



GRAY & COMPANY

# **CAPITAL MARKET REVIEW**

**First Quarter 2009**

# CAPITAL MARKET REVIEW

"Never confuse a single defeat with a final defeat."

□ F. Scott Fitzgerald

"Man will not merely endure; he will prevail."

□ William Faulkner

For encouragement and inspiration, we have drawn on two quotes from writers of the lost generation.

## The Lost Decade

These are very difficult times. The last year and a half has exacted an unimaginable toll on the wealth of households and institutions across America. The equity markets over the past ten years have generated an annualized return of -3.0%, a lost decade of returns.

Though not comforting, the current collapse of the equity markets is not unprecedented. The Standard & Poors Index experienced two similar periods of protracted negative returns during the prior century, the 1930's and the 1970's. The 30's are remembered for the Great Depression, a period of economic contraction, high unemployment, and government intervention (sound familiar). In the 70's the economy suffered through two recessions, the oil embargo, and hyper-inflation. However, these eras did not last forever. The economy shifted to a lower, more sustainable level of production based on the forces of supply and demand and the capital markets emerged more efficient.

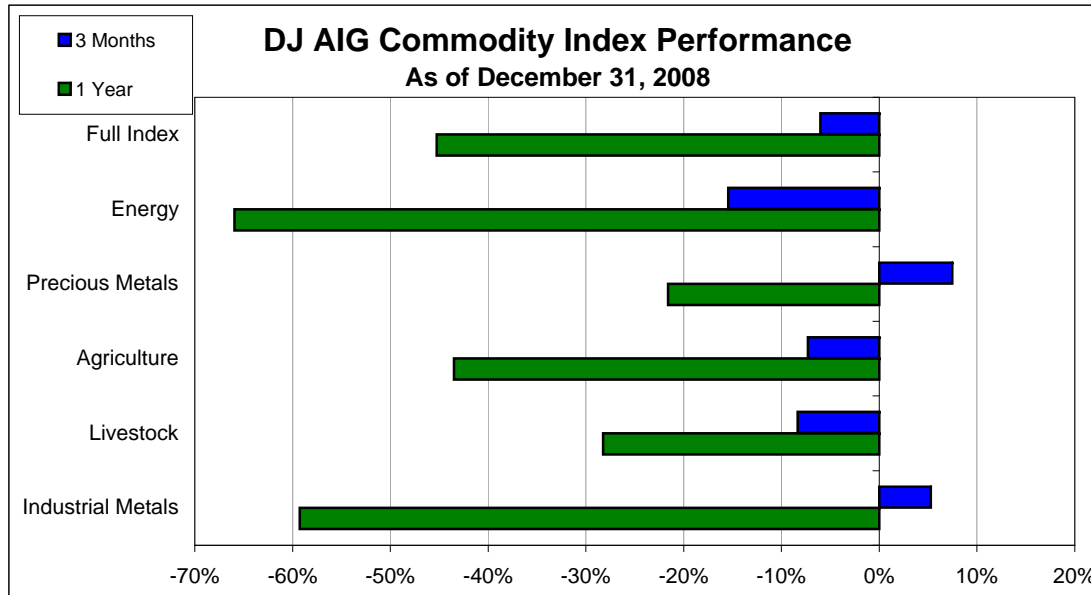
The current economic crisis was created by the abundance of easy credit. The over-consumption that followed drove asset values to unsustainable levels. As assets values declined, financial institutions with leveraged exposure to these assets were crippled. The intervention of governments around the world prevented a complete collapse of the global financial system.

In the first quarter the economy showed signs of stabilizing at a significantly lower level of production, liquidity started slowly returning to the credit market, and stocks staged a rally. Although this rally may not last, the equity markets are poised to generate attractive returns in the future. This observation is based on the relatively low valuations of equities, higher dividend yields, and stronger balance sheets of corporations around the world.

<b>Standard &amp; Poors Index: 1929 Through 1937</b>				
<b>Market Peak:</b>	September 1929			
<b>Market Bottom:</b>	June 1932			
	<u>9/29 - 6/32</u>	<u>6/32 - 6/33</u>	<u>6/32 - 6/35</u>	<u>6/32 - 6/37</u>
<b>Cumulative</b>	-84.76%	117.82%	112.16%	227.88%
<b>Annualized</b>	-49.55%	117.82%	28.50%	26.81%
<b>Standard &amp; Poors 500 Index: 1973 Through 1979</b>				
<b>Market Peak:</b>	January 1973			
<b>Market Bottom:</b>	December 1974			
	<u>1/73 - 12/74</u>	<u>12/74 - 12/75</u>	<u>12/74 - 12/77</u>	<u>12/75 - 12/79</u>
<b>Cumulative</b>	-43.36%	32.25%	39.88%	60.70%
<b>Annualized</b>	-25.67%	32.25%	11.84%	9.95%
<b>Standard &amp; Poors 500 Index: 2007 Through 2009</b>				
<b>Market Peak:</b>	October 2007			
<b>Market Bottom:</b>	February 2009 - Hopefully			
	<u>10/07 - 2/09</u>	<u>2/09 - 2/10</u>	<u>2/09 - 2/12</u>	<u>2/09 - 2/14</u>
<b>Cumulative</b>	-47.70%	?	?	?
<b>Annualized</b>	-38.50%	?	?	?

