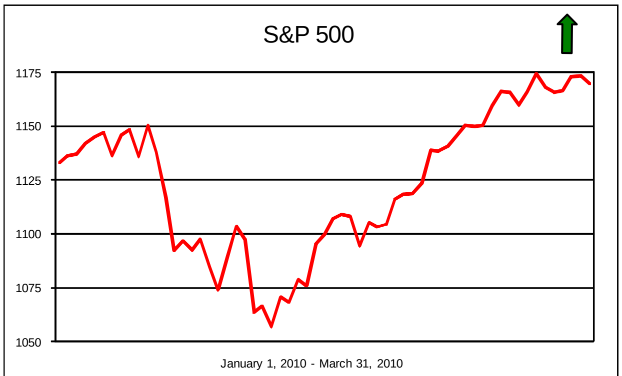
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

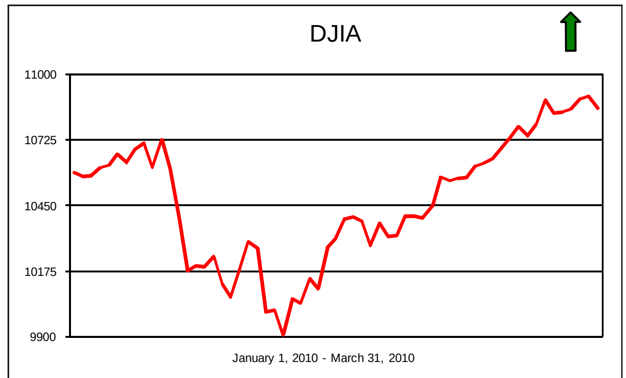
QUARTERLY REVIEW ***85th Edition*** ***2010: First Quarter***

CAPITAL MARKETS SCOREBOARD

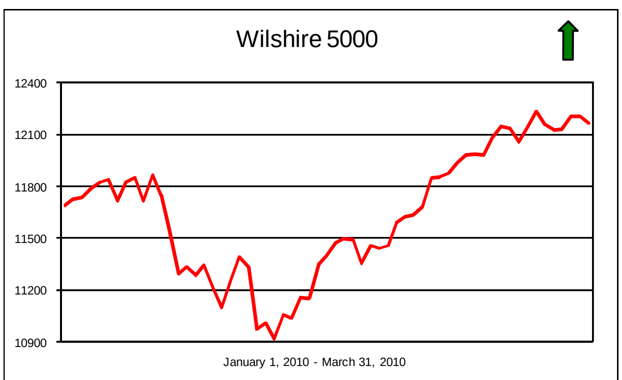
January 1, 2010 – March 31, 2010



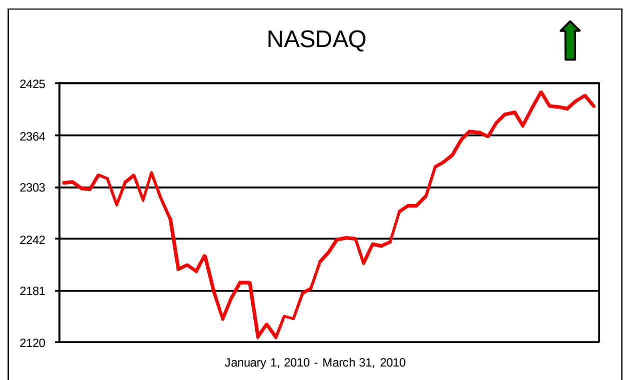
1st Qtr 5.41% YTD 5.41%



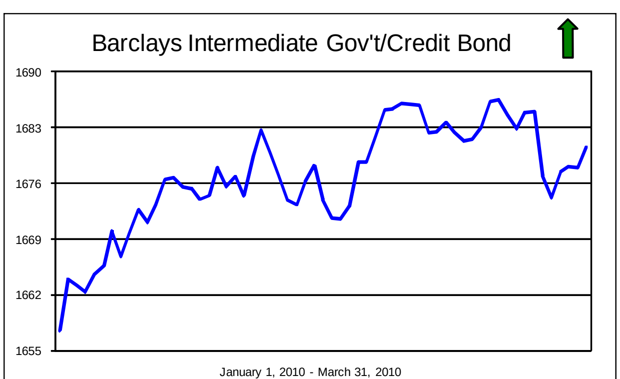
1st Qtr 4.81% YTD 4.81%



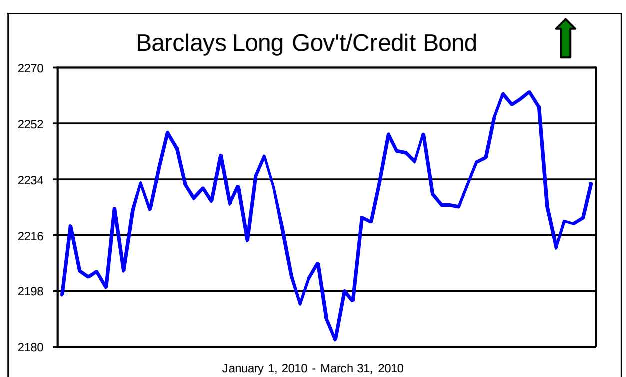
1st Qtr 6.27% YTD 6.27%



1st Qtr 5.89% YTD 5.89%



1st Qtr 1.54% YTD 1.54%



1st Qtr 1.55% YTD 1.55%

EQUITIES

Equity Market Performance

Equity markets rallied to end on a high note after undergoing an 8% correction early in the quarter. A confluence of events including news that China would take initial steps to reverse its economic stimulus program, concerns regarding European sovereign debt, and proposed financial regulations sent the market tumbling in mid-January only to see it rally back to new quarterly highs in March.

