



MARKET REPORT

THIRD QUARTER 2009

THE ECONOMY

Economic conditions around the world are improving, but the recovery is fragile. The emerging market economies could provide the source of growth needed to prevent another economic downturn.

As we look back on the past twelve months it is clear that we have been living through a period of historical significance. One year ago the rapid deterioration of the United States' residential real estate market was causing a crisis in the world financial system unlike any in modern memory. The stunning failure of major financial institutions in August and September of 2008 triggered a series of events that shut down lending and almost caused a collapse of the global financial system.

Government policymakers embarked on a bold course of fiscal and monetary stimulus, with the goal of stabilizing the system. In March of this year, the Government's efforts were being seen as too little, too late. Talk of a return to a depression-like economy was common. Fearful investors responded to these predictions by selling stocks, causing the most severe drop in global stocks in quite some time, with financials faring the worst.

That point in time appears to have been the turning point in both the economy and the stock market. Although the Government's efforts couldn't prevent the recession from becoming one of the worst since the 1930's, they have prevented the global financial system from collapsing. Although there remain real problems in the economy, it looks like economic activity has bottomed. During the third quarter economic data on several fronts were surprisingly strong, in part fueled by significant Government incentives to induce consumers to spend.

Housing activity is beginning to recover and prices are stabilizing. Sales of existing single-family homes moved higher for four consecutive months from April to July as buyers capitalized on the temporary Government tax incentive. Lower prices and mortgage rates have boosted home affordability, while a lack of new home construction is reducing inventory. Automobile sales also staged a sharp summer rebound, boosted by the "cash for clunkers" subsidy. Most categories of retail sales posted solid increases in August.

The manufacturing recovery in the United States that began in July continued in September. Initial jobless claims are gradually moving lower, business investment is starting to stabilize, and U.S. exporters are benefitting from a weak dollar and an increase in economic activity outside the U.S. Most economists now believe that global GDP will return to growth in the second half of this year. However, the global economy is just in the initial stages of a very fragile recovery that is extremely dependent on Government assistance and remains vulnerable to any disappointing news. Unemployment continues to be a concern; the September payroll report indicated that the economy lost an unexpectedly high number of jobs in September, and the unemployment rate rose to 9.8%.

Looking ahead, it appears that subdued growth and a weak recovery are the most likely scenarios, and a few bumps along the way should be expected. The global economic picture is brighter than domestically - economies around the world will benefit from an emerging middle class in markets such as China and India. The increase in an educated, technologically well-equipped middle class in these regions should provide a source of demand for the entire world and possibly prevent another global economic downturn.

THE STOCK MARKET

Just six months ago many people were convinced the stock market would never recover, but stocks have since staged a dramatic rally off the lows in March. The S&P 500 Index of mostly large capitalization U.S.-based stocks rose 15.6% in the third quarter. That index is up 19.3% in 2009 and is now nearly 60% from the bottom in March. Foreign stocks continued to outpace their U.S. counterparts, with the MSCI EAFE Index of large cap stocks in foreign developed countries gaining 19.5% in the third quarter and 29.0% for the year-to-date. The small-cap Russell 2000 Index gained 19.3% in the quarter, and is up 22.4% this year. Mid-sized companies was the best performing category in the United States, with the Russell Mid-cap Index gaining 20.6% for the quarter and 32.6% year-to-date (all returns are total return including dividends).

Emerging markets equities continued their sharp rally, with the MSCI Emerging Market Index up 20.9% for the quarter and 64.5% year-to-date. Although the pace of the advance in the emerging markets slowed dramatically toward the end of the quarter, stocks in India gained 18%, stocks in Brazil gained 20%, and stocks in Turkey gained 30%. China's Shanghai Composite Index was one of the few that fell in the third quarter, down 6.1%, after soaring almost 63% in

Stocks have staged quite a rebound thanks to Government stimulus. Although real problems remain, growth in emerging markets should provide the demand needed to lead the recovery and prevent another stock market downturn.

