

**“Contained Depression” Marks Longest Synchronized Global Downturn Since WWII; Housing Stabilization, Consumer Spending, Banks, and Policy Are Keys to Recovery**

In the first quarter of 2009, extensive deleveraging due to the credit excesses and asset bubbles of the last cycle continued to unwind, negatively influencing the financial markets and the real economy. March 2009 marked the 16<sup>th</sup> month of the current recession, matching the duration of the 1973 – 1975 and the 1981 – 1982 downturns, the longest since World War II. World Bank economists estimate that global output (GDP) will shrink this year for the first time in the post war period. In the U.S., multiple economic data points looked especially troubling. GDP contracted at a 6.3% annualized pace in Q408, the worst reading since 1982. The unemployment rate rose to a 25-year high of 8.5% in March. Production of cars and trucks plunged in January to 3.9 million annually, 67% below January 2005 levels, and the lowest since the Fed records began in 1967.

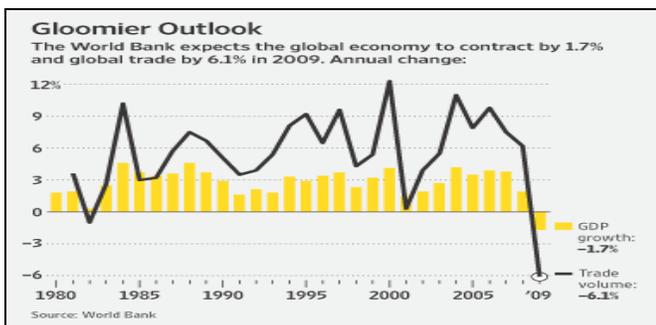
Data from the housing market continued to be exceptionally weak. According to the National Association of Realtors, the median price of a home sold in the U.S. fell to \$170,300 in January, down 26% from a year and a half earlier. Housing starts dropped to below 600,000 units in February, near all-time record lows. Approximately 5.4 million homeowners, 12%, were in foreclosure or behind on mortgage payments at the end of last year. In our analysis, stabilization in the housing market continues to be key to an eventual economic recovery. Excess housing inventories will need to be worked off to improve valuation and stabilize demand.

In response to the crisis, and one sign that the downturn will likely leave a lasting impact, households are building savings. In February, the savings rate rose to 4.2%, up from 0.2% a year ago. After a 25-year decline, we anticipate a secular rebound in the personal savings rate.

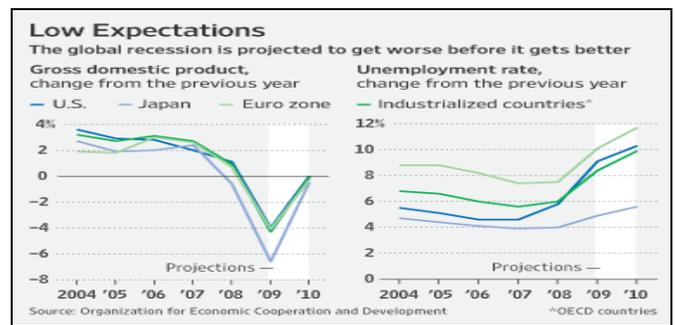
In addition, we estimate that consumer deleveraging will continue to restrain consumer-spending growth. Declining household net worth, tighter credit and rising unemployment also support this outlook. Household debts levels recently peaked at 130% of disposable income, an unsustainably high amount in our analysis.

Despite a sharp March rally, the first up month since August, broad stock indices ended the quarter lower. In the second quarter, the Dow Jones Industrial Average (DJIA) and the Standard & Poor’s 500 Index fell to 12 year lows, down more than half from the stock market peak in October 2007. In the 30-stock DJIA, five stocks traded below \$10, six stocks traded below book value and seven cut dividends. More than half the firms in the DJIA saw their price-to-earnings ratios drop to below 10-times trailing earnings. Charges regarding alleged securities frauds in the billions of dollars tied to both a New York hedge fund manager and a Texas-based brokerage firm added to investor unease in the quarter.

Policy uncertainty from Washington is also clouding the outlook for economic growth. The lack of clarity from the administration’s budget and its Financial Stability Plan, policy delays and talk of temporary bank nationalization further decreased investor confidence in the quarter. The administration’s budget projects new federal borrowing of \$2.56 trillion in fiscal 2009, with deficit projections from the Congressional Budget Office estimated to be \$1 trillion annually for the next decade. While current demand for Treasuries from domestic and foreign investors appears strong, yields and inflation concerns could rise as investor risk appetites return. The budget also calls for higher marginal tax rates and higher-capital gains taxes on wealthier Americans.