*The table above depicts the performance of the S&P 500 during the market declines in the 1930's, 1970's, and 2000's. Historically, stocks have rebounded sharply after reaching the market bottom, particularly in the first year. As a leading indicator, the equity markets generally rally before tangible evidences is available of the economic recovery. These factors underscore the importance of maintaining the asset allocation policy during the volatile markets.*

# CAPITAL MARKET REVIEW

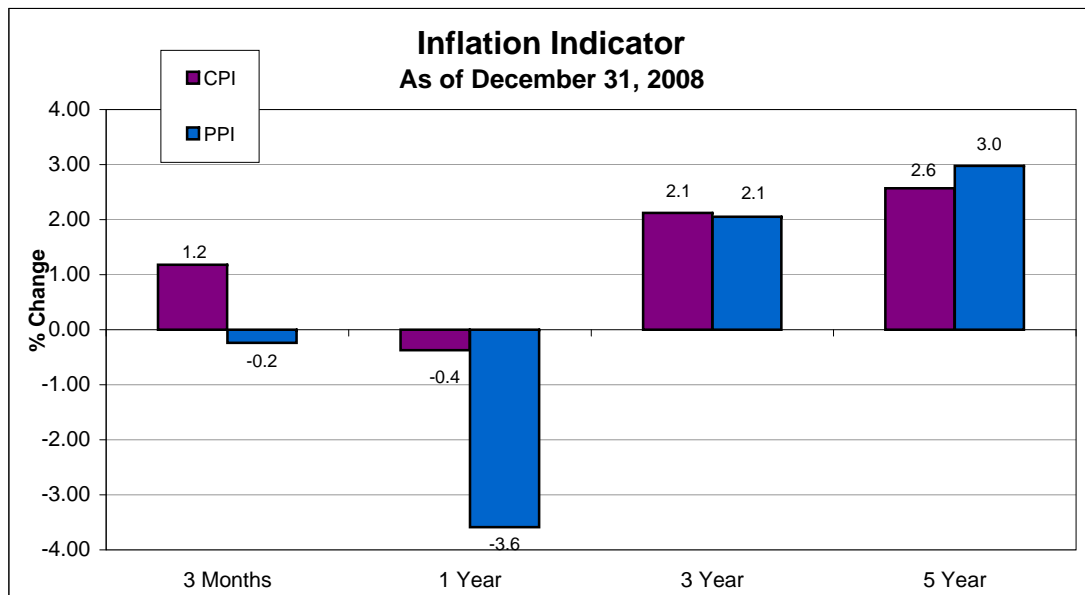


**Gold Rush:** The DJ AIG Commodity Index was down over 12% by March 2nd. However, a quarter-end rally offset much of those losses. The index finished the quarter down just over 6%.

Precious and industrial metals were the only two major components of the index with positive returns during the quarter. Gold has attracted the most media attention, due to its perceived safeness during difficult economic times (recessionary and inflationary). Silver and Copper had much stronger returns during the quarter as global demand is expected to increase in the coming months.

Despite crude oil prices rising to nearly \$50 a barrel during the quarter, the Energy sector was the down over 15% (the worst performing major sector). Agriculture and Livestock also posted negative returns during the quarter as the slowing economy weighed on demand.

The battle between inflation and deflation continued. Consumer prices moved higher this quarter easing some of the concerns over deflation, but producer prices followed commodities lower. The fear with deflation is that consumers will forgo current consumption in anticipation of lower prices in the future, further stunting economic growth. The Fed is actively monitoring prices and formulating corrective actions.



