NOESIS CAPITAL MANAGEMENT

A REGISTERED INVESTMENT ADVISOR

July 15, 2010

Dear Client:

During the past couple of months, the debt crisis in Europe has complicated the global recovery and has led to more volatility in the global stock markets. There are many unanswered questions regarding the current recovery: Is it a double dip or just a hiccup within a sustained recovery; inflation or deflation; an opportunity for investors or a sign that the recovery has stalled? There does not appear to be any consensus with respect to the answers. The lessons we have learned over the past three years should help us navigate through the current situation.

While the government was printing money like crazy in response to the 2008 financial crisis, many investors questioned the government's meteoric increase of debt and overspending taxpayer money. We believe that the government did the right thing by moving quickly and dramatically. Similar to confronting a raging wild fire in a forest, firefighters have no choice but to smother the fire with water and worry about the flooding later. Getting back to the European situation, many European governments complained about the overspending and irresponsibility of countries such as Portugal, Italy, Spain and Greece (PIGS). We believe that these European governments should be cooperating. The issues related to PIGS can be corrected later, but the priority should be addressing the crisis before it further infects the rest of the world.

Much of the "out-of-control" government spending in developed economies was due in large part to the sudden collapse in economic activities during the recent recession. As soon as real GDP levels return to their long-term trend, the leverage issue should suddenly seem much more manageable. We believe this crisis is more about fear than about fundamentals. The real risk is that the fear persists too long which in itself could damage the economy.

In addition to attending the J.P. Morgan Asian Pacific Conference in New York and the Chartered Financial Analyst (CFA) Annual Conference in Boston, last month I had the opportunity to visit Taiwan and China. The trip was very productive in gaining knowledge and insight with respect to investment opportunities in Asia, particularly in China.

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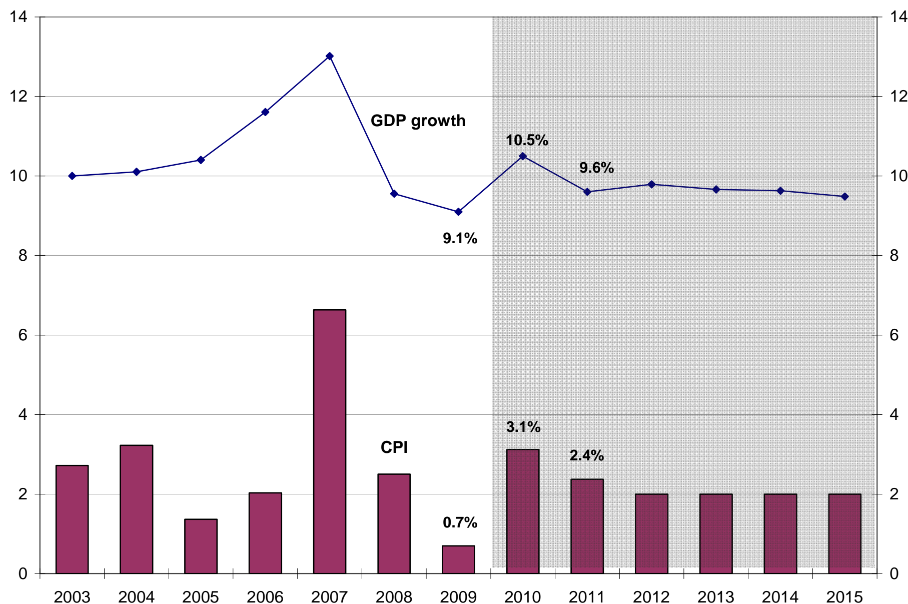
One of the highlights of my trip was the WorldExpo in Shanghai. Amazingly, I was able to fly directly from Taipei, Taiwan to Shanghai, China, a ninety minute flight that just a short time ago would have taken 12 hours! Taiwan and China recently signed the Economic Cooperation Framework Agreement (ECFA). This pact is viewed by many as the most significant agreement between the two countries since their split following the Chinese Civil War in 1949. We believe that ECFA is only the first stage of Taiwan's economic reconnection with the region. Taiwan will likely enter free-trade agreements with other neighboring partners, such as South Korea and members of the Association of Southeast Asian Nations (ASEAN).

