

POLITICAL, ECONOMIC AND CAPITAL MARKETS REVIEW & OUTLOOK FOR 2009

Summary

- Political focus in 2009 will be on the United States under the leadership of the new Obama administration
- Global economic weakness will continue, with slow and uneven recovery
- Heightened volatility in the investment markets will persist
- Companies that will benefit from increased federal government spending provide investment opportunity
- Emerging market economies will drive growth in the global economy and provide additional opportunity

Political Commentary

In November 2008, the Democratic candidate, Barak Obama, was elected as the next president of the United States. The victory was a solid one, and was accompanied by Democratic majorities in both houses of Congress. Mr. Obama's election was based on a general platform of "change."

Obama is surrounding himself with an administration of competent, intelligent and experienced leaders. Thus far, his approach has been characterized as "pragmatic." His administration will take control at a time of economic troubles. Major unresolved issues in addition to those of the economy will confront the new administration, such as reform of our systems of health care, social security and education, as well as energy and the environment.

Although the exact nature of the policies of the new administration and their effectiveness remain unknown, clearly the approach will be an active one. The president-elect has indicated that he intends to sign economic stimulus legislation promptly upon taking office. Even in the waning days of the Bush Administration, as the economic crisis verged on global collapse, the government stepped forward to intervene in an unprecedented fashion.

Under the new administration, the extensive involvement of government in the economy will likely become even more pronounced. In addition, the change in party control follows several decades in which the underlying sentiment has been to reduce government interference in free markets. The recent crisis, however, is perceived as the result of inadequate regulatory controls. The current sentiment is that regulation needs to be reinvigorated.

President-Elect Obama will begin his new administration with broad-based support from within the United States. He will also carry strong popular support and good will from other nations, people and leaders from around the world. His party will come forward with significant government programs to address the current economic problems and other issues with substantial stimulus spending and tightened regulatory controls. And he will have strong majorities in Congress to implement his initiatives. We expect the first several months of 2009 in the United States to be a dynamic time.

Over the course of the year, we suspect this initial momentum and enthusiasm will bog down. No doubt some in all areas of the political spectrum will be disappointed with the new policies. The Democratic majority in Congress will be insufficient to overrule Republican filibuster. And while the new policies may be effective, we believe that the economic problems are severe and will not be easily or quickly resolved. Towards the end of 2009, therefore, we expect there will be diminution of the initial enthusiasm for the new administration.

On the global political front, we note ongoing political tensions in many areas around the world: tensions between India and Pakistan due to the recent terrorist incidents in Mumbai, ongoing military conflicts in Iraq and Afghanistan, as well as the most recent outbreak of military actions in the ongoing struggle between the Israelis and the Palestinians. We also note growing social unrest in China and Russia, which appears to be a result of the global economic crisis.

In our Review & Outlook for 2008 we hypothesized that, due to the effects of globalization, the world economy has been gradually disengaging from its dependence on U.S. economic strength. However, in 2008 it became clear that the global economy has become more interdependent, rather than independent. Growing economic weakness in the United States and other developed markets quickly began to impact developing markets. Therefore we believe that the focus for political consideration in the year to come, particularly with regard to the economy and the financial markets, will be on the United States under the leadership of the new administration.

Another related major political concern in 2009 will be protectionism. In the face of the economic crisis, we see countries around the world scrambling to stimulate their economies to mitigate the crisis. In times of economic stress, political pressure to pursue protectionist policies in order to shore up domestic economies is common. We believe that most political leaders understand that such self-interested policies are misguided, and that there will, in fact, be impetus for ongoing stimulus to global trade. Yet we are mindful of the political tensions associated with globalization and recognize the broad popular support protectionist policies may have. We will be monitoring for nationalist tendencies.

Finally, we note the ongoing political significance of globalization. While initially many of the concerns of the new administration will be on domestic issues – including the economy, health care, and the environment – it will be quickly recognized that these are in fact global issues, and that they can only truly be addressed with a global perspective. We see that regulatory reform will be critical, and that this too must be handled on a global basis. The outlook for the U.S. economy and investment markets will hinge on the ability of major players from around the world coming together to address the problems, and the ability of the United States under the new administration to provide effective leadership in the global arena.

Economic Review and Outlook

2008 was a challenging year for the global economy. Crisis in the U.S. housing market fed into crisis in the global financial system, and the impact of both spilled over into the world economy. After failure of several well known financial institutions, and despite massive bailouts and other remedial actions of central banks, the economies of the developed world are now in recession. Furthermore, problems in these major economies are significantly reducing growth rates in the emerging markets.

In 2009, we think that global economic growth will slow significantly, with world GDP growth of 2.0% to 2.5%, driven primarily by growth in emerging market economies. Indeed, U.S. GDP is likely to contract. We anticipate substantially higher unemployment in developed economies, approaching 10%. Due to weak global economic conditions, we believe that central banks will maintain low interest rates and continue to provide liquidity. Inflation will remain muted in 2009. After 2009, however, we see risk of a sharp increase in inflation as a result of the substantial liquidity being pumped into the financial system.

