Market View April, 2009

The US economy is still contracting. The response of the federal government has been unprecedented fiscal and monetary stimulus. While the timing of the economic recovery is uncertain, we believe the US and the world economy will emerge from this difficult period stronger and more stable. Investors are likely to return to strategies backed by basic fundamentals.

Economic conditions in the US and around the globe continue to weaken. Real US GDP contracted 6.3% in the 4th quarter of 2008, the largest quarterly decline since 1982, and most forecasters expect a large drop in the first quarter of 2009. The Organization for Economic Co-operation and Development (OECD) projects the world economy will contract in 2009 for the first time in 60 years.

With revenues and profits under pressure, US companies, most of which are in service-based industries, have been laying off workers. Since December of 2007 a loss of 4.4 million jobs has pushed the unemployment rate to 8.1%, a figure that is likely to rise throughout the year. These payroll figures show the risk of a downward spiral, with job losses causing reduced consumer spending, causing more home mortgage defaults, leading to more job losses, etc. The new federal stimulus bill is aimed at avoiding this vortex.

Market Indicators 3/31/2009

	Total Return	
US Stock Markets	12 Mos.	1st Quarter
S&P 500 Index	-38.1%	-11.0%
Dow Jones Industrials	-35.9%	-12.5%
NASDAQ Composite	-32.3%	-2.8%
International Stock Markets (US $)		
EAFE Index	-46.1%	-16.2%
Japan (MSCI Index)	-35.2%	-17.6%
China (Xinhau 25)	-35.4%	-2.3%
Emerging Mkts Index	-43.2%	-0.6%
US Fixed Income Yield	12/31/08	3/31/09
6 Mo US T-Bill	0.3%	0.4%
2 Yr US T-Note	0.8%	0.8%
10 Yr US T-Note	2.2%	2.7%

The Stock and Bond Markets

Trouble at financial institutions and the economic downturn continued to plague the stock market in the first quarter. A powerful March rally could not fully reverse the earlier 2009 downturn, and the Standard & Poor's 500 Index declined for the quarter.

In a change from 2008, the price of the 10 year US Treasury dropped in the first quarter, raising the yield to 2.7% from 2.2%. Investors sold Treasuries in part due to fear of an eventual return of inflation prompted by projected massive federal budget deficits caused by the fiscal stimulus bill and declining tax receipts. Meanwhile, in a sign that investors may be growing more comfortable with taking on risk, demand for corporate bonds has picked up significantly. In response, companies have been coming to market to sell bonds with regularity, often to replace short term paper, improving the health of corporate balance sheets.

Corporate Profits and Dividends

Estimates for corporate profits for the S&P 500 Index show a decline from peak levels of $88 in 2006 to an average of $63 in 2009, with some forecasts of a 50% decline from the top. Much of this drop is due to the financial services sector that represented approximately 27% of the earnings of the S&P 500 Index in 2006 and reported significant losses in 2008. Earnings reports this year are likely to be mixed. Current estimates of company earnings project a year over year decline in the mid- to high-teens range for 2009 and positive growth in 2010.

The dividend yield on the S&P 500 Index is currently 3%, and dividends paid represent approximately 40% of company earnings. An earnings decline of 20% would bring the payout ratio to around 50%, close to the historical mean. Average stock yields are now roughly the same as the 10 year US Treasury Note, a phenomenon not seen since the 1960s. Although there have been a few notable dividend cuts over the past few months, for the most part companies appear to have the financial flexibility to maintain their payouts.

Green Shoots

"I do. I do see green shoots. And not everywhere, but certainly in some of the markets that we've been functioning in. And we've seen some improvement in the banks, as well." -- Federal Reserve Chairman Ben Bernanke when asked during a March 15, 2009 interview on 60 Minutes if he saw "green shoots" that signaled a springtime return of confidence in the financial markets.

Late last year it did not appear that Washington had a coordinated plan to deal with the financial crisis. While a clear blueprint is still not apparent, we are seeing signs of progress. The financial markets reacted favorably to the Treasury's recent Public-Private Investment Program plan to buy troubled assets from the banks. While the successful implementation of this plan is far from assured, the market response is encouraging.

Successful steps taken last fall included providing liquidity to the banking system, increasing bank funding through higher FDIC insurance levels, and guaranteeing money market funds to avoid a run. Banks' cost of funds has dropped precipitously. Several major banks recently noted that they are making a very attractive return on their basic lending business, as the spread between their cost of funds and what they charge their customers has widened significantly. Warren Buffett, an investor in banks, has been saying that over time their lending profits will help them replenish balance sheets devastated by writedowns on toxic assets. Investor willingness to buy quality corporate bonds is a sign that the panic of last fall and the rush to absolute safety may be approaching an end. A surprising increase in durable goods orders in February and a pick up in new home sales are small signs of a bottoming process. The recent stock market bounce in the month of March, while hardly an established trend, may provide some confidence in a recovery.

The problems we face today took years to develop, and it will take some time for us to work our way through them. Some of the proposed solutions of today may not be effective, and other efforts will be needed. We are confident, however, that the US and the world economy will emerge from this difficult period stronger and more stable.

A Fundamental Approach

In our most recent Market View we stated our belief that investors will return to strategies backed by basic fundamental analysis and prudent allocations to traditional investments. Ten years ago investors were scrambling to participate in the roaring bull market and buying stocks with price earnings ratios close to 30 times and dividend yields close to 1%. Today PE ratios are closer to 11 times, and dividend yields around 3%. For the first time since 1939 the 10-year return from stocks is negative. We think that from the current levels there is a very good chance that the returns of the next decade will prove attractive.

Conclusion

Economic conditions are still quite weak. Government efforts to confront the credit crisis and the economic contraction are unprecedented. While some signs of improvement are apparent, many difficult issues still remain. 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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