



GRAY & COMPANY

CAPITAL MARKET REVIEW

Second Quarter 2009

CAPITAL MARKET REVIEW

"Are we there yet?"

One of the great American traditions in the summer is to take a family vacation. For those of you with children or remembering back to your childhood, you are familiar with the repeated question "Are we there yet?" My response, if I choose to acknowledge my kid's question, is "Yes, if by there you mean (insert current location)."

The past year has felt like a very long and arduous road trip in the capital markets. With the rebound in the equity markets this quarter, you may be asking - "Are we there yet?" "Have we turned the corner?" The following commentary attempts to answer those questions and place some historical perspective to our current location.

The Recession:

The precise measurement of recessions is quite difficult, but by most estimates the current recession is the longest and most severe in our country since the Great Depression. Current data indicates the U.S. completed its eighteenth month of economic contraction in June with a decline of 3.1% in Gross Domestic Product from the peak in December 2007. Since 1940 the average recession has lasted about one year and GDP has dropped 2.1%.

Government Finances:

The projected budget deficit in 2009 is \$1,841 billion, of which 13% or \$680 billion is earmarked for Financial Stabilization. To put this in perspective, the current deficit represents 12.9% of the projected 2009 Gross Domestic Product. The only other time in the last 70 years the deficit accounted for this large a percentage of the GDP was during World War II.

The Federal Debt (the accumulation of deficits) will approach 60% of GDP with the 2009 deficit; the level of debt as a percentage of GDP has generally ranged between 25% and 50% over the past 50 years. The Treasury is responsible for financing the Government's obligations. The increase in supply of Treasury bonds impacts the other participants in the fixed income markets, as issuers compete for capital.

Foreign governments have historically been a major purchaser of Treasuries (due in part to their trade surpluses with the U.S.), holding approximately 60% of the outstanding debt of the U.S. Government. With the devaluation of the U.S. Dollar in recent years, several of these nations have suggested that they would like to reduce their currency risk. In the event the U.S. experiences an inflationary period, these nations may be reluctant to purchase Treasuries.

Unemployment:

Historically, unemployment has been a lagging statistic, meaning rates continued to move higher during the recession and peaked after the economy resumed positive growth. The current unemployment rate is 9.4% and climbing; this is the highest reading since the early 80's. Most economists forecast rates to peak near the end of the year at a level above 10%. In the past, the unemployment rate has declined slowly, by approximately 1% per year during economic recoveries. This suggests we may be years away from reaching full employment levels of near 5%.

Equity Markets:

Equity markets around the globe posted strong returns in the second quarter. As a leading economic indicator (generally moving six to nine months ahead of the economy), the results of the equity markets suggest that the economy will improve by year-end. Despite the recent rally (the S&P 500 has risen over 35% since the March lows), equities, particularly growth stocks, continue to appear modestly under valued. See the table below for other comparisons.

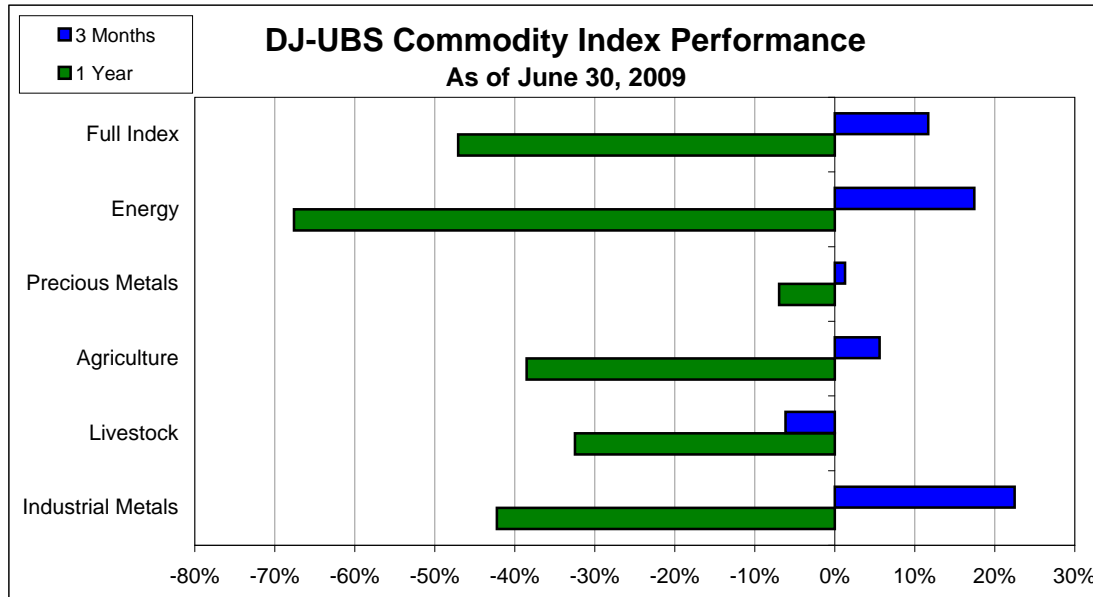
	<u>Current</u>	<u>20 Year Average</u>
Price to Book (S&P 500)	2.0X	3.0X
Price to Sales (S&P 500)	0.9X	1.5X
Dividend Yield (S&P 500)	2.60%	2.20%
P/E (Russell 1000 Growth)	14.5	23.9
P/E (Russell 1000 Value)	12.1	15.2

Miscellaneous:

The Government's stimulus has provided temporary economic assistance; true economic growth must be sustained by willing and able consumers. The average American is in the process of repairing their balance sheet - recovering from the decline in housing prices and financial assets, paying off debt, and increasing savings. Lending institutions have tightened lending practices, further hindering the consumer ability to finance purchases. Ultimately, only time will tell if and when we have arrived.