As we head into the New Year, we observe significant weakness in the economies of the U.S., Europe, and Japan. Employment is declining. Consumers are saving more and spending less. In the face of mounting loan losses, financial institutions are de-leveraging. Financial institutions also face the risk of substantial defaults within various derivative markets. Commercial real estate is encountering problems. Moreover, state and local governments are being squeezed as they confront increasing demand for services and declining tax revenues.

As credit tightens and income declines, less capital is available for growth. Furthermore, tight credit and limited access to capital markets will hinder companies in refinancing existing debts, placing further strain on corporate budgets. As a result, companies will be focused on conserving cash through reduced capital spending and layoffs.

Recovery from this period of contraction back to growth will be slow and uneven. We see governments stepping in to bolster their economies through considerable spending and tax reductions. Also, in an attempt to maintain functional financial systems, central banks are lowering key interest rates and supplying vast amounts of liquidity in an unprecedented fashion. The U.S. government is extending its reach deep into the economy, broadly expanding the money supply and taking ownership stakes in numerous corporations. Additional intervention is likely, particularly in an attempt to stem job losses. Increased regulation and the difficulty of extricating government from its increasingly deep involvement will drag out the recovery.

Finally, we observe that global trade activity has weakened considerably, alongside economic weakness in the U.S. and Europe. While economic systems within emerging markets have become more self-sustaining, the U.S. and Europe still wield considerable economic clout. Within more export driven emerging market economies, we think that work slowdowns and rising unemployment are likely – further hindering global economic growth. However, despite slowing trade and significant weakness in the U.S., Europe, and Japan, we believe that global growth will continue – albeit at a slower pace – driven by emerging economies.

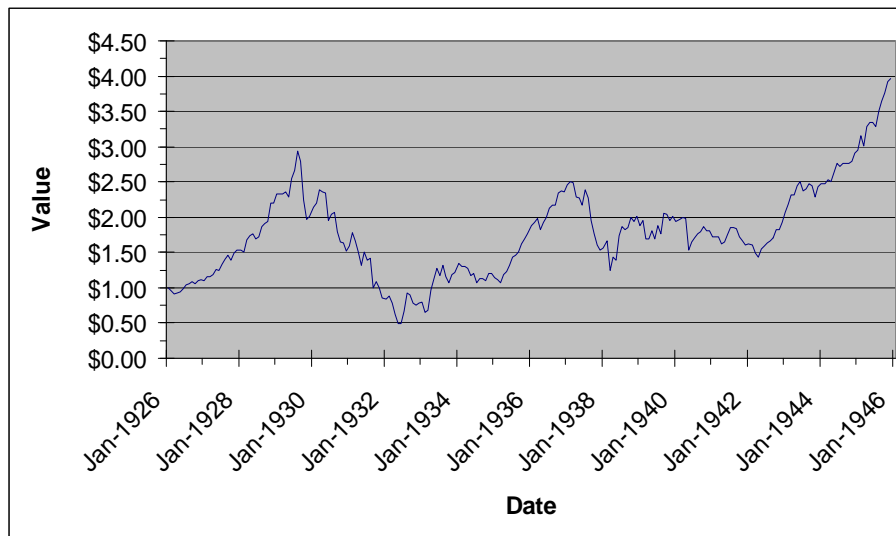
Capital Markets Review & Outlook

2008 was a difficult year for investors. The U.S. stock market declined 37% based on the S&P 500 stock market index. This was its worst yearly return since 1931, when it fell 43%. In recent history, the market's worst year was 2002, when it fell 22%. Foreign markets fared even worse, down on average over 40%. A major aspect of investment markets performance in 2008 was how pervasive the weak results were. Bonds, too, performed poorly. The average taxable bond fund was down 7.7%. Of the major asset classes, only U.S. Treasury securities and GNMA's were up, with modest 5% returns on average for the year.

Now, at the start of 2009, at a time of major political transition and economic crisis, what do we expect from the investment markets?

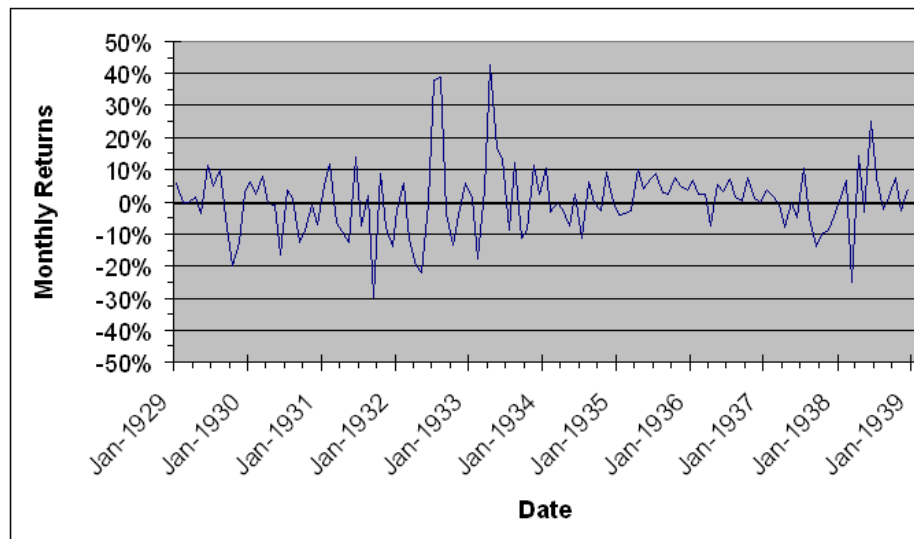
The securities markets often perform in a fashion out of synch with economic activity. Often the outlook is most bleak when the markets are poised to rebound. Our best estimate is that the heightened volatility we experienced in 2008, especially towards the final months of the year, will continue. Overall for the year, we suspect there will be no clear sustained movement in either direction.

