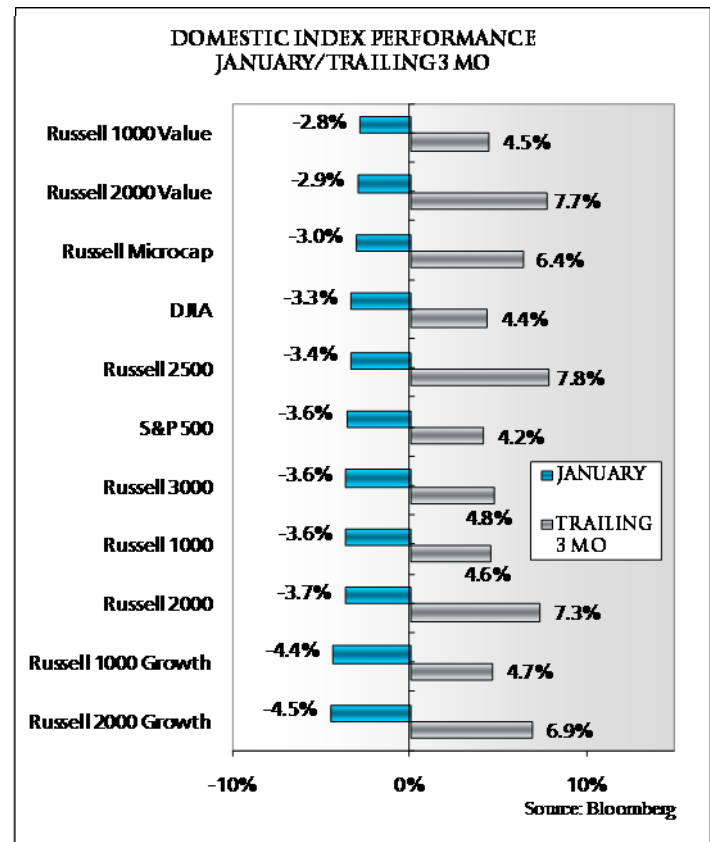


Flash Report Month Ending January 31, 2010

January Effect: Revisited

The January Effect postulates that as January goes, so goes the rest of the year. The statistics behind this phenomenon have been bandied about by market pundits ever since Donald Keim introduced the idea in the early 1980s. When one looks closer at the numbers, it is hard to discredit the efficacy of the January Effect. According to IQS, since 1929 the January Effect has proven its worth 78% of the time (meaning if market was up or down in January, the calendar year followed the same pattern). A positive January (correct 83%) proves more predictive than a negative one (correct 68%). Changing the start date from 1929 to 1950 increases the predictability of positive Januaries to 92%, but reduces that of negative Januaries to 57%.

What does this ultimately mean for investors? Since a negative start to the year predicates a negative year only 57% of the time, investors are basically left with a coin-toss. Case in point, this year's 3.6% decline follows a year in which the S&P faltered 8.4% in January only to finish the year up 26.5%. Conversely, in 2008, the January Effect played true, with the S&P's 6% tumble foretelling what would become the worst year for equities since 1931.



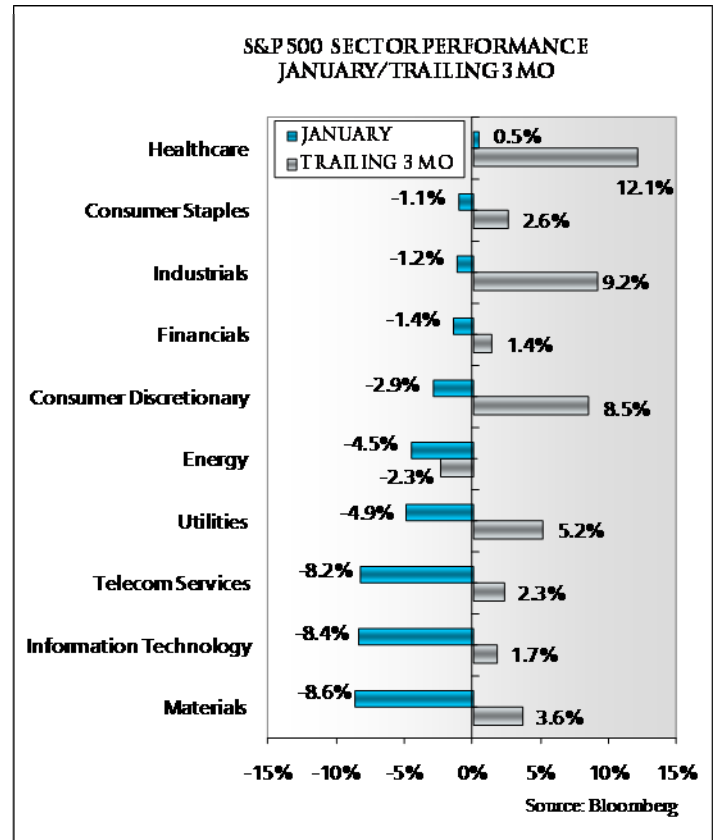
One interesting derivate of the January Effect is its influences on style investing. Growth and value stocks have traded places in leading the market during each of the past five years. In that timeframe, the style that won in January also proved victorious for the year. Looking even further back (30 years to the inception of the Russell 3000 Growth & Value indices), the style that outperformed in January ultimately led for the year 77% of the time. This year, value stocks took the early lead, with help from a weak technology sector. Investors should remember that tech makes up more than 25% of the Russell 3000 Growth index, and only 5% of the Russell 3000 Value index. Weakness in the sector can be attributed to multiple factors, but definitely not negative Q4 earnings surprises. According to Thomson Reuters, of the 41 tech companies that have reported so far, 98% beat analyst estimates (2% matched). Some companies contributing to the earnings growth included: Apple (reported \$3.67 per share vs. a \$2.09 per share estimate), Microsoft, Cisco and AMD.

