

# Market Review

## March 31, 2009

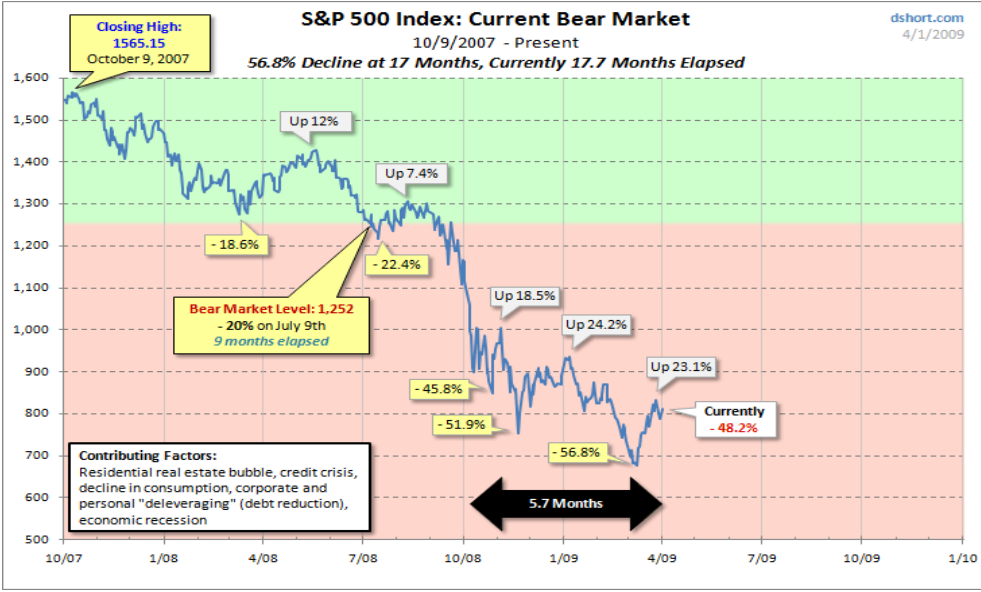
**Dear Clients & Friends,**

U.S. stocks ended the first quarter with the best monthly performance in decades, gaining 8.7% in March as measured by the S&P 500. Up until March 10<sup>th</sup> however, stocks had been on a worrisome decline that appeared to be continuing the downward momentum from 2008. Both January and February were very negative months for stocks, leaving the S&P 500 down at one point 25% for 2009 before staging the impressive rally. From the March 9<sup>th</sup> low the S&P 500 gained 23% at its highest near month-end. For the quarter the S&P 500 ended down 11%. The chart below shows the path of the S&P 500 since the start of the bear market, including this most recent rally. Globally the trend in the equity markets was similar, with a decline until early March and a rebound thereafter, for a first quarter performance of -14.6% as measured by the MSCI EAFE. In terms of stock sectors, technology was the relative best in the S&P 500 so far in 2009. We review the sectors more in the pages ahead.

Noteworthy in the first quarter was the increasing scope of government sponsored initiatives and the resulting reactions of the market. From the government stimulus package to the Federal Reserve's purchases of Treasury and mortgage securities or the guarantees of "toxic" assets of financial institutions, the federal government is decidedly involved now in major decisions about companies and industries. One question we are asking ourselves is how long and whether these interventions will help. We discuss the issue further in this letter too.

Bond markets in the first quarter were significantly influenced by the U.S. government's financial maneuvers. Actions by the Fed to purchase U.S. Treasury securities, guarantee debts and secure assets of U.S. banks and other companies such as AIG created a pull and push on interest rates all quarter long, ultimately leaving Treasury rates slightly higher for the quarter than at the end of 2008. The gap between high and low quality rates remained wide in the quarter with ongoing concerns about credit worthiness, creating purchase opportunities in corporate bonds.

<i>Market Statistics</i>		
<b>March 31, 2009</b>		
	Level	YTD%
Dow Jones	7,609	-13.3%
S&P 500	798	-11.7%
NASDAQ	1,528	-3.7%
MSCI EAFE	1,056	-14.6%
Oil (WTI)	\$48.78/bbl	
Barclays Capital Agg Bond Index		+0.1%
Federal Funds Rate	0%	-0.25%
6 Mos Treasury Bill		0.42%
2 Year Treasury Note		0.80%
5 Year Treasury Note		1.66%
10 Year Treasury Note		2.66%