Source: Bureau of Labor Statistics

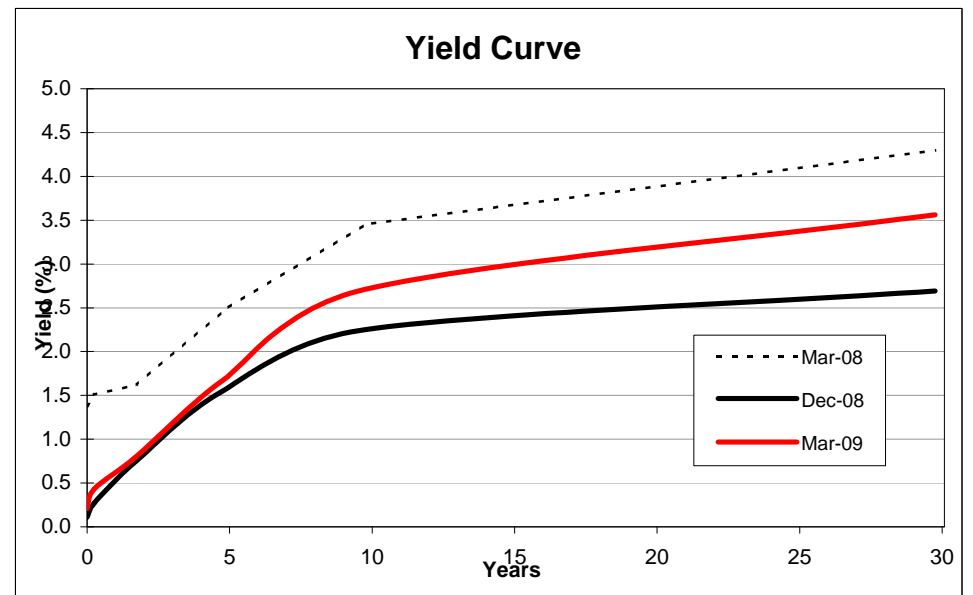
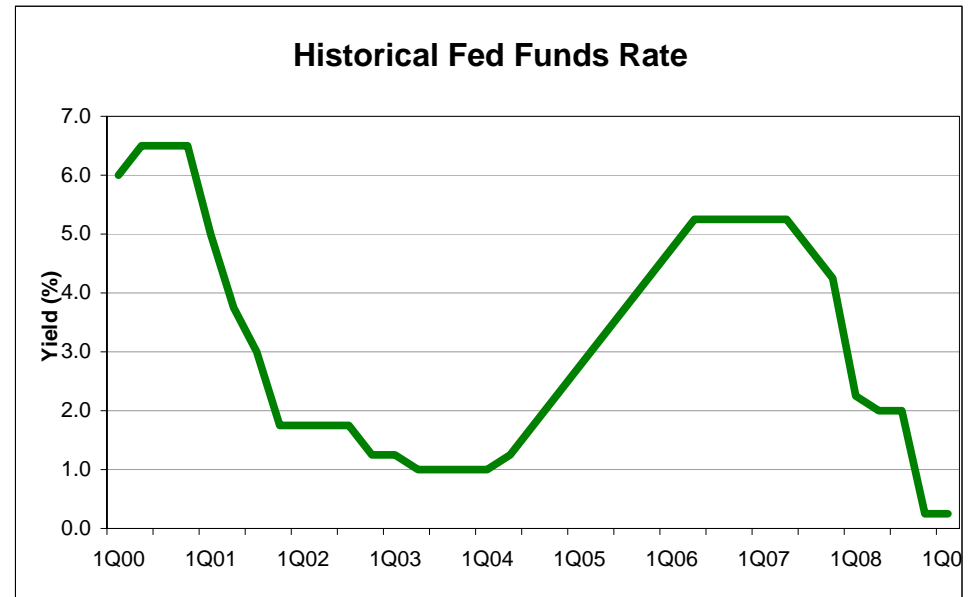
# CAPITAL MARKET REVIEW

**Name That Acronym:** The Federal Reserve, Treasury, and FDIC continued their work to stimulate the economy, stabilize the housing market, encourage risk taking, and protect against deflation.

The Government has introduced two new initiatives to help free up the credit markets. TALF (Term Asset-Backed Lending Facility) is a government sponsored program to help with the securitization of auto loans, student loans, credit card debt, and loans guaranteed by the Small Business Administration (SBA). PIPP (Public-Private Investment Program) was created to relieve banks of their toxic assets. In the simplest of terms, the investors purchase the assets of banks with the government assuming a portion of the risk. Banks benefit from the removal of the toxic asset from their balance sheet, thereby freeing reserves to make new loans. Investors benefit from the government's guarantee on the first portion of losses associated with the asset. The initial reaction from the market has been more positive toward the TALF program. However, these initiatives are far too new to make a true assessment of their effectiveness.

The Federal Reserve maintained the Fed Funds Rate at 0.25% during the quarter. They indicated that rates may stay low for some time. The Fed reiterated their plans to maintain low mortgage rates through the purchase of agency bonds and mortgage-backed securities. These initiatives are attempting to stabilize the housing market, one of the primary sources of the current crisis. The lower mortgage rates will help homeowners that have adjustable rate and traditional mortgages by reducing the reset rates or permitting them to refinance the property at a lower rate (provided they are able to qualify for a new mortgage). The lower rates will also encourage new homeowners into the market.

Yields on the long end of the curve shifted upward during the quarter, while the short-end remained nearly unchanged. Investors have started to look for higher yields after the flight to quality that occurred during the fourth quarter of 2008.



