

Capital Market Review

Second Quarter, 2009

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Johnston Investment Counsel
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Summary

While extremely fragile, and still providing mixed data, we believe the economy appears to have bottomed. While some believe there is another economic downturn ahead, we believe that is a less likely scenario (given the vast sums of money that have been spent and increased liquidity). We expect very mild economic growth to start during the third quarter and that the subsequent recovery will be weak by historical standards.

Investors became more risk-tolerant during the second quarter. All major asset classes had positive returns, and the riskier segments performed the best. Emerging market stocks and bonds returned 33.6% and 13.0%, respectively. Real estate returned 27.3% and high yield bonds returned 20.2%. U.S. stocks returned 16.8% while commodities returned 11.7%. U.S. bonds returned 1.8%. On a year-to-date basis all major asset classes with the exception of real estate have positive returns. Commodities returned 4.6%, U.S. stocks 4.2%, and U.S. bonds 1.9%. The year-to-date real estate return is -10.8%

Current Economic Conditions

Current economic conditions are mixed but are trending in a positive manner. Some indicators are worsening.

Some are stable and are consistent with a continuing deep recession, while others suggest the economy will improve during the second half of the year. This is normal. The economy cannot go from backward to forward in one step. At any economic turning point, there will be data that provides mixed signals.

With that said, we believe the recessions force is slowing. Improving confidence among purchasing managers, and a rise in expectations for future capital expenditures are signs of manufacturing improvement. Consumer and business confidence surveys all show improvement. Housing is no longer a major drag on the economy as it has been for the past couple of years. While it is too early to talk of a housing recovery, existing home sales and affordability have improved even though prices are still going down and foreclosures will be increasing.

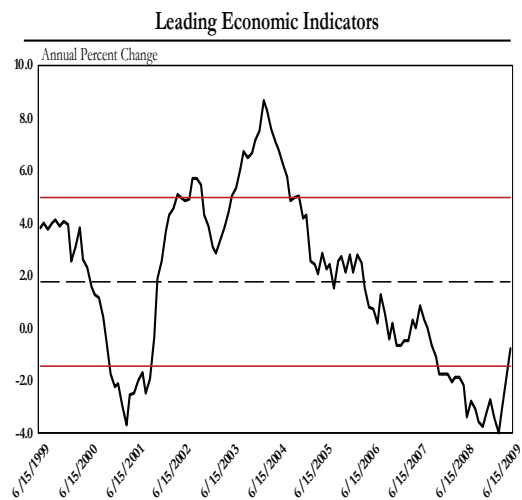
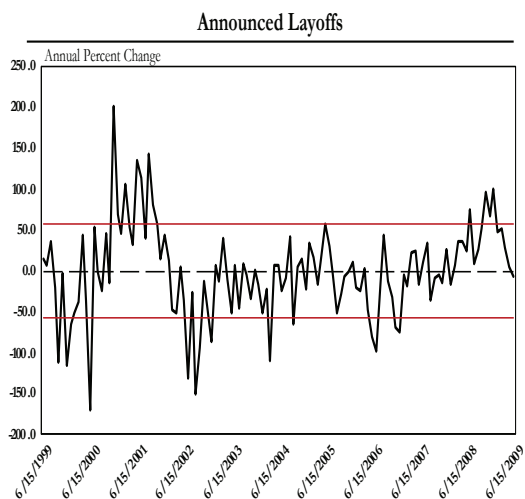
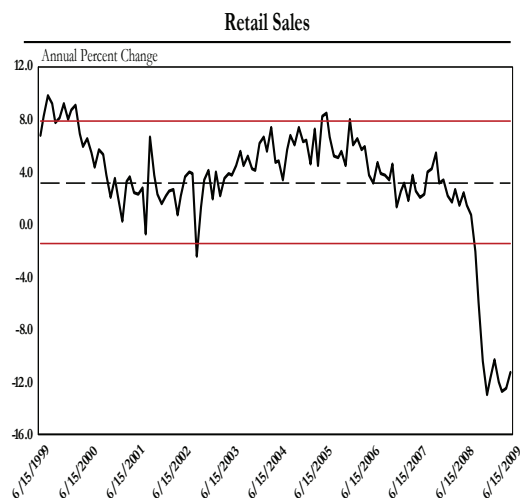
Labor market conditions remain extremely weak. Nominal wages continue to fall and the average workweek has declined to 33 hours (the lowest on record). Many workers are being asked to take pay cuts or reduce their hours. Several employment surveys expect layoffs to slow, which are confirmed by lower initial claims for unemployment. Unfortunately, these surveys expect hiring to remain dormant. Clearly, for any recovery to take significant hold, a stronger labor market is needed to boost wages, as well as, improve consumer spending and confidence.

