

Market Review

March 31, 2008

Dear Clients & Friends,

U.S. Equity markets stumbled in the first quarter as volatility increased to levels not seen since 2000 and 2002. Growing uncertainty about problems in the housing sector and collateral issues in the credit markets weighed on investors, as well as warnings about corporate earnings from companies sensitive to consumer spending and financial services. Without aggressive action by the Fed, however, the quarter might have been much worse.

The S&P 500 ended the first quarter down 9.5% on a total return basis, while the Dow Jones Industrial Average declined 7.6%. The table below shows how other market averages and interest rates stood at the end of the quarter. Global equity markets declined in concert with the U.S. market, and sometimes more so, with the MSCI EAFE index falling 8.9%, despite proclamations by many pundits that there would be a “de-coupling” of the U.S. economy and markets from those of foreign counterparts, particularly the emerging economies such as China.

Most noteworthy perhaps was that the first quarter was a period of unprecedented actions by the U.S. Federal Reserve. In most times of declining economic growth the Fed has used the key Federal Funds short-term interest rate to inject liquidity and future growth into the economy. This time the Fed has been more like a major league baseball pitcher utilizing every pitch in its repertoire, including ones not used since little league. The Fed lowered its key interest rate, the Fed Funds; dropped its secondary interest rate, the discount rate; introduced several short-term lending facilities to commercial and investment banks, and saved the fifth largest investment bank from going bankrupt. The chart below shows the path of the S&P 500 since the market peak in October, reflecting the volatility associated with the occasional fits and starts for investors in the past five months:

<i>Market Statistics</i>		
<i>March 31, 2008</i>		
	Level	YTD%
Dow Jones	12,263	-7.6%
S&P 500	1,323	-9.5%
NASDAQ	2,279	-14.1%
MSCI EAFE	2,039	-8.9%
Oil (WTI)	\$101.58/b1	
Lehman Agg Bond Index	+3.8%	
Federal Funds Rate	2.00%	
6 Mos Treasury Bill	1.51%	
2 Year Treasury Note	1.68%	
5 Year Treasury Note	2.54%	
10 Year Treasury Note	3.49%	



Chart courtesy of stockcharts.com

U.S. Economy – Recent Data Validate Concerns About Recession

Key economic indicators for the U.S. economy were consistently weak in the first quarter, as the table on the next page shows. Housing data have continued to paint a picture of markets in significant decline without signs of a bottom. Year-over-year home prices for the 20 largest cities as measured by the S&P Case Schiller index fell 10.7% in January and prices are down 12.5% from their peak levels in July 2006. Likewise, the number of unsold new single family homes in the U.S. now stands at 9.8 months supply, an amount not seen since the early '80s.

The slowdown in housing is affecting other areas of the economy - most importantly consumer confidence, employment and retail sales. Employment numbers as reported each month by the Bureau of Labor Statistics may

actually be understating the current level of job losses because of statistical adjustments that attempt to make up for the long-term changes in the population and labor force. The message of these figures as they relate to investors is that consumer spending, along with home sales, may take some time to recover.

Recent U.S. Economic Data								
	December		January		February		March	
Housing starts (thousands)	Dec-06	1,629	Jan-07	1,403	Feb-07	1,487		
	Dec-07	1,000	Jan-08	1,071	Feb-08	1,065		
	Year over Year % Change	-38.61%		-23.66%		-28.38%		
Building permits (thousands)	Dec-06	1,628	Jan-07	1,566	Feb-07	1,541		
	Dec-07	1,080	Jan-08	1,061	Feb-08	984		
	Year over Year % Change	-33.66%		-32.25%		-36.15%		
Durables Goods Orders (\$ millions)	Dec-07	224,687	Jan-08	214,724	Feb-08	212,267		
	Month to Month % Change	4.4%		-4.7%		-1.7%		
Inflation CPI	Dec-07	0.4	Jan-08	0.4	Feb-08	0		
	Year over Year % Change	4.10%		4.30%		4.00%		
Inflation CPI ex Food & Energy	Dec-07	0.2	Jan-08	0.3	Feb-08	0		
	Year over Year % Change	2.40%		2.50%		2.30%		
Retail Sales (\$ millions)	Dec-07	380,711	Jan-08	382,336	Feb-08	380,197		
	Month to Month % Change	-0.1		-0.4		-0.3		
Consumer Confidence Index	Dec-07	90.6	Jan-08	87.3	Feb-08	76.4	Mar-08	64.5
Index of Leading Economic Indicators	Dec-07	135.9	Jan-08	135.4	Feb-08	135		
	Month to Month % Change	-0.1		-0.4		-0.3		