S&P 500 (GICS Sector)	Return % (Price Only)
	1st Qtr 2010
Industrials	12.45
Financials	10.82
Consumer Discretionary	10.05
Consumer Staples	5.04
Health Care	2.89
Materials	2.41
Information Technology	1.67
Energy	.08
Utilities	-4.61
Telecom Services	-5.66
S&P 500 Index	**4.87**

On a total return basis (including dividends), the Dow Jones Industrial Average (DJIA) rose 4.8%, the broader based Standard & Poor's 500 (S&P 500) increased 5.4% and the NASDAQ Composite gained 5.9% for the first quarter of 2010. Lower-quality stocks continued to lead the way higher. The Russell 2000, an index of small company stocks, outperformed its large company counterparts gaining 8.9%. As the accompanying chart indicates, the Industrial Sector was the best performing sector followed by the Financial Sector. Keeping in tune with the low quality rally, small/midcap regional banks drove the KBW Bank Index to a 21% gain.

While U.S. equity markets performed in a positive fashion, the international equity markets were mixed. The MSCI Europe, Australasia, Far-East (EAFE) index of 21 developed countries was flat for the quarter, posting a 0.2% gain. European countries faced with sovereign debt and budget issues including Greece, Spain, and Portugal fell 5.9%, 9.0%, and 4.3%, respectively. Meanwhile, less levered European nations, France and Germany, gained 1.0% and 3.3%. Japan's Nikkei 225 Index, which lagged a year ago, posted a respectable 5.2% increase in the quarter. Emerging markets were hampered by debt concerns and monetary tightening in several countries. China's Shanghai Composite Index fell 5.1% as government leaders announced measures to curb lending and land sales amid escalating property values while Brazil, one of the top performers last year, managed a 2.3% increase.

Fourth Quarter Revenue and Earnings Announcements

When revenue and earnings were announced for the fourth quarter of 2009, one of the key factors was the large number of companies that were able to deliver top line (revenue) growth ahead of consensus estimates. Of the companies in the S&P 500, 69% beat expectations on the top-line. This figure compares to 33.8% in the prior year quarter and 59% in the third quarter of 2009. In aggregate, S&P 500 fourth quarter revenues were up 6%, the first year-over-year increase since the third quarter of 2008. According to Credit Suisse Quantitative Research, the top performing sectors relative to expectations were Information Technology, Consumer Discretionary, and Energy.

Percentage of S&P 500 Companies Beating Consensus Revenue & EPS Estimates

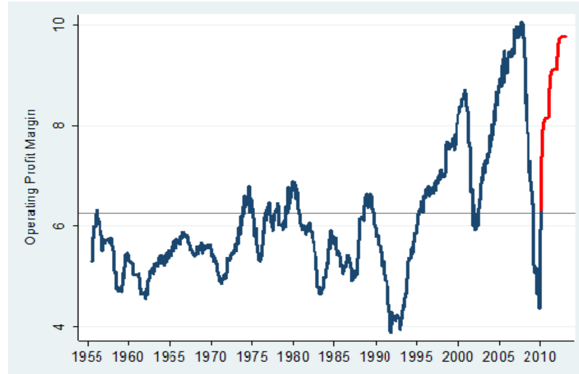
	4Q 2008	1Q 2009	2Q 2009	3Q 2009	4Q 2009
% Beating on Top-Line (Revenue)	33.8%	36.4%	50.1%	59.0%	**69%**
% Beating on Bottom-Line (EPS)	60.1%	67.5%	72.3%	79.0%	**73%**
Revenue to EPS Surprise Ratio	0.56	0.54	0.69	0.76	**0.95**

Source: *Strategas Research Partners*

In terms of earnings, 73% of companies in the S&P 500 beat consensus per share estimates for the quarter compared to 60.1% in the prior year quarter. However, on a sequential basis, the number of companies beating expectations dropped slightly from 79% the prior quarter. The Revenue to Earnings Per Share (EPS) Surprise Ratio, presented in the chart courtesy of Strategas Research Partners, jumped to 0.95 for the quarter. Earnings quality improved with a greater percentage of companies exceeding expectations due to stronger revenues than in the recent past in addition to ongoing cost rationalizations. Excluding stocks in the financial sector, fourth quarter earnings were up 19%.

