

SARATOGA BANK & TRUST COMPANY NATIONAL



INVESTMENT NEWSLETTER

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ECONOMIC SUMMARY

The initial report of third quarter Real Gross Domestic Product (GDP) indicates that the U.S. economy grew by 3.5% (subject to revision) in the third quarter of 2009. This growth rate exceeded the consensus forecast which called for a 3.2% gain. This marks an improvement from the 0.7% increase realized in the second quarter and a marked turn around from the -6.4% contraction in the first quarter of 2009. We continue to believe that the U.S. economy bottomed-out in the first quarter of 2009 and two consecutive quarters of growth support this position.

The primary drivers of economic growth were an increase in personal spending and inventory restocking associated with the "Cash-for-Clunkers", or CARS program. The impact of government action upon the economy's third quarter growth should not be underappreciated. Increased auto production alone accounted for nearly one-half of the U.S. economy's growth in the third quarter. Also contributing to economic growth were the first time home buyers tax credit, increased federal government spending and export growth aided by a weaker U.S. dollar; which is itself a by-product of the unprecedented fiscal and monetary stimulus of the U.S. government.

Forecasts for economic growth in the fourth quarter of 2009 and through 2010 are near universally positive. The risk of a double dip recession has become a more remote possibility according to most forecasters. In question is the strength of the economic recovery, with forecasts ranging from modest growth to a "V" shaped recovery marked by

strong economic growth of 3.5% or more in 2010.

While the pace of economic recovery is the subject of debate, there is near universal agreement among forecasters that the U.S. will experience a "jobless recovery." Forecasts call for unemployment through 2010 to range between 9.0 and 10.0%. Sustained unemployment of near to 10.0% will impact final demand and consumer spending and will constrain potential U.S. GDP growth. So too will more limited access to credit, restrained wage growth and stagnant disposable income. Elements that may support real consumer spending going forward are the repair to consumer balance sheets achieved through increased savings over the past year, real wage growth in a low-inflation environment as a result of strong productivity gains, improved housing affordability, pent up demand for housing and autos, and downward pressure on retail prices evidenced by significant price discounting.

Recent data indicates that inflation remains subdued, in part due to lower energy prices compared to the year ago period. September's measures indicate that the Consumer Price Index (CPI) fell 1.3% year-over-year while the Core CPI, which excludes food and energy, rose by 1.5% year-over-year. The Producer Price index (PPI) fell 4.8% year-over-year while Core PPI rose 1.8% in the same time frame.

Labor productivity growth remains strong, with third quarter productivity rising 9.5%

following a 6.9% increase in the second quarter of 2009. Increased productivity has resulted in Unit Labor Costs falling 5.2% in the third quarter on the back of a 6.1% decline in the second quarter. Increased labor productivity is considered by many to be a constraint on future inflation expectations.

The Institute of Supply Management's Non-Manufacturing Index, a measure of the health of the Service Sector of the U.S. economy, was little changed in October measuring 50.6 compared to 50.9 in September. A reading of greater than 50 indicates expansion; a reading of less than 50 indicates contraction.

Manufacturing results were mixed with the Empire Manufacturing Index and Chicago Purchasing Managers Index improving while the Richmond Fed Index and the Milwaukee Purchasing Managers Index declined. Factory orders rose 0.9% in September marking the fifth increase in six months. Considerable unused manufacturing capacity continues to sit idle. Capacity Utilization was 70.5% in September; a modest improvement from 69.6% in August. The manufacturing sector continues to lose jobs, with manufacturing payrolls down 60,000 in October.

The housing market continues to exhibit signs of stabilization and recovery. Housing starts rose to an annualized rate of 590,000 units in September, following a rate of 587,000 in August. Building permits declined modestly to an annualized rate of 573,000 in September, following a 580,000 annualized rate in August. Existing home sales continue to show positive signs with a 5.5% increase in September.

Home prices rose in August, marking the fourth consecutive monthly increase. The Case Schiller Home Price Index, which measures twenty large metropolitan areas of the U.S, shows a -11.32% year over year decline for August, further evidence that the pace of housing price declines have slowed since March of 2009. New home sales achieved an annualized rate of 402,000 in September, a decline from an annualized rate of 417,000 units in the prior month. Pending home sales rose 6.1% in September, following a 6.4% increase in August. Year-over-year, pending home sales rose 19.8% for September.