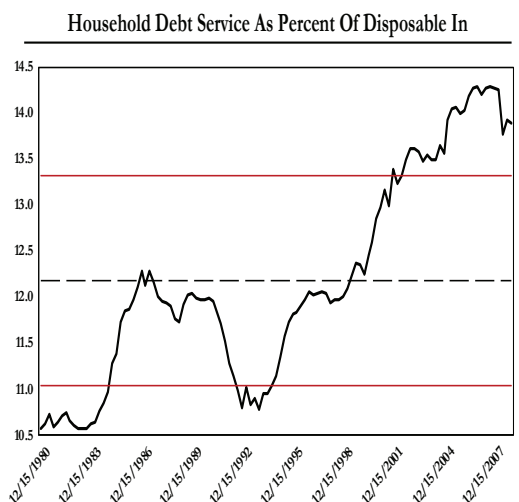
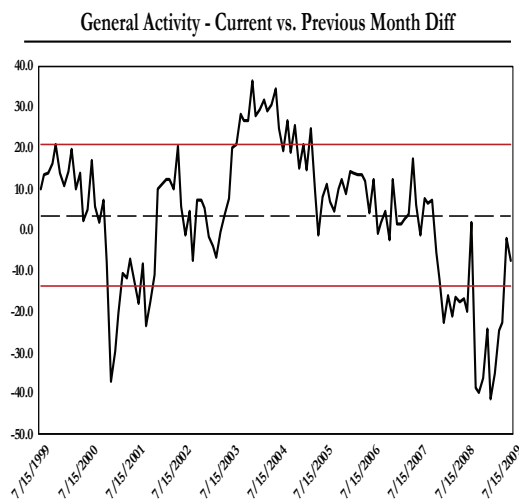
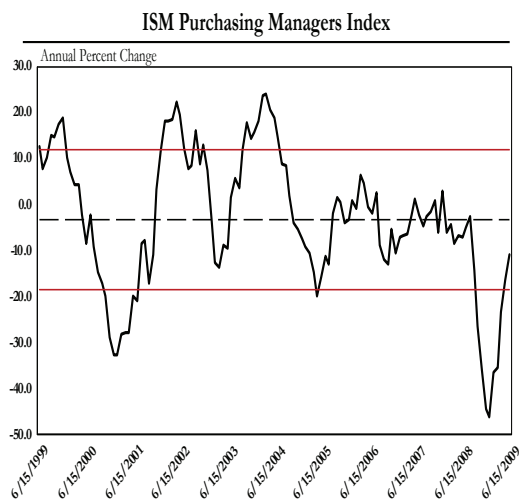
Global gross domestic product will probably decline by over 2% this year, the first decline since WW II. With that said, coincident indicators point to a bottom and stabilization for the global economy. Sentiment is improving as consumers and businesses expect better times ahead. China, India, and the U.S. will likely be the first countries that recover. The recovery in Europe, due to its inconsistent policy response, will lag other developed countries.

Future Economic Conditions

A consensus is building that the recession will likely end during the second half of 2009. In fact, many expect positive economic growth (just barely positive) during the third quarter. Historically, deep recessions are followed by steep recoveries – the V shaped pattern. In these cases, autos and housing were extremely strong contributors to growth coming out of recession. We think it is unlikely, given the remaining housing issues as well as consumer's financial situation, these industries will lead to a vigorous economic recovery.

Our sense is that any future recovery may be subdued –





at least for a few years. This recession has caused significant damage to the collective psyche. At least for now, Americans will be focusing on repairing their financial situation. That means more saving and less consumption. We have already seen the savings rate increase to 7% from 0% a year ago. Credit card debt must go down and retirement balances must be repaired. Homes will no longer be used as piggy banks. Yet, there is an old adage that says “don’t ever bet against the American consumer”. While, over multiple years or decades that may be true, we do not expect the consumer to come roaring back during the next few years.

We expect consumers to increase their holdings to lower yielding instruments (after experiencing a stock market collapse for the second time within ten years). This will likely raise the cost of equity capital for business. In addition, banks will likely face higher capital requirements, which will lead to higher lending rates for both business and consumers. Since business and consumers’ cost of money will be increasing, we expect lower demand, capital investment, and productivity. This will lead to lower future economic growth.

