



MARKET REPORT

FOURTH QUARTER 2008

THE ECONOMY

After a year of disturbing developments, the U.S. Government's swift response to the financial crisis should allow us to avoid a depression-like drop in economic activity.

2008 will long be remembered as one of the most turbulent years in history as many unprecedented events left unsettled conditions around the world. Worldwide economic activity fell off sharply late last summer. The downward spiral intensified during the fourth quarter, plunging economies in the United States and many other countries into a recession. The price of crude oil surged to a peak of around \$147 per barrel, and then sunk to around \$37 as global economic weakness deepened. The subprime mortgage crisis and the resultant credit crunch caused numerous well-known banks to either fail or be acquired and caused a major restructuring in the U.S. financial system. The investment banking business model as we know it, would be a thing of the past, as all five major investment banks were liquidated, acquired, or converted to commercial banks.

The automobile industry is in serious trouble, and the possibility of one or more U.S. auto companies filing for bankruptcy is very real. Retailers had a disappointing holiday season, unemployment is rising, house prices remain depressed, and the Federal Reserve slashed its forecasts for growth. As if investors needed additional reasons to mistrust Wall Street, Bernard Madoff, the former head of NASDAQ, was accused of running a \$50 billion Ponzi scheme. The stock market reacted to all of this by suffering its worst one year drop since 1931.

With the economic picture bleak, are there any signs for optimism that the U.S. can soon emerge from the recession and begin growing again? We believe the main reason for optimism is the U.S. Government's fast, aggressive policy response from both a monetary and fiscal perspective. It appears that the lessons learned from the mistakes that were made in the years leading up to the 1930's may enable us to avoid a more severe, protracted period of economic weakness.

The Federal Reserve and the U.S. Government acted swiftly with what could ultimately be the largest economic stimulus effort in U.S. history. The Fed dropped its target for the Fed Funds rate to an unprecedented low near 0% and doubled the amount of credit it provides in order to inject liquidity into the financial system. The Fed also committed to purchase \$800 billion of troubled mortgage, agency and consumer debt. Meanwhile, the U. S. Government committed \$700 billion to the TARP plan, which includes a massive recapitalization of the banking system. Both the Fed and the Government promise to do much more in 2009. At some point these policy initiatives will become a burden to the Government's budget and increase inflationary pressures. For now, however, most economists agree that they are necessary steps to stabilize the economy and are the main reason why the current situation, while difficult, should not worsen to the point where we enter an era similar to the Great Depression of the 1930's.

THE STOCK MARKET

In 2008 the stock market experienced a historic sell-off, and there was nowhere to hide as every economic sector experienced large declines. Investors sold stocks and fled to ultra-safe Treasuries. Essentially, just about any investment not backed in some form by the U.S. Government experienced large drops in price. Treasury bonds were up 14%, while the S&P 500 Index of large-cap U.S. stocks was down 37.0% and the Russell 2000 Index of small-cap U.S. stocks was down 33.8% on a total return basis. Foreign stocks fared even worse, with the MSCI EAFE Index of foreign developed-country equities falling 43.1% and the MSCI Emerging-Market Index plummeting 53.2% - in both cases their worst annual performance on record. In the United States, the past ten years rank as the worst ten years in the history of the market dating back to 1825 and including the Great Depression. During this time stocks, as a broad group, are negative for only the second time in history and their performance trails that of almost every other asset class, including Government bonds, gold and even real estate.

Although it may seem counterintuitive, we believe that now actually may be a good time for long-term investors to be invested in stocks. Certainly the headlines will remain troubling with a global recession, rising unemployment, rising credit card delinquencies, and the turmoil in the U.S. auto industry. As grim as things may appear it is important to remember that periods of uncertainty and negative sentiment sometimes offer investors attractive long term data which indicate that after a long and severe decline, equity markets tend to provide very good returns. Ten year periods of

Stocks usually begin to recover halfway through a recession, so although stocks dropped substantially in 2008, investors who remain patient and disciplined will be rewarded when the recovery occurs.

