

ECONOMIC AND MARKET OUTLOOK SECOND QUARTER 2009

In contrast to the situation at year end, signs of a bottoming out of our economy are beginning to appear. Last year felt the full blast of the implosion of the financial markets. Beginning with the September massacre and followed in rapid succession by bank failures around the world during October, the collapse spread beyond Wall Street to the real economy. Individual and institutional investors suffered irreversible losses in the collapse of Fannie Mae, Freddie Mac, Lehman, American International Group, and other highly rated institutions. Business and consumer confidence was shattered by the suddenness of the onslaught, and financial instruments from stocks to high quality corporate bonds declined sharply. Only U.S. Treasuries gained a clear sign of a flight to safety.

Government plans to get in front of the crisis were quickly drafted. The initial \$700 billion Troubled Asset Relief Program, intended to cleanse the banks balance sheets of frozen assets, was actually passed on October 3, 2008. Diverting some of the funds to save AIG and the auto companies caused confusion and political anger, and the urgency of implementation quickly gave way to the presidential campaign. The year ended and a new year began in an economic limbo created by a lame duck presidency and a bitterly divided Congress.

The first quarter quickly exposed the economic cost of the virtual shut down of the economy and the paralysis of the government. In fear of job losses American consumers spent little on Christmas and even less on big ticket items like automobiles. Businesses suddenly were caught with excess inventories at virtually every stage of production, and manufacturing was drastically reduced. Exports suffered as conditions around the world mirrored those in the U.S. Unemployment rose sharply. Banks remained heavily invested in assets they were unable to price, forcing enormous write downs against regulatory capital, regardless of whether or not the assets were still solvent. All lending including commercial paper, the life blood of short term business financing, froze. Various measures of economic activity collapsed, providing plenty of grist for those who saw only darkness ahead.

There are emerging indications that the economy may be starting to level off. Housing starts have risen modestly for three months and permits have also moved up. New home sales rose in February and January sales were revised upward slightly. The National Association of Realtors reported its gauge of previously owned home sales increased 5% in February including condominiums, which also rose sharply. Reacting to historically low mortgage rates refinancings are very strong, providing immediate increases in income to those lucky enough to be in a position to refinance. Mortgage applications have been rising for several months now. A new tax credit for first time home buyers, low mortgage rates, and the decline in house prices, provide the most attractive package of financial incentives for home buyers in decades.

The importance of housing in this era of financial turmoil cannot be over emphasized. Inflated house valuations and ease of obtaining mortgage money regardless of whether the purchaser could afford it, is the seminal cause of the long chain of events leading to the prolonged recession. Healing this open wound in our economic fabric is critical to restoring confidence, mending bank balance sheets, and reaching economic stability. In other areas also, an unexpected turn to the better continues to surprise sporadically. Based on the latest retail data, consumer spending this quarter will recover somewhat from the sharp decline late last year. In the manufacturing arena orders for durable goods gained sharply in February. Likewise, the credit markets have shown improvement, notably in the commercial paper market and inter bank lending. While welcome, these indications do not yet provide evidence of a sustained turn in our economic fortunes.

After a disorganized and distracted start the administration and the monetary authorities have unleashed a blizzard of new initiatives designed to keep mortgage rates low and infuse life into the securitization market. The Federal Reserve will start buying Treasury notes and bonds as part of a \$30 billion quantitative easing program which, it is hoped, will push mortgage rates lower and forestall an increase. The new Public/Private Investment Program seeks to create a market for the structured investments still clogging banks balance sheets, impeding their ability and willingness to begin lending more aggressively. The Target Asset Lending Facility will jump start a new securitized bond market for companies which need access to this market, such as automobile companies. While many details of these programs still have to be resolved and acceptance is questionable, given the public lynching of AIG executives, we believe on balance these initiatives will ultimately be helpful in restoring confidence and freeing capital. Unless carefully handled, longer term these initiatives have the potential to cause serious market distortions.

There are challenges ahead. Notably, unemployment will continue to rise and the overhang of unsold houses will continue to weigh on the economy. Housing is now at or very close to equilibrium, however, and the industrial economy does not appear to be getting any worse. A return of confidence will unlock the enormous sums of money now stored in personal and corporate coffers. In an environment free from inflation pressures, our fears about the unintended consequences of such massive spending and the fiscal profligacy evident in Washington are longer term. The stock market has felt the full brunt of the fallout from the recession. In our opinion, the values created by the decline are exceptional.

Investment Policy Committee
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