THE BOND MARKET

Bond prices rose as many feel that the recession has ended. But the economy remains weak with many problems. Going forward returns in the fixed income markets could be much lower than normal.

the first half of the year. Worries have arisen the past few months that the pace of the Chinese recovery is too dependent on the Government and is unsustainable.

In the United States, the big gains followed a brutal period which saw most stock indices lose more than half their value from October of 2007 to March of 2009. Even after this year's gains the S&P 500 is still down 6.9% from October of last year and more than 30% off its highs in October of 2007. But the rally gained momentum during the third quarter as the economy showed signs of stabilization and investors realized that the economy is not sinking into a depression. Corporate profits have rebounded the past few quarters, but this has been mainly due to cost cutting. That is normal during this phase of the economy's recovery, but the key to stocks' ability to push higher will be if companies can increase profits through increases in the demand for their products and services and not just cost cutting.

The stocks that have led the market higher have been the companies that benefit the most from a rebound in economic activity. Financial, technology and consumer companies have led stocks higher. Foreign stocks have benefitted from the expectation that economic growth will be stronger overseas than in the United States. The International Monetary Fund projects the global economy will grow by 3.1% next year. Emerging countries are expected to grow by 4.7%, but the U.S. is only expected to grow by 2.8% in 2010. Companies around the world, including those in the U.S., will benefit from the growing middle class in the emerging markets. These markets will be the source of growth in demand for consumer products, and also cause a continuation of the need to build out the infrastructure within these countries as people move into the cities.

For now, investors are feeling better that the economy has bottomed and is beginning to grow again. But many are still nervous due to concerns that consumers remain hobbled by debt, unemployment remains high and home prices are still depressed. Longer term, additional risks to growth loom such as increased regulation, taxation, inflation, and an aging population. The U.S. economy has been benefiting from ongoing Government support, and question about the timing of the removal of this support is being debated. How these issues play out will determine if this is the beginning of a sustained rally in the stock market.

Our view is that the market will continue to rise as the economy recovers. However, the returns in the stock market will be moderate compared to other periods of economic recovery due to the uneven nature of the recovery and the long term drag that Government spending will have on the economy.

Bonds also rose as credit conditions improved across the board. The Barclays Aggregate Bond Index was up 4.0% for the quarter and is now up 6.2% so far in 2009. Corporate bonds rose, with investment-grade corporate bonds up 8.2% and high-yield, or junk bonds, up nearly 15% on average. The total return of almost 48% for junk bonds this year is well above the returns in most areas of the stock market. The credit market is getting back to normal, and financially strong companies are now finding it relatively easy to borrow.

U.S. Treasury bonds were up 2.1% during the quarter despite worries that foreign central banks would scale back purchases. The Federal Reserve has used all of the tools in its arsenal in order to stimulate the economy, and its purchases of Treasuries and mortgage-backed securities helped keep yields low, which translate into lower home-mortgage rates.

So far the stimulus provided by the Federal Reserve and the U.S. Government has not been inflationary. The weakness in the economy is preventing the Government's unprecedented monetary and fiscal stimulus from having the inflationary effect it normally does. There is too much labor and raw materials and too little demand for products and services, keeping prices low. Also, banks are not lending as much, preferring to keep more funds on their balance sheets in order to maintain a cushion for potential bad loans. As a result, the stimulus has yet to create new jobs and will not be inflationary over the next twelve months. Longer term, however, as the economy recovers the demand will return and inflation could become a problem, but we don't believe this will occur until late next year at the earliest.

Meanwhile, low short-term rates and measly returns from safe investments such as money-market mutual funds have prompted investors to seek higher yields and move money into riskier assets. Many now feel that the recession has ended, but the economy remains weak and many problems still exist. After such strong returns recently, going forward returns in the fixed income markets could be much lower than normal.

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