The remaining sectors also surprised, with 93% of consumer discretionary and 76% of industrial stocks outpacing estimates. In aggregate, of the 220 of 500 S&P companies that have reported, 78% outpaced analyst expectations. Thomson Reuters noted that "companies are reporting earnings that are 17% above the estimates, which is above the 2% long-term (since 1994) average surprise factor and above the -6% surprise factor recorded over the past eight quarters."



What is interesting is how investors have reacted to the positive earnings. According to Seeking Alpha, the average stock that reported earnings through 2/2/2010 was down 0.5% on the day of its report (a staggering figure given that 78% of companies have beaten estimates). More importantly, companies outpacing analyst estimates were up only 0.6% (industrial stocks that beat earnings actually fell 0.9%) while companies missing estimates were down 3.7%. Materials and energy stocks were the most punished, falling 7.4% and 7.3% respectively, after missing earnings.

Since earnings are better than expected, investors' negative reaction may be a derivative of stagnating revenue growth. So far, revenues have come in in-line with expectations. The sectors most responsible for the less-than-stellar growth are utilities and financials – financials, in particular, have been uninspiring so far in 2010. Citigroup, by far and away the biggest revenue detractor in the sector, reported revenue of \$5.4 billion, almost \$13 billion below expectations. If one removed the company from the fold, instead of in-line results, S&P 500 revenues would have positively surprised by 2%.



Further pressure has come from negative EPS guidance. Twenty-three companies have issued lower guidance so far in Q1, which, though better than historical norms, has resulted in a sell-off across market sectors. Perhaps the reason for the negative sentiment is not the quantity, but the types of companies that have become more cautious. Global giants such as Pfizer, Johnson & Johnson, Potash, Motorola, US Steel and Coca-Cola all issued conservative guidance for the coming quarter and/or year. As a result, investors may be tempering their expectations for a robust earnings recovery in 2010. Such changes in sentiment puts into question whether current valuations (P/E ~28x) are justified, and may result in market weakness if the remainder of the earnings season yields a cautious outlook for earnings growth.

When describing 2009, many quality-biased money managers commented that “what worked last year [2008] failed this year [2009].” Interestingly, many predicted the same thing for 2010 – this is holding true so far, as materials and technology stocks (the top performers in 2009) trailed all other sectors in January.

Looking ahead to the remainder of 2010, it will be interesting to see which of the predications are realized. If what worked last year fails this year, value will outperform growth; consumer staples and health care will outperform technology and materials; and small caps will outperform large. Of course, the January Effect holds true this year, it will be a long 2010 for all investors, regardless of style, market cap or sector.

Sources: Wall Street Journal; Bloomberg; Morgan Stanley, Thomson Reuters; S&P; Seeking Alpha



China Dictates Cool-off; Greece Hurts Confidence in Eurozone

After returning 42.1% in 2009, international stocks (MSCI ACWI ex-US Index) declined 4.9% in January, likely due to profit taking and risk reduction efforts. The MSCI EM Index lost 5.6%. Investors are concerned about the Chinese government dictating a lending freeze and the impact of Greece's budget crisis on the eurozone.