**U.S. Economic Review – Recent Focus by the Press is on “Less Bad” Data**

Economic news in the first quarter was generally very weak, with revised data on U.S. economic growth, as measured by gross domestic product (GDP), for the end of 2008 showing an annualized decline of 6.3% and corporate profits down over 22% in a year. Other measures of economic growth and consumer confidence were at record lows including manufacturing capacity utilization at just 68%. Consumers slowed their activity considerably as personal income declined 0.2% in February. Employment data and claims for unemployment insurance worsened in the quarter, too. All of these data point to an additional 6% to 8% decline in the economy

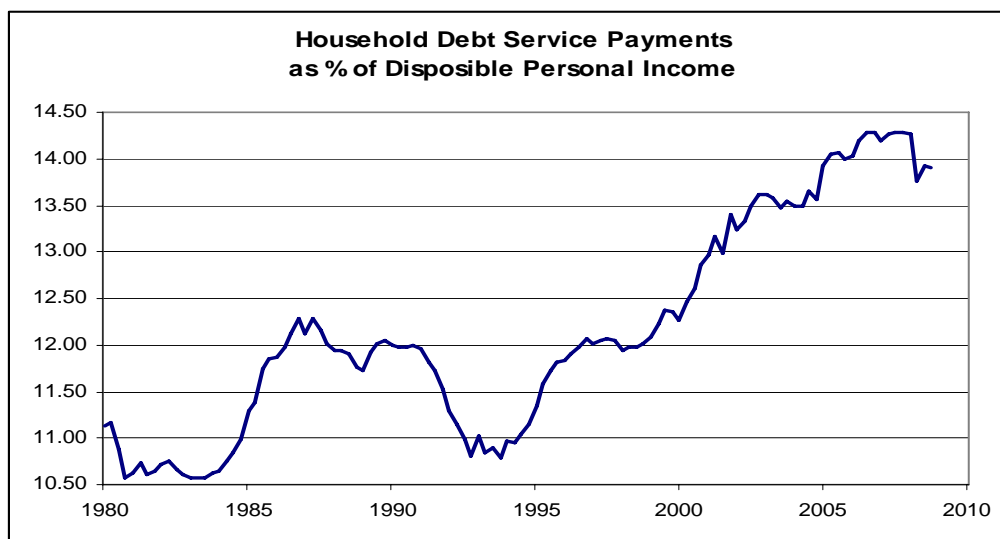
in the first quarter, which also implies a further decline in corporate earnings. If still heading in that direction, April would mark the 17<sup>th</sup> official month of recession, longer than downturns in the 1970s or 1980s.

Many in the press are wondering if we are near a bottom in the economy because recent economic news is “less bad” than prior readings. For example, some looked at February housing data as signaling a future improvement. Housing starts, new home sales and mortgage applications rose for the month. Some measures of manufacturing or economic activity sentiment were slightly better too. Our view is that the data has yet to indicate that a sustained improvement in the economy is at hand. In addition, seasonal factors make some of the improvements, such as an increase in housing activity in February, fairly routine each year. The growth in housing starts in February was also mainly related to multi-family homes, i.e. apartments that will ultimately be occupied by some who lose homes in foreclosure or those who lose jobs and cannot afford to own a home.

Current inventories of unsold homes are still at twice the level of average times and, looking forward, the data is still far from indicating an immediate bottom in housing. The ratio of average home prices to average family incomes has been a reliable indicator of affordability of homes for families and up until 2001 that ratio was 2.7 to 1. At the peak of the housing market that ratio grew to over 5.5 to 1 and is still 3.5 to 1 today, implying that home prices could still fall by 15% assuming low growth of incomes in the recessionary economy. Low mortgage rates could help, however. But a full housing market recovery could still be some time away.

Beyond housing, we continue to look at what might help the economy turn around or conversely, what will weigh on the ability to achieve growth. Our primary concern about the timing of a turnaround in the U.S. economy remains the financial health of American consumers, who have been hit with job losses and high debt levels. The chart below shows the historically high level of debt payments to personal income. While somewhat better in recent readings, compared to peak levels in late 2007, the overall debt burden is still excessive.

The “de-leveraging” of the American consumer that needs to occur will likely continue into the next few years at the cost of economic growth, given that consumer activity accounts for 70% of U.S. GDP. Similarly, personal savings rates are likely to rise to a more normal level of 5% of income, which will restrain economic growth as well. Unlike what happened with last year’s stimulus money, consumers will keep much more of the \$150 billion in increased savings from the refinancing of mortgage loans and from having less withheld from their paychecks.



Source: Board of Governors of the Federal Reserve System

Businesses are similarly cautious in their spending at the moment, primarily in employment but also in planned spending on technology or other capital improvements, according to recent executive surveys.

