

Market & Wealth Management Update February 28, 2009

Stocks Continue to Feel the Weight of Major Slowdown in the Global Economy

Stocks had another difficult month in February, declining 11.7% as measured by the Dow Jones Industrial Average. As the table below indicates, the Dow is now down 19.5% for the first two months of 2009, the worst start for the index in its 113 year history. Other stock markets were also weak in February, including foreign stocks, as measured by the MSCI EAFE, or the S&P 500 in the U.S., both of which are down nearly 20% in 2009.

Renewed pressure on the financial sector worldwide and a continued slew of weak economic data were factors behind the new round of selling in most equity markets. In particular, financial stocks in the S&P 500 dropped 18.4% for the month and are now down 40% for the year. As losses at firms like Citigroup and AIG mount, the U.S. government felt compelled yet again to take additional steps to provide capital, raising its ownership levels.

The chart below shows how the slide in the S&P 500 compares to prior bear markets. Since the peak in October 2007, the market has now declined over 50%, making the drop one of the worst bear markets on record.

In this update, we discuss these recent events and confirm our outlook given the latest economic and earnings data.

Market Statistics		
February 28, 2009		
	Level	Year-to-Date %
Dow Jones	7,063	-19.5%
S&P 500	735	-18.6%
NASDAQ	1,378	-12.6%
MSCI EAFE	998	-19.4%
Oil (WTI)	\$44.76/bl	
Barclays Agg Bond Index		-1.2%
Federal Funds Rate	0-0.25%	
6 Mos Treasury Bill	0.40%	
2 Year Treasury Note	0.95%	
5 Year Treasury Note	1.95%	
10 Year Treasury Note	3.00%	