Source: The Wall Street Journal



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The Financial Stability Plan includes a comprehensive stress test for financial institutions with over \$100 billion in assets to assess whether the organizations have the capital necessary to continue lending and to absorb the potential losses that could result from a more severe decline in the economy. The plan also consists of \$75 billion devoted to mortgage foreclosure mitigation, \$200 billion for agency mortgage purchases and an expansion of the Fed's previously announced Term Asset-Backed Securities Loan Facility (TALF) to a \$1 trillion if needed. The goal of the TALF, originally announced last Fall and scheduled to start in February, is to jump-start the securitization markets for new consumer auto, credit card and other asset-backed lending. In March, the U.S. Treasury announced details of its long-awaited plan to remove troubled assets from banks' balance sheets. The plan will finance as much as a \$1 trillion in purchases of illiquid real-estate loans and securities using a combination of funding from the U.S. Treasury and private investors. Removing troubled assets from bank balance sheets is critical to restoring credit creation and economic growth.

Inflation and interest rates will likely remain historically low in the short-term due to both excess capacity in the economy and the policy response from the Federal Reserve. Outside the volatile commodity sector, house price declines and wage pressures are restraining consumer inflation. After a flat reading in January, the consumer price index rose 0.2% in February, down from 4.0% a year ago. Since December, the Fed maintained a 0.00% – 0.25% range for its target fed funds rate. In March, it announced larger purchases of agency debt, mortgage backed securities and Treasuries to keep pressure on market interest rates in order to stimulate lending. Quantitative easing also seeks to increase the money supply to diminish the likelihood of deflation.

#### Historical Price-to-Earnings Ratios

Peak	Trough	Price Decline	P/E At:	
			Peak	Trough
Sept. '29	June '32	86%	22.0x	10.7x
March '37	April '42	60%	28.1x	13.4x
May '46	June '49	30%	33.6x	10.7x
Aug. '56	Oct. '57	22%	26.9x	24.5x
Dec. '61	June '62	28%	38.5x	26.3x
Feb. '66	Oct. '66	22%	31.4x	25.3x
Nov. '68	May '70	36%	31.7x	21.9x
Jan. '73	Oct. '74	48%	22.8x	11.3x
Nov. '80	Aug. '82	27%	10.9x	8.5x
Aug. '87	Dec. '87	34%	18.0x	10.3x
July '90	Oct. '90	20%	16.9x	14.4x
March '00	Oct. '02	49%	26.9x	15.9x
<b>Oct. '07</b>	<b>March '09</b>	<b>56%</b>	<b>22.4x</b>	<b>13.4x</b>
Historical Average		38%	25.6x	13.9x

Source: Barron's and Goldman Sachs

In downturns over the past 60 years, the S&P 500 has hit bottom an average of six months before a recession ended and about nine months before employment reached a peak. While valuations are a moving target when economic conditions worsen and earnings estimates are revised lower, stocks remain on the low end of their historic range based on normalized earnings. We will be carefully watching for signs that the policy response is gaining traction and for any indication of a resumption of growth in the economy.

The current environment in the economy and the financial markets is the most challenging in the modern era and we are especially appreciative of your continued confidence in this difficult period. While we cannot predict the exact timing of a turn, our experience from previous cycles has taught us that a prudent approach to portfolio positioning is critical. In our view, the best way to manage through the downturn is to continue to maintain a diversified, conservative mix of defensive growth companies, high-quality bonds and cash.

We believe that companies with consistent earnings growth, solid balance sheets and expanding market share will perform well if the economy experiences a modest recovery. These large cap growth companies can not only withstand the near-term challenges, they can also be opportunistic by investing in attractive products and desirable geographic regions and by making value-added acquisitions to improve the potential for future growth. Our newest and best ideas continue to be generated from the economically defensive Healthcare, Consumer Staples and Utilities industry sectors. In fixed-income, we continue to find attractive tax-equivalent opportunities in the investment grade municipal bond market. These securities can also provide for a double-exempt (federal and state) stream of stable income for investors.

#### S&P 500 Earnings Estimates by Industry Sector

S&P 500 Sector	'09 Est. Earnings Contrib.	'09 Est. Earnings Change	2009 Est. P/E	Current Index Weight
Con Disc.	5.2%	-25.0%	18.8x	7.4%
Con. Staples	16.5%	1.0%	11.1x	13.2%
Energy	18.8%	-55.0%	10.0x	13.9%
Financials	0.0%	NM	NM	9.7%
Health Care	22.0%	7.0%	10.4x	16.8%
Industrials	11.5%	-35.0%	11.9x	10.3%
Technology	14.3%	-30.0%	15.9x	17.4%
Materials	1.7%	-65.0%	27.5x	3.1%
Telecom	4.8%	-12.0%	10.8x	3.7%
Utilities	5.3%	2.0%	11.6x	4.5%
Index Total	100.0%	-23.4%	13.4x	100.0%

Source: Barron's & Citigroup Global Markets, NM = Not meaningful.

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