Source: JP Morgan Asset Management "Market Insights" Second Quarter 2009.

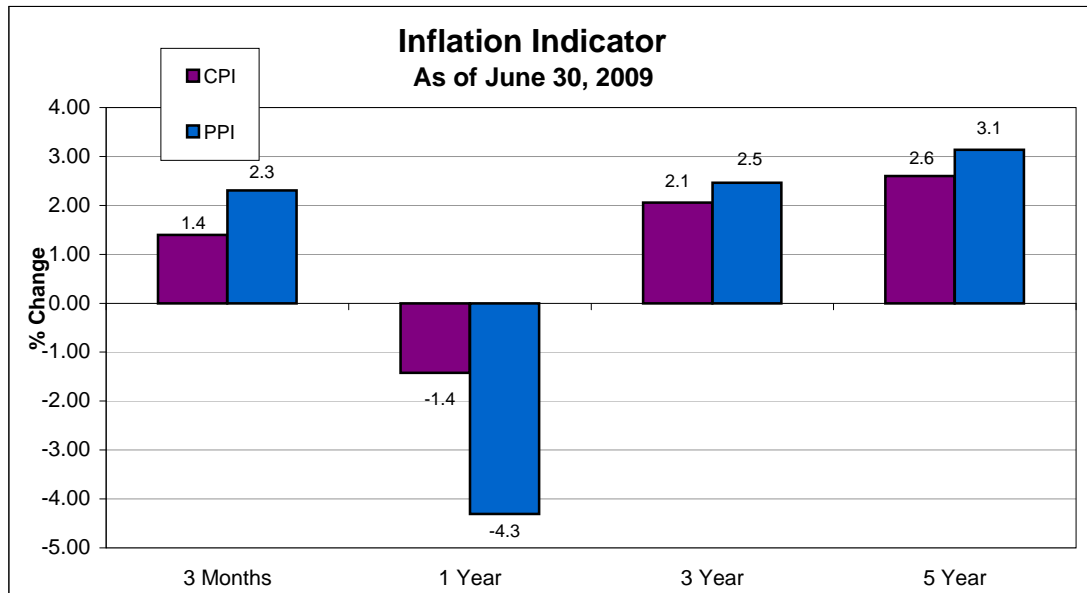
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The China Effect: Commodities continued to rally during the second quarter. The surge in prices was based on the expectations that global economic growth will recovery faster than previously anticipated, particularly in the emerging markets. The Dow Jones-UBS Commodity Index finished the quarter up over 11%.

Industrial Metals and Energy were the strongest performing components of the index, returning 22.5% and 17.4% respectively. These sectors benefited from China's stockpiling of copper, crude oil, and other basic materials to meet the government's expansionary plans. Energy demands are also increasing in India and other developing nations despite the economic contraction. Gold and other precious metals were nearly unchanged during the quarter.

Despite the current run, many commodities are priced at one half of their peak 2008 prices. The Dow Jones-UBS Commodity Index is down over 47% for the trailing year.



The debate between inflation and deflation continued, but inflation won again. Producer prices followed the rise in commodities. Consumer prices also moved higher, though, at a slower pace. Over the past year, commodities prices have driven the CPI and PPI into negative territory.

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

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More of the Same: The governmental agencies continued to implement their stabilization and stimulus programs during the quarter.

The Federal Reserve maintained the Fed Funds Rate at 0.25% during the quarter and reiterated their low rate intention for the foreseeable future. The current policy will likely remain in place until an economic recovery is well underway.