***The bottom line from our perspective is that “less bad” economic data would certainly be a good development if sustained, but the trend must be confirmed by more than a single month of data. There continue to be many factors why the economy remains in a fragile condition and why there is the possibility we are in a “W” shaped recession in which the economy partially recovers because of the deficit spending, only to slip back into another downturn in 2010. This possibility affects the outlook for stocks and companies’ financial health.***

## Government and Monetary Intervention Measures – A Brief Review

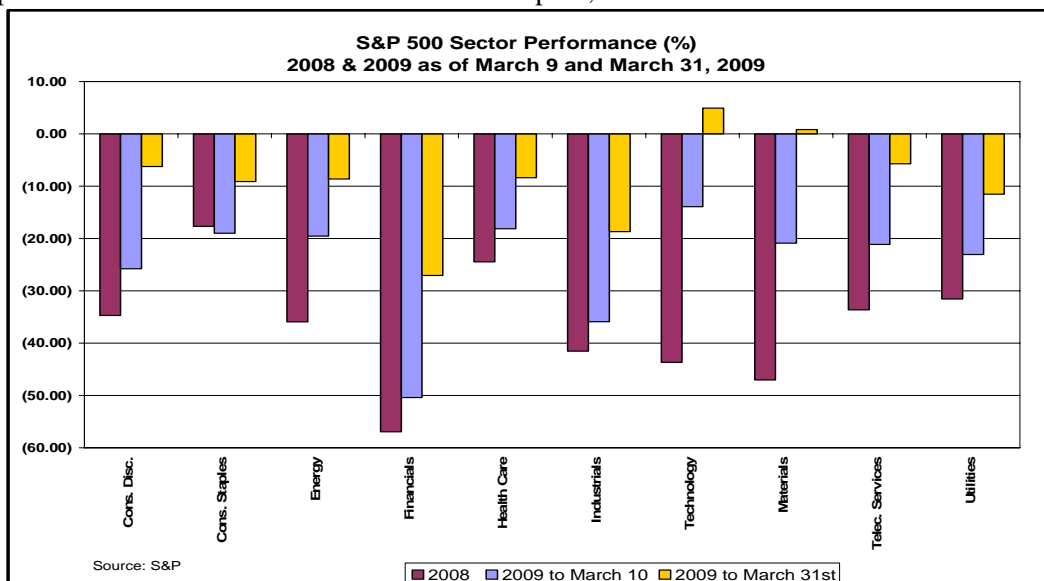
The first quarter also contained almost daily announcements by government or central bank leaders on new measures to try to help the economy and markets find stability. In the U.S. the new administration pursued an economic stimulus plan and additional government intervention in banks and auto manufacturers.

One announcement of particular impact was the March 10<sup>th</sup> speech by Treasury Secretary Geithner of the government's intention to purchase "bad" assets of financial institutions alongside of private investors. This proclamation was widely seen as a positive step in avoiding the decade-long problems that Japan's financial institutions had in the 1990's with the burden of bad assets. Having private investors participate was seen as a move in the right direction to the market. Beyond the U.S. government, central banks around the world have been taking action to inject capital into the financial system by buying a variety of assets. The U.S. Fed made large purchases of U.S. Treasury and agency securities along with providing guarantees of troubled assets.

Our analysis of the government's actions taken to achieve stability in the economy and markets was that they are necessary steps for the near term, but we look at what happens once these props are removed? We consider the effect of federal stimulus through deficit spending as fleeting by early 2010 and once gone could require another round of government spending. Therefore, along with a likely reduction in consumer debt levels, a decrease in government spending prior to the stabilization of the economy could pose a threat to recovery. Longer-term, the effect of the massive accumulation of debt by the U.S. government is a risk to the strength of the U.S. dollar, the instigation of inflationary pressures and the flexibility to deal with known fiscal problems such as Medicare.

## Equity Markets – Downtrodden Financial and Cyclical Stocks Rally the Most in March

After being down as much as 25% for the year by March 9<sup>th</sup>, U.S. stocks ended the first quarter with a solid rally in the last three weeks of March. Because of the rebound the S&P 500 ended the quarter down only 10.8% on a total return basis. The rally measured 23% from the low point and represents the third increase near or above 20% since the market peaked in 2007 (see chart on first page). Such rallies are typical of a bear market and may or may not signal the bottom. Because of the volatility in the markets the past six months, rallies such as this one do not feel satisfying, but they do provide some relief for investors. The chart below shows the performance of sectors of the S&P 500 in 2008, then for the year-to-date up to March 10<sup>th</sup> and then the year-to-date return of the sectors through March 31<sup>st</sup>. Noteworthy is how financials, industrials and technology stocks recovered significantly. In many cases, the financial stocks down the most were the ones to gain more, while higher quality stocks did not. Because of the continuing concerns we have about the liabilities of financial firms and the need by many companies across the sectors to raise additional capital, we view the rise in such stocks as unsustainable.