Signs of the economic boom in China are hard to miss. Brand new, towering office buildings are everywhere. The transportation infrastructure including new highways and subways is spectacular. The world's finest retailers line the streets. Most of this did not exist ten years ago. It is amazing to witness how quickly a country that used to be so poor has become so powerful and prosperous, in the big cities at least.

While China remains a communist country, the government is managed by a committee within the communist party. As China moves away from a centrally controlled government, its execution capability is getting stronger. China boasts a strong balance sheet at all levels: country, household, and consumer. We firmly believe in China's bright long-term growth prospects (See Chart 1).

Chart 1: Economic Growth and Inflation of China (%)



Note: Grey area is the IMF's forecast.

That being said, China's road ahead is not without challenges. Its economy is facing the dilemma between rising inflation (influenced by overheated property markets and rising labor costs) and potential economic slowdown (hurt by declining economic momentum worldwide). To contain the property bubble, the Chinese government recently has aggressively tightened its policies. In fact, we already see price corrections of as much as 15% in several first-tier cities. However, these markets remain to be tested in the second half of 2010, when the over supply of completed housing units hits the market.

You have undoubtedly heard about labor unrest in China. The heart of the matter is that cost of living, especially in the big cities, was increasing, whereas wages were not keeping pace. This caused laborers to leave their city jobs and go back to the countryside, where they came from originally. This caused further labor shortages and upward pressure on wages. Many factories have had no choice but to raise wages to prevent potential conflicts and to attract new workers at a time when many cities are struggling with labor shortages. Leaders in China are now supporting wage increases as a way to stimulate domestic consumption and force labor-intensive businesses transitioning to innovation-focused and service-oriented activities. Labor disputes will continue to be tricky and need to be dealt with carefully.

Overall however, we believe there is tremendous growth ahead for China and the current market correction could eventually create more investment opportunities for us. While we have historically focused on global organizations with strong exposures/positions in emerging markets, recently we have started covering some local companies in these markets. We believe that our own in-house global experience is an asset as we continue to examine investment opportunities in these emerging markets.

RECENT PURCHASES

Johnson & Johnson (JNJ)

Johnson & Johnson is the world's largest and most diverse healthcare company. The company maintains a diverse revenue base (36.4% pharmaceutical, 38.1% medical devices and diagnostics, and 25.5% consumer). It has a robust research pipeline and exceptional cash-flow generation that together create a superior competitive advantage. Many of the challenges faced by the company are already reflected in the stock price.

J.P. Morgan (JPM)

J.P. Morgan is widely considered a top-notch financial power house and has been one of our favorites for a long time. During the 2008 financial crisis, J.P. Morgan was arguably the best capitalized bank in the world. We sold a portion of our JPM position last year, but have recently decided to add it to our portfolio again.

FIXED INCOME UPDATE

The weak US economic recovery in combination with the European sovereign debt crisis indicates that inflation remains subdued and is not a near-term threat. In this low inflation, low interest rate environment, finding acceptable yields without taking undue risks remains a challenge.

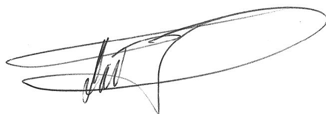
We do not want to underestimate the duration of this low yielding environment thereby taking the risk of overweighting short-term maturities. We would forego valuable yield while waiting for a gradual increase in interest rates. Looking at the yield curve and its slope, we identified the maturity range of two up to six years as the sweet spot. Diversifying in a balanced mix of maturities is a more prudent way to await better interest rate times.

Europe's sovereign debt crisis led to risk aversion among global investors and a consequent widening in corporate credit spreads relative to treasuries. This is a reversal of the last 12 months trend, which saw a constant decline in bond yields due to high money inflow in this area. With a somewhat more attractive yield level and no big change in the risk outlook, we believe that investment opportunities exist in the debt of high quality companies.

There are a couple of internal developments at Noesis that I want to mention. First, Steve Smith, CFA, joined our firm in June. Steve will be based in Birmingham, Alabama and has over 20 years of industry experience. We are excited about Steve coming on board and look forward to expanding our business in the Alabama market. Second, after ten years with the firm, Greg Reynolds has left Noesis to join a trust company. We wish Greg success with his new position.

Finally, we thank our clients for the referrals we received recently. This past quarter we were fortunate to open a significant number of new accounts. As always, please contact us if you have any questions or wish to discuss your portfolio.

Sincerely,



Joseph Lai, CFA
Chief Investment Officer

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

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