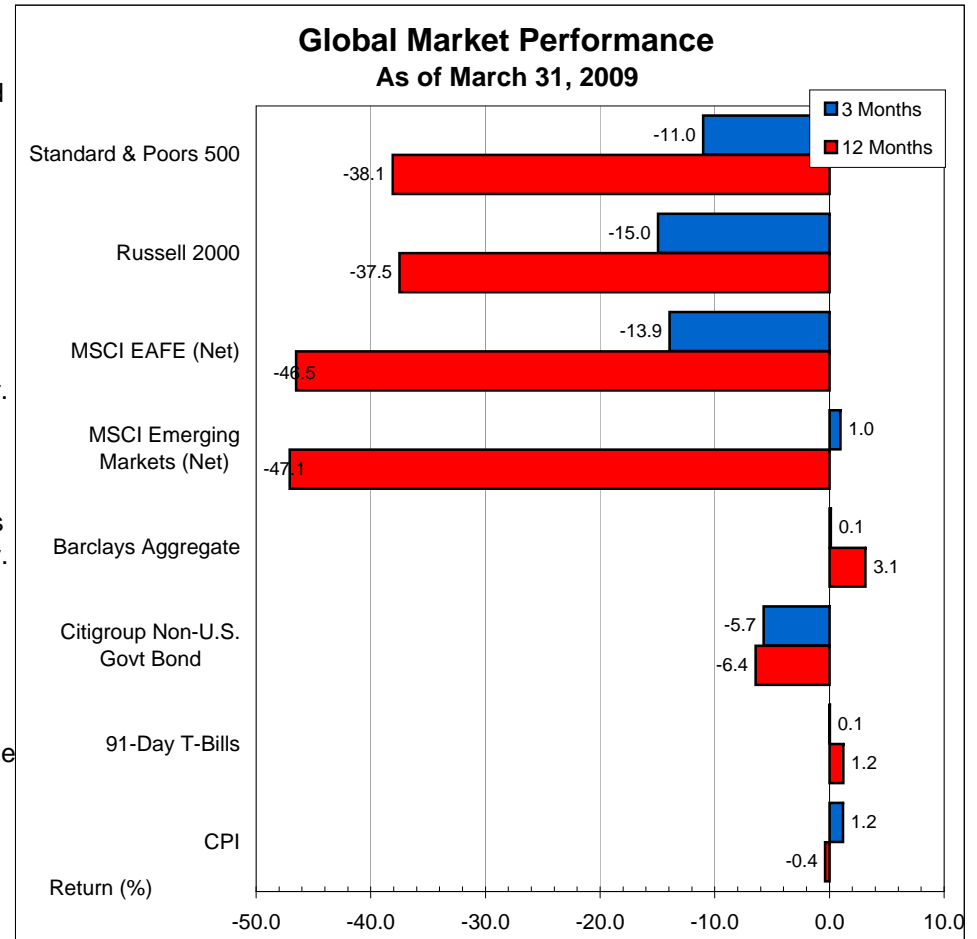
# CAPITAL MARKET REVIEW

Governments around the globe continue to intervene in the markets, attempting to repair financial institutions, restore consumer confidence, and spur economic activity. Their actions include infusing banks with additional capital, extending loans to troubled manufactures, lowering interest rates, and initiating other programs. The concern is that this intervention will have unintended consequences in the future, such as hyper-inflation or prolonged public participation in private enterprises.

Consumer demand continues to be weak. Individuals fear for their jobs and are saving more of their disposable income. In response, corporations are reducing staff and decreasing expenditures.

Equities in most developed markets declined for the sixth consecutive quarter. However, March was generally positive - particularly for companies with stronger balance sheets. Another positive was the delinking of the markets; equities started to move independently of one another as several emerging markets posted positive returns during the quarter. The fixed income markets provided little help due to interest rates being so low at the start of the quarter. The dollar also advanced versus most currencies, further hindering overseas investments.

Other asset classes continue to devalue. Estimates for real estate show double digit losses in the first quarter. Private Equity will be impacted by the decline in equities, lowering expected returns and extending the maturity of the investments.



## U.S. EQUITY MARKET

Total Returns - Periods Ending March 31, 2009				
	3 Months	1 Year	3 Years	5 Years
<b>Standard &amp; Poors 500</b>	(11.02)	(38.07)	(13.04)	(4.76)
<b>S&amp;P MidCap 400</b>	(8.66)	(36.10)	(13.61)	(2.84)
<b>S&amp;P SmallCap 600</b>	(16.84)	(38.06)	(16.46)	(3.94)
<b>Russell 1000</b>	(10.45)	(38.26)	(13.24)	(4.54)
<b>Russell 1000 Growth</b>	(4.12)	(34.27)	(11.28)	(4.38)
<b>Russell 1000 Value</b>	(16.77)	(42.42)	(15.41)	(4.94)
<b>Russell 2000</b>	(14.95)	(37.50)	(16.80)	(5.24)
<b>Russell 2000 Growth</b>	(9.73)	(36.36)	(16.19)	(5.36)
<b>Russell 2000 Value</b>	(19.63)	(38.90)	(17.54)	(5.30)
S&P 500 Sector Performance				
	3 Months	1 Year	3 Years	5 Years
<b>Energy</b>	(11.43)	(37.86)	(4.00)	9.67
<b>Materials</b>	(2.28)	(45.15)	(10.38)	(1.61)
<b>Industrials</b>	(20.98)	(50.36)	(17.38)	(5.93)
<b>Con. Discretionary</b>	(8.00)	(34.88)	(15.18)	(7.89)
<b>Con. Staples</b>	(10.54)	(23.31)	(1.18)	0.74
<b>Health Care</b>	(7.98)	(19.67)	(7.02)	(2.45)
<b>Financials</b>	(28.71)	(62.88)	(33.04)	(19.02)
<b>Info Technology</b>	4.32	(29.70)	(10.19)	(4.34)
<b>Telecommunications</b>	(7.15)	(25.15)	(5.15)	1.07
<b>Utilities</b>	(10.77)	(29.63)	(2.50)	4.83

Returns are annualized for periods greater than one year.

**An End in Sight?:** Stocks staged a nice rally in March, but the gains were insufficient to offset the losses incurred in January and February. This marked the sixth consecutive quarter of negative performance from the equity markets; the total decline stands at nearly 50% from the previous high set in 2007.

All cap ranges and styles were down during the quarter; however, pockets of strength and weakness sharply divided the market's performance. Growth styles handily outperformed their Value counterparts. The division was based on two sectors in particular - Growth's exposure to Technology and Value's exposure to Financials. Small Caps trailed Large Caps for the second quarter in a row.

