Second Quarter 2009 Capital Markets Review

The performance of the equity markets during the second quarter of 2009 was a welcome respite from the dismal performance witnessed during the prior four quarters. Investors bought shares of companies which had been badly beaten down during the market sell-off with the hopes that the government stimulus programs implemented around the world would help to reduce the potential of a second great depression. While headwinds remain for the markets, as well as the economy, prospects for economic expansion, even if slow, seem to have more merit.

Coming off of 20+ year lows seen in March, equity markets were up overall for the second quarter with the S&P 500 Index turning in a gain of 15.9%, pushing the index to a gain of 3.2% for the year-to-date period. With an impressive reversal, the Financials sector of the S&P 500 led the markets to the upside, gaining over 35% for the quarter. From the March 9, 2009 lows, the sector was up almost 92%. During the second quarter Technology stocks added another 19.4% bringing the sector return to over 24% for the year-to-date period. Performance of small and mid capitalization companies was better than the larger cap companies, particularly on the growth side. The Russell 2000 Growth Index was up 11.4% for the quarter, which vastly outperformed the Russell 2000 Value Index, which lost -5.2% for the quarter.

International equity markets participated with the performance of the U.S. equity markets as gains were achieved in most of the major exchanges. Equities in China and Hong Kong rallied in spurts during the quarter as prospects for GDP growth in the emerging economies is projected to outpace GDP growth of most of the developed global economies in the next couple of years. Data released in early June demonstrated that economic growth in China and Hong Kong showed expansion for the third straight month. The primary question lingering in investor minds is the ultimate sustainability of economic expansion and secondarily the extent of the economic growth. Emerging markets, as measured by the MSCI-EM Index, returned 33.6% during the second quarter and were up 34.3% year-to-date (in U.S. dollars). International developed markets, as measured by the MSCI-EAFE Index, were up 25.4% for the quarter and up 7.9% year-to-date (in U.S. dollars).

Governments around the world continue with an accommodative liquidity posture, as estimates suggest over 100 countries have reduced their short term interest rates in the past year to assist with re-inflating their respective economies. Here in the U.S., the target rate for Fed Funds continues to be below 0.25% and the Federal Reserve Board emphasized during their latest meeting that the low interest rate environment will remain until economic conditions improve enough to warrant an increase. This accommodative posture seems to be assisting with

improvement of the credit markets as well as improving the potential for the U.S. economy to show signs of life.

The Treasury continued its efforts of buying longer term Treasury bonds in an effort to keep the interest rate yields for Government bonds low. Recently however, the activity does not seem to be keeping rates as low as the Treasury had hoped. Among fixed income securities, the credit markets were decent performers for the second quarter. The 10.9% return for investment-grade corporate bonds during the second quarter was the best since the mid-1980's. At the opposite end of the credit scale, Treasuries went from being the strongest performers for all of 2008 to the poorest performers for the first half of 2009. Mortgage bonds also outperformed Treasuries by a wide margin in the first half of 2009, as spreads narrowed. In the municipal bond market returns, were affected by California's fiscal problems, and the majority of market sectors had slightly negative returns as yields rose during most of the month of June. The Barclays Aggregate Bond Index was up 2.1% for the quarter, and was up 1.9% for the year-to-date period through June 30th. The 10-year Treasury yield finished the second quarter of 2009 yielding 3.52% which is up considerably from the 2.68% seen at end of the first quarter.

As we move forward through the coming months and quarters, there are reasons to feel better about the economic outlook today than at any point during the past nine months. That said, risks do remain within the global economy. During the first half of the year, the banking industry went through testing in an effort to ascertain the risk levels on their balance sheets. While the "stress test" process for the banking industry was not without its flaws, it did lift some uncertainty and allow many entities to raise equity capital. Over $100 billion of new equity was raised in the second quarter with financial institutions accounting for approximately half of the total. This reopening of the equity financing markets was a fairly significant development as it allowed the banks in particular, to begin the healing process.

Although there are signs the downturn is largely behind us, the path to economic recovery will not be quick and easy. It is unlikely that consumers will have the ability to provide stimulus to help pull the economy out of the current state. In addition, some considerable headwinds are facing U.S. consumers in the coming years - tax refunds have come and gone, financial leverage remains high, consumer net worth is depressed, job insecurity is fairly high and there is uncertainty regarding future taxation and health care costs. Additionally, while many household expenses are down year over year, the rebound in energy prices provides a psychological hurdle. Consumers are saving more and will likely continue to do so. Also, signs of improvements within real estate, particularly the single-family housing sector, are few and far between, which only adds to the uncertainty.

Investors will be keeping a close eye on the corporate profit picture during the upcoming earnings season, particularly regarding any future guidance company managements may be willing to provide for the second half of 2009 and into 2010. Reported earnings are expected to be down again for the second quarter year-over-year period. However, the potential for increases at the corporate profit level improves for the third and fourth quarters due to the dismal profit announcements reported for the same periods in 2008.

With the uncertainty regarding the speed and strength of any economic expansion in the coming months and quarters, we believe it is important for investors to consider increasing the yield of

their portfolios, as long as the yield can be derived from assets which are not too far out on the risk spectrum. In an effort to benefit from higher yielding assets, we continue to maintain a portion of client assets in preferred securities. We have also taken steps to increase portfolio yields through the use of corporate bond portfolios which invest in assets which fall between Treasury securities and assets which are considered to be "junk" bond status. Additionally, there may be asset classes within the markets which will benefit from price appreciation potential but we believe investors must choose those assets carefully as the risk-environment abates. We believe the type of market environment investors face in the next few quarters will be more beneficial to actively managed portfolios rather than the more broadly diversified indices. The recent equity moves to the upside have demonstrated that this is a "stock-pickers" market rather than an indexing environment and so far into 2009 we have been rewarded with impressive results from the portfolio managers we rely on for clients.

With the massive amounts of stimulus being thrown at the current economic situation, we believe inflationary pressures may present themselves within the next few years. Current data suggests that inflationary pressures are moderate at-best; however, buying "insurance" from inflation on portfolios is currently fairly inexpensive. We continue to maintain Treasury Inflation Protected Securities (TIPS) within client portfolios as we are not yet convinced that potential intermediate- to longer-term inflationary pressures have been adequately addressed by the Fed. That said, we do believe the liquidity which has been added to the global economy is necessary to help improve the chances for stimulating economic growth. As always, we look forward to discussing your specific investment results with you in the coming weeks.