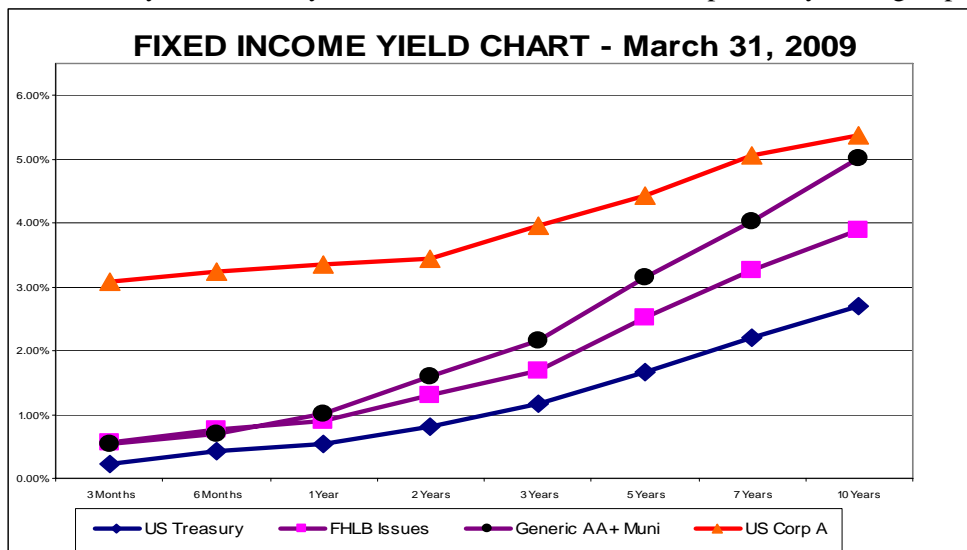


The stock market rebound has been driven by the belief that risks to the banks and the economy have been reduced. But together with the problem of weak balance sheets and "toxic" assets at many companies, our analysis leads us to see the potential of companies' financial positions getting worse. Our view of the prospects of companies is based on our own analysis of the balance sheets and earnings outlooks, rather than relying on

Wall Street estimates. Historically, Wall Street analysts and companies have not been accurate in their forecasts, nor in their ability to spot the turning points up or down. The current environment makes it difficult to assess future earnings but by our calculations many individual stocks are not as cheap and not as compelling in terms of near-term catalysts. We acknowledge a long-term view is required and that the market may improve before earnings do. Our review of the financial statements of even the highest quality companies found another item overlooked by many analysts - that profit margins continue to be at multi-year highs and are likely to decline in the recession. Continued discrimination in new stock purchases and active management of holdings is warranted.

### Fixed Income – Yields Imply Risk Aversion Still Exists and the Potential that Treasury Yields are Too Low

While U.S. Treasury interest rates moved slightly higher in the quarter, which was good for income oriented portfolios, a more significant development for bond investors and issuers alike was the continued wide difference between government bonds and corporate bonds. The chart below shows the relationship of various types of bonds across different maturity timeframes and the fact that “A” rated industrial sector corporate bonds have quite a gap between their respective yields. The reason for the wide spreads is the continued risk aversion by investors about corporate bonds. The high yields required by purchasers to own corporate bonds and the sellers to issue them speak to the concern about future financial problems. For non-taxable portfolios, we still view high quality corporate bonds as a way to selectively add to income levels without imprudently adding to portfolio risk.



Source: Bloomberg

### Investment Strategy – Looking for Confirmation of Stability

At the end of 2008 we wrote about the likelihood of new purchases in quality companies now that earnings estimates had finally come down and would hopefully stabilize. However, in our day-to-day scrutiny of company earnings data in the first quarter we did not find the outlook for companies had stabilized. Nor did we find insight into the timing of any improvement. Near-term prospects for corporate profits and balance sheets worsened and we expect first quarter earnings and beyond to be weak. With all this said, we still hope to be able to buy more stocks if we find data in earnings releases or financial statements to give an indication of stabilization or growth.

In the meantime, we will remain patient for more quantifiable upside in stocks even if it means missing an initial upward move in the prices of a few quality stocks. While we agree with those now forecasting the potential for solid long-term returns in stocks, our analysis does not lead us to conclude the time has come to be aggressively raising stock allocations. We continue to favor defensive positions in the stocks we own, moderate allocations overall relative to long-term targets and an overweight bond and cash position despite the yields. Capital preservation remains paramount when our research and analysis tells us that reward to risk levels are low.

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

*Christopher H. Lyford*

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