

Trust and Investment Division

As of June 6, 2009

Signs of improvement in the U.S. housing market, rising consumer confidence and a rally in financial stocks suggest that the economy is bottoming out and the worst of the financial crisis may be behind us. Indeed, job losses in May were the least in eight months. Stock markets have risen sharply since March 9th (39%) as several of the biggest banks in the country announced they were profitable in the first quarter. The three month rise in the S&P 500 has been the biggest three-month gain in the post World War II period.

Many banks that issued preferred stock to the government as part of the Troubled Asset Relief Program (TARP) have been successful in raising additional capital with a goal of refunding the TARP money as soon as allowable. With the apparent stabilization in the financial markets, it appears interest in participating in the various government programs is waning. Those banks would prefer to solve their problems without government assistance, if they can.

With the improvement in market confidence, the government can now concentrate on the GM bankruptcy. If the Chrysler situation is any indication, GM could well emerge from bankruptcy in reasonably short order – 60 to 90 days. Auto sales by the Detroit Three fared better than analysts expected in May, indicative of the aggressive discounting and an increased willingness of consumers to visit the showrooms. If a “cash for clunkers” program is introduced, as many expect, auto sales could jump in the next six months. Further, the scrap rate for autos has slightly exceeded 10 million vehicles a year. In the first quarter of this year, auto sales advanced at an annual rate of 9.5 million units.

Indications of an improvement in the economy are coming from many sources. Real disposable income was much stronger than expected in April thanks to fiscal stimulus and May is likely to post another up tick. With the rise in consumer confidence, the unprecedented slump in consumer spending may be behind us. Even the housing market is showing signs of improvement. New homebuilding may be stabilizing and pending and actual sales are picking up. The inventory of unsold homes is finally edging downward, thanks to continued rapid declines in house prices. Manufacturing is likely on the cusp of a rebound as orders are finally increasing at the same time that inventories are plunging at a record pace. Inventory reductions have been a huge factor contributing to the economic contraction. That process may now be set to reverse.

There are now signs that the global economy is improving. Copper is up 80%, lumber is up about 20%, and oil prices have risen to just under \$70 per barrel. The decline in the U.S. dollar, accompanied by the improvement in the global economy, could boost U.S. exports, narrowing the trade deficit.

To be sure there are headwinds. Longer-term interest rates have risen sharply as the supply of government bonds has surged and inflation concerns are front-page news. This has resulted in mortgage rates rising. The more rates go up, the more home prices need to go down to match consumers' payments. Unemployment may continue to rise even while economic conditions improve. Outside of the effects of the fiscal stimulus plan, disposable income growth may stagnate if fuel prices continue to rise. But, inflation may be contained for now. Wage freezes continue to eliminate the prospect for spiraling employment costs in the next few quarters, and savings as a percent of disposable income has jumped. Also, capacity utilization rates worldwide are very low, which mitigates any sustained excess-demand pressures that might push prices upward. Remember, rising commodity prices do not necessarily equal inflation, as we saw in the first half of this decade.

We believe the stage is set for a deceleration in the rate of economic decline in the second quarter. By the third quarter, inventories are expected to be "right-sized," and we are more likely to get a positive bounce from consumption as the fiscal stimulus measures gather greater momentum. The third quarter is increasingly looking like the quarter that will allow a gradual transition to positive growth, with a gain in activity projected in the fourth quarter of 2009. Unemployment will remain high for some time, likely peaking in mid-2010. A sustained jobless recovery cannot be ruled out, but compared to the last three quarters, expectations may be for improvement not deterioration.

As we move into an economic recovery phase we forecast several trends: Investors may be willing to take on more risk; equities may be favored over bonds; commodities may benefit from heightened inflation concerns, resource constraints, and a desire to own non-dollar denominated assets; the global recovery may be led by emerging markets; and small and mid capitalization equities may experience out performance relative to large capitalization equities.

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