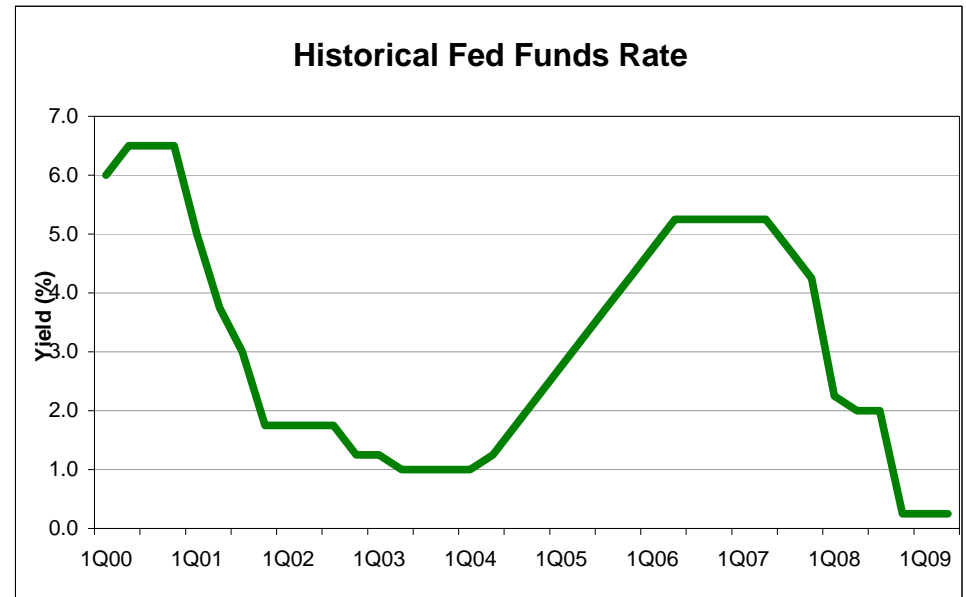
The Government continued their purchase of treasury and agency bonds and mortgage-backed securities. This initiative was adopted to lower interest rates (particularly mortgage rates) and stabilize the housing market, one of the primary sources of the current crisis. During the second quarter the housing market showed signs of improving, but rates started drifting higher.

TALF (Term Asset-Backed Lending Facility) is a government sponsored program providing investors with leveraged exposure to auto loans, student loans, credit card debt, loans guaranteed by the Small Business Administration (SBA), and recently added CMBS. *(Wasn't leverage what got us in this mess.)* This program has helped narrow the spreads on asset-backed securities.

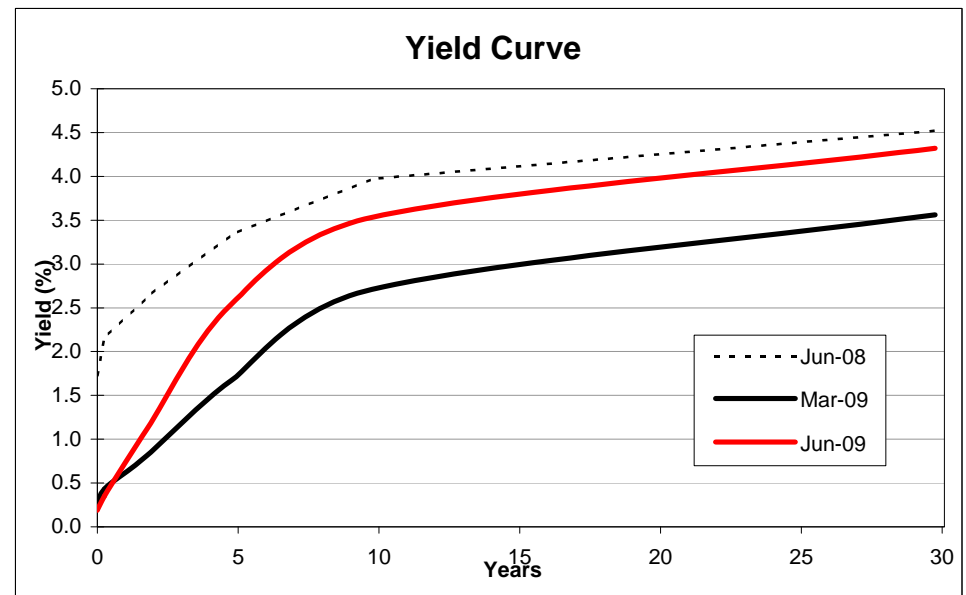
PPIP (Public-Private Investment Program) was created to relieve banks of their toxic assets. In the simplest of terms, the investors purchase the assets of banks with the government assuming a portion of the risk. Banks benefit from the removal of the toxic asset from their balance sheet, thereby freeing reserves to make new loans. Investors benefit from the government's guarantee on the first portion of losses associated with the asset. This program has yet to be fully implemented.

The yield curve steepened for the second consecutive quarter despite the intervention of the government; the Real 10-Year Treasury Yield (current yield minus Core CPI) ended at 1.7%, well below the 20-year average of 2.9%. Investors continued to favor higher yielding securities, looking for inflation protection and unwinding the flight to quality that occurred during the fourth quarter of 2008.

