MARKET REPORT

FIRST QUARTER 2009

THE ECONOMY

Economic conditions around the world continued to deteriorate during most of the first quarter of 2009. But just when things looked like they would never improve and many market pundits were predicting a Depression-like scenario, economic data points from around the world began to improve. Signs are beginning to indicate the global economy may be bottoming, and the recovery everyone has been waiting for might actually arrive later this year. In the United States, reported results for March's retail sales, housing starts, new home sales, existing home sales, and durable goods have all come in better than what was expected. The Conference Board Leading Economic Indicator increased in both December and January before posting a slight drop in February. The Institute for Supply Management's (ISM) manufacturing report also came in slightly ahead of expectations in March, and the gauge of new orders rose from February to March.

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The trend in the economic data is certainly better than many peoples' depressed expectations, especially the housing numbers. Governments around the world are making a coordinated effort to stimulate the global economy through monetary and fiscal actions. In the United States consumers will begin to see the benefit of tax cuts which will start to take effect on April 1. The announcement in March that the Federal Reserve will purchase $300 billion of longer-term Treasuries over the next six months has lowered interest rates, driving up the levels of mortgage refinancing. Together these moves will provide a significant lift to consumer spending the remainder of this year. Overseas there also are signs that conditions may be bottoming. Manufacturing statistics have been improving, most notably in Europe and China. The Japanese and Korean governments have both recently announced national programs to increase employment.

This global recession is not over, and there are still problems in many economies around the world. Soon, the current recession will be the longest on record in the United States. Job losses continue at an alarming rate, and the unemployment rate continues to rise. The auto industry is in serious trouble and General Motors may need to be restructured in bankruptcy proceedings (possibly Chrysler too). The worldwide financial system remains in an extremely fragile state. These developments ensure that the negative news will continue for some time. But the recent encouraging economic numbers suggest that Gross Domestic Product (GDP) growth could begin to show improvement (that is, be less negative) in the second quarter, and may even turn positive by the fourth quarter of 2009. It is possible that the first quarter of 2009 could mark the weakest period of the current recession.

The recent positive developments reinforce the McKinley Carter investment team's view that economic conditions will not parallel those of the 1930's. A comparison of the facts further illustrates the point. During the Great Depression, GDP fell a total of 29% from its peak. The current downturn has seen GDP drop a total of 4.3% so far (both numbers are non-annualized). Although GDP might still drop the next several quarters, it is not expected to come close to depression levels. Unemployment peaked during the Depression in 1932 at 25%. The current rate stands at 8.5%, and most economists are predicting a peak unemployment rate of around 10%. Also, the existence of social security and unemployment benefits today makes the current economy much more stable than that of the 1930's.

THE STOCK MARKET

Stock market volatility reached new heights during the first quarter. Investors have seen numerous large price swings in the stock market take place in just a few days that usually take years to occur. For example, if one uses the textbook definition that a bull market occurs when the stock market rises at least 20% and a bear market occurs when the market drops 20%, the first quarter actually contained both a bear market and a bull market. From the end of last year to March 6, the S&P 500 Index lost 25% of its value. But just when economic conditions appeared darkest, stocks soared over 23% in a rally over the next 13 trading days. By the end of the quarter, and despite the rally, the stock market had dropped for the sixth straight quarter, the first time that has happened since 1970.

During the first three months of the year the S&P 500 Index of mostly large U.S. companies fell 11% and the Russell 2000 Index of smaller companies dropped 15% on a total return basis. Overseas the market fared no better, with the MSCI EAFE Index of developed countries falling 13% for the quarter. Although stocks around the world posted losses in the first quarter, the rally toward the end of the quarter certainly was encouraging. As we've noted before, the stock market will typically begin to advance while economic conditions are still declining as investors anticipate a recovery

before economic improvement is clearly visible. This appears to be the main reason for the recent rise in stock prices, although the rally lost a little steam during the last few days of the quarter when investors began to worry again that the upcoming quarterly corporate earnings announcements would be dismal. Investors also began to doubt how successful the Federal Reserve will be in stabilizing the mortgage market and spurring economic growth by aggressively purchasing Treasuries and mortgage securities. These concerns prompted investors to view the bounce as an opportunity to lock in gains, however small they may be relative to the recent losses.

The rally toward the end of the quarter certainly was encouraging, but concerns remain. The rally was driven by a string of positive developments during the month of March. A continuation of the rise in stock prices depends largely on a continuation of improvement in economic data.

But despite these concerns many remain optimistic that the market will continue to trend higher because the rally was driven by a string of positive developments during the month of March. We finally received some positive economic news both in the United States and overseas, particularly in China where manufacturing is starting to rebound. In the United States consumers are starting to show signs that they have begun to spend again, and housing data is beginning to indicate that the drop in prices is starting to bottom. Also, some major U.S. banks announced in March that they were profitable the first two months of the year. Firms in many other industries have reduced their inventories, which will put them in a better position to grow production in the future. Investors also remain optimistic that the Obama administration's bank recapitalization plan and the various moves by the Federal Reserve designed to lower interest rates will further spur economic activity.

By mid April, we will see if investors will resume buying stocks or if the recent rally was built more on hope than reality. Whether the rally continues or not depends largely on a continuation of positive economic data points. Without a doubt, sentiment towards stocks is much better as the second quarter begins than it has been in many months. In April we will begin to see clues about whether the economic downturn is bottoming, or if the bottom is still several quarters away. Corporations will report earnings beginning in the second week of April, and various economic reports will be reported before then, which will give clues as to whether business is stabilizing. If corporations at least meet expectations the market should keep climbing, but if they disappoint the rally could lose steam.

The Bond Market

The improvement in sentiment in the stock market did not translate into much improvement in the credit markets. Government programs helped to stabilize short-term debt markets, and there were some successful issues of new debt raised by higher-quality companies. But investors are still not comfortable investing in fixed income investments of lower-quality companies while the economy continues to struggle and the United States Government piles up debt. In addition, banks and other financial institutions have received more government bailout money, yet can only raise cash with the help of government programs that either inject capital or guarantee debt; investors are still not willing to buy securitized debt from these firms.

Although there has been an increase in investors' willingness to assume risk, recovery in the bond markets has proven to be extremely difficult. Bond investors hope that the bond market will improve as the Federal Reserve and Treasury programs have more time to take effect.

Although a recovery in the bond markets has proven to be extremely difficult, the hope is that the situation will improve as the Federal Reserve and Treasury programs have more time to take effect. The programs initiated in the past quarter are designed to stimulate the credit markets and keep interest rates low in an effort to provide a boost to the economy. Working together, the two branches of the United States government increased their purchases of securities backed by mortgages, bought back Treasuries, and began efforts to bolster bank balance sheets and spark lending to consumers and businesses.

Looking at interest rates, the moves have largely done what they were intended to do, although it is not clear if the improvements in rates will provide the boost to economic growth that is needed. The average 30-year mortgage rate is below 5%, which has generated a surge in mortgage refinancing. But despite the government's Treasury purchases, the 30-year Treasury-bond still fell in price and is now yielding over 3.5%. Investors remain worried about all of the additional bonds that must be issued in order to fund all of the various bailouts. The 10-year Treasury also dropped in price and its yield is up by 0.5% to 2.7% at quarter-end. One positive development in the bond market has been an increase in the willingness of investors to assume additional risk. According to the Wall Street Journal, an investment in junk bonds on average returned more than 5% since the start of the year, versus a 10-year Treasury return of negative 3.3%.

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