Johnston Asset Management

GLOBAL INVESTMENTS

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Perhaps the market is telling us something. At the end of September the S&P 500 is 57% off the lows of March 9, and up over 14% in the quarter that just ended. Things are getting better. The financial system, while still shaky, is working. Many of the fiscal and monetary stimulus measures that were put in place are working. Most of these actions have only just begun to have an impact, and others have yet to be felt. The housing market has bottomed in many areas. Employment, while still bleak, is no longer in freefall, and corporate profits are holding up reasonably well. All these factors are reflected in the stock market's strong recovery.

We do not think the coast is clear, and are particularly concerned about three macro trends. First, a weaker US dollar will be a reality for the foreseeable future. The US government has issued an extraordinary amount of additional debt in the last year. Some say we have saturated the global markets for US sovereign debt. Current account and budget deficits remain high, and the dollar's use as a reserve currency is being questioned as never before. Confidence in the dollar will return when deficits are brought down and policy paths become clearer. We have always held that the greatest growth companies are not all domiciled in the US, and have always allocated a portion of our portfolios to non-US companies. This becomes a defacto hedge against a weak dollar, as does the fact that most of our US based holdings serve overseas markets with products manufactured and priced locally, or with exports.

Second, high inflation is probable in the next few years as governments have printed money to fend off deep recessions. As deflation is the larger near term concern, central bankers will have to demonstrate extraordinary skill in timing their policy reversals, and few have a good track record in this area. Our response is to invest in companies that have pricing power and the ability to pass along raw material cost increases to their customers.

Richard Johnston
President

Finally, we are concerned about what will happen to growth when the fiscal and monetary stimuli are removed. The end of the "cash for clunkers" program is a sobering example of this effect as vehicle sales *dropped 35% in one month* after the program's end. In free market economies government spending cannot substitute for innovation. Companies that invest in research and develop new products that better meet their customers' needs will always have avenues for growth. Whether it is an efficiency boosting wireless product enabled by Qualcomm technology or a lifesaving new heart valve from Edwards Lifesciences that ends up reducing hospital stays, innovation will always cause share gains and command premium prices.

Some of our portfolios' value that was lost in the last two years has been recaptured. With few exceptions the companies in our portfolios have remained sound investments and piloted a treacherous period safely. However, we believe the rebound in the market is discounting an optimistic outlook, and we temper our natural optimism with concern about the potential pitfalls mentioned above.