Over the past year, the performance of Large Caps and Small Caps has been nearly identical, with Growth holding an advantage over Value. During the current bear market, Large Cap has declined less than Small Cap, as has been the case historically. However, unlike past cycles, Growth has lost less than Value.

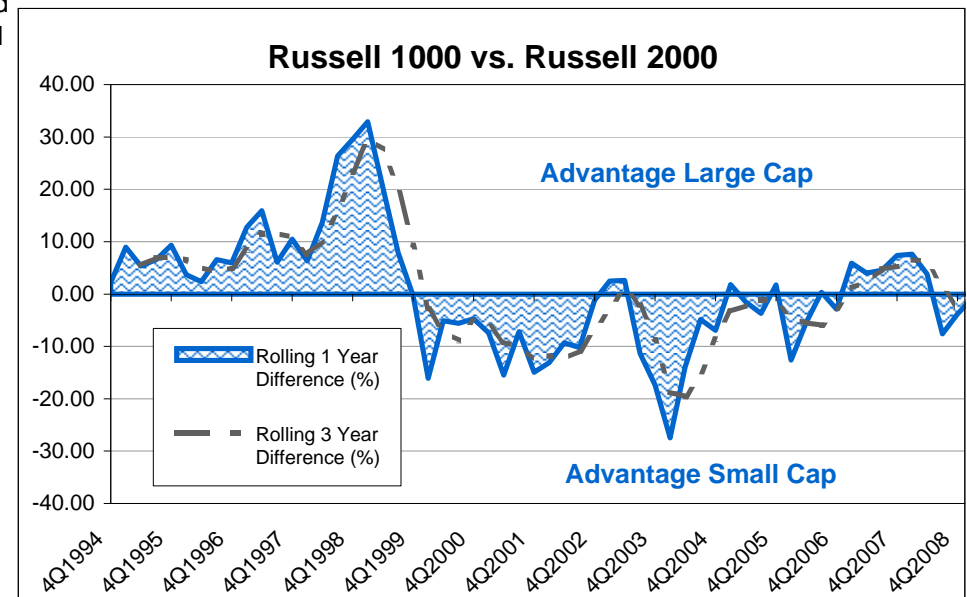
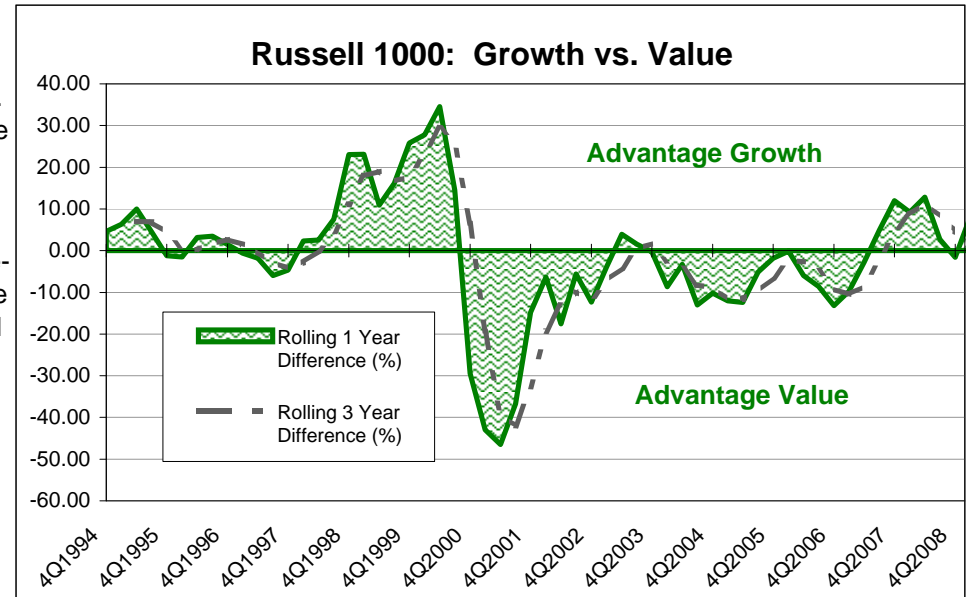
Technology was the one bright light in an otherwise dark quarter. The sector was up over 4%, as investors favored stocks with strong balance sheets and low debt. Financials led the market in losses again due to their leveraged exposure to toxic assets. Industrials also posted deep losses; the recession has devastated their revenue streams and forced management teams to slash their expenses.

# U.S. EQUITY MARKET

**Value Sectors Collapse:** Financials and industrials, two of the more prominent sectors in the value indices, suffered significant losses again. The Russell 1000 Growth Index outperformed the Russell 1000 Value Index by over 12.5% this quarter, reversing the trend from the last two quarters of 2008. The 1250 basis point difference in performance was the greatest style variance since the Tech/Growth wreck of 2000 - 2001.

Interestingly, the style and capitalization shifts appear to be related. Growth's out performance coincides with large cap's advantage. Small cap's rolling one-year return narrowly exceeds large cap after this quarter's relative performance from the Russell 1000. In prior periods, runs in value have been accompanied by the out performance of small cap equities. Growth equities and large cap equities have also experienced periods of out performance to their style/capitalization counterparts. These style and capitalization cycles are linked to the economic cycle. The different stages of the economic cycle produce favorable conditions for different sectors of the equity market.

