



Unprecedented governmental efforts have thus far had the desired results, and financial markets have begun to repair. The future course of economic growth and potential unintended effects of the government stimulus are important wildcards. Given the strength of the potential crosscurrents, investors must stay selective.

The Economy and Financial Markets

A wall of financial stimulus and government guarantees have stemmed the economic decline and begun to restore order to the financial markets. All categories of stocks fell precipitously in the first two months of 2009. A subsequent powerful rally strongly favored low-quality stocks that had been decimated in 2008. As a result, the Standard & Poor's 500 Index produced a modestly positive six-month return and the Dow Jones 30 Industrials Index, which is dominated by somewhat higher-quality companies, produced a slight negative return. Most corporate bonds have produced attractive returns in 2009.

Two Key Questions

Two major economic questions face investors in the months and years ahead:

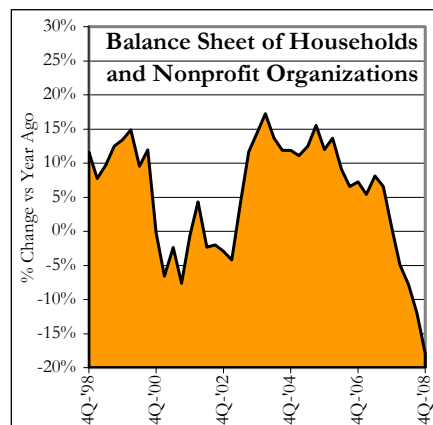
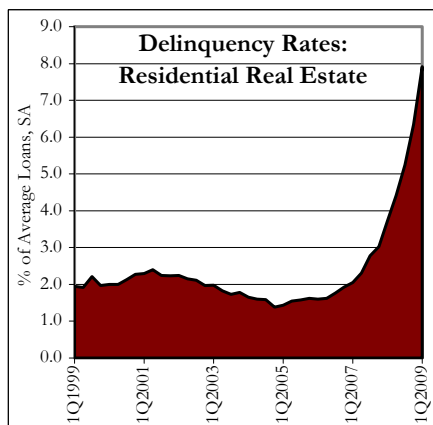
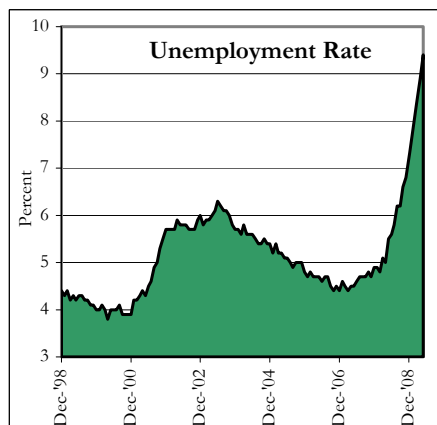
Can US consumers resume their established pattern of consumption and thereby help restore economic growth?

Will the unprecedented stimulus and money creation of the last eight months produce unintended economic dislocations such as high levels of inflation or financial bubbles?

The US Consumer

Since the 1950s the consumer has been the engine of US economic growth. Even as the consumer's income growth slowed in the last twenty years he regularly increased current consumption by saving much less and borrowing much more. For many years this live-for-the-day approach was supported by the availability of easy credit and a pervasive social attitude favoring current consumption.

Growth in consumer spending accounted for greater than three-quarters of US economic growth during the past twenty years. This growth was only partially supported by higher incomes. Consumers saved much less and borrowed much more in order to pay for the two decade long spending spree. For example, inflation adjusted annual per capita US savings declined from greater than \$1,800 in 1987 to about \$190 in 2007. During the same time, inflation adjusted average household debt increased from about \$56,000 to \$124,000.



<u>Market Indicators 6/30/2009</u>		
	Total Return	
<u>US Stock Markets</u>	<u>12 Mos.</u>	<u>Year-to-Date</u>
S&P 500 Index	-26.2%	3.2%
Dow Jones Industrials	-23.0%	-2.0%
NASDAQ Composite	-19.1%	17.0%
<u>International Stock Markets</u>	<i>ETF Returns in US\$</i>	
EAFE Index <i>(Europe, Australia, Far East)</i>	-31.0%	4.2%
Japan (MSCI Index)	-23.4%	-1.2%
China (Xinhau 25)	-11.0%	32.7%
Emerging Mkts Index	-27.1%	30.1%
<u>US Fixed Income Yield</u>	<u>12/31/08</u>	<u>6/30/09</u>
6 Mo US T-Bill	0.3%	0.3%
2 Yr US T-Note	0.8%	1.1%
10 Yr US T-Note	2.2%	3.5%

The downturn in real estate values, rapidly increasing unemployment and tighter credit standards quickly changed the consumer's spending, borrowing and saving decisions in 2008. It is impossible to tell if consumers will continue to spend less and save more in the years ahead or if they will return to the pattern of the last twenty years. More stringent lending standards and lower real estate values may affect loan availability. The average Baby Boomer is now 55 years old and only ten years away from the traditional retirement age. At the end of the last consumer recession in 1991, the average Baby Boomer had almost three decades to prepare for retirement.

Pending retirement, restrictive lending standards, and a societal shift favoring less current consumption may continue to dampen consumer spending for a time. However there is also the prospect that a future stabilization in home prices and employment levels may provide sufficient encouragement for consumers to resume their growth in consumption. The consumer's spending and saving decisions will dictate the level of US economic growth over the next three to five years.

Unintended Dislocations?

In order to ease the credit crisis and to rescue the financial system, various entities of the US Government and their counterparts in many major countries have stimulated the financial system to an unprecedented level. The Federal Reserve's balance sheet expanded from \$900 billion last September to \$2 trillion today as the Fed engaged in various activities to support the financial system. The US Federal budget deficit is now projected to reach \$1.8 trillion this year compared to \$161 billion in 2007.

During more normal economic times, large amounts of money creation and government deficit spending result in higher inflation. Weak underlying economic conditions and excess capacity in most industries have thus far counteracted the stimulus' inflationary effects. Longer-term, the Federal Reserve and other central banks will need to drain the majority of the stimulus funds from the financial system in order to avoid high levels of inflation or the creation of financial bubbles. Similarly, large budget deficits tend to encourage inflation, push interest rates higher and depress the value of the debtor's currency. The successful navigation of these difficult challenges will likely require the enactment of unpopular policies by the Federal Reserve, the Administration and by Congress.

Conclusion

The investment horizon is clouded by two major questions: the future spending pattern of the US consumer and the potential unintended consequences of Government stimulus. Answers to these questions will likely only come in increments, but they could have a major impact on asset values. Equity investors should own a portfolio of companies that will withstand a potentially challenging environment. Ideally, portfolio companies should have the financial strength to expand at the expense of weaker competitors during periods of slack demand. Attractive opportunities in the fixed income markets may appear less frequently than in the last nine months. Investors should be selective.