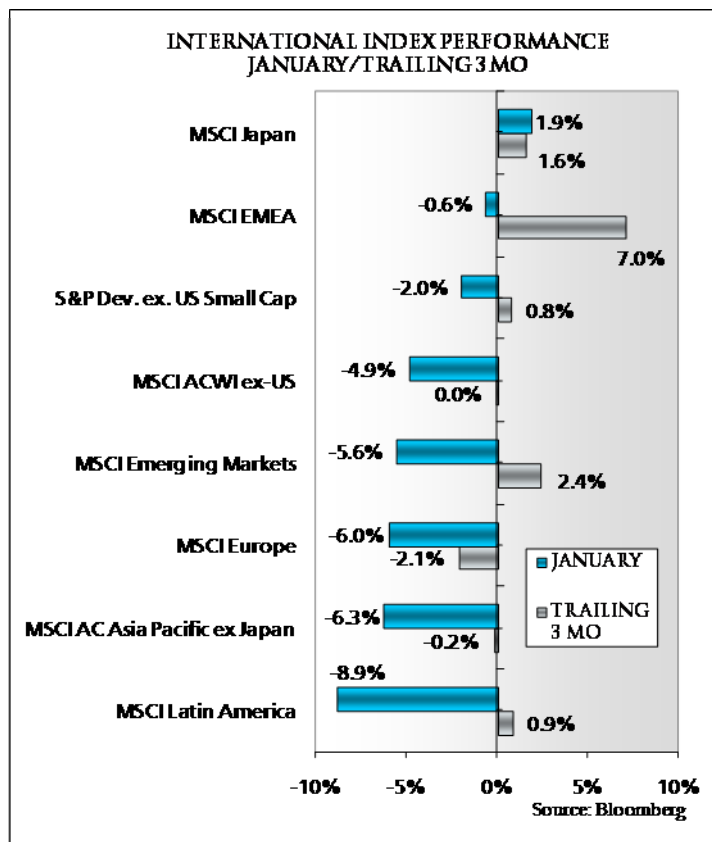
Equities in most regions declined in January, with the exception of the MSCI indices for Japan, Chile and several countries in North Africa and the Baltics. Japan rose 1.9% after being the global performance laggard in 2009 (up only 6.4%). Five of the ten best performing large cap international stocks in January are based in Japan, including Yahoo Japan and Nintendo, both rising over 15%.

Chile rose 3.2% on positive sentiment from the election of a new President, Sebastián Piñera, a Harvard-educated economist who also happens to be a billionaire. He derives his wealth from various businesses including consumer credit, airlines, and media. Mr. Piñera is the first freely-elected conservative president in more than 50 years. Chile was also admitted in January to the OECD (Organization for Economic Co-operation and Development), which was described by the BBC as "one of the most prestigious economic clubs in the world." Since the end of the Pinochet era in the 1970s, the country has risen out of poverty, sustained over 4% economic growth, promoted free trade and achieved high levels of prosperity and civil liberties.

In North Africa, Egypt and Morocco gained 7.3% and 4.3%, respectively in January. Egyptian Media Production, a media conglomerate rose 69%. Nigeria (in the Frontier index) rose 8.5% after falling 22% in 2009. The biggest winners for the month were two other countries from the Frontier index – Estonia (+49.4%) and Lithuania (+19.0%). Tallink Group, an Estonian-based cruise operator, rose 65% for the month. Estonia, with low debt, a budget surplus and a deficit under the 3% threshold, is likely to join the EU in 2011. The country quickly reacted at the start of the financial crisis by cutting wages by roughly 20% to shore up its fiscal situation. Estonia is likely to have positive GDP growth in 2010.

Asian stocks (MSCI AC Asia ex-Japan) fell 6.3% in January, after returning over 73% in 2009. China led the decline, with the MSCI China Index falling 8.6% during the month. China had four of the ten worst performing large cap international stocks in January, including China Citic Bank and China Resources & Land, both falling more than 20%. Hong Kong and Taiwan both fell roughly 6.5%, and India declined by 5.3% for the month (after more than doubling in 2009). The Chinese government has been concerned about excessive lending growth and inflation, and has attempted to cool-off an economy that grew at 10.7% in Q4.

At the beginning of the year, the Chinese central bank and the commercial banks set a 7.5tr yuan (\$1.1tr) target on 2010 lending, with the desire to spread lending throughout the year. However, the banks reached 15% of the annual target within the first two weeks. In response, the central bank ordered banks in mid-January to drastically slow lending and increased bank reserve requirements. By the end of the month, fears rose that an interest rate hike would be required to slow inflation, which has already accelerated in S. Korea, Indonesia and Thailand.