U.S. Equity Valuations

The 2010 consensus estimate for EPS for the S&P 500 is $78.16, a year-over-year increase of approximately 20%. Analysts are forecasting 2011 EPS growth of roughly 18%, to $93 per share. William Hester, Senior Financial Analyst with Hussman Funds, notes that revenue per share for the S&P 500 is expected to grow 5.5% in 2010 and 7% in 2011. The differences in these growth rates imply a swift rise in operating margins to near peak levels achieved in 2007. Hester argues that these forecasted operating margins are critical to investors who rely on using a Price/Earnings (P/E) multiple based upon forward earnings. The current forward multiple on the S&P 500 is 15 times earnings compared to what Hester deems to be the long-term average of about 12 times earnings. This implies the equities market is slightly overvalued even with lofty operating margin assumptions. Another valuation approach based upon cyclicality adjusted P/E ratios shows the current multiple at slightly more than 20 times earnings compared to the long-term average of 16. Professor Robert Shiller told the *Wall Street Journal* when the ratio has gotten above 20 in the past, it has signaled that the market was expensive and sooner or later would hit a stretch of subpar returns.



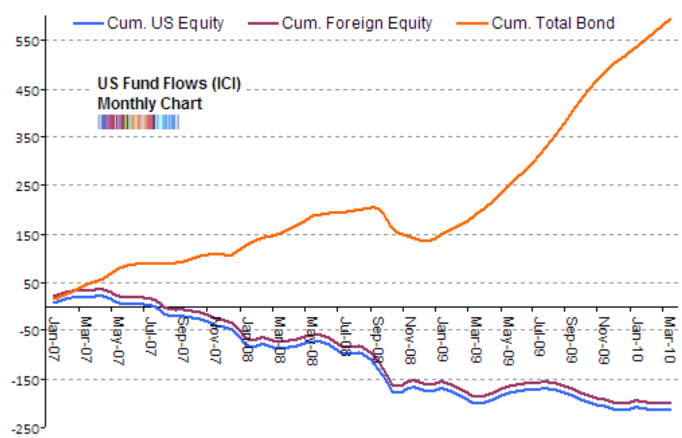
Source: *www.hussmanfunds.com/rsi/valuationforwardearnings.htm*

However, not everyone is bearish on the current valuation of the market. Jeremy Siegel, Professor at the University of Pennsylvania Wharton School of Business and author of “Stocks for the Long Run,” argues that Shiller’s method is flawed in that it fails to adjust for the egregious write-offs taken by large financial institutions in 2008 and 2009. Prof. Siegel notes that his research shows the common P/E ratio for stocks coming out of a recession is 18.5 times earnings, which means that the current 15 multiple is still well below where it should be. Applying his average multiple suggests that the S&P 500 could reach nearly 1400, close to 20% upside from quarter-end levels.

Mutual Fund Flows

Investors continue to be skeptical of the stock market as they attempt to recover from the second of two 40%+ drops in equities over a 10-year period. In what may be deemed a sign of capitulation, individual investors have shunned equities in favor of bonds. Data released in the first quarter showed that net fund flows into bond mutual funds totaled $375 billion in 2009 versus a mere $11.8 billion for equity mutual funds. Part of investors’ aversion to equities can be attributed to the fact they often view the stock market in light of how the economy is performing. Also, even with the run-up in equities lately, a recent poll conducted by Bloomberg shows only 3 of 10 people who own equities, bonds, or mutual funds say the value of their portfolio has risen from a year ago.

A look back at the last four bull markets since 1987 reveals a pattern whereby net inflows into equity funds are slow in the first twelve months before jumping significantly in the second year. The most recent data from the Investment Company Institute shows $19 billion flowed into equity funds the first quarter of 2010, compared to a $41 billion outflow in the first quarter of 2009. Flows into bond funds have slowed some this year but at $80 billion, bond fund inflows still reflect a strong preference by investors for bonds over equities. Some argue that a rise in rates may trigger an exodus from bonds. Whether that money finds its way into equities is debatable. Nevertheless, it bears watching whether equity fund flows will mirror past bull markets and continue to accelerate throughout the year, or if investors’ distaste for equities continues to manifest itself in higher bond fund inflows.



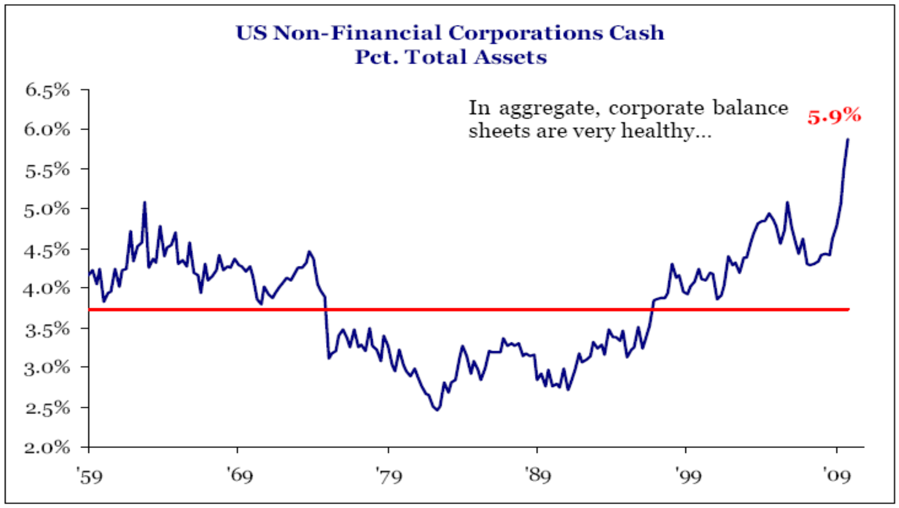
Source: *www.tradersnarrative.com*

Corporate Balance Sheets

Corporate balance sheets are flush with cash. The total amount of available cash on the balance sheets of the companies making up the S&P 500 was $831 billion at the end of 2009, up over 30% from prior year levels. Furthermore, liquid assets held by all domestic non-financial corporations are currently at the highest percentage of total assets since the mid-1960s. With short-term interest rates still hovering slightly above zero, improving business conditions and normalizing credit markets, management teams have been putting that cash to use in the form of dividend payouts, share buybacks, and mergers and acquisitions (M&A).