Historical Fed Funds Rate



Yield Curve



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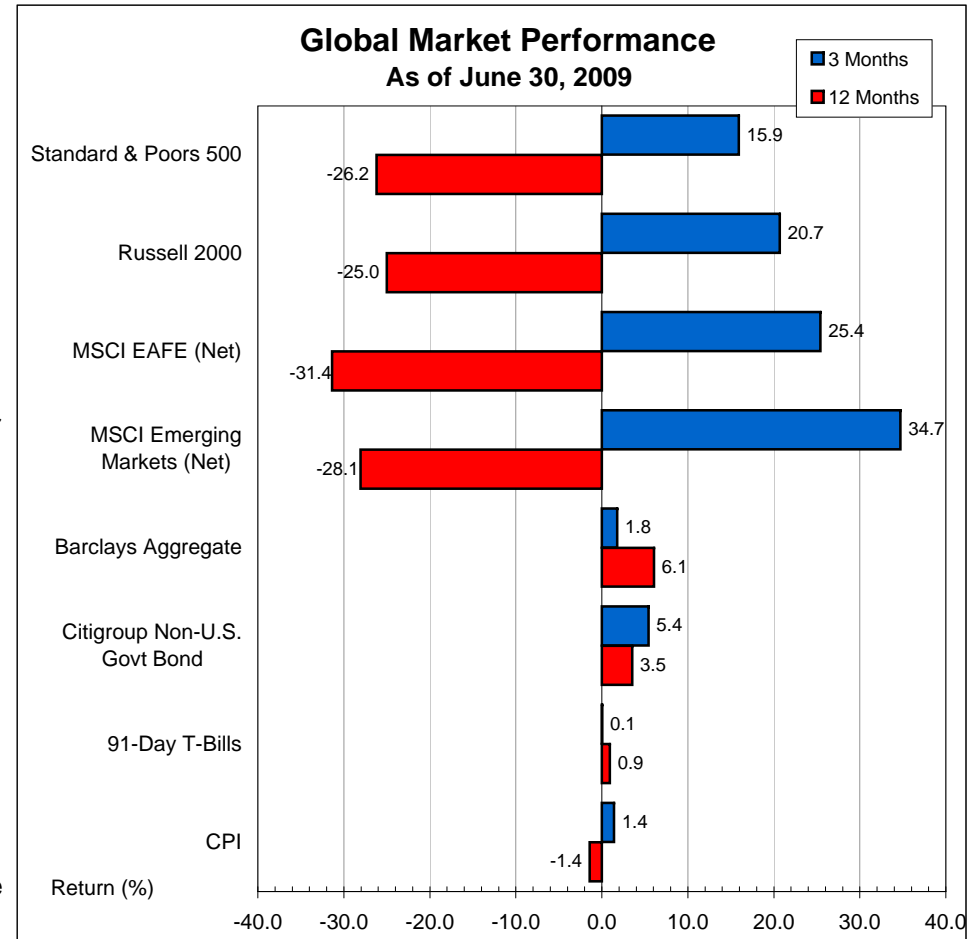
Greed is Good: For the past year and a half the markets have been coping with the housing market collapse, the subsequent impairment of financial institutions, and a global recession. Governments have intervened to return normalcy to the markets, aid stressed industries, and spur economic growth. This quarter the capital markets responded and rewarded risk taking.

Equity markets around the world posted double digit returns. The segments of the equity market with higher perceived risk generated stronger returns, led by the emerging markets and finance sector. Despite the strong returns this quarter, the markets have a long way to recovery the losses of the last six quarters.

The fixed income markets also rotated from the safety of governments bonds into corporate securities. The shift toward higher yielding issues led to steeper yield curves and narrower spreads around the globe; at quarter end, the yield curves in the United States, United Kingdom, and Euro Zone were nearly identical. This quarter, investment grade posted their highest returns in over twenty years and high yield securities generated their best results ever.

The strong performance from the capital markets is primarily attributed to the intervention from governments. These initiatives may cause higher inflation and/or prolonged public participation in private enterprises. For the markets to continue their recovery, economic growth will need to come from an increase in private consumption.

Other asset classes continue to devalue. Estimates for real estate show a third consecutive quarter of losses. 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 June 30, 2009				
	3 Months	1 Year	3 Years	5 Years
Standard & Poors 500	15.93	(26.20)	(8.21)	(2.24)
S&P MidCap 400	18.75	(28.02)	(7.54)	0.36
S&P SmallCap 600	21.07	(25.31)	(9.57)	(0.90)
Russell 1000	16.49	(26.69)	(8.20)	(1.85)
Russell 1000 Growth	16.32	(24.49)	(5.44)	(1.82)
Russell 1000 Value	16.69	(29.03)	(11.11)	(2.14)
Russell 2000	20.68	(25.01)	(9.88)	(1.70)
Russell 2000 Growth	23.38	(24.84)	(7.83)	(1.32)
Russell 2000 Value	17.98	(25.25)	(12.07)	(2.28)
S&P 500 Sector Performance				
	3 Months	1 Year	3 Years	5 Years
Energy	10.78	(41.27)	(2.03)	10.35
Materials	16.24	(38.91)	(5.63)	0.89
Industrials	18.91	(34.38)	(12.47)	(4.18)
Con. Discretionary	18.00	(16.64)	(10.22)	(4.73)
Con. Staples	9.82	(11.07)	0.98	2.55
Health Care	8.89	(11.45)	(2.73)	(1.32)
Financials	35.55	(38.52)	(25.91)	(13.51)
Info Technology	19.74	(17.91)	(1.39)	(1.39)
Telecommunications	3.45	(19.19)	(3.90)	1.94
Utilities	10.15	(28.20)	(1.14)	7.21

Returns are annualized for periods greater than one year.

