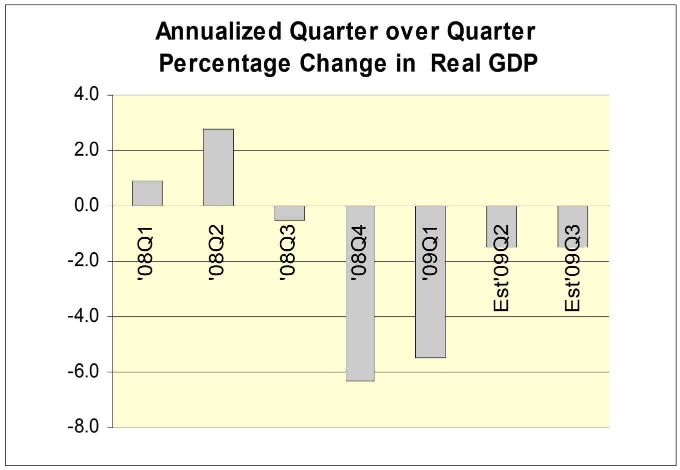
Investment Update
Second Quarter, 2009

Economy

Recent economic developments suggest a moderation in the rate of decline for most important metrics. Most forecasts now call for a small decline in third quarter GDP in the 1-2% range followed by positive growth in the year's final quarter. If this consensus is accurate, the economy will have experienced four quarters of declining GDP, the longest stretch of negative growth in over 70 years. The prospects for a return to growth are encouraging, but there is reason to be cautious regarding the strength of the recovery. Typically, most recession/recovery periods are V-shaped; a sharp decline followed by a strong recovery. The rebound has usually been facilitated by a re-liquefaction of the economy which brings about a restocking of business inventories and a recovery in consumer spending.



Our concern relates to consumer spending which accounts for over two-thirds of the economy. Debt leverage reached record highs for the consumer about one year ago, as highlighted by a negative savings rate compared to a more typical level of 6-7%. For years, stock market gains and rising home real estate prices made up for very low savings from income, but the past years events have drastically altered this equation. Not only have values declined, but consumer incomes have suffered as a result of rising unemployment and slower wage and salary growth. Consumers must now reduce debt loads and at the same time increase savings. This is an important change and will require considerable time to accomplish. For this reason the recovery in 2010 will likely be modest and restrict GDP growth to low single digits.

To offset the financial crisis and resulting demand contraction, the Federal Reserve has injected massive liquidity into the economy. Our financial system seemed on the verge of collapse in the post-Lehman bankruptcy environment, but the aggressive actions of the Federal Reserve effectively reduced the risk of a systemic failure. At this juncture the financial system has pulled back from the abyss, but the price of salvage has been a massive increase in liquidity, and this has important implications for future inflation. Currently, high unemployment and unused capacity minimizes inflation pressure, but even the modest recovery expected in 2010 could drastically change the inflation picture. The tricky policy response required of the Federal Reserve will be to soak up excess liquidity without restricting credit availability so as to maintain the recovery. Policy may achieve this goal, but success will depend on achieving a difficult balancing act.

The current administration is also attempting to initiate major new environment, energy, education, and healthcare programs. It is clear that these programs will require massive new outlays that can only be financed by a combination of increases in the already substantial federal debt and higher taxes and costs on all income groups. In addition, the Federal authorities are crafting a host of regulations on a variety of issues affecting business. No doubt some reforms are needed, but new requirements may impinge on free market efficiencies and lower investment returns. Currently, the Federal authorities have effective control of the banking system and the automobile industry, and are seeking an expanded role in the healthcare and energy industries. There should be concern that ill-advised regulations could have a profound effect on our economic performance once the economy has recovered and a new expansion phase is in place.

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In summary, there is a sound basis for optimism that the worst of the recessionary pressures have passed, and that a recovery of at least moderate proportions is likely. Longer term, the expanded role of the government in the economy raises concern that our future economic performance will be constrained.

Equity Markets

	2008	2Q2009	2009 YTD
S&P 500	-38%	15%	2%
NASDAQ COMPOSITE	-41%	20%	16%
MSCI EAFE	-45%	24%	6%
MSCI EMERGING MKTS	-54%	34%	34%

In almost every market stocks have appreciated substantially since the March lows. The removal of fears of a credit collapse and resulting world-wide depression largely explains this improvement.

Another important factor was that the sheer quantity of increases in liquidity made it inevitable that some of this liquidity would find its way into the equity markets. Where do we go from here?

Market history demonstrates that no trend continues without interruption, and so a pull-back is a logical expectation. In addition, the summer months are frequently marked by a lackluster pattern. Fundamentally, domestic stocks as a class are no longer cheap on a valuation basis. In order to sustain current levels and to justify further advances, solid gains in the economy, both domestic and world-wide, are necessary. As previously discussed this may be a challenge.

Corporate profits, the ultimate driver of stock prices, have been sharply reduced primarily by weakness in the financial sector. While profits are down in most other sectors as well, there is a general consensus that business managers have done a good job controlling costs. The result could be that even the modest demand pick-up we expect would produce unexpectedly good profit gains.

An additional consideration is the future course of government involvement in the economy. A worst-case outcome would lessen corporate profit growth expectations, lower confidence, and negatively affect stock prices. Hopefully and presumably, that is an extreme position, but the issue needs to be resolved and, therefore, remains an uncertainty. Pulling these issues together leads us to be cautious regarding the outlook for stock prices over the next few months.

Credit Markets

The Federal Reserve has stated its intention to maintain short-term rates as low as possible for as long as the economy operates below potential. No change, therefore, is expected in the foreseeable future.

In the case of longer rates market forces are at work, and a different picture emerges. Yields on Treasuries and mortgage securities have moved up in recent months, leading to concern that the economic recovery might be held back as borrowing costs rise. While improved prospects are probably a factor, fears about inflation resulting from massive government borrowing is also a consideration. Both of these pressures are likely to continue in the future, but these are not near term concerns.

Selected opportunities are available in the fixed income area. High-grade corporate bonds and tax-exempt municipal bonds in the intermediate maturity range are priced to offer attractive yields. Quality spreads have narrowed considerably but are still wide by historical standards. This maintains the incentive to move slightly down the quality scale.

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