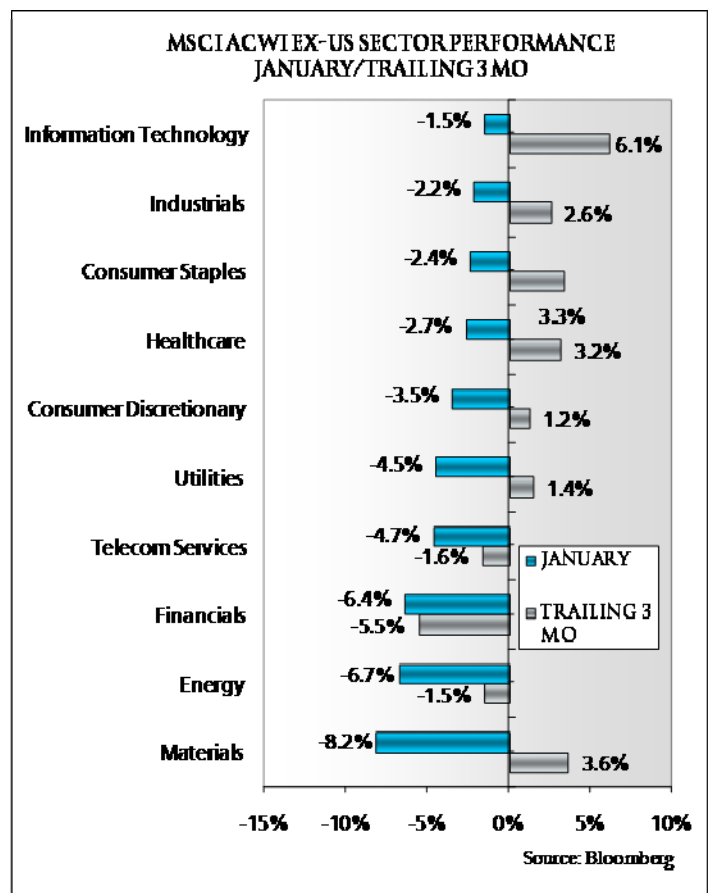
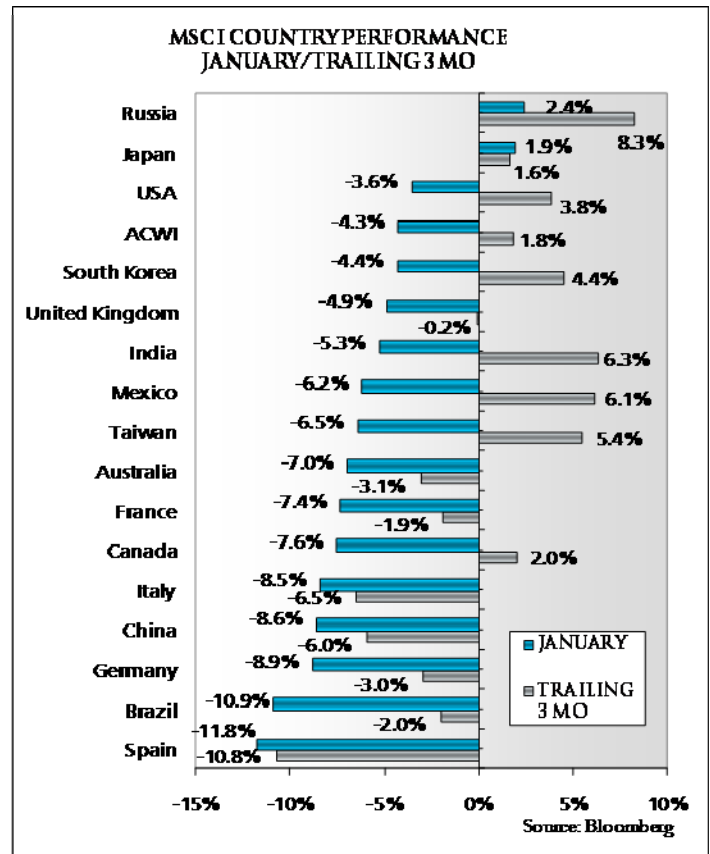
According to the Xinhua News Agency in China, Premier Wen Jiabao said on February 1 “[t]here are still problems of imbalances and unsustainable development in China's economy.” Also of increasing political concern is the real estate boom. Housing prices are up more than 20% in the coastal cities and ratios of monthly mortgage cost to income have increased, especially in Beijing. If the central bank continues to increase rates to fight inflation, the real estate market could cool quickly or even worse, correct to the downside.

European stocks (MSCI Europe) fell 6.0% in January (underperforming US stocks) after returning almost 37% in 2009. More than one-third of the decline was due to the euro weakness against the dollar, as concerns about Greek sovereign debt and rising CDS spreads plastered the headlines. The worst performing European countries were Spain, Greece and Portugal, falling 11.8%, 10.4% and 10.2%, respectively. These three countries are considered among the most fiscally unsound in developed Europe. Excluding the negative currency impact, European stocks fell 3.8%, roughly in-line with declines in the US.

Greece is taking its lumps from increased controversy and media exposure. To avoid further antagonizing the eurozone, the Greek government came to an agreement with the European Commission to cut public wages and accelerate pension and healthcare reform. Greece's economic reform program aims to reduce its budget deficit from over 12% of GDP in 2009 to below 3% (the EU target for all countries) by 2012 – a tall order. Spain and Portugal are next to get the media spotlight, and are already under the microscope due to their respective fiscal situations and lack of global competitiveness. Some pessimists expect a demise of the euro, as politics continue to interfere with EU decision making.

