Capital Market Review

First Quarter, 2009

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Summary

Unrelenting job losses, depressed consumer and business confidence amidst a very severe recession led U.S. stocks lower for the first quarter. This represented the sixth straight quarterly decline in the stock market. During March, stock and bond investors took solace in a number of positive – or perhaps only less negative – economic reports. In fact, March stock market returns were the strongest monthly return since 2000.

First quarter capital market returns, with the exception of emerging market stocks and U.S. bonds were negative. U.S. stocks returned -10.8%, international stocks were down -13.9%, and emerging market stocks eked out a gain of 0.5%. Real estate investment trusts (reits) were down nearly 30% for the quarter and commodities declined over 6%. U.S. intermediate-bond returns were just barely positive.

Economic Conditions

During the early part of the quarter, investors were concerned that the recession, which started in December 2007, showed no signs of abating and, in fact, may worsen. Job losses were approaching 5 million, and the unemployment rate rose to 25 year highs. In addition, retail sales, industrial output, and fourth-quarter GDP

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Continued on next page

suffered their worst declines in decades.

But, in March, there were some initial signs that the economy, while not growing, was declining less rapidly. Stabilization of existing conditions is necessary before growth can resume. Some of these more positive indicators included: improvement in retail sales and commodity prices, industrial demand, and new home sales.

In addition, the government response has been significant. Two policy initiatives, in particular, have gained traction with the markets:

- The Treasury Department announced a joint private/public fund that would purchase up to a trillion dollars of illiquid assets. The theory is that if banks balance sheets can be "cleansed" of bad assets, they will start lending again.
- The Federal Reserve announced it would spend an additional trillion dollars to purchase mortgage-backed securities issued by Fannie Mae and Freddie Mac as well as longer-maturity Treasuries. The goal is to lower longer-term interest rates. Ideally, this will also lower mortgage interest rates spurring on additional refinancing/purchases.

Also, the Financial Accounting Standards Board (FASB) announced new mark-to-market accounting rules. These rules are designed to help financial institutions in giving them more flexibility in valuing some of their more hard to price assets. While this rule change will not eliminate the credit crunch, it, along with several other policy initiatives, should reduce the severity.

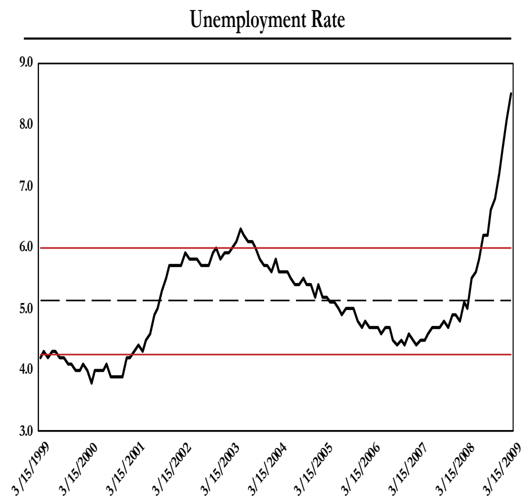
Consumers should benefit from the payroll tax credit that was recently passed. In addition, those homeowners that refinance will see lower mortgage payments that will put badly needed cash into their pockets.

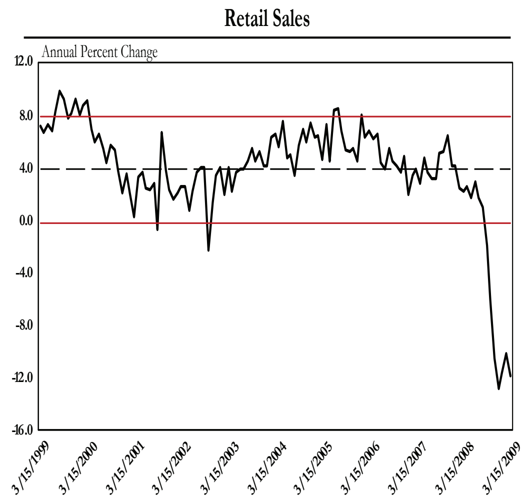
While there may be some cause for optimism, the economy is by no means "out of the woods". Expect another couple of quarters of declining economic growth followed by a quarter or two of extremely weak growth. The recovery will hopefully "get some legs" during the first half of 2010.