Up, Up, and Away: Stocks continued the rally that started in March and snapped a six quarter losing streak. The equity market was trading at near panic levels in the first quarter before evidence of the stabilization and stimulus programs encourage investors to redeploy capital in stocks. The next leg of the rally will be fueled by economic fundamentals and corporate profits.

The S&P 500 increased almost 16% in the second quarter and has risen 35% from the March lows. Year-to-date the index is up 1.8%. The other indexes have also experience similar run ups from their March lows to recapture most if not all of their January and February losses. However, the markets have a long way to go to reach their record highs.

All cap ranges and styles rose this quarter. Small Cap posted the strongest gains, besting Large Cap for the first time since the 3rd quarter 2008. The Growth/Value performance was split, with Large Value and Small Growth out performing their growth/value counterparts.

Over the past year, the performance of Large Caps and Small Caps has been very close, 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 loss less than Value.

The strongest performing sector was Financials, reversing a trend of under performance for the sector related to the industry's exposure to toxic assets. Telecommunications was the worst sector performing sector.

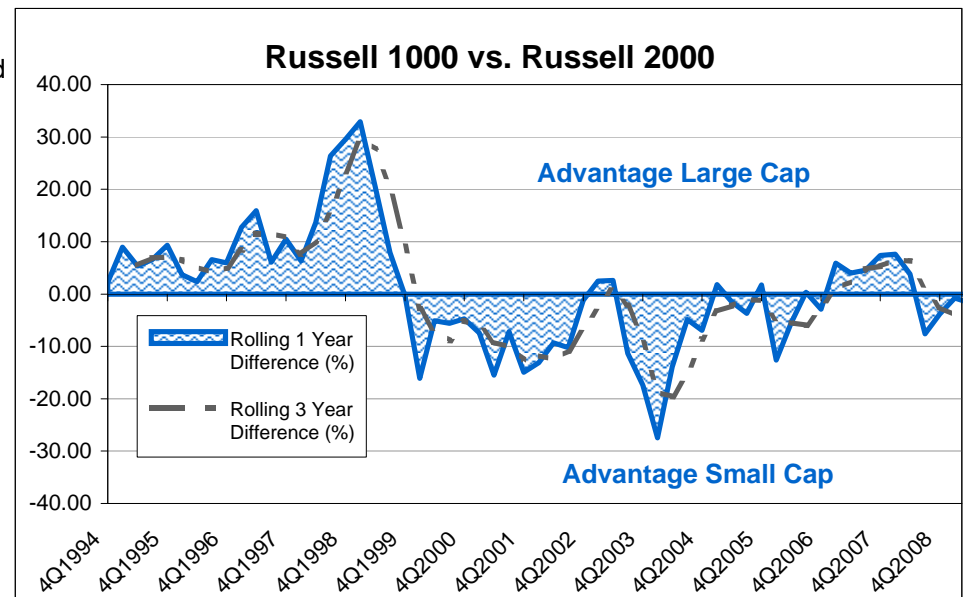
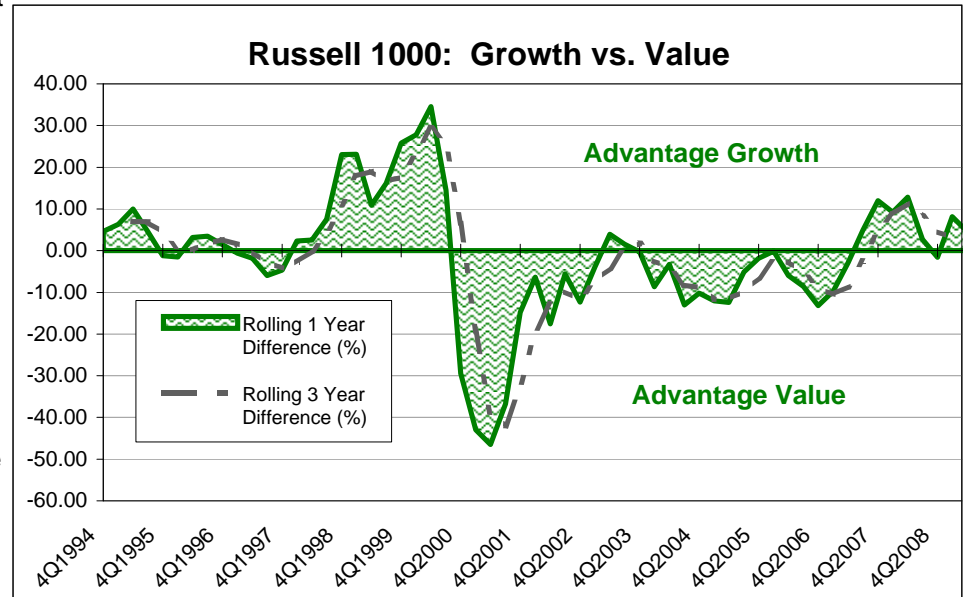
U.S. EQUITY MARKET

Growth/Value, Large/Small - Its All Good: All segments of the equity market enjoyed double digit returns this quarter. Small Cap was the best performing capitalization range, as is generally the case during a shift toward economic recovery.