Many are concerned about the prospects of future inflation. We do not believe, over the next year or so, that inflation will be a significant issue. There is simply too much excess capacity – and not enough demand. No one has any pricing power. The massive increases in money supply will hopefully be reduced to more normal levels, and that should reduce inflationary pressures. The trick, of course, is timing. The Fed does not want to significantly reduce the money supply while the economy is still fragile, nor should it be done all at once and shock the economic system. It is a very fine line that the Fed will have to walk. Expectations for long-term inflation are around 3% -- well within a “normal” range. But, one cannot rule out the possibility of significantly higher inflation. At least for the next 12-18 months, we believe hyperinflation has a much lower probability.

In addition, there are widespread concerns about the financial condition of the United States -- given our bulging budget deficits and expanding social agenda. This year, the expected deficit is \$2 trillion – four to five times what it was last year. While a good portion of this amount represents the various stimulus and bailout packages, other countries are questioning the U.S. commitment to responsible budgets. In fact, China has called for a discussion of a new reserve currency (currently the dollar is the world’s reserve currency). These factors suggest that, over time, the dollar will likely decline.

In summary, the economy appears to have bottomed and

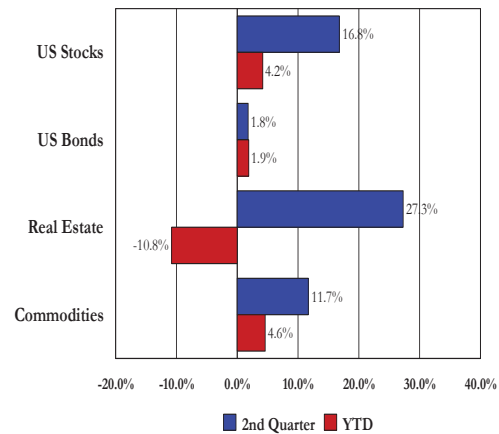
will slowly start improving over the next few months and quarters -- but it is still very fragile. It is therefore good that the highest payouts from the stimulus package will be “hitting” the economy now and for the next several quarters. Ideally, this additional spending will solidify a budding recovery. However, we expect the recovery to be subdued.

Second Quarter Asset Class Returns

Based on data suggesting economic stabilization, stocks continued the rally that started in mid-March. Although, the rally stagnated in June.

During the quarter, U.S. real estate investment trusts (reits) were the best performing asset class returning 27.3%. U.S. stocks returned 16.8% followed by the commodity return of 11.7% and bond return of 1.8%. Year-to-date with the exception of real estate, all major asset classes have positive returns.

Capital Market Returns
Periods Ending June 30, 2009

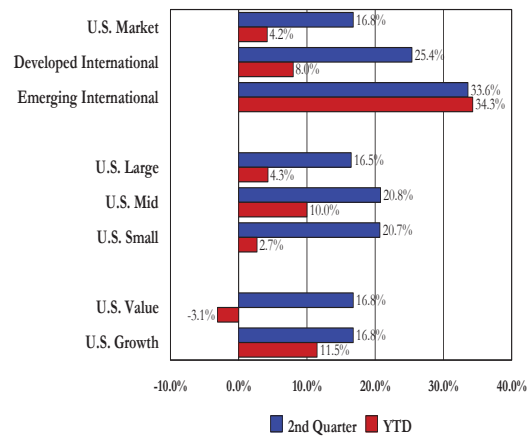


Stock Market Returns

Emerging market stocks have been the best performing segment through June 30, returning 33.6% during the second quarter and 34.3% on a year-to-date basis. Developed international stocks outperformed U.S. stocks and returned 25.4% and 8.0% during the second quarter and year-to-date, respectively. U.S. stocks returned 16.8% and 4.2% during the second quarter and on a year-to-date basis.

During the second quarter, mid-cap stocks were the best performing company size segment closely followed by small and then large-company stocks. Mid, small, and large-cap stocks returned 20.8%, 20.7%, and 16.5%, respectively. On a year-to-date basis, mid-cap stocks returned 10.0%, leading the large-cap stock return of 4.3% and the small company stock return of 2.7%.

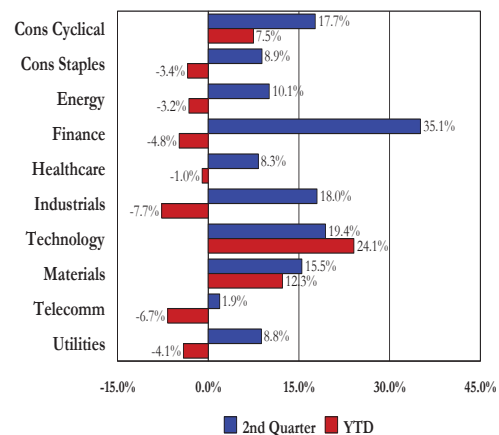
Stock Market Returns: By Nationality, Size, and Approach
Periods Ending June 30, 2009



