



MARKET REPORT

SECOND QUARTER 2009

THE ECONOMY

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As we head into the second half of the year the global economy remains in a fragile state. The effects of the unwinding of the huge corporate and consumer debt bubbles have caused massive wealth destruction, and it is not over yet. But the economic picture is much better now than it was a few months ago. In early March many economists were predicting a very dire scenario – this was when the conversation about the possibility of a worldwide depression was at its loudest. Now, although we still face significant challenges and there's no shortage of negative forecasts (especially on employment), it appears that the outlook for the global economy is much improved and the prospect of a meltdown of the financial system has past. Economic activity continues to worsen around the world, but it is doing so at a slower rate, which suggests that we are getting closer to an economic bottom. The debate now mostly centers on when the recovery in economic growth will begin, and if the recovery will be quick and powerful or slow and weak.

After much research, the McKinley Carter investment team is of the opinion that the economic recovery may begin by year end, but it will be a very weak and slow recovery. Governments around the world have provided massive stimulus and have demonstrated they will do whatever is necessary to avoid an economic calamity. But while the massive bailout and stimulus spending probably allowed us to avoid a depression, it (along with longer-term demographic factors such as spiraling health-care and other entitlement spending) is also causing the federal deficit to balloon, which could lead to a weaker dollar and inflation down the road.

In the years ahead both consumers and businesses will likely exhibit lower spending habits as they both pay down debt and increase savings. In effect, the global economy needs to be reset to the level where it might have been without the artificial boost of the credit bubble. The key to an economic turnaround is housing, which started the cycle of damage. The housing market is showing signs of bottoming, with stronger demand and historically high levels of affordability. But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle. There are more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments, and high unemployment will make things worse. The length of time it takes for the housing market to reach a bottom will go a long way to determine the sustainability of a rebound in economic activity.

What will be the repercussions of huge government spending and intervention in financial markets? Some argue that these actions will create an environment of slower future growth and inflation. We agree, but believe those concerns may be years away. We do not believe inflation is currently a threat because there is an enormous amount of excess manufacturing capacity and available labor so it is unlikely there will be higher costs to pass along. Inflation that is driven by strong increases in demand is unlikely as well. Over the intermediate-term there is even some concern that deflation could take hold if the global economy doesn't experience a sustained rebound. However, looking out a few years, the bigger risk is that policy makers' efforts to avoid a deflationary cycle are too successful and trigger a run up in the inflation rate to modestly high levels or worse. But if the stimulus is unwound too early the economy could relapse. In any event, there will be great political pressure to deal with on both sides of the issue.

THE STOCK MARKET

After a horrendous 2008 and a dismal first quarter in 2009, the second quarter saw robust gains – stocks in general had their best quarter in more than 10 years. In April and May investors regained their appetite for risk and dove headfirst into all stocks, but mostly into those stocks that promised to come out of the recession best positioned to profit the most from a rebound in demand. Valuation was only a secondary consideration, if at all. In June investors became more cautious, and stocks were only able to add small gains on to the big gains in April and May. Overall stocks closed the second quarter with their biggest three-month gain in more than 10 years. The large-cap S&P 500 Index gained 15.9% for the quarter, and is now up 3.2% for the first half of 2009. The small-cap Russell 2000 Index surged 20.7% in the second quarter, but year-to-date is up only 2.7%. (All returns are on a total return basis.) Growth continues to significantly outperform value, especially within small capitalization companies.

Despite losing ground in June stocks scored even larger returns overseas, particularly in emerging markets. The MSCI EAFE Index of large companies in developed countries soared 25.4%, bringing its year-to-date gain to 8.0%. The Vanguard Emerging Market Stock Index gained 34.2%, which is also its year-to-date return. China and Brazil each gained over 25%, and India gained almost 50%. The outlook for these and other emerging economies improved during the quarter when the group of 20 industrial and developing nations made the decision to put more money into the

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THE BOND MARKET

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International Monetary Fund to deal with the financial crises. This move will primarily benefit emerging economies. Most economists are predicting GDP growth in 2009 to be around 6% in emerging markets, compared with declines in developed markets.

In developed European markets, like in the United States, the biggest gainers in the second quarter were riskier companies that had weaker balance sheets. Many investors were anticipating a strong economic recovery and bought stocks in the more cyclical sectors while selling stocks in more defensive sectors. However, by the end of the quarter, investors around the world were having second thoughts about the strength and sustainability of the recovery.

As we reflect on a tumultuous first half of the year and look ahead to the rest of the year, we are struck by the degree to which conflicting signals characterize the investment environment. Economic activity continues to worsen but at a decreasing rate. However, the consequences of massive wealth destruction and the unwinding of too much private-sector debt continues to be a drag on economic activity and the stock market. This uncertainty makes it difficult to see with any certainty if stocks can continue to climb the rest of the year. The severe recession appears to be triggering the end of a multi-decade run of disinflation and falling interest rates, debt growth, rapid consumption, and risk taking, which seems more likely than not to result in a period of adjustment with increased regulation, debt reduction, less consumer spending, and a more cautious view toward risk taking.

This is why we believe that while the market should recover over the next few years, investors will display higher-than-normal aversion to risk. Returns from stocks (and bonds) over the next five years will likely be less than might be expected coming out of a recession. As a result, we believe that investors would be wise to look at investments outside of plain vanilla stocks and bonds and toward alternative investments such as commodities, high yield bonds, real estate and long/short strategies.

A reversal from the "flight to safety" that occurred during the height of the crisis led to a recovery in the riskier fixed income markets during the second quarter. Many investors that previously worried about losses decided they didn't want to miss out on the rally in corporate debt and other riskier assets. Every bond that was deemed to have a higher risk profile than Treasuries rallied while the Treasury market posted record declines.

As global economic conditions improved, credit markets thawed and more borrowers were able to raise cash. As a result, corporate bonds rallied after posting a large loss the previous two quarters. The total return on the iShares Investment Grade Corporate Bond exchange traded fund was 8.8% in the quarter. Conversely, Treasuries as an asset class dropped 3.1% for the quarter. For the first half of the year Treasuries have dropped 4.5% on average, which is the worst six-month performance in the history of Merrill Lynch's Treasury Master Index, according to the Wall Street Journal.

High-yield, or "junk" bonds, which are issued by companies with speculative-grade credit ratings, benefitted from investors' return to risky assets and rebounded strongly for the quarter. The gap between yields of these bonds and those of Treasuries contracted to 3.3 percentage points from six percentage points at the end of March. This gap is a widely cited measure of how much risk investors are willing to assume, and at the end of the second quarter it was back at levels last seen before the failure of Lehman Brothers precipitated the credit crunch.

As the next few months go by and investors receive further clarity on when the economy will begin to grow, we will find out if this risk-taking posture was warranted or not. Already there have been signs the recent rally in riskier assets could be running out of steam. Toward the end of June corporate bonds had given up some of their gains as more people became worried that the recovery in the economy won't occur as soon as everyone had hoped. This would lead to additional defaults among individuals and corporate borrowers. As with the stock market, a great deal hinges on the ability of Government's ability to restart economic growth without causing inflation. As with stocks, this tug-of-war will likely cause much volatility in bonds but below average returns over the next several years.

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