While this outlook is mere conjecture, at least we have history to provide us with a guide. The following chart, based on Ibbotson Associates data, shows the performance in the U.S. stock market during the Great Depression, another time of economic stress. It shows how \$1 (with dividends reinvested) fared over the period 1926 through 1945:



During the first four years, investors saw their investment triple in value. From the peak in 1929 to the depths of 1932, however, the portfolio fell to less than half of its original 1926 value. If an investor invested at the top, he would have seen his investment decline 85% – although that represents losses only for those who needed to sell. Still, recovery was a protracted affair, with many setbacks along the way. It took nearly 15 years for the markets to rise above the peak in 1929. For those who bought in at the beginning and simply held on, the average annual return for the full 20-year period was 9.7%.

The next chart shows the volatility of the stock market during this period. It is a graph of the month-to-month percentage change for the ten-year period starting in January 1929:



We point out the exceptionally wide swings in market value on a month-to-month basis. Note the breathtaking plunge of 30% in September of 1931, followed shortly by a 20% drop in April and another 22% decline in May of 1932. Then in June and July of 1932, the returns in each month were up over 38%, cumulatively nearly doubling the investment value during that 60-day period. During the ten-year period there were 31 months in which the returns – either positive or negative – were 10% or greater. Even during this very troubled time, the market moved in a highly unpredictable fashion. Also, recovery periods were sharp and unexpected.

History will not repeat itself, yet it gives us a picture of how the markets performed during a difficult economic period. Obviously stock market investors – even holders of well diversified portfolios – need to be prepared for gut-wrenching periods that may stretch out for multi-year time frames. In our view, it is treacherous to attempt to second guess the rapid swings in market value. Investors who profited most were those who were able to step in and add to holdings after experiencing extraordinary declines. In retrospect this was clearly the optimal strategy. In the course of events, however, it is very difficult to have the fortitude to pursue it.

As for our current strategy, we maintained underweight in equity investments throughout 2008. Following the sharp sell off last year, we have now become more neutral. Valuations look reasonable. We are looking for long-term investment opportunities in companies with strong cash flow, limited need for debt, and attractive growth opportunities. Specifically, we favor companies that will benefit from increased government spending in the following areas:

- Infrastructure – roads, bridges, waterways and ports
- Alternative energy – energy production that reduces dependence on foreign oil
- Other “Green” initiatives
- Medical savings initiatives, such as electronic medical records
- Education initiatives

Regarding foreign stock markets, in 2009 we believe that selected emerging markets provide the best opportunities. With regard to other assets, including bonds, real estate, and commodities, we expect that 2009 will be another challenging year. For bonds, the opportunities we see are mixed. Key interest rates will remain low given central banks' focus on maintaining liquidity and concerns of a deflationary spiral. Although safe, cash or Treasuries will compensate investors poorly. On the other hand, the return potential of corporate bonds – both investment grade and high yield – is significant. Our expectations for other fixed income investments are as follows:

- Municipal bonds – yields currently favorable, but defaults higher than average due to economic difficulties of local governments
- International bonds – holdings not hedged to the U.S. dollar superior to U.S. government debt, as foreign central banks catch up to the Fed's interest rate cuts
- Treasury Inflation Protected Securities (TIPS) – prices and yields on these low-risk securities are currently attractive.

For real estate investment trusts (REITS), the problems for commercial real estate in 2009 make investment in this sector dicey. With regard to commodity-related investments, our outlook for 2009 is unfavorable due to ongoing weakness in the housing markets and general global economic downturn. Our long-term view on oil, however, is positive. Global demand for energy will continue to grow, particularly as developed economies recover, while current low prices have reduced incentive to develop new supplies.

Summary & Strategy for 2009

2008 was a difficult year for investors. In 2009 we anticipate another wild ride, though overall less negative. Despite the poor economic outlook, we have become more optimistic on stocks. We favor companies that will be beneficiaries of government spending. We also find significant unique investment opportunities in areas of higher risk, such as corporate bonds and emerging markets. As always, however, we deem it paramount to invest in a well-diversified fashion, due to the risk of ongoing blow-ups, and in anticipation of renewed inflation.

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