Dividends

Eight companies have initiated dividends so far this year. Starbucks, one of the more well known companies, recently announced that it will begin paying a dividend for the first time in the company's history. General Electric, who in early 2009 ordered its first dividend cut since 1938, indicated that they hoped to begin raising their dividend again in 2011. For the first quarter of 2010, companies in the S&P 500 have announced $5.2 billion in combined net dividend increases, marking the best such quarter since the fourth quarter of 2007. S&P analyst, Howard Silverblatt, estimates there will be a 5.6% increase in dividend payments for 2010. This would follow a 21% decline in 2009.



Source: *Strategas Research Partners*

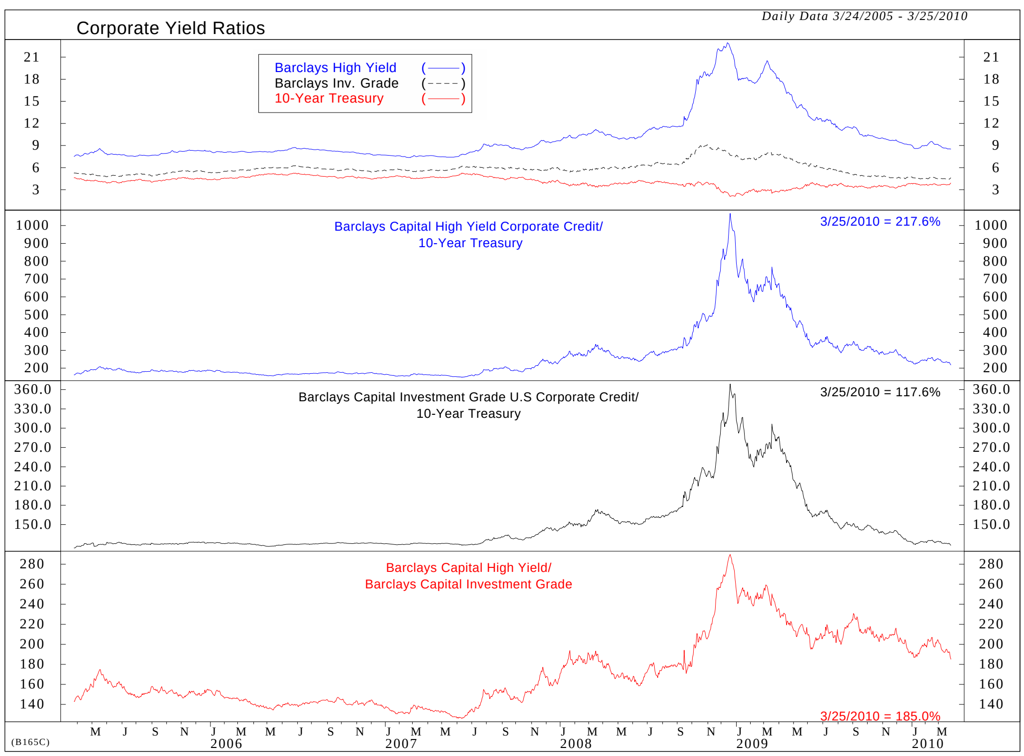
Mergers & Acquisitions (M&A)

Of all the acquisitions conducted in the U.S. so far this year, approximately 50% have been funded with cash. This compares to 24% of all deals done in 2009. Management teams, seemingly under the impression that their stock is undervalued in light of an economic recovery, have opted to utilize a greater percentage of cash relative to stock in order to fund acquisitions. Jason Trennart of Strategas Research Partners expects M&A activity to continue to accelerate throughout the year due to valuations, which are low enough for many deals to be accretive to earnings for the acquiring company.