Materials, energy and telecom were the lagging sectors in MSCI ACWI ex-US, all falling more than 6% in January. Technology fell only 1.5%, and now leads 3-month performance (+6.1%). In emerging markets, the same three sectors mentioned above were laggards, but the largest detractor was consumer discretionary, down 8.6% in January.

With the markets falling in January and an inordinate amount of media attention on China and Greece, investors want to run for the hills again.



After global equities rose during eight of the last ten months of 2009, a 5% drop was a shock to the system. The market tends to be irrational just when you most expect it to be rational and continue along a straight line upward. In terms of opportunities, European stocks are trading closer to value prices than growth prices, with MSCI Europe yielding 3.4% (vs. 2% for US large cap stocks). According to Deutsche Bank Research, over 50% of stocks in DJ Stoxx 600 have more than a 4% dividend yield. In addition, Japan is trading at a 1.19x P/B ratio compared to the rest of the world (MSCI ACWI ex-Japan) at 1.92x, a 38% discount.

Looking beyond the broad country and sector indexes, there are plenty of opportunities on a stock specific basis. While Chinese stocks did fall double digits in January, more than ten stocks in China rose more than 25% in January (with one stock CITIC 21CN Co. Ltd. rising 72%). Skilled managers can find the standouts in China (or the Egyptian media company, or the Estonian cruise operator); there are many stocks that will shine regardless of the broad macro factors. For talented managers, 2010 will likely be a stock-pickers paradise.

Sources: MSCI, Financial Times, Economic Times, Xinhua News Agency, Business Week. Deutsche Bank Research, Globe and Mail - "Free-market reform admits Chile to the club." January 25, 2010.



Fixed Income: A Fresh Start

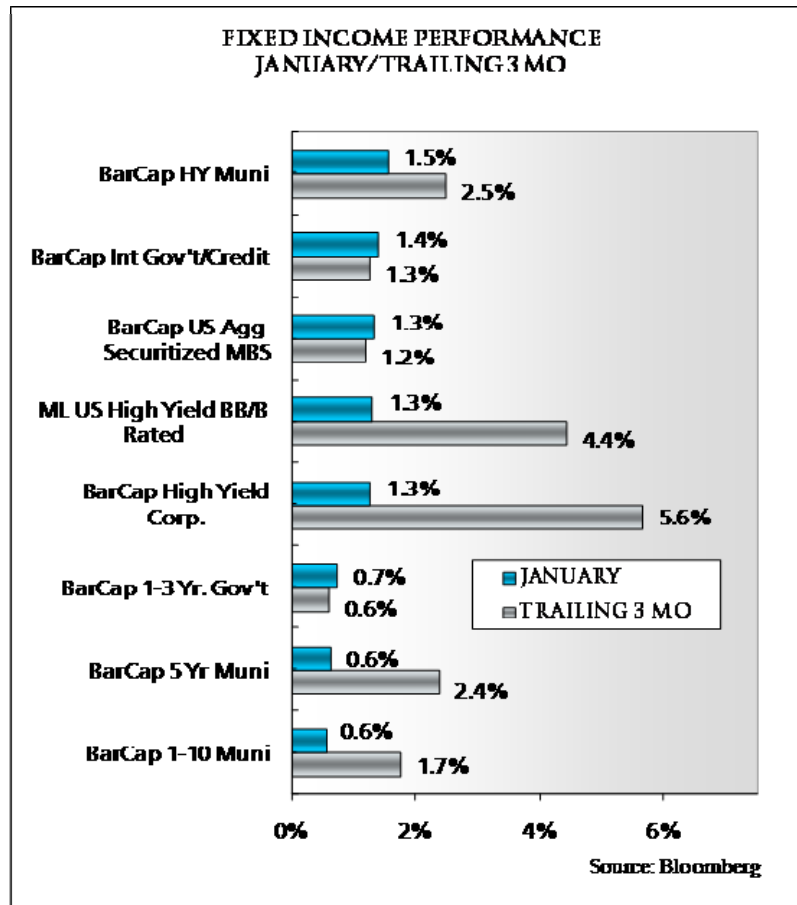
Economics: The economic recovery gained firmer footing during the month of January with the knockout 4th quarter GDP report, signaling that the recession is officially entering the rearview mirror. Even with evident improvement being experienced around the globe, many outstanding questions are still hounding economists and consumers alike.

Foremost, when will stability return to the jobs market? Revisions to the November jobs report showed that the economy posted its first monthly jobs gain in nearly two years, picking up about 4,000 jobs. Since 2010 represents a census year, temporary hiring will experience a sizeable boost in the first several months of the year, with the Census Bureau expecting to hire 1.2 million individuals. The hope is that by the time the census is complete heading into the summer months, private employment will gain traction and pick up the excess slack.

