



Johnston Asset Management

GLOBAL INVESTMENTS

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When we last wrote you the US and global equity markets were in the midst of staging an impressive recovery off their lows of March 9. Through June 30 the S&P 500 index is up an impressive 36% from the recent low point and Morgan Stanley's EAFE international index is up 48%. It seems that the communal wisdom of stock markets has determined that our worst fears for the economy will not be realized, at least not tomorrow. On the other hand, we've had an enormous move in the market, isn't it over-priced? We doubt it and offer the following reasons:

First, companies reacted more aggressively going into this downturn than ever before. Inventories were cut, as was headcount. They did a great job keeping their operating costs and capital requirements low. This was and probably remains unpleasant if you lost your job, but it was the right thing to do for shareholders.

Second, valuations remain reasonable. For example, as of this writing the S&P 500 is trading at approximately 15 x forward earnings, a low multiple to be sure, but not rock-bottom. But the earnings estimates being used for this calculation are quite depressed. This is also true for most of the

companies in the portfolio. Businesses slowed down and management teams conservatively cut back their forward guidance for revenues and profits. They cut costs at the same time, but not enough to completely offset the lost revenues.



Peter J. Cummiskey
Vice-President / Partner

Despite the rally in the market, there is still plenty of potential for more appreciation. Employment will eventually bottom and demand growth will resume. We are seeing signs of stability and perhaps even some growth here and there in both the US and Chinese economies. We expect the US economy to have positive growth for the second half of 2009. Given how low inventory levels are, we expect new demand to be converted very quickly into profit growth. Coming out of the recession we expect earnings growth to accelerate at above-trend levels for a couple of years, which bodes well for stock prices.



A good example of these trends is Adobe Systems, a company we recently added to the portfolio. It has usually been an expensive stock because it is at the epicenter of the digital media revolution. Adobe's products are used to create digital content that can be published either on the internet or in print. They are virtually unchallenged in the field. Their customers felt the pinch of the recession and cut back spending.

Adobe's earnings will fall 27% in 2009, but the company cut its staff by 8% last winter, and when demand picks up, we believe they will be able to sustain double digit revenue growth on a lower cost base for several years. We paid a low earnings multiple for the stock and think it will become a core holding.

ADOBE Systems