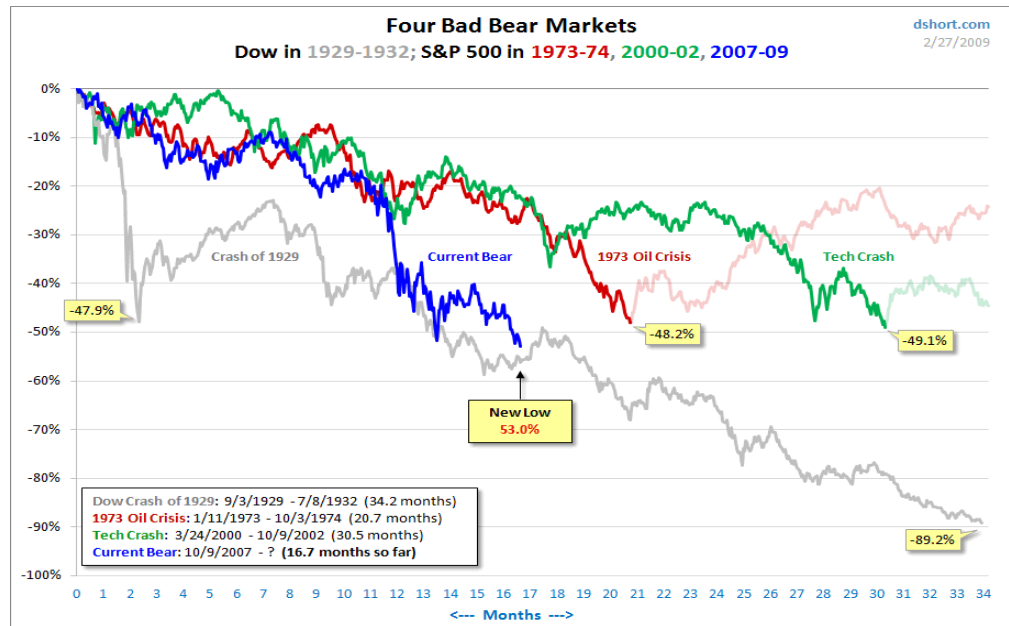


Chart Courtesy of dshort.com

Economic Data Points to Sharp Decline in U.S. and Global Markets

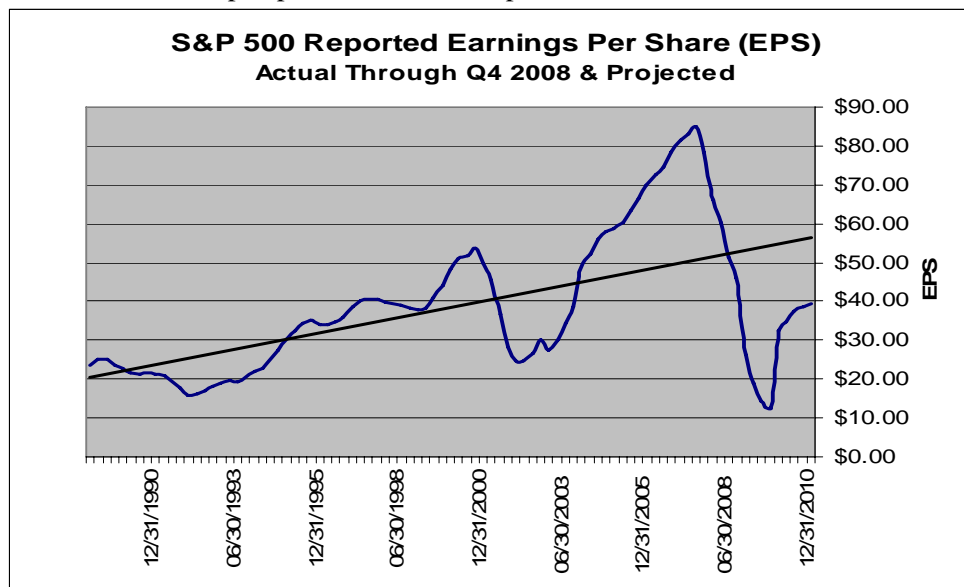
On the last day of February the U.S. government released a revised estimate of fourth quarter 2008 economic growth, as measured by the gross domestic product, or GDP. According to the report, the U.S. economy sank 6.2% at an annualized rate in the last three months of 2008, which was the largest decline since the recession of 1982. All components of the GDP report reflected weakness in the economy, including personal consumption expenditures, business investment and residential investment. Of additional note was how quickly export activity was falling in the fourth quarter, at over a 20% annualized rate, following increases in the previous quarters.

Additional economic data in February continued the downward trend from the recent months, with weekly claims for unemployment insurance consistently above 600,000 and the monthly data on the unemployment rate rising to 7.6% for the U.S. as a whole. Moreover, in states like California unemployment has already increased above 10%. Industrial production in the past month showed that manufacturing activity has also been slowing down at a record pace. For example, manufacturing capacity utilization shows how much of the country's industrial capability is being used. In January this indicator fell to 68%, the lowest measure on record since its tracking began in 1948.

Retail sales data also pointed to continued weak conditions in 2009. Consumer spending on non-durable goods such as food and clothing slowed by 9.2% in the last quarter of 2008 and retail sales for the major chain stores showed worse than expected results so far in 2009. Housing data showed a drop of nearly 20% year-over-year for prices of homes, as measured by the Case-Shiller home price index. Construction of new homes started in January renewed the downtrend of prior months, with housing starts now down by over 80% since the peak in early 2006. Lastly, recent data from the Federal Reserve point out that loan delinquency rates nationally are rising to levels not seen since the 1990 recession across most categories, from consumer to commercial.

Trend in Earnings Data Re-Emphasize Why Stocks Are Still Not “Cheap”

The above data presents a stark picture of the U.S. economy and the global malaise. While we pay attention to economic information on a daily basis, along with stock, commodity and interest rate data, what matters more to us is how much the companies we follow, or those in which we invest, will earn at the bottom line. On that front data now revised for 2008 show earnings for the S&P 500 were at just \$26.16 per share overall. At the beginning of last year many called for reported earnings to be \$70 to \$90 per share. Looking ahead for the full year of 2009, most now expect earnings for the S&P 500 to be \$30 to \$40 per share, with some respected analysts now predicting even lower. The chart below shows how earnings are declining relative to recent periods and the longer-term trend line. On a valuation basis, the long-term average for stock prices relative to earnings (P/E) is 15. The current P/E based on expected earnings this year is 22.7. Despite attempts by market strategists and academics in recent days to argue that the market is cheap, the data and long-accepted methodologies of measuring value validate our conclusion from the perspective of bottom up stock research that the market remains expensive.



Source: S&P

Investment Strategy - What does the above data and analysis mean in terms of our outlook and near-term strategy? For managed portfolios we have moved more to the sideline in terms of new purchases, until stocks are less expensive relative to earnings. We are also re-evaluating existing holdings and selling stocks that no longer present attractive upside. We do expect to find attractive long-term values in stocks as a bottoming process occurs in companies' earnings, but our research indicates that a downside potential in earnings still exists, more than stabilization or improvement. Therefore, we continue to be at the low end of stock allocations and are not buying many new stocks quite yet. Bond and cash allocations remain above average to preserve capital and income.

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