Historically, the style and capitalization shifts appear to be related - the out performance of Growth coinciding with an advantage for Large Cap. The current trend shows Growth and Small Cap with the advantage, due in large part to their relative exposure to the finance sector. 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 appears to have shifted from the slowing/recessionary stage (favoring Health Care and Consumer Staples) to an early recovery stage (favoring Industrials and Materials). 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. The Energy sector is largely affected by the price of oil. Financials have suffered due to the impairment of their balance sheets and decline in revenues; however, the sector rebounded strongly this quarter after trading near bankruptcy levels.



U.S. FIXED INCOME MARKET

180 Degrees: With evidence of economic improvement and renewed interest in accepting risk, the fixed income markets reversed course this quarter. Corporates, especially High Yield, handily out performed all other segments of the fixed income market.

The Federal Reserve's actions have restored some normalcy to the fixed income market. However, the yield curve steepened during the quarter despite the quantitative easing efforts (purchasing bonds to add liquidity to the market and lower interest rates). Additionally, the market has begun to focus on the governments ability to finance the ever expanding national deficit with foreign investments (currently over 60%).

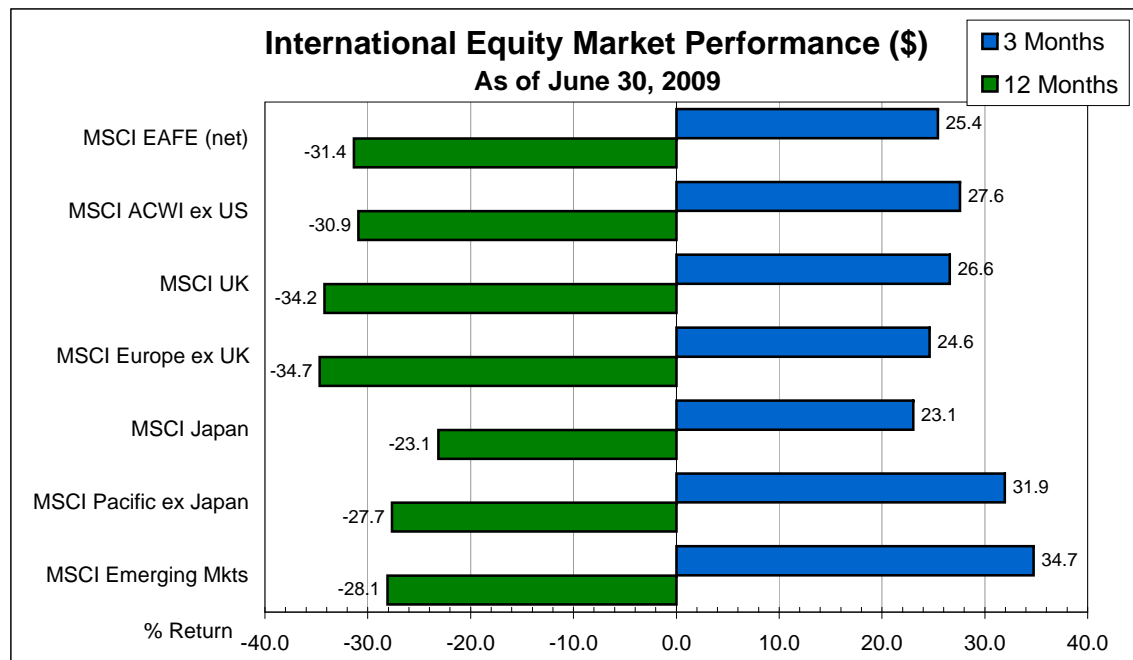
Credit spreads narrowed significantly during the quarter (see bottom table). The contraction in spreads propelled Credits(investment grade) to their best quarterly return ever, out performing Governments by over 11%. High Yield also benefited from tightening spreads and out performed domestic equities during the quarter. Despite these record setting return differentials, spreads remain at relatively wide margins.

Treasury yields continued to rise from extremely low levels during the quarter and returns were negative. Government intervention helped Mortgages achieve their fourth consecutive quarter of positive performance.

Going forward the Federal Reserve and Treasury face several challenges to managing their participation in the fixed income markets: 1) maintaining low rates to spur the economy, 2) financing the growing national debt, 3) avoiding high inflation rates, and 4) the withdrawing their intervention programs without creating a disruption.