THE BOND MARKET

A flight to safety caused an extreme disparity in fixed income asset prices as Treasuries rose but corporate and municipal bonds dropped.

below average performance in the stock market, like we have just experienced, are usually followed by above average performance. The rebounds don't always come immediately, but they do come. In 1931, the Dow's worst year ever, the index fell 53% and then declined 23% in 1932. Not until 1933 did the market recover with a 67% gain.

That being said, what will 2009 look like? We know that the recession will last at least another few quarters, so corporate profits are likely to keep falling. However, it is important to keep in mind that during the 14 U.S. recessions since 1926, the stock market has generated a positive return in more than half of the instances, and the average return for all recessions is nearly 9%. On average, the stock market has begun to recover about halfway through a recession, with the typical rebound being about 25% from market low point to the end of a recession. Typically new bull markets tend to begin during a period of economic weakness, not after. Bear markets that have occurred during past recessions have ended during those recessions 73% of the time.

Many stocks are now trading at extreme discounts to their intrinsic value and most certainly will be worth more in a couple years. Valuations for both U.S. and global equities are now well below long term averages and dividends are at the highest level in a decade. U.S. stocks reached a price-to-earnings (P/E) ratio of about 13, below the historical average of about 16. Foreign P/E ratios, for both developed countries and emerging markets, dropped below 10 and are at their lowest levels in more than two decades. Many market gurus who had been bearish for some time have begun to change their outlook on the stock market and have become bullish, citing low valuations and low interest rates. In 2009 investors' fear of risk may give way to bargain-hunting, with plenty of stocks at prices not seen in years.

The theme in fixed income markets during 2008 was the same as the equity markets: risk aversion and a flight to safety. As last year's tumultuous economy sent many investors running to safe U.S. Treasuries demand skyrocketed, prices rose and yields tumbled to record lows. Treasuries were by far the best-performing fixed income category, returning about 14% for their best year since 1991. Meanwhile prices of corporate and mortgage bonds sank sending yields soaring. Investment-grade corporate bonds lost nearly 7% and corporate "junk" bonds fell 26% in 2008 on a total return basis. At the end of the year the yield spread between corporate bonds and Treasuries, a measure of investors' risk aversion, was higher than what it was during the Great Depression.

The year was marked by unprecedented moves by the Fed and Treasury, which committed billions of dollars in attempts to restore order in the credit markets. The Federal Reserve cut its key interest rate seven times in 2008 in an attempt to boost the economy, leaving its target near zero. The Government also increased its lending to financial institutions in order to inject liquidity into the markets. In order to restore investors' confidence, the Government also provided guarantees on some bank and finance-company debt and effectively guaranteed parts of the short-term markets. To restore consumer confidence the Government also took steps to lower residential mortgage rates and to ensure that consumers can obtain loans.

The full impact of many of these actions remains to be seen, but so far investors appear to have reacted favorably. However, it is still difficult for some companies to sell certain bonds. While credit markets rebounded somewhat in the final weeks of the year, the yield differential between corporate bonds and asset-backed securities as compared to Treasuries, or the spread, remains very wide. This makes it more expensive for many companies to issue new debt.

As we enter the New Year many bonds are at their cheapest prices in decades. While the economy is clearly struggling, we believe that the fixed income market is priced for a worst-case scenario. With corporate defaults expected to rise substantially in 2009, more volatility will undoubtedly be in store for the credit markets. But, our view is that at some point during 2009 investors will recognize the opportunities that exist in high quality corporate bonds (which are yielding up to 6%) and municipal bonds (which are yielding up to 5%) versus money market accounts (which are yielding less than 1%). As the appetite for risk slowly returns cash should move out of money markets into these sectors. We believe that the Federal Reserve's reduction in short term rates to near zero are at least partly intended to force money out of money market funds and back into stocks and bonds in search of returns.

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