The economic cycle entered the slowing/recessionary stage (favoring Health Care and Consumer Staples). As the economy recovers (early-recovery stage) the Industrials and Materials sectors will tend to out perform. The late-recovery stage (favoring Technology and Telecommunications) never gathered much momentum this past cycle; these sectors have out performed the overall market during the downturn in equities. Energy and Financials are being influenced by factors independent of the current economic cycle.



## U.S. FIXED INCOME MARKET

**No Yield, No Credit, No Service:** The programs implemented by the Federal Reserve and Treasury have helped restore some normalcy, particularly to the short-term credit markets. The government continues to implement new programs to alleviate liquidity problems, spur economic growth, and restore investor confidence. Inflation returned during the first quarter, easing deflation concerns.

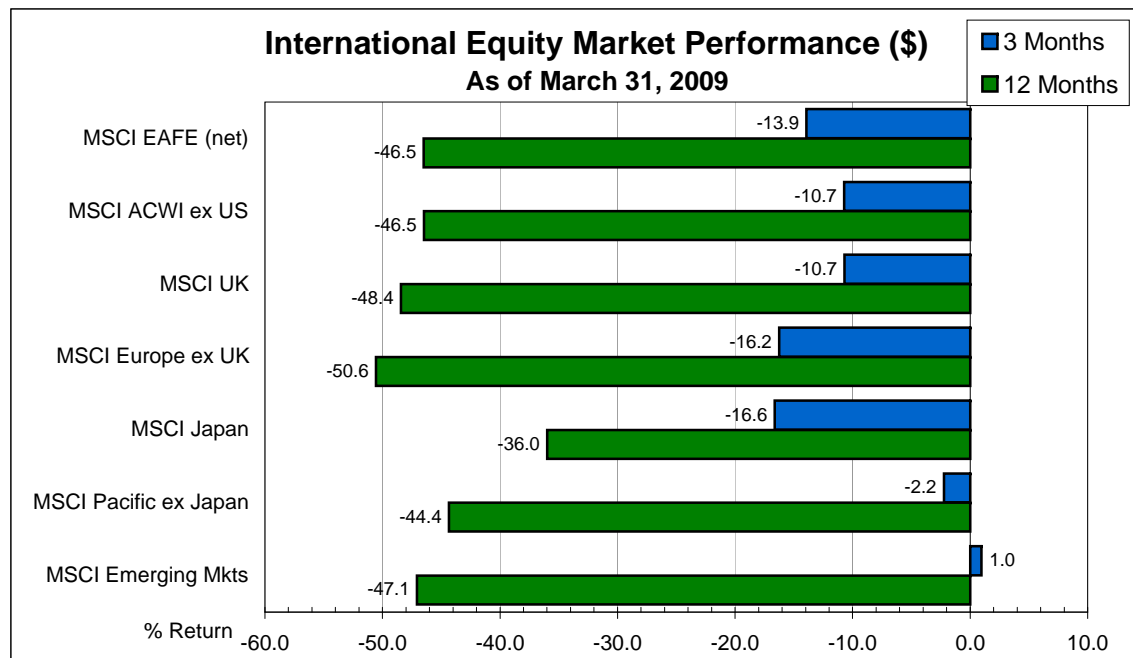
Yields for Treasuries with maturities over 5-years increased from historically low levels during the quarter, generating negative returns for the sector. The upward shift in the yield curve is attributed to renewed inflationary pressures. The inflationary data also sparked interest in Treasury Inflation Protected Securities (TIPS), as these securities returned over 5.5% during the quarter.

Mortgages were another strong performer as spreads narrowed during the quarter. This sector's performance is partly based on the government's intervention into the market. Corporates were the weakest sector within the credit market. The negative returns were based on a number of factors, including the recession, new issuance, and downgrades. High Yield rebounded sharply as spreads narrowed from the unprecedented levels at year end.

Going forward the fixed income market faces several challenges: 1) Treasury yields are very low, 2) there is a lack of liquidity for many issues, 3) there remains a possibility of a prolonged recession and/or high inflation rates, and 4) the market's reliance on the government's continued intervention.

<b>Total Returns - Periods Ending March 31, 2009</b>				
	<b>3 Months</b>	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>
<b>Barclays Aggregate</b>	0.12	3.13	5.77	4.13
<b>Barclays Intm G/C</b>	(0.05)	1.97	5.63	3.69
<b>Barclays G/C</b>	(1.28)	1.77	5.47	3.74
<b>Barclays Govt</b>	(0.98)	6.95	8.08	5.24
<b>Barclays Credit</b>	(1.75)	(5.22)	1.81	1.62
<b>Barclays Mortgage</b>	2.20	8.09	7.58	5.57
<b>Barclays High Yield</b>	5.98	(19.31)	(4.65)	(0.10)
<b>Barclays U.S TIPS</b>	5.52	(2.03)	5.75	4.16
<b>Barclays 1-3 Yr Govt</b>	0.32	3.91	5.92	3.94
<b>Barclays Long Govt</b>	(5.29)	11.99	10.46	7.28
<b>Credit Spreads (in basis points)</b>				
<b>Mar-09</b>				
<b>Aaa</b>	224			
<b>Aa</b>	395			
<b>A</b>	516			
<b>Baa</b>	723			
<b>Ba</b>	1068			
<b>B</b>	1456			
<b>Caa</b>	2723			