ECONOMICS AND FIXED INCOME

Fixed Income Market Performance

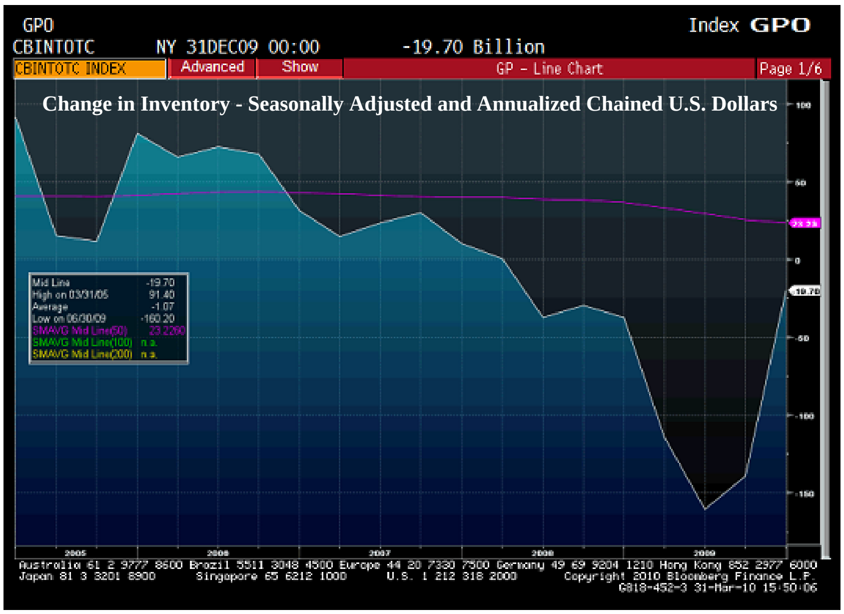
Treasury bonds returned 1.6% in January, 0.4% in February and negative 0.9% in March after declining 1.3% in the fourth quarter of 2009 according to Merrill Lynch's Treasury Master Index. Investment grade corporate bonds showed a similar pattern of a stronger January, 1.2%, followed by a weaker February, 0.4%, then a weaker March, 0.3%. High-yield, a.k.a. "junk", bond returns moved along a slightly different path as January and February were positive at 1.5% and 0.2% but weaker than the fourth quarter of 2009. Following those two months, junk bonds posted a very strong March at 3.1%. The lowest rated junk bonds, CCC or Lower increased in value by 2.4% in January, decreased by 0.2% in February and then regained 4.2% in March.



Economic Pulse – Gross Domestic Product (GDP) and Consumer Spending

When the Bureau of Economic Analysis (BEA) announced their third and final GDP revision for the fourth quarter of 2009 at 5.6%, some economists were still cautious because the bulk of the gain came from an improvement in inventories, not final demand. Without final demand, e.g., consumer spending, inventories will become bloated, GDP will decline and the risk of a "double-dip" recession increases. As has been repeated ad nauseum by the financial press in recent times, consumer spending represents nearly 70% of the economy, which is why there has been so much concern about high unemployment and the economic recovery. However, we may not need to wait for people to find employment before they start spending again. The February retail sales report announced in March, which tracks spending on clothing, automobiles, food service, etc. and represents about 23% of GDP, showed a rise of 0.3% month-over-month; ex-auto sales, it rose 0.8% month-over month. Both are impressive numbers in light of the snowstorms that were expected to restrain spending. In addition, the Personal Consumption Expenditures index has risen from -0.9% in July 2009 to 1.8% in February 2010 (latest data available). A decline in the savings rate provided further evidence of this phenomenon as Americans saved just 3.1% in February after reaching the 6.4% level in May 2009.

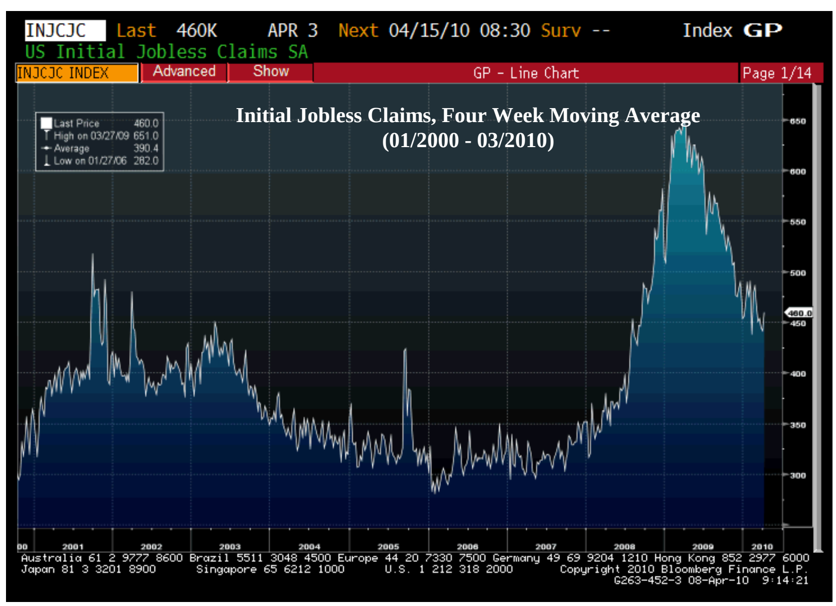
Economic Pulse – Inventory Levels



The economic bears may be right, but some of the available data points appear to hold promise for a sustainable recovery. For instance, even though inventories were responsible for almost 70% of the growth in fourth quarter GDP, the actual level of inventories continued to decline. A *positive* GDP contribution from inventories that declined (*negative* growth) seems contradictory, but, in reality, is not. The reason: GDP measures the quarter-over-quarter, seasonally adjusted annualized rate of change in inventories, not the actual level. As the accompanying chart illustrates, inventories shrank $19.7 billion in the fourth quarter of 2009 but the rate of change was significantly less negative quarter-over-quarter.

Economic Pulse – Employment Part I

Recent data suggests that the employment outlook is improving. Temporary hiring, which has historically been a harbinger of permanent employment, has surged in recent months. Furthermore, the productivity of those still employed registered in at 6.9% in the fourth quarter. While down from the six-year high of 7.8% (seasonally adjusted) posted in the third quarter of 2009, productivity is still a major positive economic force in the U.S.

