

FROM THE ECA RESEARCH DESK . . .

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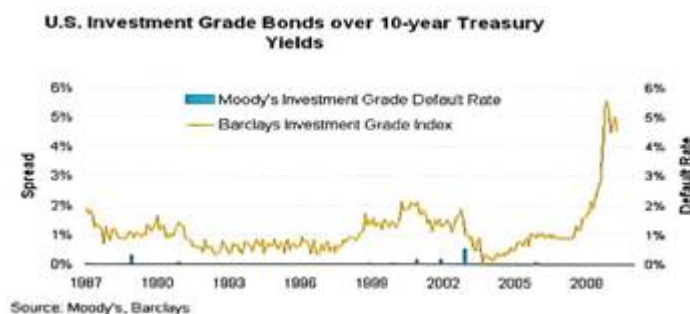
We have seen dramatic market value improvement in both equity and credit markets since reaching a low in early March, but we think it is still necessary to exercise caution.

Equity market action:

- Our March 13 'Research Notes', recounted Knott Capital's change in outlook from bearish to bullish. Knott encouraged investors to start buying stocks - the market was oversold, a recovery imminent. Since that date, stocks have indeed rallied, over 20%.
- Technology stocks and emerging markets have been among the best performing areas, up 20% and 30% respectively.
- After dropping 28% in the first 2 1/2 months of the year, stocks have recovered their losses to get back within 5% of where they started the year.
- Over the past two months, advancing NYSE stocks have swamped decliners by more than 1.5 to 1 – the highest ratio in over 20 years.
- Fear of being left behind, short covering and the immense amount of (now nervous) cash on the sidelines is adding fuel to this bull.
- Emerging markets, especially Brazil and China will lead the world out of recession.

Improvements in the credit markets:

- In late 2008, the yield spread between U.S. Treasuries and investment grade corporate bonds reached the widest levels in decades as fearful investors ran for the safety of Treasury securities.
- Spreads reached almost 6% from the historical norm of about 1.5%.
- 6% is a handsome premium for taking a small additional risk in high quality corporate bonds. We used this opportunity to overweight corporate bonds in client portfolios.
- Bond prices are moving higher as credit markets improve. The yield spread has tightened (now about 4.5%), remaining well above the historical average. High grade corporate bonds have appreciated nicely and are still well priced, offering attractive yields. But, stay short as inflation and higher interest rates are in our future.



Longer Term Concerns:

- Unprecedented government intervention in the private sector.
- Federal Reserve monetization of debt (money creation) to cover:
 - Private debt and bank investment losses – TARP and other bailout schemes
 - Auto company private pension and healthcare liabilities
 - Unfolding, out of control social security liabilities
 - Broken Medicare and Medicaid programs
- Ultimately, we cannot 'print our way' out of all this debt. If that were so, banana republics would be world powers.
- Debt:
 - Consumers: Mortgage and credit card payments (as a % of household income) are at a 30 year high.
 - Government: Huge, new government spending programs will lead to annual budget deficits of \$1.8 trillion on top of the already existing \$11.2 trillion government debt (now 79% of current GDP).

-The Wall Street Journal recently reported that the Federal Housing Administration (FHA) now issues 1 in 3 new mortgages - many with the same characteristics as sub-prime loans. Losses on this \$562 billion portfolio of mortgages are growing and are guaranteed by taxpayer dollars.

-These concerns will lead to inflation, or worse-stagflation. Be sure to have a 'real asset' component in your portfolio – stocks that have pricing power, basic materials, precious metals, natural resources (such as timber), commodities and real estate (be careful – prices, down about 30% from their peak will likely fall another 8% to 10%).

-Consumers and businesses are retrenching and deleveraging, becoming more “thrifty”. While this will generate an increase in the savings rate and a lower debt-to-income ratio, it also means less spending and a slower economy.

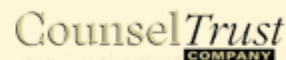
-Jobs, real estate prices, the unwinding of excess debt and ongoing credit availability are the 'lynch pins' of economic recovery and hence corporate profits, leading to better stock and bond prices.

-Economic recovery and healthier markets depend on fixing personal balance sheets and housing price stability. With one-third of all mortgages exceeding home values, the unsold inventory of homes will be slow and painful.

-More government bailouts are not the answer. The application of basic free market economic fundamentals will lead the way to recovery, but it will take longer and recovery will be weaker than the consensus believes.



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