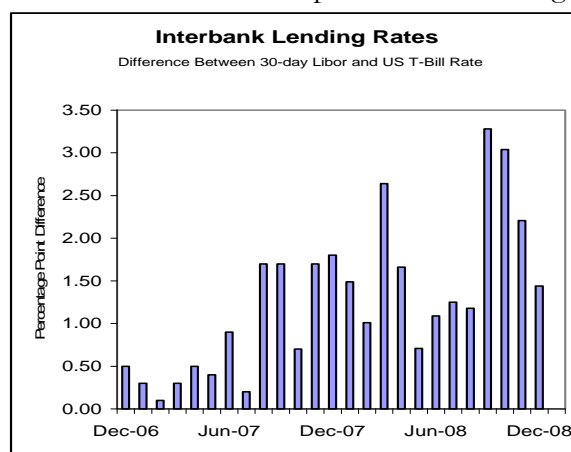


The economy continues to weaken but government intervention is unprecedented and likely to expand. With short term US Treasury rates near zero, high quality stocks and bonds may offer unusual long term opportunities. After disappointing results from unproven investments, investors are likely to return their focus to strategies backed by basic fundamentals.

Economic conditions in the US and around the globe continue to deteriorate. The recession, which began in the housing market, is spreading to virtually every part of the economy. In the US, consumers, financial institutions and other businesses are rushing to pay down debt and cut back on spending. This process of deleveraging is occurring simultaneously throughout the economy and its impact is painful and revealing: assets are losing value, unemployment is rising, and foreclosures and bankruptcies are increasing. In addition, many states and local governments are in a cash squeeze and, as is typical in periods of significant market decline, frauds and scams are being uncovered.

One of the most significant consequences of the deleveraging has been the freezing of credit. Having seen many of their investments go bad, banks have been forced to shore up their balance sheets by reducing their loan portfolios and building their reserves. Since bank lending is the fuel of economic growth, it is an important indicator of the economy's current economic health. Interbank lending (Libor) rates, a measure of banks' willingness to lend to each other, remain stubbornly high relative to short term US Treasury rates.



Source: Baseline

Washington to the Rescue, Again

While Washington has responded to the rapidly unfolding crisis with unprecedented monetary stimulus, due to the uniqueness of the crisis they have not had the luxury of working from a coordinated plan. Instead, the focus so far has been on ad-hoc crisis management steps beginning with the Treasury's massive \$700 billion Troubled Asset Relief Program aimed at unfreezing credit. Recently, the Federal Reserve has aggressively lowered short-term interest rates and, in an unusual move, has suggested it may push long term rates down as well in order to rekindle the housing market. Incoming President-Elect Obama is formulating a comprehensive, multi-faceted fiscal stimulus package of "shock-and-awe" proportions. Foreign government responses to the crisis have been timid to-date but are growing in scale and becoming increasingly coordinated. Europe, Asia and Latin America have all launched fiscal and monetary packages similar in concept (if not in scope) to those in the US. Still, as the crisis spreads deeper into the economy (e.g. the auto industry) and roots itself in other countries, the healing process could be drawn out well into 2009 or later.

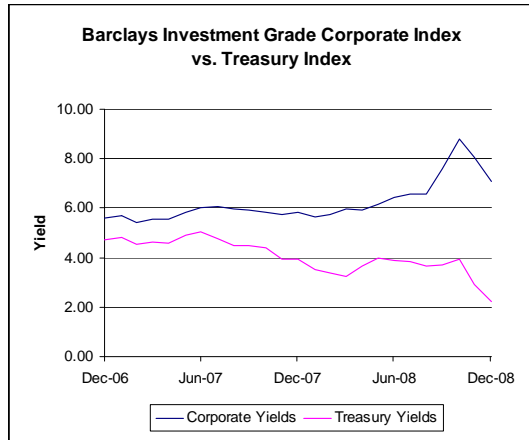
A Cyclical Downturn

While this recession may well cause profound and lasting changes in the way individuals and certain businesses operate, we believe the economic problems today are consistent with the classic pattern of expansion and contraction of a free market economy. That is, once the deleveraging process has worked its way through the economy and consumers and banks have restored their balance sheets, a normal economic equilibrium will return. The global economy has been tested many times. The facts are always different, but at the depth of every crisis, it always looks like an impossible task to climb out of the hole. These emotions are what define and create the troughs of economic cycles.

Risk Aversion is Extreme as Treasury Rates Reach Record Low

Investors have responded to the unfolding crisis by reducing risk across their entire portfolio and seeking shelter instead in the safety of US Treasury securities. In a fear-driven “rush for the exits” phenomenon, almost no asset class was spared. Stocks, bonds, international securities, hedge funds, and commodities were all sold and, due to an absence of buyers, prices plummeted. The one exception has been US Treasuries where strong demand pushed yields to record lows: at year-end the 6-month T-Bill yielded

0.26% and the 10-year note yielded 2.21%. These extremely low yields, especially compared to investment grade corporate bonds, are indicative of a panic-driven flight to quality. While the spread between corporate and Treasury yields has partially recovered from last fall, today’s gap is still historically wide and provides an opportunity for investors who are able to ride out the current storm.



The drop in stock prices caused by the market’s aversion to risk has led to higher dividend yields. The average dividend yield on the S&P 500 Index is currently 3.1%, well above the yield on the current 10-year US Treasury Note. The last time stock dividends regularly exceeded 10-year Treasury yields was in the early 1960s.

Back to Basics

While few investors over the past year have been spared from significant price declines, some of the largest losses have been borne by those in so-called alternative assets strategies: in many cases, the more esoteric the approach, the bigger the loss. Since the 2000-2002 bear market, numerous investors sought higher returns by betting in new or non-traditional areas where the risks were not fully understood. These unproven investments in leveraged hedge funds and/or financial derivatives may have performed well for a short period of time but many have now fared far worse than traditional strategies. The Bernard Madoff scandal, while a massive deception, epitomizes investor’s eagerness to seek higher returns without understanding the underlying investments.

We believe investors will return to strategies backed by basic fundamental analysis and prudent allocations to traditional investments. That is, following the failed promises of improved returns from “alternate assets,” investors will likely reallocate these funds back to selected investments in securities of companies supported by reasonable valuations, solid balance sheets, and strong prospects for sustainable sales, earnings and dividend growth. Importantly, just as investors may have earlier reached too far for superior returns, too large an allocation to cash and other ultra safe investments may also be a mistake.

<u>Market Indicators</u>		
	<u>Total Return</u>	
<u>US Stock Markets</u>	<u>2008</u>	<u>4th Qtr</u>
S&P 500 Index	-37.0%	-21.9%
Dow Jones Industrials	-31.9%	-18.4%
NASDAQ Composite	-40.0%	-24.4%
<u>International Stock Mkts</u>	<i>ETF Returns in US\$</i>	
EAFE Index (Europe, Australia, Far East)	-41.0%	-19.3%
Japan (MSCI Index)	-26.8%	-9.2%
China (Xinhua 25)	-47.6%	-14.7%
Emerging Mkts Index	-48.9%	-26.7%
<u>US Fixed Income</u>	<u>12/31/07</u>	<u>12/31/08</u>
6 Mo US T-Bill	3.40%	0.26%
2 Yr US T-Note	3.00%	0.77%
10 Yr US T-Note	4.00%	2.21%

Conclusion

Economic conditions are deteriorating but at the same time global policy responses are unprecedented and likely to expand significantly. Investors have sought the safety of US Treasury securities and may return to strategies focused on basic fundamental analysis. We continue to believe a prudent allocation to selected high quality stocks and bonds is the best strategy for long term investors.

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