Inflation in both the U.S. and globally remains a concern particularly as it relates to the most basic necessities including gasoline and food, thereby reducing funds available for spending on other items. Commodity prices globally have been soaring for goods such as wheat, copper and oil, not only due to strong demand, but also from speculation by investors and hedge funds. The chart below shows the increase in a basket of commodity prices:



Ultimately whether or not the U.S. is in recession will not be officially determined for some time, usually after the economy has already started to recover. The more significant issue is the effect that a slowdown, however mild or lingering, would have on corporate earnings and interest rates, as we discuss in the following sections.

Global Equity Markets Decline Broadly, Refuting the De-Coupling Thesis

The U.S. stock market, much like this year's winter in Maine, confronted a consistent barrage of storms from news related to prolonged problems in the housing market and consumer spending, which has affected stocks of mortgage companies, those who ultimately owned or promoted securities backing the housing boom, (including Bear Stearns) the more volatile technology firms such as Google and lastly, retailers such as JC Penney.

The Fed's aggressive actions to stem eroding confidence in the U.S. financial system saved the market from more serious levels of declines. Fed officials acted most dramatically on two different occasions. First, on January 22nd, there was talk of a major European financial institution that had suffered large losses from trading activities. This rumor prompted the U.S. equity market toward an intra day loss of over 500 points on the Dow Jones. In an unprecedented move, the Fed acted preemptively, dropping its key short-term interest rate by three quarters of one percent. The Dow Jones closed down only 128 points.

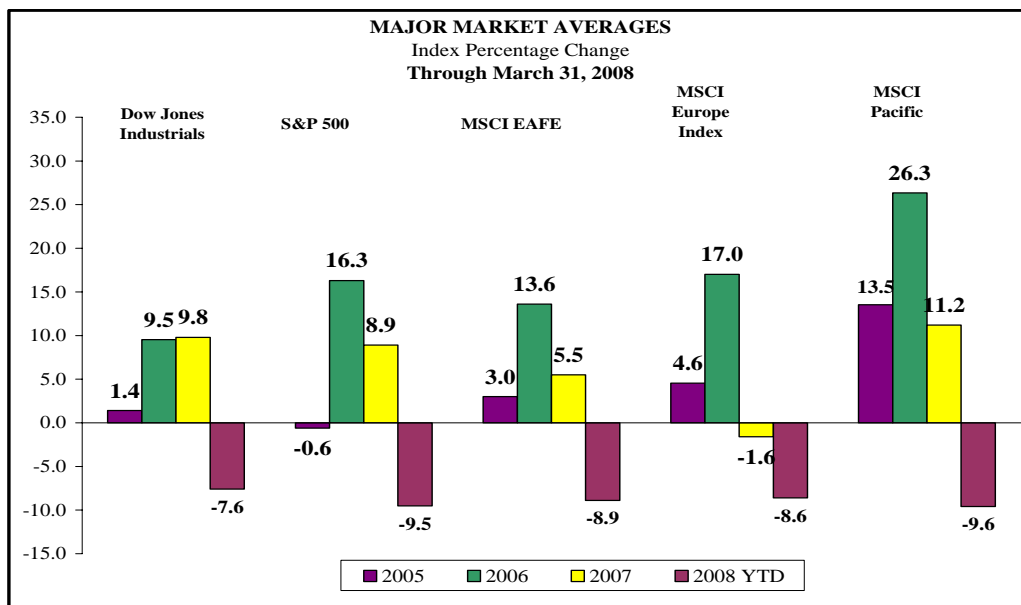
Second, in early March, rumors swirled that a major U.S. investment bank was in danger of defaulting on some of its more risky debt, causing the stock market to plunge. Over a hectic weekend a deal was engineered by the Fed to save Bear Stearns from collapse with the sale of the company to JP Morgan at a bargain price. In addition to each of these exceptional moves, the Fed lowered rates at other times in the quarter, bringing the Federal Funds rate from 5.25% in September to 2%, which is a reduction of rates equal to the average for most economic cycles.

Each of the Fed's moves helped the stock market temporarily stem the tide of selling activity but, as the numbers for the first quarter show, equities still ended the quarter down nearly 10%. As we have noted for several quarters, earnings expectations coming into this year were high. The slowing economy and warnings by blue chip companies that earnings are under pressure have prompted investor disappointment and declines in the market.