# INTERNATIONAL EQUITY MARKET



## MSCI Country Indexes (Net) Three Months Ending March 31, 2009

	Return US\$ (%)	Local Currency (%)	Currency Effect (%)
France	-16.0	-12.0	-3.9
Germany	-19.5	-15.8	-3.8
Italy	-20.6	-16.9	-3.7
Spain	-18.5	-14.7	-3.8
Switzerland	-15.4	-9.6	-5.8
UK	-10.7	-10.4	-0.3
<b>Europe Total</b>	<b>-14.6</b>	<b>-11.5</b>	<b>-3.0</b>
Australia	-1.6	-1.2	-0.3
Hong Kong	-0.5	-0.5	0.0
Japan	-16.6	-9.2	-7.5
<b>Pacific Total</b>	<b>-12.8</b>	<b>-7.1</b>	<b>-5.7</b>
China	1.3	1.3	0.0
India	-1.5	2.6	-4.1
Brazil	12.5	11.0	1.4
Mexico	-14.0	-12.4	-1.6
<b>Emerging Total</b>	<b>1.0</b>	<b>4.1</b>	<b>-3.2</b>

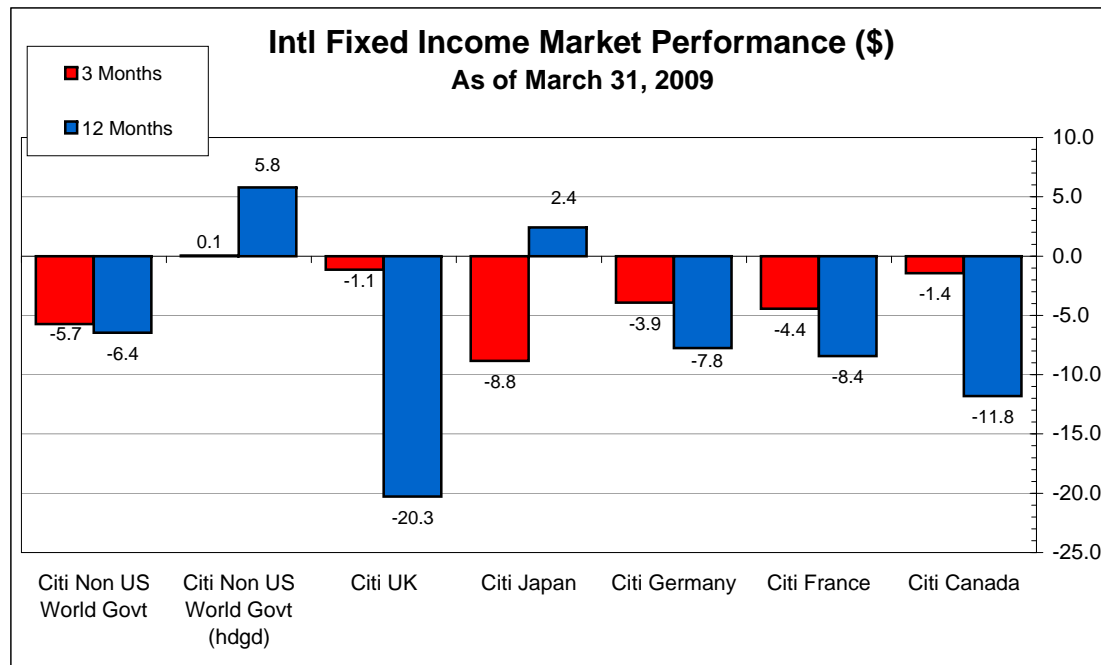
**Two-Headed Monster Strikes Again:** The financial crisis and global recession continued to exert losses on equity markets around the world. The finance sector was under extreme pressure. In general, European banks were more highly leveraged and exposed to Eastern European countries. Foreign governments have followed the U.S. government's lead, utilizing fiscal and monetary policies to help stabilize the markets and stimulate demand. The equity markets finally responded in March, as every country recorded positive returns during the month. However, these gains were largely unable to offset the losses incurred during January and February. Norway was the lone exception within the developed markets, returning 3.24% during the first quarter.

The losses in the United Kingdom were slightly less than other countries in Europe. However, their economy faces a more difficult path to recovery. The Bank of England reduced rates three times during the quarter and the Pound stabilized after several quarters of weakness. In Euro-land, the equity markets suffered double digit losses again and the Euro slipped against other currencies. The European Central Bank cut interest rates twice during the quarter. These central banks are assessing ways to lower interest rates for longer maturities.

Japan's reliance on exports weighed heavily on their market and stocks posted more losses. The strong Yen and reduced global consumption has severely impacted production within the country. The Bank of Japan intends to purchase roughly \$11 trillion in corporate debt to stimulate economic growth.

The Emerging Markets rebounded strongly in March and, as a group, were marginally positive for the quarter. The Chinese government announced new construction projects and plans to stockpile commodities. (copper, soybeans, oil, etc.). Emerging countries rich in natural resources enjoyed a sharp rebound as commodity prices rose at the end of the quarter.