Shifting gears to the GDP report, the economy grew at a 5.7% pace in the fourth quarter, easily outperforming economists' expectations. A slower pace of inventory reduction provided the biggest gain, contributing nearly 3.5% to the headline figure – the largest such contribution in 25 years. The economy cannot rely on inventory growth alone, and a 2.0% increase in personal consumption expenditures offers an encouraging sign that consumer demand is gradually improving. Consumers are not ready to abandon their newly spendthrift ways, however, as was made clear by the most recent \$17.5 billion contraction in consumer credit.

The outlook for inflation remained relatively unchanged during the month of January. Consumer inflation, as measured by the consumer price index, rose 0.1% for the month of December. The index was weighed down by rent and owners' equivalent rent, the government's preferred method of calculating housing costs. This component began to show considerable weakness in 2009, and, with a 40% weight in the index, housing exerts obvious influence on headline inflation. Conversely, food and energy costs increased rapidly over the past 12 months and will act as a drag on consumers' pocketbooks looking forward. The dichotomy between rising energy costs and falling housing costs will frustrate consumers through 2010.

Federal Reserve: The Federal Reserve garnered attention toward month-end when one reserve official felt it was no longer appropriate to keep interest rates at record lows for an "extended period." Following the most recent FOMC meeting, the Fed agreed to hold rates at 0% to 0.25%, but Kansas City District President Hoenig voted against language surrounding "extended period." This is not particularly surprising given recent comments Mr. Hoening made, indicating that he would prefer to see rates at a much higher level. However, this could present the beginning of dissension among the regional presidents, suggesting that even the Federal Reserve is struggling to predict the future direction of inflation and economic growth.



Treasury Markets: The US Treasury market rallied for the better part of January as yields across the curve fell. The curve steepened even further as yields did not move in parallel fashion – 10 and 30 year yields fell approximately 20 basis points, while 2 and 5 year yields fell 30 basis points. The curve remains steep with a net yield pick-up of 280 basis points between 2 and 10 years. For the month, the US Treasury market returned 1.6% with long bonds dominating performance.

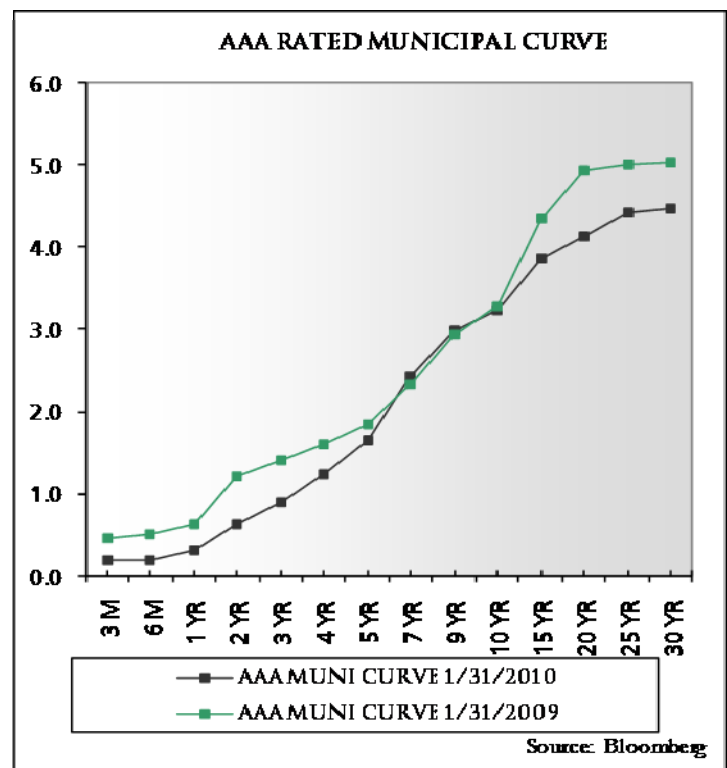
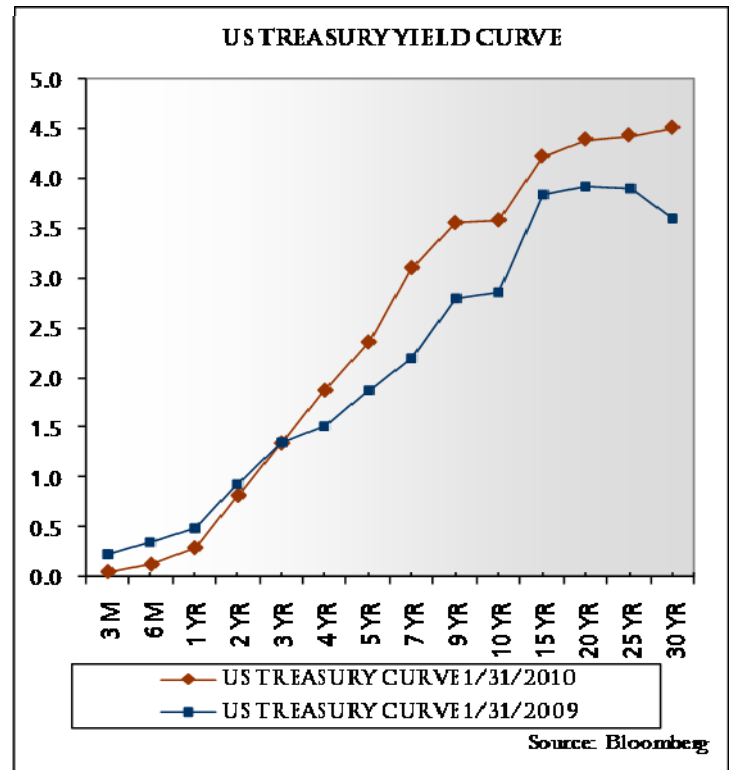
Supply in the Treasury market remained at its steady pace as \$235 billion in new bonds, bills, notes and TIPS were placed in January. Demand remained robust as this new supply was easily digested by both foreign and local buyers.

