

Market & Wealth Management Update July 31, 2009

Market Rally Continues – Without Signs of Imminent Revenue Growth

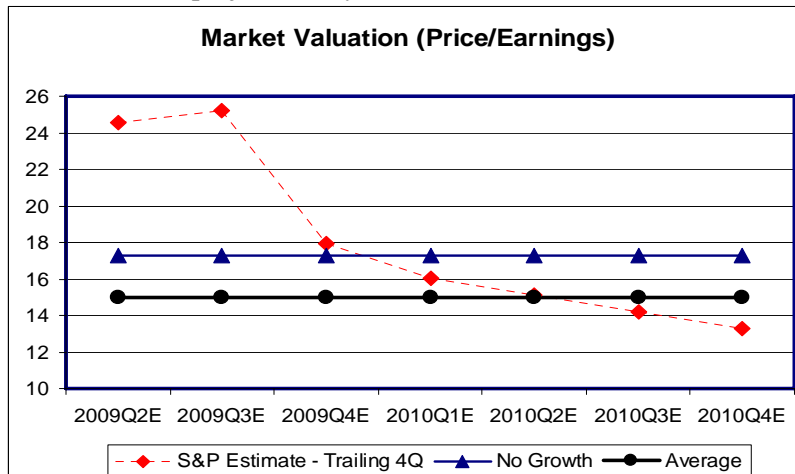
During July stock markets continued the rally that began in March as investors cheered better than expected economic news and earnings. For the month, the S&P 500 rose 7.5%, leaving the index up 9.3% for 2009. Since its March low the S&P 500 has gained a remarkable 45%, led by technology, finance and consumer stocks. The first chart below shows the path of the S&P 500 this year, reflecting the increase since early March.

As we discuss below, based on our analysis of the data, while the recent second quarter profit numbers were better than expected for many companies, the absolute levels of the earnings were still low. Most importantly, companies met or beat estimates primarily by cost cutting rather than increasing revenues. In future quarters, should revenue growth pick up significantly, the market's rally ultimately might be more justified. From our standpoint the rise has not been supported by the fundamentals, our outlook and what companies are forecasting.

Market Statistics		
July 31, 2009		
	Level	Year-to Date %
Dow Jones	9,171	+4.5%
S&P 500	987	+9.3%
NASDAQ	1,978	+25.5%
MSCI EAFE	1,425	+15.2%
Oil (WTI) \$69.51/bl		+55.7%
Barclays Agg Bond Index		+3.5%
Federal Funds Rate	0-0.25%	
6 Mos Treasury Bill	0.25%	
2 Year Treasury Note	1.11%	
5 Year Treasury Note	2.54%	
10 Year Treasury Note	3.48%	



The next chart shows how expensive the market is, based on a comparison of the average price to earnings ratio over time (black line) to the forecasted P/E of S&P (red line). The blue line shows the market's valuation should there be no growth in earnings by the end of 2010. The red line also shows valuation levels into 2010 with the quite optimistic earnings forecasted by S&P. The chart shows that the market's is not inexpensive historically, nor will it be cheaper until after mid-2010, based on current bullish projections by Wall Street. This is a reason for our caution.



Source: S&P

This chart highlights the data behind our view of why the market is not inexpensive, which differs from how the market is behaving in its rise without any data to confirm future strength in earnings. In our experience, estimates for earnings and the economy are consistently too optimistic. Our analysis finds that there is not enough hard data



to make current valuation levels compelling. Until fundamentals and the outlook for revenue growth improve, it's hard to make a case for making new purchases.

Another widely discussed view of the earnings reported in July is the perception that results exceeded expectations. While over 70% of companies in the S&P 500 beat estimates projected before the quarter-end, above the normal "beat" rate of 60%, estimates had come down so much prior to the quarter-end that it was easy to beat expectations. Our analysis of the quarter found that, on average, revenues were down 15% compared to the first quarter. This is an important point. Some analysts focus on comparisons to year ago results, but our work also looks to whether new business activity is improving. Our conclusion based on companies' reports was that on a revenue-only basis, which excludes the effect of cost cutting companies are still doing, real growth remains quite elusive. Moreover, comments by many companies set a cautious tone with respect to revenue growth all the way to the end of 2010. Pressure will remain on companies to keep costs down with job cuts or low investments.

The bottom line from July is that earnings data came in better than the lowered expectations, creating a belief that future earnings would continue to beat expectations. We question the bullish assessment of the second quarter earnings by others, based on the specific comments by companies during recent earnings conference calls indicating challenges may persist for some time. The important point is that whether or not a bottom is occurring for the economy and earnings, growth rates could be quite modest, making current valuations high.

Economic Data in July Raise Hopes of a Near-Term Bottoming

One highlight from the economic news of July was the rising tide of press about the improving housing market. The news started mid-month with the increase of new homes under construction, with a reported 14% increase in starts on new single family residences. The month ended with a report that existing home sales had risen 11% in the month. On a year-over-year basis starts are still down over 25% and the level of just 430,000 on an annual rate basis compares with the nearly 1,800,000 starts at the peak. Existing single family home sales came in at an annualized rate of 384,000, which is 20% lower than last year, but up from the 45% decline recorded in January.

In other words, increases in housing are coming from levels so low that the percentage gains look high month to month, but in fact are quite low on an absolute basis. This trend persisted in all forms of housing data during July, from new and existing home sales to home prices. The housing market may indeed be reaching its low point, which is good, but its growth path may be slow to return to normal levels. Other factors, as we've written in the past, include job losses that restrain investments in new homes, tighter lending standards and higher levels of consumer debt than average. On the positive side, mortgage rates are low, prices are still 15-20% below year ago levels and the first-time buyer tax credit is attracting individuals back into the market.

The latest ISM manufacturing survey for July reflected some improvement in new orders, production and employment, but further data will be needed to confirm that the increase is sustainable. Comments by companies we track would indicate that the path may not be a smooth one as most are continuing to acknowledge very difficult conditions exist because of restrained consumer and business spending, which may remain on the horizon.

Investment Strategy – Watching a market rise while one is maintaining a defensive position is not easy. Periods when the market is appreciating while fundamentals are not improving may sometimes last for many quarters. Our patient process does not change based on price appreciation (or depreciation) when fundamentals indicate caution is warranted. We believe that either revenue growth will have to begin to pick up quickly or the market will be disappointed by upcoming levels of earnings, despite lowered expectations. Consumers will have to spend more, which will require job growth and lower debt levels, and companies will have to see solid expansion of revenues and margins. Until our outlook improves, we will remain cautious on new purchases and active in taking good gains when stocks are at or above target prices. At present, overbought conditions make many stocks' valuations unappealing and the need for active management of existing holdings critical. As always, we look forward to our next opportunity to visit with you and we appreciate your support and referrals to our company.

A handwritten signature in black ink that reads "Christopher H. Lyford".

Christopher H. Lyford, CFA
Managing Director, Chief Investment Officer

Acadia Trust, N.A. is a Maine-based wealth management firm, with a distinctive approach based on our disciplined research process, value-oriented style of equity investing and our high quality approach to fixed income investing. As a trusted advisor to our clients, we provide portfolio management, trust, estate, financial planning and retirement plan services throughout New England.

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