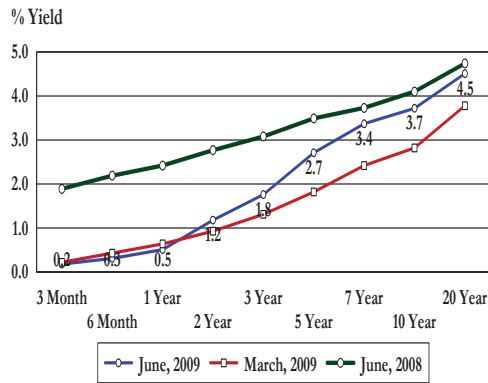
There was no meaningful difference between value and growth stocks during the second quarter -- both investment approaches returned 16.8%. However, on a year-to-date basis, growth stocks significantly outperformed value stocks (11.5% vs. -3.1%) reflecting strong first quarter growth-style performance.

Finance stocks had, by far and away, the best sector performance during the second quarter returning 35.1%. Other outperforming sectors included: Technology (19.4%), Industrials (18.0%), and Consumer Cyclical (17.7%). The worst performing sectors during the second quarter included: Telecommunications (1.9%), Healthcare (8.3%), Utilities (8.8%), and Consumer Staples (8.9%).

U.S. Stock Returns By Sector
Periods Ending June 30, 2009



Bond Market: U.S. Government Yields To Maturity

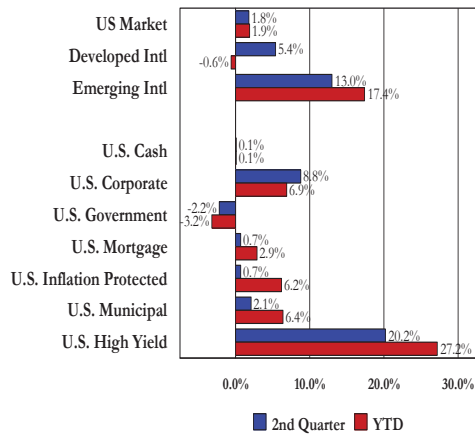


On a year-to-date basis, seven of the ten economic sectors have below zero performance. Industrials (-7.7%), Telecommunications (-6.7%), Finance (-4.8%), and Utilities (-4.1%) are the worst year-to-date performers. Technology (24.1%), Materials (12.3%), and Consumer Cyclical (7.5%) are the only sectors to have positive year-to-date performance.

Bond Market Returns

Emerging market bonds were the best performing bond sector during the second quarter, returning 13.0%. Developed international bonds returned 5.4% while U.S. bonds returned 1.8%. Year-to-date, emerging market bonds returned 17.4%, followed by U.S. bonds at 1.9% and developed international bond returns of -0.6%.

Bond Returns By Nationality and Sector
Periods Ending June 30, 2009

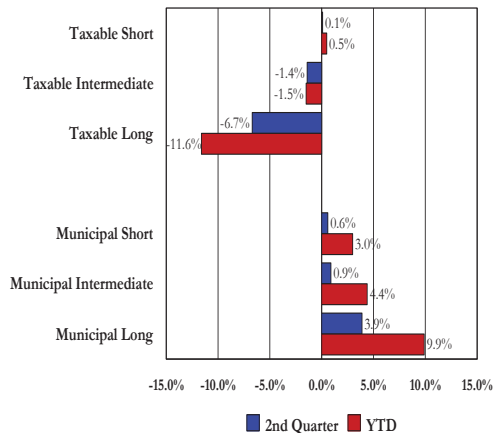


Within the U.S. market, high yield bonds returned 20.2% and 27.2% during the second quarter and year-to-date, respectively. U.S. corporate bonds have had decent results returning 8.8% during the second quarter and 6.9% year-to-date. U.S. Government bonds have trailed other sectors with a second quarter return of -2.2%, and a year-to-date return of -3.2%.

Current Portfolio Strategy

While there is still the possibility of an additional economic downturn, we believe the more likely scenario is for economic stabilization followed by a period of subdued economic growth.

U.S. Bond Returns By Maturity and Taxability
Periods Ending June 30, 2009



In terms of bonds, we believe high yield, medium quality, and investment grade corporate bonds offer the best return and risk characteristics. Unless the U.S. signals a vigilance toward bringing its budget under control, international bonds may also be a reasonable investment opportunity (the expectation that the dollar will decline).

With respect to stocks, historically, coming out of a recession, small-company and value stocks have outperformed large and growth stocks. We therefore recommend an overweighted position to small, value, and mid-cap stocks. In addition, we believe allocations to both developed and emerging market international are appropriate at the present time.