Total Returns - Periods Ending June 30, 2009				
	3 Months	1 Year	3 Years	5 Years
Barclays Aggregate	1.79	6.06	6.43	5.02
Barclays Intm G/C	1.67	5.27	6.14	4.57
Barclays G/C	1.86	5.26	6.17	4.80
Barclays Govt	(2.21)	6.63	7.27	5.41
Barclays Credit	8.81	4.07	4.86	4.08
Barclays Mortgage	0.69	9.37	7.82	5.96
Barclays High Yield	23.07	(2.41)	2.09	4.34
Barclays U.S TIPS	0.65	(1.11)	5.80	4.96
Barclays 1-3 Yr Govt	0.14	4.94	5.74	4.21
Barclays Long Govt	(6.66)	6.93	8.39	6.95
Credit Spreads (in basis points)				
	Mar-09	Jun-09	Change	
Aaa	224	107	(117)	
Aa	395	211	(184)	
A	516	287	(229)	
Baa	723	404	(319)	
Ba	1068	804	(264)	
B	1456	885	(571)	
Caa	2723	1413	(1310)	

INTERNATIONAL EQUITY MARKET



MSCI Country Indexes (Net) Three Months Ending June 30, 2009

	Return		
	Return US\$ (%)	Local Currency (%)	Currency Effect (%)
France	21.5	15.0	6.5
Germany	23.5	16.9	6.6
Italy	29.0	22.1	6.9
Spain	36.6	29.3	7.3
Switzerland	16.3	11.2	5.1
UK	26.6	10.2	16.4
Europe Total	25.3	15.5	9.7
Australia	28.4	10.3	18.1
Hong Kong	35.8	35.8	0.0
Japan	23.1	20.2	2.9
Pacific Total	25.7	19.8	6.0
China	35.6	35.6	0.0
India	59.8	50.9	8.9
Brazil	40.9	20.0	21.0
Mexico	35.6	26.6	9.0
Emerging Total	34.7	24.5	10.3

The Streak Ends: Equity markets around the world posted strong gains in the second quarter, as the governmental stimulus programs showed signs of moderating the global recession. In the U.K. and France, the equity indexes snapped a streak of seven consecutive quarters with negative returns (five in Germany).

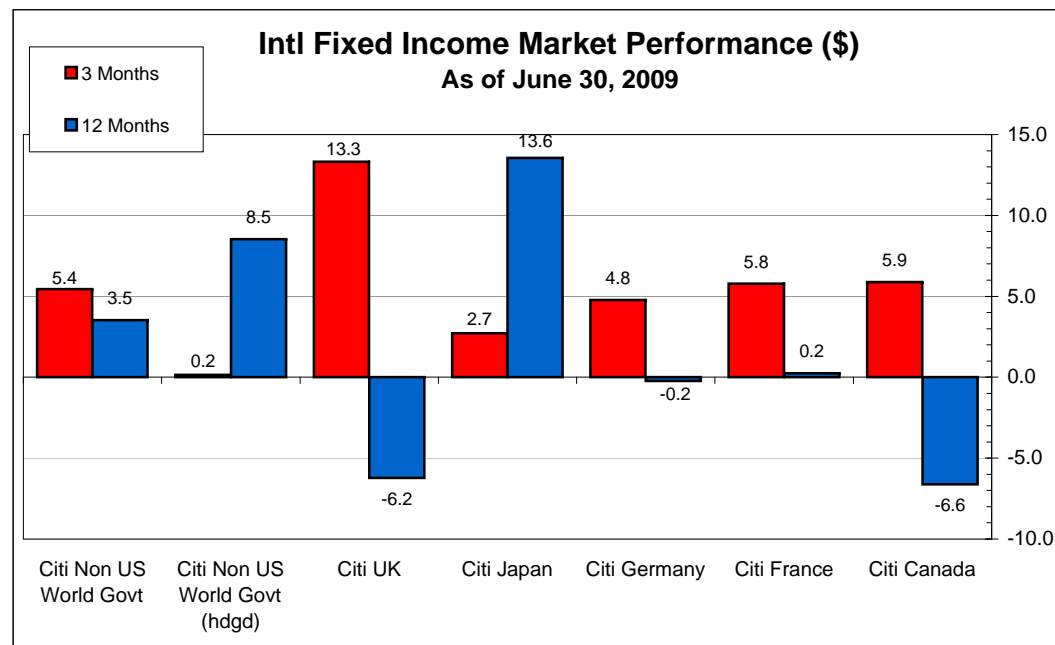
The results in the United Kingdom were some of the smallest due to the numerous obstacles (housing, banking...) to their economy; however, the Pound Sterling advanced after several quarters of weakness. In Western Europe, the returns were slightly stronger and the Euro strengthened against the dollar. The governments in Euro-land have exercised more restraint in terms of their fiscal and monetary policies; their actions may hindered shorter-term economic growth while protecting against a weaker currency and higher inflation in the future.

Japan recorded the best performance of the major developed nations. Their multiple stimulus programs have helped the economy, which appears to have reached a bottom. However, their economic growth will be hindered by their reliance on exports during the global recession.

The Emerging Markets enjoyed the strongest gains, as they benefited from growing domestic economies, significant exposure to commodities sectors (Energy and Materials), and healthier banking institutions. Also, the stimulus programs have been effective; the plans have been implemented quickly and represent a meaningful percentage of their GDP.

