



MARKET REPORT

FIRST QUARTER 2010

THE ECONOMY

The majority of the recent economic data that has been released this year has generally been consistent with an economy that is gradually improving. We believe economic growth will likely moderate in the second half of this year.

At the beginning of 2010 the global economy was still very weak and dependent on Government support. It was our opinion that demand from the private sector would need to improve in order for the recovery to continue. By the end of the first quarter it appeared that this transition was beginning to occur. The majority of the economic data that has been released in the U.S. this year has generally been consistent with an economy that is gradually improving and private sector demand is rising. Meanwhile, governmental stimulus is expected to dissipate in coming quarters, although it will continue indefinitely.

Recent data indicates that corporate manufacturing activity is recovering and companies are spending to replenish inventories. Consumers are also beginning to resume spending, as evidenced by stronger-than-expected retail sales during the first few months of the year. Even the housing market has been improving, as the Case/Shiller Home Price Index for January showed an increase for the eighth straight month.

Perhaps most importantly, we appear to be entering a period of net job creation. The labor market remains weak, but monthly job losses likely peaked some time ago. The March payrolls report showed that 162,000 jobs were created for the month, 123,000 of them from the private sector. Although the unemployment rate was unchanged at 9.7%, the turnaround in private sector jobs growth is a good sign.

Also, there are large portions of the emerging world that continue to provide the demand needed to drive global economic growth. In the United States, a large portion of corporate earnings growth is expected to come from the demand from a rising middle class in these countries. This part of the world is not immune to the weakness in the developed world, but they are potentially more resilient.

Although this is all encouraging, it will probably not be enough to deliver powerful global economic growth. Economies around the globe continue to struggle with the aftermath of massive wealth destruction and the end of a long-term period of expanding indebtedness. Many sectors of the global economy still must reduce debt, including households, local governments, and national governments in most developed countries and some lesser developed countries (such as Greece).

The deleveraging process is likely to take several years, during which spending and economic growth will likely be subpar. In recognition of this, companies appear to be only gradually increasing production, spending and hiring. As a result, the labor market will probably remain weak and continue to hinder the housing recovery. While the housing market is improving thanks to massive federal support that has improved affordability and subsidized new purchases, the volume of potential foreclosures remains large. By some estimates one-quarter of all homeowners with mortgages have a mortgage balance that is greater than their home's value.

We do not believe the economy will dip back into a recession, but we also do not anticipate a high level of economic growth. We believe the economic data in the second half of this year and into 2011 will likely be more moderate than the past few quarters. However, we are not overly concerned about inflation over the next year. Manufacturing capacity remains extremely high relative to history. The combination of slow growth and excess labor means a period of wage-driven inflation similar to the 1970s is unlikely. Although we do not believe we will experience a serious rise in inflation over the near term, as we move through the deleveraging period there is a higher risk of a spike in a year or two.

THE STOCK MARKET

Stocks continued to grind higher during the first quarter as economic conditions around the world continued to improve, but it was not a smooth climb. Before rising strongly over the last six weeks of the quarter, U.S. stock markets dropped over 8% during a three week period from late January to mid February when the news flow around the world was at its most troublesome.

During this time China took its first steps toward slowing its growth in order to avoid inflation, the viability of the Euro came into question when European countries struggled with burdensome debt loads and Greece was on the verge of defaulting on its debt, and the political rhetoric in the U.S. reached a fever pitch with both political parties claiming economic disaster would result if they don't get their way on health care legislation.

By the end of the quarter, though, all domestic equity asset classes were well into positive territory on a total return basis. The large-cap S&P 500 Index was up 5.4%, the Russell Midcap Index gained 8.7% and the small-cap Russell 2000 Index gained 8.9% for the first three months of the year.

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THE BOND MARKET

By the end of the year, the potential for interest rates to rise significantly is perhaps the biggest worry for investors in bonds, because rising rates hurt the value of existing bonds.

Foreign stocks also are in the black for the year, with the MSCI EAFE Index of developed countries up 0.9% and the Vanguard Emerging Market Stock Index up 2.5% for the quarter. The European Monetary Union was the worst performing region given the financing troubles that Greece and others face.

The returns were driven by the increasing perception that the current environment is favorable for stocks. Corporate earnings in the U.S. continue to be stronger than many analysts anticipated thanks to effective cost controls which have boosted productivity and increased earnings power. As a result, many corporations have very strong balance sheets and are sitting on high levels of cash. At some point, these companies will need to start spending, either on investments in their businesses or stock buybacks.

Valuations in the stock market seem favorable as well, although there are many opinions about stock valuations. In March two well-known professors voiced completely different views on the market's valuation. Wharton Finance Professor Jeremy Siegel believes the market is undervalued at current levels, while Yale Economics Professor Robert Shiller believes the stock market is overvalued. Our data shows the average price/earnings ratio (based on the next 12-month earnings estimates) of S&P 500 companies is about 14, which is very close to its long-run average and is in a range that can be considered reasonable.

The combination of rising earnings, an improving global economy, low interest rates and reasonable valuations provide an attractive environment for stocks. Also, the low yields that are available in cash and fixed income create a powerful incentive for investors to look to stocks for returns. But the risk of a short-term stock market correction is high due to the current economic and political uncertainty. As a result we believe that between the end of the first quarter and the end of the year further gains in the stock market will be minimal.

Our expected return the rest of this year for emerging-markets equities continues to be slightly higher than U.S. equities, although the premium has shrunk due to strong recent performance. Much of the emerging world is not saddled with high debt levels, and many of these countries have commodity-driven economies that benefit from the global infrastructure build out. We believe that the stock markets in foreign developed countries will generate returns similar to U.S. equities.

In the first quarter, high-yield and corporate bonds continued their rally from last year. The Barclays Aggregate Bond Index returned 1.9% in the first quarter, and high-yield bonds ended the quarter up 4.8% on average. Emerging-market bonds, as measured by the JPMorgan GBI-EM Global Diversified Index, returned 5.4%.

For the time being, the after-effects of the credit crisis will probably continue to restrict the global economy's growth, keep inflation from rising, and keep the Federal Reserve from raising rates. If interest rates stay low and the recovery continues, it is possible that the more risky sectors in the bond market will continue to do well over the next quarter or two.

But by the end of the year, the potential for interest rates to rise significantly is perhaps the biggest worry for investors in bonds, because rising rates hurt the value of existing bonds. The U.S. Federal Reserve has signaled it will begin to raise rates sometime in the near future. But exactly when they will begin hiking rates is uncertain. The Central Bank is still walking a fine line: if they raise rates too soon they risk strangling the global recovery, but if they wait too long they risk inflation.

Even without the Fed's likely moves higher, an increase in the supply of Treasuries may cause rates to begin to move higher, and the riskier bonds that have performed the best over the past year will likely drop in value. After such strong performance, corporate and high-yield bonds are no longer cheap, and are vulnerable to a drop if the economy doesn't improve as rapidly as many hope, or if interest rates begin to rise. Also, U.S. Treasuries are likely to do poorly as the Federal deficit balloons and rates begin to rise.

Currently we are finding the most value in emerging market bonds, which continue to offer attractive yield potential in 2010. Emerging market countries also are decreasing their debt as a percentage of their GDP, as opposed to most developed nations which are increasing their debt to GDP ratios as they deal with the economic crisis. Even so, the debt of emerging countries is still subject to a fairly high level of sovereign risk. In short, although we expect foreign bonds to outperform their domestic counterparts, we don't expect much in the way of returns from any bond sector in 2010.

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