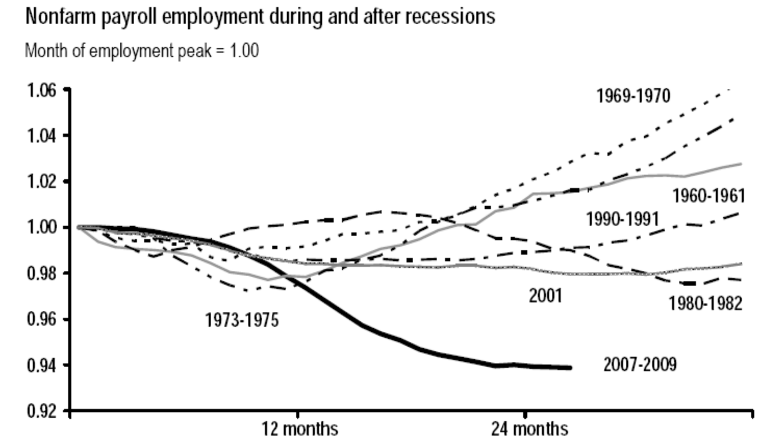


Also, the four week moving average of initial jobless claims, a component of the Index of Leading Economic Indicators, shows a clear downtrend. The moving average provides better insight into the trend since jobless claims are easily distorted by non-economic events like a holiday-shortened workweek. The last four readings for this series were 460,000 (affected by Easter), 442,000, 445,000 and 454,000 versus a peak of 651,000 from the final report for March 2009. The average since January 2000 is 383,000.

Economic Pulse – Employment Part II

The hit to the labor markets during this recession is unparalleled versus any prior recession of the past 60 years. Total nonfarm payroll employment declined more than 6% from its previous cyclical peak in December 2007, roughly double that of prior recessions. In turn, the unemployment rate more than doubled from 4.5% in the second quarter of 2007 to over 10% in the fourth quarter of 2009. In March, reports showed that a broader measure of unemployment, which includes discouraged and unemployed workers, increased to almost 17%.

Not only have we seen a sharp increase in the number of unemployed, but the share of the labor force characterized as long-term unemployed (27 weeks or more) stands at 4.0% - a record in the history of the series dating back to 1948. Given the severity of the recession and lingering concerns about the strength of the recovery, businesses have been reluctant to hire. Michael Feroli, economist at JP Morgan, proposes that the extension of emergency employment benefits is another contributing factor to the record rise in the average duration of unemployment. Studies have shown that an increase of one week in the availability of benefits raises the average duration of unemployment by 0.2 week. Based on Mr. Feroli's calculations, 47 extra weeks of benefits translates to a 1.5% increase in the unemployment rate.



Source: JP Morgan Economic Research

While the blow to the labor markets has been lengthy and severe, jobless claims as mentioned above are in a downtrend and March nonfarm payrolls increased 162,000, the first 100,000+ gain in the category since November 2007. This follows a better than expected gain of 36,000 for the snowstorm-stricken month of February. The first quarter also brought about news releases of plans to add workers. Notably, tech bellwether Cisco announced on their earnings call that they plan to add 2,000 to 3,000 workers this year. In fact, a January study conducted by the human resources consulting firm Towers Watson found that 92% of U.S. companies plan to hire in 2010, albeit at a slower than normal rate when coming out of a recession.

Municipal Bonds Default Risk

The historically staid, low-volatility, municipal bond market made headlines during the first quarter of 2010 as a number of media outlets and financial commentators bemoaned the woeful condition of individual state and local municipality finances.
No question, municipalities are not dealing with the best of circumstances at the moment. The headwinds include dramatically lower sales tax revenues, diminished taxable real estate values and higher safety net costs like unemployment benefits. Perhaps the most daunting problem, although not the most immediate, is public sector employees' and retirees' pensions and other post-employment benefits (OPEB). The Pew Center on the States published a study in February of this year indicating that the gap between promised benefits and funded benefits is $1,000,000,000,000 (that's $1 trillion with a 't') as of fiscal year 2008.

On the other hand, municipalities have some factors working in their favor. For instance, states have at least three significant tailwinds, according to Strategas Research Partners. First, the federal government has already allocated $135 billion of stimulus funds to the states, but has only spent $66 billion. Further, Strategas expects Congress to approve another $25 billion for fiscal 2011 and states are raising taxes, which Strategas estimates to total approximately $25 billion or about what is needed to fill the budget gaps. Finally, state tax revenues have actually rebounded (stopped declining) and will likely turn positive in the second half of 2010. According to a Bloomberg article published on March 30th, the fifteen largest states by population are projecting tax revenue gains of 3.9% for fiscal 2011 (July-June 2011), while the Chief Economist at Moody's Economy.com, Mark Zandi, estimates that tax revenues will rise 3.5% on average for all 50 states.

