



ECONOMIC OUTLOOK

The turmoil within the mortgage and sub-prime credit markets

that began developing in the summer of 2007 spread rapidly during the summer of 2008. The realization of the magnitude of the unquantifiable credit risk exposure of the securitized mortgage backed securities, collateralized debt obligations and credit default swaps within financial institutions overwhelmed both the domestic and international credit markets. In September the environment of fear and investor panic was magnified by the bankruptcy of Lehman Brothers, the nationalization of Fannie Mae and Freddie Mac, as well as the forced combination of Merrill Lynch into Bank of America, and Wachovia into Wells Fargo.

During this time, the financial markets began to freeze up as the lack of liquidity created by crisis of confidence in what had become known as “toxic debt” instruments halted the normal short term funding markets. In reaction to this blossoming credit panic, the Federal Reserve Board and the Treasury began a coordinated program of adding liquidity to the system and providing back up funding sources to those areas most affected by the liquidity pressure including the commercial paper and money market systems. On October 3rd, the Treasury Department and the Federal Reserve System, in conjunction with Congress and the Administration, developed the Troubled Asset Relief Program, or TARP, to oversee the use of \$700 billion to strengthen the capital base of the financial system, remove much of the toxic debt instruments from balance sheets of major financial companies, and continue the program of adding liquidity to the financial system. These initiatives have been reinforced by a coordinated effort internationally of our major trading partners to provide similar programs to restore liquidity and capital support within their markets.

Over the past month, the effects of the increased liquidity, lower interest rates and the TARP initiatives have begun to impact the financial markets. Liquidity measures have started showing gradual improvement and the credit squeeze that froze the economy has begun to lessen. Based on the variety of initiatives that have been instituted over the past two months in reaction to the growing financial paralysis, it is our view that the gradual improvement in the credit markets will continue.

A return to more normal levels, however, will likely take months, not weeks.

A good deal of damage has been done to many corporate balance sheets and as the TARP program is put into place, it will likely remove these toxic assets at a discounted market rate continuing the pressure on company earnings and balance sheets.

The financial shock caused by the credit crisis has, in our view, pushed the U.S. economy into a recessionary environment that is likely to continue through the first half of 2009. Consumer spending, which represents over 70% of GDP (Gross Domestic Product), is a major component of domestic growth and will likely be pressured by economic uncertainty, rising unemployment levels, and tightened credit requirements as the financial sector focuses on improving their losses both in the area of mortgage and home equity lines as well as credit card delinquencies. Corporate spending is already showing a decline as balance sheet concerns and projected demand slowdown have cut back on business investment and production schedules.

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As we move through this period of economic weakness, there are a number of negatives that should be considered. This economic slowdown will likely be global with most of our major trading partners also showing weakness because of our growing economic interdependence. While credit stress is beginning to show improvement, a return to normal liquidity will take time and many corporate balance sheets remain weakened by the recent trauma. The consumer will likely have reduced access to credit lines and their real income gains will remain limited during this period of rising unemployment and economic weakness. Several industries that provide significant positive cyclical rebound potential off of recessionary lows such as the automobile and housing industries will likely be slow to improve based on consumers low saving rate and reduced access to credit.

Although these negative factors seem dramatic, there are also a number of positives that should begin to generate a gradual return of confidence over the next few quarters. Interest rates have been brought down to historically low levels and the economy has been provided with tremendous near term liquidity. Financial institutions are being restored to a position of strength and the forced consolidation that has taken place should make them stronger in the future. A number of regulatory safeguards are being put in place to monitor the financial industry and product flow to guard against a repeat of the excesses experienced over the past decade. GDP growth has been relatively strong over the past seven years with solid productivity gains that may provide an eventual solid rebound once consumer confidence is restored. International markets are now much more interdependent and the rapid rebound expected from a number of our trading partners should provide initial stimulation to our economy. The commodity pressure brought on by a rapid escalation in energy and raw material prices that had negatively impacted both consumers and corporations has reversed dramatically, as exemplified by the 50% price decline in oil over the past three months, and will result in a net stimulation to the economy both domestically and internationally.

EQUITY MARKET

Since the market highs of October of 2007, the market as measured by the S&P 500, has recorded a peak to trough decline of just over 40%. The initial 20% decline that was experienced over the eleven months through September of this year was followed by a sharp additional 20% sell-off in early October as the severity of the credit freeze was recognized and investor panic ensued. The October decline was significantly

magnified as mutual fund and hedge fund redemptions escalated and heightened margin calls forced portfolio managers and individual investors to liquidate positions without regard to the underlying strength of the companies involved. While the fundamental outlook remains clouded and there are numerous fundamental risks that still must be dealt with heading into 2009, it is our view that the current valuation levels of the market have discounted a great deal of the incremental risk. Though earnings pressure will likely create continuing near-term volatility, we view the current valuation levels, as represented by the S&P 500, (11 times earnings, less than 4 times book value and yielding over 3%) as being an attractive entry point for longer term investors. The current price/earnings multiple valuation ranks in the lowest quintile of average valuation levels reached over the past sixty years.