As the month closed, the Obama administration’s proposed budget was presented and it was not pretty. With the deficit set to increase to \$9 trillion in 10 years, Moody’s saw fit to chime in on the creditworthiness of the US. No, the US is not due for a downgrade or even a change to its outlook, but the rating agency did comment as follows:

“The ratios of general government debt to GDP and to revenue are deteriorating sharply, and after the crisis they are likely to be higher than the ratios of other Aaa-rated countries. If the current upward trend in government debt were to continue and become irreversible, the rating could come under downward pressure. The trend and the outlook would be more important than any particular level of debt.”

This is pretty tough talk and perhaps the US Treasury Department is listening, however we figure the government was well aware of the situation prior to Moody’s comment. The reality is that for the time being, demand remains robust and risk averse investors continue to view US Treasuries as the debt of choice.

Municipal Market: For the month, the Barclay’s 1-10 year Municipal Index gained 60 basis points as the curve retraced some of the steepening experienced in later months of 2009. The primary driver of return was again, flows. Investors searching for yield, particularly retail investors, sold money market funds in favor of short bonds and municipal bond funds. As noted by Municipal Market Advisors, the weekly money market fund out-flows reached \$9 billion in mid-January, the most since the fall of Lehman Brothers in September 2008. While all proceeds did not find their way into the muni market, a good majority did. The net result was that yields fell and valuations relative to Treasuries remained high, although not as rich given the late-January rally in US Treasuries.



Reviewing credit, headline and rating risk remained high. Based on growing budgetary problems, the AA-rated State of Washington had its outlook dropped to negative from stable by Moody's. California was in the news again as S&P lowered its rating to A- from A. Overall, the tone of the muni headlines was one of heightened concern regarding the credit worthiness of investment grade issuers. Be prepared for a continuation of this risk for the first 6 months of the year as states work to balance budgets for the next fiscal year.

The 'noise' in the market did not amount to much in terms of valuations, as credit spreads generally narrowed. High yield munis provided an even better glimpse into this market activity. The Barclay's High Yield Muni index returned 1.5%, as spreads relative to investment grade munis compressed further. See the previous discussion regarding the search for yield as the major reason for the continued tightening of credit spreads.

New supply issued by the market appeared basically in-line with yearly projections. \$32 billion in new bonds were issued in January which was comparable to past January, but as expected, over a third was issued as taxable municipal debt.

It seems taxable munis will remain a fixture in the municipal market for the foreseeable future. The late January request by the Obama administration to extend the Build America Bond program past the current deadline of December 2010 confirmed that BABs will probably become a permanent sector. Congress still needs to approve the request, but given the success of the program, we would be surprised to see Congress nix the proposal. One significant note, the request suggested a reduction in the federal subsidy provided to municipalities from the current 35% to 28%. This could alter the supply expectations in 2010. As issuers rush to place debt at the 35% subsidy level, the market may experience a change in the mix of taxable to tax exempt supply. This in turn may provide further support for tax exempt munis, thus bolstering performance in 2010.

Corporate Market. Historically, the high yield market performs well in January; since the inception of the Barclay's index in 1984, January has generated an average return of 2%. January 2010 did not disappoint, generating a 1.3% return. Low quality bonds led the way with a healthy 1.7% return for CCC rated bonds. Liquidity remained robust with trading volume relatively strong – picking up from the December holiday lull. The new issuance (primary) market had healthy start with \$14.5 billion in bonds issued in January.

When compared to Q4 2008, Q4 2009 earnings are substantially stronger and issuers are reporting solid results. The tone to the announcements in the high yield market appears stronger and outlooks brighter for balance sheet strength and cash-flow generation. There was a vast swath of companies across a number of high yield sectors announcing stronger results and healthier outlooks, specifically technology, chemicals, paper/packaging and airlines, all suggesting activity is picking up. This in turn should lead to continued improvement in credit quality and falling defaults.