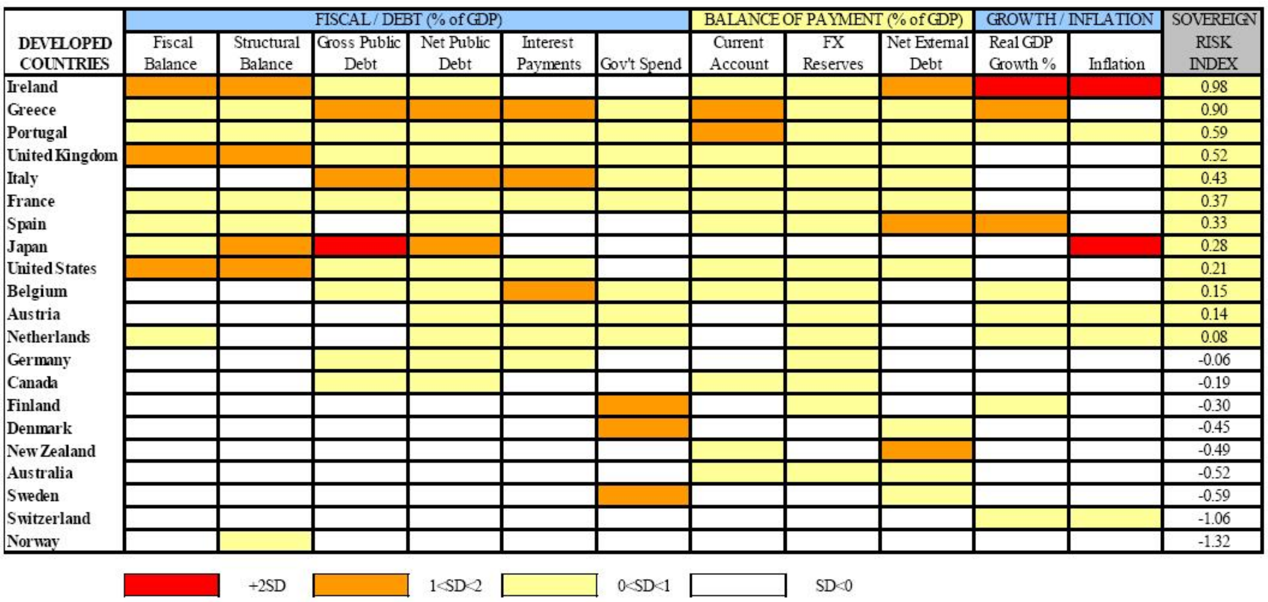
COMMENTARY: Debts, Deficits & Defaults

Sovereign debt is issued by a national government. This topic has been in the news lately because of the potential default of the sovereign debt of Greece. The country had been accumulating debt at a rapid pace for years as a result of deficit spending. The latest data from the International Monetary fund (IMF) indicates that the ratio of Greece's public debt to GDP was 108%,

the fourth highest in the world after Japan, Singapore and Italy. Note that Greece has reportedly *never* complied with the financial mandates supposedly imposed as part of its membership in the euro area Economic and Monetary Union (EMU).
History reminds us that not all government debt is risk-free, as numerous countries have defaulted on their debt in the last century: Austria, Germany, Italy, Greece, Hungary, Colombia, Brazil, Japan, China, Turkey, Argentina (twice), Russia, Ukraine, Ecuador, and North Korea. Most of the defaults have been caused by wars or irresponsible monetary and fiscal policies and hyperinflation. In addition to Greece, other countries with potential debt problems include Spain, Portugal, Great Britain, Ireland, and Japan. Unfortunately, the U.S. is heading in that direction.

Analysts at the Royal Bank of Canada may have developed the easiest (and certainly most colorful) way to gauge the risk of U.S. Treasuries relative to other countries. Their heat map of sovereign risk provides a quick overview of a country's total relative risk, as well as its strengths and weaknesses by major macro category.

Exhibit 1: RBC Heat Map



Source: OECD, Bloomberg, Fitch, IMF and RBC Capital Markets

The U.S. fiscal deficit has increased rapidly since 2008 due to the financial crisis and recession, and huge deficits are forecast for decades in the future. The budget deficit was $1.6 trillion in fiscal 2009 and the forecast for 2010 is a deficit of $1.35 trillion. These deficits are more than 10% of GDP, ratios not seen since World War II. Projections by the Obama administration are for the deficit to still be 4% of GDP in 2020. Past deficits and future U.S. fiscal deficits have to be funded, which is the role that sovereign debt plays. The U.S. currently has $7.5 trillion of publicly held debt outstanding and almost $5 trillion of nonpublic debt, most of which is held for social security payments in the future. Half the public debt is owned by foreign investors, with China and Japan being the largest owners.

How do you measure the ability of a country to service its sovereign debt? One common measure is to compare a country's debt to its annual output of goods and services, i.e. GDP. By that measure, the U.S. is in pretty good shape. Many reports cite the Congressional Budget Office's (CBO) *Debt Held by the Public* figure when discussing the U.S. debt burden, even though it excludes the debt held by the other governmental accounts such as the Social Security Trust Fund. The U.S. debt ratio using Debt Held by the Public is currently just over 53%, but is projected by the CBO to rise to 68% by 2020. In comparison to Greece's debt burden, 68% does not seem too onerous. However, the CBO projections do not line up with the consensus outlook. The reason: the CBO's baseline projection uses current law instead of projected changes to current law (such as the expiration of the tax cuts enacted in the last decade and annual appropriations increases equal to the rate of inflation). Under more realistic assumptions, the CBO projects that Debt Held by the Public will equal nearly 100% of GDP in 2020.

