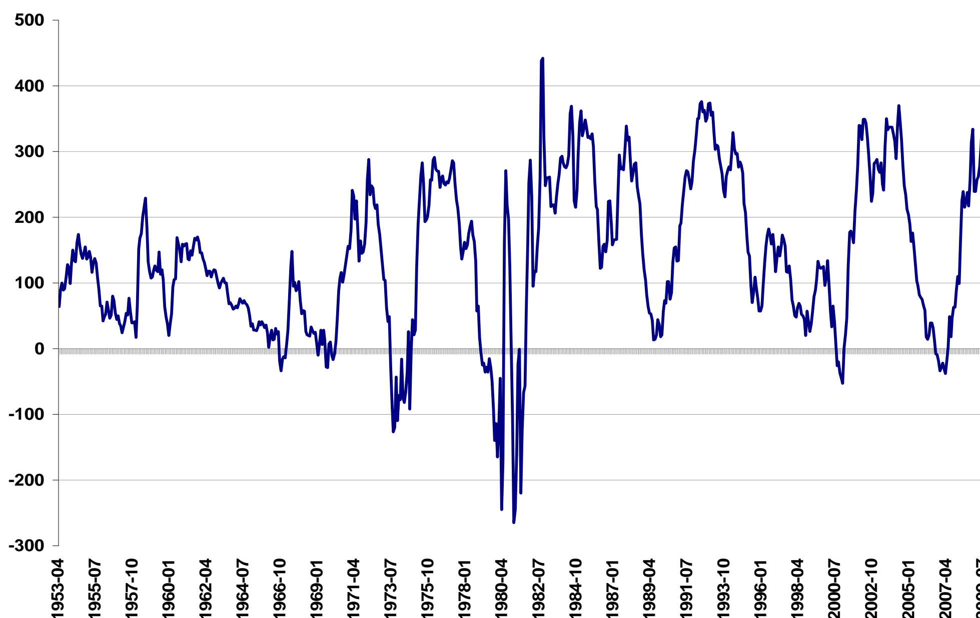
Chart 3: Yield Curve Spread



During the past quarter, we purchased a Goldman Sachs subordinated bond with a 5.793% coupon until June 2012. At that time, it will float based on market interest rates, with a minimum coupon of 4%. The income is taxed as ordinary income and, at the purchase date, had a current yield of 7.7%. The maturity date is in 2049; however, we do not anticipate holding this bond to maturity. The bond was purchased at a substantial discount to par and we anticipate selling it when we are at a different point in the economic cycle and when market conditions may place more of a premium on this type of bond.

During the fourth quarter we circulated a survey to our clients and thank everyone who provided us with very constructive feedback. We also appreciate the referrals that many clients provided. Your confidence in us drives us to work hard. As always, we are available to discuss your portfolio and/or address any questions.

Sincerely,

Joseph Lai, CFA
Chief Investment Officer

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

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