From our perspective, the silver lining from the fall of the market is that many quality stocks have declined to more attractive valuation levels. We added such stocks to portfolios while selling others at targets in our usual discipline. This process is ongoing. We expect additional stocks to be added to portfolios in the months ahead.

Equity valuation levels are more attractive now than at the October 2007 highs but from an historical perspective, are not yet at levels for a slowing economy. In our view, expectations for earnings have not been lowered enough. We expect the next quarter to either validate earnings for companies in which we see opportunities or to uncover disappointment and create better valuations. Patience remains particularly important for some of the groups most affected by the market malaise, including consumer discretionary and financial stocks. We believe projected earnings do not match the economic realities in the U.S. and that Wall Street has not yet applied the same view.

At the end of last year many market strategists advocated increasing exposures to foreign stock markets and companies with foreign based earnings because of the declining dollar, stronger economic growth prospects abroad and anticipated higher returns for non-U.S. markets. The thought by some was that foreign economies, particularly those of developing countries, would de-couple from the U.S. and continue to perform well even with a U.S. slowdown. The chart below reflects how returns in the first quarter of 2008, including the effect of the lower U.S. dollar, failed to support the de-coupling thesis.



Global markets as measured by the MSCI index for the Europe and Pacific markets are faring little better than the S&P 500. History has pointed to high correlations among world stock markets, not lower, when markets decline. That said, we continue to believe that there are opportunities for investors to benefit from a declining dollar.

Fixed Income – Fed’s Unprecedented Actions Drive Rates Lower in the U.S.

Rates took another major leg downward in the first quarter of 2008. The Fed’s aggressive response to fears about the credit and equity markets, and a slowing U.S. economy, pushed yields for bonds and money markets down to less attractive levels. As a result, finding high quality, safe harbor investments in the form of government agency or higher rated corporate bonds as an alternative to cash has become even more of a priority in 2008.

U.S. Interest Rates - Fed Funds & Treasury Yields					
	7/16/2007	9/30/2007	12/31/2007	3/31/2008	Change Since 7/16/07
Fed Funds	5.25%	5.00%	4.00%	2.00%	-3.25%
3 Mo	4.97%	3.80%	3.34%	1.43%	-3.54%
6 Mo	5.05%	4.07%	3.50%	1.51%	-3.54%
2 Yr	4.87%	3.98%	3.05%	1.68%	-3.19%
3 Yr	4.88%	4.02%	3.25%	2.14%	-2.74%
5 Yr	4.95%	4.25%	3.44%	2.54%	-2.41%
10 Yr	5.04%	4.59%	4.03%	3.49%	-1.55%
30 Yr	5.13%	4.84%	4.45%	4.35%	-0.78%

Of significant importance during the quarter for bond investors was the crisis in confidence that occurred in traditionally safe areas of the credit markets. Most noteworthy was the trouble in the often-used auction rate preferred fixed income securities. Many municipalities and large non-profit organizations such as universities or hospitals issued those securities as part of their financing; and investors with sizable cash positions purchased them for yields and assumed high liquidity, but found themselves locked out of immediate liquidity.

Also noteworthy was that higher yield and even tax-free bonds have yields at levels competitive with or better than agency bonds. Credit markets are only slightly calmer now after the massive liquidity injected by the Fed. The hope going forward is that the bold steps taken will make investors feel more secure in purchasing bonds, enabling borrowers to raise money and adding to economic growth.

Summary

Uncertainty and volatility in financial markets can raise concern about the status of investment portfolios and the ability to meet future goals. Recent events in the markets highlight the importance of having a strategy commensurate with risk tolerances and time horizons, along with an active management philosophy in portfolios. In addition, the particularly painful paths of stocks with readily identifiable exposures to known problems in the financial, housing and consumer sectors represent good examples of how our objective, bottom-up research process adds significant value by analyzing such risks and avoiding them. As a result, our core equity portfolios have proven durable in this market, with performance well above the S&P 500 in 2007 and so far in 2008.

Welcoming Our Team in Ellsworth

We would like to welcome our new colleagues following the merger of Union Trust Company into Camden National Bank. The addition of the trust department of Union Trust, a community bank based in Ellsworth, brings a dedicated and talented team of trust and investment professionals who are similarly passionate about delivering a distinctive client experience. Please join us in welcoming our new colleagues to the Acadia Trust team.

As always, we look forward to our next opportunity to visit with you and appreciate your continued support.



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