There comes a point in time when sovereign debt relative to GDP starts to affect economic growth. A recent study shows that when total debt, public **and** nonpublic, relative to GDP exceeds 90%, it reduces economic growth. With U.S. total debt of $13.8 trillion in 2010 and GDP estimated to be $14 trillion, the U.S. is beyond the tipping point, and it gets even worse in the next decade. By 2020, if public debt alone is $15 trillion, it means each and every one of the 300 million people in the U.S. will have a sovereign debt liability of $50,000, and that is not including the hefty interest payments over the next decade. It is estimated that annual interest payments on the federal deficit will increase from $200 billion this year to nearly $1 trillion by 2020, and that is assuming that interest rates don't increase much from current levels.

CBO's Baseline Projections of Federal Debt (U.S. $ in billions)

	Actual 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Debt Held by the Public	7,544	8,797	9,785	10,479	11,056	11,556	12,055	12,595	13,133	13,678	14,329	15,027
Debt Held by Government Accounts												
Social Security	2,504	2,595	2,695	2,802	2,922	3,055	3,194	3,332	3,466	3,592	3,709	3,815
Other government accounts[a]	1,826	1,868	1,915	1,978	2,051	2,112	2,200	2,284	2,368	2,459	2,531	2,599
Total	**4,330**	**4,463**	**4,610**	**4,780**	**4,974**	**5,167**	**5,394**	**5,616**	**5,834**	**6,051**	**6,240**	**6,415**
Gross Federal Debt	11,874	13,260	14,395	15,259	16,030	16,723	17,449	18,211	18,967	19,729	20,568	21,442
Debt Subject to Limit[b]	11,853	13,239	14,374	15,238	16,007	16,701	17,426	18,188	18,944	19,706	20,545	21,418

Source: CBO

Who is buying all of this debt? Before the financial crisis, more than half the U.S. debt was purchased by foreign investors, but since then foreign purchases have declined dramatically. In an ironic twist of fate and what some consider an incestuous relationship, the government and the Fed bailed out the banks, and now the U.S. banks are bailing out the government by purchasing billions of dollars of U.S. Treasury securities. They can do this because the Fed has made short-term interest rates extraordinarily low and the yield curve – the difference between short-term and long-term rates – has been steep. As a result, the cost of bank funds (deposits), which are short-term in nature, are low and they can invest in longer-term (Treasuries) at higher rates. This is called "surfing the yield curve" and is how Japan fixed its banking system in the 1990s.

Bank profits due to this strategy are significantly higher, an estimated $30 billion annually. Banks are getting a pretty good deal for nearly blowing up the financial system. Who pays for these extraordinary low interest rates? If you have renewed a CD lately, it's obvious – anyone who saves. Savers are in a sense funding the bank bailouts, not only as taxpayers but also as depositors. The average rate paid to depositors dropped from 4.5% in August 2007 to 1.45% at the end of 2009. Longer-term rates dropped much less, both absolute and relative, than short-term rates. The good times for banks will last as long as the Fed keeps rates at current low levels.

With deficits projected for years to come, it will be very important for the U.S. to get its' fiscal house in order. There are no easy solutions, only difficult ones which require sacrifice. For one, to reduce the budget deficit, it will be necessary to reduce spending. Federal spending as a percent of GDP has averaged 20-21% in recent years. Today it is around 25%. It will be difficult to pare down this relative spending back to 20-21% because less than one-fifth of the budget is related to non-security discretionary spending. To cut spending significantly, it will have to come out of the defense budget or the entitlement programs, such as social security, Medicare, and Medicaid, which are now approaching one-half of all expenditures in the budget. Other solutions involve revenue generation, i.e. taxes, and there are many proposals being discussed including a national sales tax, value-added tax and simplification of the tax code. Raising income taxes alone would help but there are not enough people making more than $250,000 annually in income to make a significant impact. The top 1% of income earners already pay more than one-third of the personal income taxes. If income taxes are the solution, an income tax increase would have to be more broadly based. Finally, with the recent stimulus programs, quantitative easing, etc., there has been a lot of conjecture about the U.S. government trying to generate inflation, as a means to essentially cheapen the debt that is paid off in later years. This may be a solution in reducing the U.S. debt burden but it is a questionable one since much of the debt is now more interest rate sensitive than in the past. Whatever steps are taken, the key will be that they are serious and significant enough to stop the debt spiral and ensure the U.S. is able to service its debt. The contagion associated with a country like Greece possibly defaulting has raised a cautionary flag; should the U.S. debt ever be downgraded, the repercussions would likely be serious and long-lasting, affecting not only the economy and the financial markets but all aspects of U.S. international relations. For investors, it is better that these types of steps are taken soon, even with the likely slowdown in economic growth, then to wait and find out after-the-fact it is too late. The financial markets can handle slower growth as long as prospects point in the right direction, just as we have witnessed in the equities market lately.

"A small debt produces a debtor, a large one, an enemy." ***Publilius Syrus (Roman author, 1st century B.C.)***

April, 2010