# INTERNATIONAL BOND MARKET



## Citigroup World Government Bond Indexes Three Months Ending March 31, 2009

	Return	Return	Return
	US\$ (%)	Local Currency (%)	Currency Effect (%)
Austria	-4.9	-0.4	-4.5
Belgium	-3.9	0.6	-4.5
Denmark	-5.2	-0.7	-4.5
France	-4.4	0.1	-4.5
Germany	-3.9	0.6	-4.5
Ireland	-9.1	-4.9	-4.3
Italy	-2.5	2.1	-4.6
Netherlands	-3.8	0.7	-4.5
Spain	-3.8	0.8	-4.5
Sweden	-5.9	-1.6	-4.3
Switzerland	-5.4	1.1	-6.5
UK	-1.1	-0.8	-0.3
<b>Europe Total</b>	<b>-3.7</b>	<b>0.8</b>	<b>-4.5</b>
Japan	-8.8	-0.7	-8.2
Australia	-1.2	-0.8	-0.3
Canada	-1.4	0.4	-1.9

**Currency Drives Returns Down:** The recession deepened globally as economic indicators showed further deterioration with industrial output declining sharply and unemployment rates continuing to rise during the quarter. Governments intervened, lowering interest rates and injecting liquidity into the markets. Negative sentiment drove spreads wider during the quarter. The finance sector, in particular, was punished and additional downgrades were announced.

With forecasts for near zero inflation, the European Central Bank and the Bank of England lowered interest rates again. European governments increased budget deficits to inject capital into the system and spur economic activity. In the Euro-land markets, government bonds generally provided less than 1% returns and corporate were negative (in local terms). The strengthening Dollar further hindered performance for U.S. investors. In the United Kingdom the results were negative for both government and corporate bonds (in local terms); the Pound was nearly unchanged against the Dollar.

The Japanese economy is under extreme pressure due to the nation's dependence on the exportation of autos and electronics. During the quarter, imports exceeded exports for the first time in over a decade; industrial production declined sharply leading to higher unemployment rates and further contraction in consumer spending. Government bonds fell (in local terms). The Yen depreciated against the Dollar after strong gains last quarter.

## SELECTED INDEX RETURNS - PERIODS ENDING MARCH 31, 2009

	Quarter	One Year	Three Years	Five Years	Ten Years
<b>US EQUITIES</b>					
Dow Jones Industrial Average	(13.3) %	(36.4)	(9.7)	(3.8)	(0.5)
Standard & Poors 500	(11.0)	(38.1)	(13.0)	(4.8)	(3.0)
Russell 3000	(10.8)	(38.2)	(13.6)	(4.6)	(2.3)
S&P MidCap 400	(8.7)	(36.1)	(13.6)	(2.8)	4.2
Russell Mid-Cap	(9.0)	(40.8)	(15.5)	(3.5)	2.3
S&P SmallCap 600	(16.8)	(38.1)	(16.5)	(3.9)	4.3
Russell 2000	(15.0)	(37.5)	(16.8)	(5.2)	1.9
Growth Stocks - Russell 3000 Growth	(4.5)	(34.4)	(11.7)	(4.5)	(5.0)
Value Stocks - Russell 3000 Value	(17.0)	(42.1)	(15.6)	(5.0)	(0.2)
<b>US FIXED INCOME</b>					
Barclays Aggregate	0.1 %	3.1	5.8	4.1	5.7
Barclays Intm Govt/Credit	(0.1)	2.0	5.6	3.7	5.4
Barclays Govt/Credit	(1.3)	1.8	5.5	3.7	5.6
Barclays Government	(1.0)	7.0	8.1	5.2	6.2
Barclays Credit	(1.7)	(5.2)	1.8	1.6	4.7
Barclays Mortgage	2.2	8.1	7.6	5.6	6.2
Barclays High Yield	6.0	(19.3)	(4.7)	(0.1)	2.6
Barclays U.S TIPS	5.5	(2.0)	5.8	4.2	7.4
Barclays 1-3 Yr Government	0.3	3.9	5.9	3.9	4.8
Barclays Long Government	(5.3)	12.0	10.5	7.3	8.0
<b>INTERNATIONAL (Measured in US Dollars)</b>					
MSCI EAFE (Net)	(13.9) %	(46.5)	(14.5)	(2.2)	(0.8)
MSCI ACWI ex U.S. (Net)	(10.7)	(46.5)	(13.2)	(0.7)	n/a
MSCI Europe (Net)	(14.6)	(49.9)	(14.3)	(1.8)	(1.0)
MSCI Pacific (Net)	(12.8)	(38.7)	(15.0)	(3.2)	(0.6)
MSCI Emerging Markets (Net)	1.0	(47.1)	(8.2)	5.9	7.8
Citigroup Non-U.S. Govt Bond	(5.7)	(6.4)	7.4	4.4	5.5
<b>REAL ESTATE</b>					
NAREIT Index	(29.8) %	(55.8)	(24.7)	(9.4)	3.6
NCREIF Property Index	(7.3)	(14.7)	4.2	9.4	9.4
<b>OTHER</b>					
91-Day T-Bills	0.1 %	1.2	3.6	3.2	3.4
Consumer Price Index (percent change)	1.2	(0.4)	2.1	2.6	2.6
Producer Price Index (percent change)	(0.2)	(3.6)	2.1	3.0	2.6

Note: Returns for periods longer than 12 months are annualized.