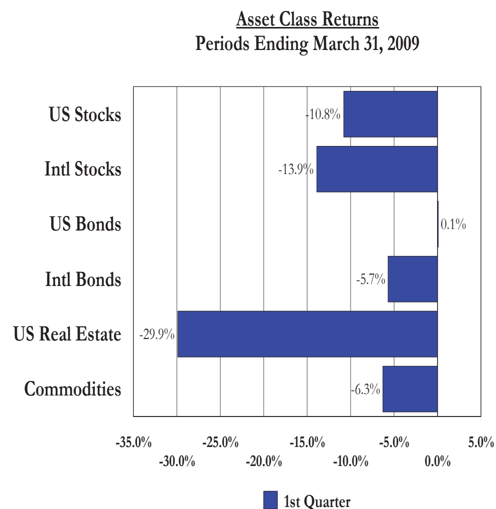
First Quarter Asset Class Returns

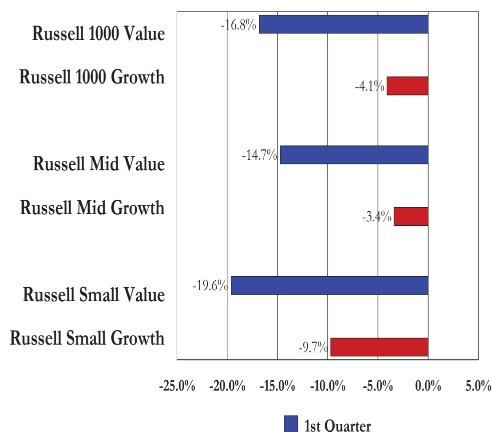
Bonds were the only asset class to have a positive return -- and that was just barely. Real estate (reits) got crushed during the quarter as investors became increasingly concerned about commercial real estate (in addition to residential) and the ability to re-finance the large debt load.

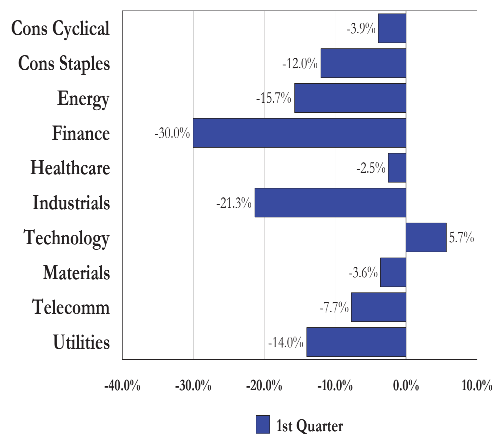
Even after strong returns in March, stocks had meaning-

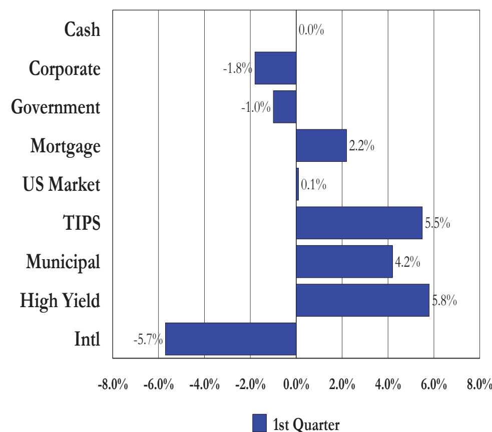












ful losses for the full quarter. U.S. stocks outperformed their developed international counterparts. International bonds declined due to the rising dollar as investors sought the safety of the U.S. currency. Commodities returned -6.3%.

U.S. Stock Market Returns

During the first quarter, mid-cap stocks had the best company size performance with a return of -9.0%. Large-cap stocks returned -11% while small-cap stocks returned -15%.

In terms of investment approach, the growth approach significantly outperformed the value style -- regardless of company size. The growth approach has a greater emphasis on companies whose earnings tend to be less economically sensitive. This should be beneficial in times of recession. Generally speaking, it also leads to more emphasis to certain sectors such as healthcare, consumer services, and technology.

Technology was the only sector to have a small gain during the first quarter. Other sectors that did relatively well include: healthcare, materials, and consumer cyclicals. Finance, industrials, and energy were the worst performing sectors during the first quarter.

Bond Market Returns

The U.S. bond market had a 0.1% return during the first quarter led by the returns of the mortgage sector. Both corporate and government bond returns were negative.

Treasury inflation protected notes (tips) performed well during the quarter after becoming incredibly cheap during the fourth quarter. High yield bonds rebounded from a disasterous 2008. Even so, the yield spread on high yield bonds remains extremely attractive. International bonds returned -5.7% in response to the significantly higher dollar.

Current Outlook

We are in a period of significant volatility as investors try to interpret each bit of economic and political data. We are probably approaching an economic inflection point. We believe the economy may continue to deteriorate for a while, but the rate of decline should lessen.

In terms of portfolio strategy, we plan to emphasize large-company and growth-style stocks (no change from our recent strategy). We are becoming somewhat more optimistic on the international markets and may re-establish positions. In terms of bonds, investment grade corporate and high yield bonds are quite interesting, but we believe it may be too soon to establish a position.