Consumer spending remains resilient as total retail sales fell 1.5% in October while retail sales ex-auto and gas rose 0.4%. Chain store sales achieved a 1.5% increase year-over-year. Additionally, the seasonally adjusted annualized selling rate (SAAR) for autos

increased to 10.45 million in October from 9.20 million in September. This remains well below the average for the last six years of 15.19 million SAAR and below the estimated replacement rate of 12 million SAAR.

The Index of Leading Economic Indicators (LEI) rose 1.0% in September, marking the sixth consecutive monthly increase and the largest six month gain since 1983. Eight of the ten indicators rose in the month of September; the exceptions being the average hourly workweek and building permits. The improvement was attributable to improved consumer expectations, lower jobless claims, higher equity prices and changes in the differing costs of borrowing short-term or long-term. The strength of the LEI indicates that the economy can be expected to grow in the first quarter of 2010, setting the table for a continuation of the economic recovery.

We believe that the level GDP growth achieved in 2010 will be determined by the level of final demand and that, despite the challenges facing consumers, the U.S. economy will experience modest economic growth in 2010 with contained inflation.

The ability of the U.S. consumer to maintain spending in the face of 10.0% unemployment is a product of an impressive increase in productivity, stabilization of the average hourly work week, real wage growth and price deflation evident in significant retail discounts. By mid-2010 the U.S. economy will begin to be net gainer of jobs and unemployment will begin a slow and gradual decline, but is likely to remain at or above 9.0% in 2010.

Resilient consumer spending, growth in residential and equipment spending, inventory restocking and pent up demand will sustain economic growth in 2010. Stabilization in labor market and home prices combined with the wealth effect of a rising stock market will help consumer confidence improve.

We note too that the spending portion of the fiscal stimulus program, for the most part, is yet to kick in. Tax cuts, transfer payments for food stamps and extended unemployment insurance, and transfers to states to support Medicaid and other current spending are in place. It is estimated there is nearly \$384 billion left to spend on various projects, including infrastructure, channeled through the states. Therefore, we expect non-defense spending to increase and provide further support for growth.

By Peter M. Capozzola, CFA

FIXED INCOME OUTLOOK

At its meeting on November 4th, the Federal Reserve Open Market Committee (FOMC) reaffirmed its plan to keep interest rates low for “an extended period” in the face of still-high unemployment and low inflation, but expressed growing confidence that an economic recovery is at hand.

The FOMC singled out “low rates of resource utilization, subdued inflation trends and stable inflation expectations” as the conditions that are likely to warrant rates near zero for some time. Fed officials cautioned that weakness in the labor market was limiting consumer spending, putting a brake on the recovery and keeping inflation under wraps. The FOMC was more optimistic about growth prospects than at its September meeting, noting that household spending seems to be expanding. Economic data released subsequent to the FOMC’s last meeting on September 23rd show that the recession is over, with clear improvements in manufacturing and the housing sector. GDP rose by an annualized rate of 3.5% in the third quarter of 2008 as the government’s massive stimulus plan, most notably “cash for clunkers” boosted consumer spending.

With the recovery underway, Federal Reserve officials are giving thought to how to unwind the unprecedented stimulus that has been injected into the economy. In reading comments made by Fed officials, it is apparent that most do not believe that the economy is yet healthy enough for the Fed to either remove stimulus or raise interest rates. We agree and do not expect the FOMC to raise its Federal Funds Target Rate until the third quarter of 2010 and possibly not at all in 2010. We also believe the Fed will be cautious about removing the liquidity they have injected into the financial system, not wanting to derail the economic recovery. We believe the Fed is likely to allow inflation to appear before raising its Federal Funds Target Rate. Additionally, historically the FOMC only begins to raise interest rates once the unemployment rate appears to be on a sustainable downward path. This approach is consistent with their mandate to create conditions of full employment. We expect unemployment to peak in the first half of 2010. The Fed may then begin to shrink its balance sheet, and possibly initiate a rate hike in the third quarter of 2010.

We believe the 10 year U.S. Treasury will trade in a relatively narrow range over the next six months. This

reflects ongoing uncertainty of the sustainability of the economic recovery and associated inflation expectations, and the conflicting forces of the U.S. dollar as a safe haven in times of uncertainty and concerns that the U.S. government deficit will lead to a weaker U.S. dollar. We expect additional Treasury supply, the expiration of the Fed purchase programs, and an economic recovery may add upward pressure on long-term yields in the second half of 2010.