INTERNATIONAL BOND MARKET

Citigroup World Government Bond Indexes Three Months Ending June 30, 2009



	Return US\$ (%)	Return Local Currency (%)	Currency Effect(%)
Austria	6.4	0.7	5.7
Belgium	7.1	1.4	5.7
Denmark	5.0	-0.6	5.6
France	5.8	0.1	5.7
Germany	4.8	-0.8	5.6
Ireland	7.6	1.9	5.8
Italy	7.0	1.2	5.7
Netherlands	5.9	0.2	5.7
Spain	6.2	0.5	5.7
Sweden	4.4	-2.1	6.6
Switzerland	3.9	-0.6	4.5
UK	13.3	-1.4	14.7
Europe Total	6.3	0.6	5.7
Japan	2.7	0.3	2.4
Australia	12.0	-3.8	15.7
Canada	5.9	-2.3	8.2

More Intervention, Steeper Yield Curves, and Narrowing Spreads: Economic indicators (production, unemployment, consumer spending...) continued to deteriorate during the quarter, however, at a slowing pace during. With depression fears subsiding, the fixed income markets underwent a strong rotation from government bonds towards corporate securities. Accordingly, corporate bonds handily out performed government bonds.

In Europe the ECB reduced the target interest rate 50 basis points to 1.0% and added new quantitative easing programs (the purchase of bonds to add liquidity and maintain lower rates). Despite these actions, yields rose along the longer segments of the curve. Investors favored the corporate bonds at historically wide spreads, particularly lower quality issuers; corporate spreads tightened by approximately 150 basis points during the quarter. The dollar declined by over 5% to the Euro during the quarter.

The U.K. faces additional challenges to reviving the economy. Due to projected budget deficits that are larger and extend longer than previously anticipated, the nation may lose its AAA credit rating. Despite this issue the Bank of England held rates at 0.5% and continued with their quantitative easing plans. The yield curve steepened and credit spreads narrowed; corporates out performed gilts by 12.5% during the quarter. The dollar declined by over 14% to the Pound during the quarter.

Japan continues to experience significant declines in exports to China and the U.S. The reduction in industrial production (30% year over year in May) is leading to higher unemployment rates and further contraction in consumer spending. However, the rate of decline is slowing and the economy is showing signs of stabilizing at a significantly lower level. Government bonds rose slightly in local terms during the quarter and the dollar depreciated against the Yen.

SELECTED INDEX RETURNS - PERIODS ENDING JUNE 30, 2009

	Quarter	One Year	Three Years	Five Years	Ten Years
US EQUITIES					
Dow Jones Industrial Average	11.9 %	(22.9)	(6.3)	(1.7)	(0.4)
Standard & Poors 500	15.9	(26.2)	(8.2)	(2.2)	(2.2)
Russell 3000	16.8	(26.6)	(8.4)	(1.8)	(1.5)
S&P MidCap 400	18.8	(28.0)	(7.5)	0.4	4.6
Russell Mid-Cap	20.8	(30.4)	(9.3)	(0.1)	3.2
S&P SmallCap 600	21.1	(25.3)	(9.6)	(0.9)	4.8
Russell 2000	20.7	(25.0)	(9.9)	(1.7)	2.4
Growth Stocks - Russell 3000 Growth	16.8	(24.5)	(5.7)	(1.8)	(3.9)
Value Stocks - Russell 3000 Value	16.8	(28.7)	(11.2)	(2.2)	0.2
US FIXED INCOME					
Barclays Aggregate	1.8 %	6.1	6.4	5.0	6.0
Barclays Intm Govt/Credit	1.7	5.3	6.1	4.6	5.7
Barclays Govt/Credit	1.9	5.3	6.2	4.8	6.0
Barclays Government	(2.2)	6.6	7.3	5.4	6.1
Barclays Credit	8.8	4.1	4.9	4.1	5.8
Barclays Mortgage	0.7	9.4	7.8	6.0	6.3
Barclays High Yield	23.1	(2.4)	2.1	4.3	4.7
Barclays U.S TIPS	0.7	(1.1)	5.8	5.0	7.2
Barclays 1-3 Yr Government	0.1	4.9	5.7	4.2	4.7
Barclays Long Government	(6.7)	6.9	8.4	7.0	7.5
INTERNATIONAL (Measured in US Dollars)					
MSCI EAFE (Net)	25.4 %	(31.4)	(8.0)	2.3	1.2
MSCI ACWI ex U.S. (Net)	27.6	(30.9)	(5.8)	4.5	n/a
MSCI Europe (Net)	25.3	(34.5)	(8.4)	2.3	1.3
MSCI Pacific (Net)	25.7	(24.5)	(7.3)	2.1	0.8
MSCI Emerging Markets (Net)	34.7	(28.1)	3.0	14.7	8.7
Citigroup Non-U.S. Govt Bond	5.4	3.5	7.9	6.2	6.5
REAL ESTATE					
NAREIT Index	27.5 %	(40.6)	(18.1)	(3.6)	5.1
NCREIF Property Index	(5.2)	(19.6)	1.0	7.6	8.5
OTHER					
91-Day T-Bills	0.1 %	0.9	3.2	3.2	3.2
Consumer Price Index (percent change)	1.4	(1.4)	2.1	2.6	2.7
Producer Price Index (percent change)	2.3	(4.3)	2.5	3.1	2.7

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