Sources: Bloomberg, Barclays, Municipal Market Advisors



Mixed Start to 2010

Hedge funds posted mixed returns in January, as the downturn in equity markets worked against most directional strategies. Despite overall negative performance for hedged equity strategies, which declined 0.8% for the month, most outperformed the major global equity market indices in January. The same held true for market neutral strategies, which dropped 0.5% in the month versus the S&P 500's decline of 3.6%. According to Bank of America data, long/short managers' net exposure declined as the month came to a close, falling to 30%-32% net long (and below the historical average range of 35%-40% net long). Strategies continue to be tilted toward large caps, with a high quality bias.

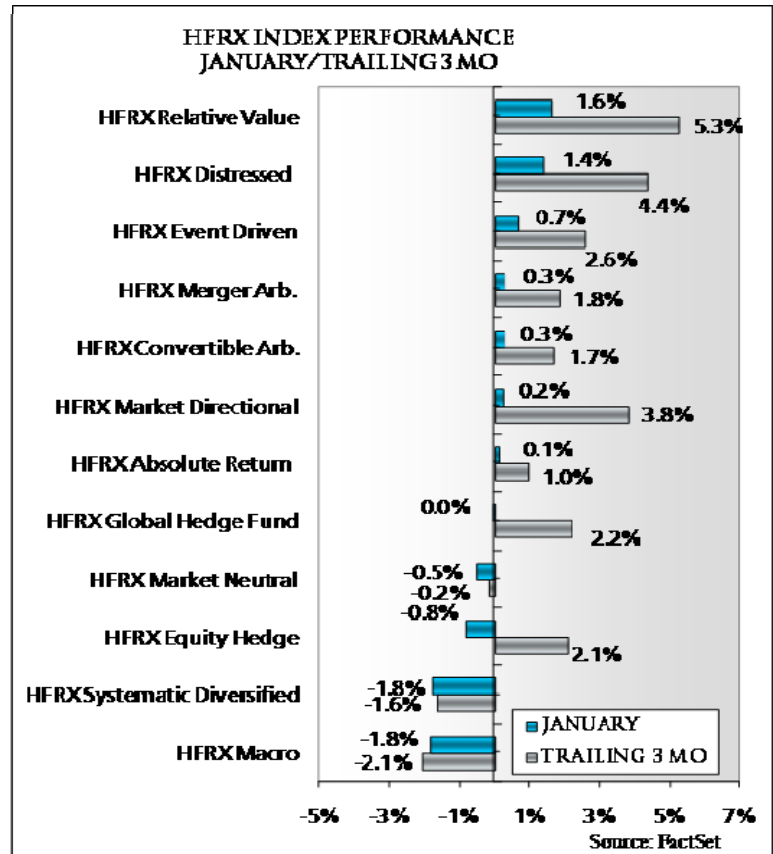
As was the case in December, systematic CTAs and macro strategies struggled for the month, with the HFRX Systematic Diversified index and HFRX Macro index each declining 1.8% in January. Crowded long positions in gold worked against managers, as did short positions in 10 & 30 year Treasuries. Short US dollar positions also detracted from performance in the month, as the strengthening dollar continued its upward march that began in late 2009.

Distressed strategies again posted positive performance, gaining 1.4% in the month, as did other credit related strategies like relative value (+1.6%) and event driven (+0.7%). The positive returns coincide with the strength in corporate credit, with the Citigroup High Yield index gaining 1.1% in January despite faltering in the second half of the month. Triple-C credits led returns, jumping 1.7% in the month. High yield has now generated eleven consecutive months of positive returns since bottoming in early 2009.

Convertible arbitrage strategies barely kept their positive streak alive, gaining a scant 0.3% in January after gaining over 42% in 2009. The weak performance was primarily driven by the downdraft in equities, though the decline was stymied somewhat by the continued strong credit environment. Hedged convertible strategies did outperform the long-only proxy, as the BarCap Convertible Index fell 1.6% in the month. According to recent research from Barclays, the spread between non-investment grade convertibles and the BarCap High Yield index contracted to 172 basis points in the month. This is just shy of the long term median of 134 basis points and suggestive that the valuation dislocation in HY convertibles is all but gone.

In summary, equities have retrenched, trends have turned, and spreads are slowly narrowing to normalized levels. While this month's returns were by no means impressive, they were a reminder of the diversification benefits that alternatives bring to an equity-centric portfolio. Given the potential regulation aimed at restricting banks' investments in hedge funds, private equity and proprietary trading platforms (AKA, the "Volcker Rule"), one is left with the distinct impression that January was but an interesting start to what is sure to be an interesting year for alternative investments.

Sources: Barclays, Bank of America



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