



MARKET REPORT

FOURTH QUARTER 2009

THE ECONOMY

The conflicting evidence suggests a sustainable yet subpar economic recovery. The transition from Government-dependent growth to private sector demand-led growth should occur in 2010, but the process will be difficult.

The global economy may have turned the corner during the fourth quarter of 2009, and as we begin 2010 economic growth appears to be gaining traction. However, the recovery is still very weak and dependent on Government support. Although the U.S. and other Governments will continue to provide monetary and fiscal stimulus, at some point demand from the private sector must improve in order for the recovery to last.

For example, corporate earnings have rebounded strongly due to aggressive cuts in labor and other costs. Corporations are now operating very efficiently, and any increase in demand will quickly boost profits. But it remains to be seen if businesses and consumers will increase their spending and create the necessary demand.

There are reasons to be optimistic. Despite rising energy prices, the Federal Reserve is so convinced inflation will remain subdued that it has indicated it will keep the Federal funds rate low for an indefinite period. The employment situation is slowly improving. Inventories will need to be restocked after many corporations allowed them to be depleted last year, which will have a positive impact on growth. And the emergence of an educated, technologically savvy middle class in new markets such as China and India should provide a source of demand for corporations around the world.

But there are also many risks that could derail the global economic recovery. Consumers in the U.S. and other developed nations are in the process of paying down debt, which will continue to be an economic headwind. In the United States household debt levels doubled in the last decade on an absolute basis and were 50% higher when compared to Gross Domestic Product (GDP). Higher debt payments, job insecurity, and uncertainty about the economic future makes it very likely that consumption growth will be subpar compared to the recent past.

Governments around the world have been filling the void created by the lack of consumer spending with expansionary monetary and fiscal policy. The Federal Reserve and European Central Bank both have disclosed plans to withdraw much of the emergency liquidity they supplied during the crisis. Over the next several years Government spending will have to decrease and taxes will have to increase, which will seriously constrain economic growth.

Another result of the past two years is likely to be stricter regulation. Currently the U.S. Government is increasing its regulatory oversight in hopes of preventing another financial crisis. It is possible that the combination of lower consumer spending, reduced Government stimulus and stricter regulation will cause businesses to become even more cautious and delay expansion plans. A lack of corporate borrowing and spending would lead to another drop in economic growth.

The uncertain housing situation is another economic headwind. About 25% of homeowners currently have mortgage balances more than their homes are worth. Meanwhile, mortgage delinquencies are rising again. Another wave of foreclosures amid continued high unemployment makes it unlikely that home prices have bottomed.

We believe that the conflicting evidence suggests a sustainable yet subpar economic recovery. The transition from Government-dependent growth to private sector demand-led growth should occur in 2010, but the process will be difficult. The result is likely to be a year of only modest 2% - 4% GDP growth, which is much lower than the typical growth after such a dramatic downturn, but it is a lot better than what we've just been through.

THE STOCK MARKET

When the dust settled on one of the most eventful years in memory, most stock indexes had big gains for the year. After a disastrous 2008 and first quarter of 2009, stocks finished the year with a powerful run that began in early March and continued through the end of the fourth quarter. Large-cap stocks as measured by the Standard and Poors 500 Index gained 6.0% in the final quarter and 26.5% for the year. In both the quarter and the full year, growth stocks sharply outpaced value. Between larger-caps and smaller-caps, returns were pretty similar, but mid-caps did the best; the Russell Midcap Index posted a full-year return of 40.5%.

The equities of emerging-market countries handily beat developed-market countries, including the U.S. The MSCI Emerging Market Stock Index was up 8.6% in the fourth quarter to bring its full-year gain to 78.5%, versus a gain for the predominately developed market MSCI EAFE Index of 2.2% for the quarter and a still-impressive 31.8% for the year.

These gains were made possible by the unprecedented efforts to restart the financial system and stimulate the economy by Governments around the globe. Investors who had fled from all but the very safest investments in 2008 dove back into the most volatile stocks. Companies in sectors that had taken the biggest beating surged the most. Many companies posted big stock gains simply because they weren't going out of business.

Stocks rallied strongly in 2009 as Governments around the globe undertook unprecedented efforts to stimulate the economy. In 2010 gains will be harder to come by and limited to those companies that are actually growing.

THE BOND MARKET

Improvement in the economy combined with extremely low interest rates created the incentive to take on risk and pushed the riskiest bonds to substantial returns in 2009.

It is safe to say that during the first half of the year very few would have predicted that markets would rebound so strongly. In 2010 gains will probably be harder to come by and limited to those companies that are actually growing. In order for the advance to continue, investors will need to see gains in corporate revenues and real improvement in the economy.

There are many reasons to be optimistic. As we enter 2010 the stock market continues to benefit from low interest rates that are still providing the necessary liquidity for the economy to repair itself, and from the Federal Government's stimulus that continues to pour into the economy. Stock-market valuations are not cheap anymore, but they are attractive relative to other assets. Many corporations, especially large companies, expect the economy to continue to improve and are giving increasingly upbeat assessments of their business expectations over the next year.

However, while larger corporations have seen their access to credit improve as their businesses stabilize, smaller companies have not. Small businesses are still facing challenging operating conditions and are having difficulty obtaining credit. Continued weakness in the small business sector makes us somewhat cautious, but overall the combination of better credit availability, improving employment and rising manufacturing activity could push the economy and stock market higher through the end of 2010. We believe, though, that the market's rise will be much less than in 2009 with some disruptions along the way.

We believe that stocks should continue to outperform bonds and cash. Foreign stocks, especially those in emerging markets, will do better than domestic stocks thanks to stronger economic growth and more attractive valuations. Within U.S. stocks, large-cap, high quality stocks are positioned to do well thanks to an improving economy, low interest rates and attractive valuations. They also receive a greater percentage of their business from foreign countries, and will benefit from a weaker dollar and the demand coming from a growing middle class in emerging markets.

During 2009 there was a dramatic reversal of returns in the fixed income markets. In 2008 Treasuries were the only fixed income sector that produced a positive return, but in 2009 Treasuries were the only sector to produce negative returns. Every other bond sector produced positive returns, and as was the case for equities, the riskiest and most speculative bonds provided the best returns.

The Barclays Aggregate Bond Index gained 6.4% for the year, but U.S. Treasury notes and bonds, the safest securities in the world, lost anywhere from 6% to 15% with the longest maturities losing the most. High-yield bonds, the most speculative corporate bonds, soared. The Merrill Lynch U.S. High-Yield Cash Pay Index gained 56% for the year.

Extremely low interest rates, the strong stock market rebound and improvement in the economy boosted confidence and increased investors' willingness to assume risk and seek higher potential returns. If interest rates stay low and the recovery takes hold, it is possible that the more risky sectors in the bond market will do well again in 2010. But 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.

The U.S. Federal Reserve has been very clear that it intends to keep the Federal Funds rate near zero, but they will need to raise rates eventually. Central banks around the globe are still walking a tightrope: if they raise rates too soon they risk strangling the global recovery, but if they wait too long they risk inflation. Either way, when rates do begin to rise the riskier bonds that have performed the best over the past year will likely drop substantially in value.

In 2010 we are not likely to see a repeat of the exceptionally good performance enjoyed by corporate bonds that occurred in 2009. Also, U.S. Treasuries are likely to continue to do poorly as the Federal deficit balloons and rates likely rise at some point during the year. 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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