Credit spreads have tightened significantly as the credit crisis has eased and investors have become more comfortable with the economy and their appetite for risk has increased. We believe that non-financial corporate bonds remain attractive and afford an opportunity for enhanced yields.

Credit spreads for high yield bonds have also tightened significantly and we believe are not attractive at this level. In particular since credit defaults tend to lag the economy and typically do not peak until after a recovery has become established.

FDIC insured corporate bonds should be viewed as an attractive opportunity relative to U.S. Treasuries for those fixed income investors seeking a high degree of safety.

Where practical, and not a disruption to either client liquidity needs or Investment Objectives, we recommend that anticipated proceeds of upcoming bond maturities be “pre-invested” given the slope of the yield curve and our expectation that money market yields will remain low relative to Fixed Income yields.

We anticipate a moderately-paced economic recovery. Taking note of lax labor and capital resources, we do not anticipate that significant inflationary pressures will emerge despite the stimulative monetary and fiscal actions taken to date. We consider the possibility that a flattening yield curve will emerge likely and consequently recommend modestly extending the average duration of fixed income portfolios beyond that of their respective benchmarks.

While yields on Treasury Inflation Protected Securities (TIPS) currently indicate minimal inflationary expectations, we consider TIPS a prudent and undervalued investment as we expect future inflation, while modest, to exceed the level priced into TIPS at this time.

By Peter M. Capozzola, CFA

EQUITY OUTLOOK

The S&P 500 returned -1.86% in October and is now up 17.03% year-to-date through October 31, 2009. The third quarter earnings reporting season is underway and we expect S&P 500 earnings to make a comeback. It is possible we may see an end to a long pattern of declining year-over-year quarterly earnings comparisons.

The third quarter of 2009 represents the market's first chance to better year-earlier earnings results. In the third quarter of 2008, S&P 500 earnings were \$15.96. Initial estimates for the third quarter of 2009 call for earnings of \$14.56. However, if we get a repeat of the upside earnings surprises that characterized the second quarter of 2009, which we believe is likely since earnings surprises have historically shown strong momentum, there is a solid chance for an upside beat. We have seen upward estimate revisions and positive earnings surprises and expect this trend to continue.

With an outlook for positive economic growth, and expectations of double digit earnings growth by S&P 500 companies in 2010, notably some forecasts call for earnings growth of greater than 20% in 2010. We believe there are attractive opportunities in the equity markets in particular since the S&P 500 trades at 17.5 times the 2010 consensus earnings forecast and is in our consideration reasonably valued.

We believe earnings will also benefit in 2010 from the recent and potentially further weakness in the U.S. dollar which will benefit many of those U.S. companies that derive a significant portion of their earnings from abroad.

We remain overweight in the information technology and industrial sectors, reflecting our expectation for a rotation in leadership to cyclical sectors from defensive sectors. We are also overweighting the energy sector. The economic recovery and OPEC's reduction of crude oil output may renew pricing pressures. Expectations for a global economic recovery have helped push oil prices well above their February lows. Developing nations are expected to increase their usage of oil at a time when petroleum companies have reduced project spending. The materials sector has been increased to an overweight. The monetary stimulus propping up the global economy may increase inflation expectations over the next few years. As global demand reaccelerates, and infrastructure spending continues in emerging economies, demand and prices for basic

materials may rise. Also, investors seeking non-U.S. dollar denominated investments may seek investments in basic materials. We continue to be underweight in the consumer discretionary and financial sectors. We recognize there are challenges facing the consumer in the form of rising unemployment and lack of availability of credit, and that business spending may remain curtailed until clear economic trends are in place. We are suspect of the rally in financials, and the speed of the rebound in the shares of companies which in the not distant past were garnering unflattering headlines. The financial crisis may be waning, but a credit cycle is upon us, with banks expected to add to their loan loss reserves and contend with tighter margins as asset yields reset lower. We decreased the Telecommunications and Utilities Sectors from marketweight to underweight. These sectors, with relatively attractive dividend yields, and in the case of utilities, stable earnings had been seen as a safe haven during the credit crisis. With the U.S. economy transitioning to growth and economic recovery, we decided to re-allocate a portion of the funds invested in these defense sectors into more economically sensitive sectors. Marketweight sectors are consumer staples and healthcare.

By Peter M. Capozzola, CFA

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