HISTORIC PERSPECTIVE

Source: SCCM

Bear Market: Start	Bear Market: End	% Decline	Duration	Market Recovery: Next 12 Mos (S&P 500)
6/15/48	6/13/49	-20.57	12 Mos	42.07%
8/2/56	10/22/57	-21.63	15	31.02
12/12/61	6/26/62	-27.97	7	32.66
2/9/66	10/7/66	-22.18	8	33.06
11/29/68	5/26/70	-36.06	18	43.73
1/11/73	10/3/74	-48.20	21	37.96
11/28/80	8/12/82	-27.11	21	59.40
8/25/87	12/4/87	-33.51	3	22.40
3/24/00	9/21/01	-36.77	18	-12.50
1/4/02	7/23/02	-31.97	7	17.94
10/9/07	To be determined	40% to date	12	To be determined

The preceding table sets forth the market action during the past ten post World War II recession driven bear markets. Having had earnings pressure and investor fear present in each of these prior periods, it is interesting to note that the market tends to discount the economic weakness once the recession has been recognized. The general equity market, as measured by the S&P 500, typically shows a significant market value rise following the market lows within each cycle in anticipation of the eventual economic recovery well before the economic environment shows material improvement. This trend has given rise to the market adage, *"Initially bull markets climb a wall of worry during difficult economic times"*. As shown in the table, the average post World War II recession driven bear market lasted thirteen months, resulted in a market decline

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Reasons to consolidate all your investments at Davidson

With the recent stock market losses, we have received numerous calls from existing clients requesting that we accept receipt of investment assets held at multiple other institutions. Typically, these other assets are not being actively managed and certainly not as part of an overall investment plan. On occasion, however, the assets are being actively managed, but without adequate planning.

When discussing the issues with these clients, it became clear that they identified three significant risks of spreading their assets out among different advisors and the advantages of consolidation with Davidson Trust Company:

1 First, there is the need for an "investment quarterback" or "chief financial officer" of your investments. When you have investment assets with multiple advisors, whether you realize it or not, YOU are that quarterback (often by default). As quarterback you are responsible for investment issues such as rebalancing the portfolios among asset classes, stock sectors, and investment styles. In addition, you are responsible for identifying and implementing reallocations when your situation or goals and objectives change. If you do not believe you are equipped to handle this role the topic needs to be addressed and we can help.

2 Second, there is a need for the asset allocation of all of your investments (not just the ones currently at Davidson Trust Company) to reflect your feelings and family dynamics in light of your current situation and future goals. When assets are spread out among advisors it is up to the client to maintain their asset allocation. The natural inclination is to overweight an allocation based on your feelings (these days "fear", but in stronger markets "greed"). Feelings are usually based on something that has already occurred and managing on this basis is management which will trail the market.

3 When multiple advisors are involved, there is a risk of excessive overlap and excessive conflicts. For instance, if one of your managers is selling a stock which another one is buying, you are either incurring a needless capital gain or alternatively running into a problem with the wash sale rules. Conversely, if both managers like the stock, you may be exposed to an overweight in the position. The same could also be true in regard to asset sectors and asset classes.

Davidson Trust Company can accommodate your decision to have multiple investment managers by serving as a coordinator of managers for investment policy and reporting purposes. During these difficult times, individuals have a heightened sense to risk. Consolidation of your investment assets at Davidson Trust Company can lessen these risks and address the need for coordination of all of your investment assets.



of 30.6%, and reached its low point well before the risks in the economy were viewed as being resolved. To date, the current recession driven bear market has lasted thirteen months and has resulted in a market decline that at its low point was close to 40%. While no one can predict the ultimate low value or date of the bear market end until well after the fact, our view is that most of the risk in the market has largely been discounted. Over the twelve months following the bear market lows, the average market performance of the S&P 500 has been over thirty percent.

Each of the Davidson Trust Company Investment Policy Statements and personal asset allocation benchmarks have been developed to maintain your optimum risk-adjusted rate of return over the longer term. At current depressed market valuation levels, we will suggest maintaining your long-term asset allocation guidelines within the portfolio with a focus on your long-term goals. If intermediate cash flow needs require greater portfolio stability to fund planned initiatives over the next year, however, allocation levels may be modified at any time to reflect your changing priorities or simply to improve your comfort level during these difficult times. Within individual investment portfolios, we recommend using the current near-term market volatility to rebalance sector weightings, take advantage of specific undervaluation levels to add to selected securities, and make use of individual tax loss opportunities to lessen year-end capital gains tax liabilities.

INTEREST RATES

As a result of the recent credit events and massive liquidity injections by the United States and other governments coordinated with a lowering of discount rates, the basically frozen credit markets have begun to show signs of movement. Treasury rates, the global first choice of a safe haven, which were trading in negative returns at quarter-end are now trading in positive territory. The exceptionally steep corporate yield curve continues to offer very high interest rates on perfectly creditworthy names, but the volatility is simmering down a bit. Portfolio managers continue to be locked into selling names, not of choice, but the names that they can sell if they need to raise cash. The good news is that there are a few more names being added to the list accepted on the Street as tradable.

Portfolio managers for pension plans, mutual funds, etc. are set up for year-end already (two months ahead of schedule). Most are keeping inflows of money in cash. Because of this seasonal feature of the markets and the reluctance of market participants to dip their toes into the credit water right now, we do not look for any significant cooperation from the markets until the new year. For now, interest rates longer than 3 months are practically frozen in time, certainly a historic event. This will improve next year, yield curves will flatten, spreads will come in versus Treasuries and confidence and fluidity will return to the markets.

PRIVACY POLICY

We know you are concerned about the confidentiality and security of your nonpublic personal and other client information you provide to us. Davidson Trust Company does not sell or otherwise distribute nonpublic personal information to other organizations or individuals.

Once your information is on our systems, it is protected from outside access and our employees are not permitted to disclose any information they have access to as a result of their work with outside individuals or organizations. In addition, we maintain physical, electronic and procedural safeguards to protect your nonpublic personal information from unauthorized use.

Should you be concerned about the accuracy of any information we have in our database concerning you, you may request a copy of your records by contacting our office. We will send you a copy of your records for your review and update, if needed.

If you have any questions or comments regarding our privacy policy, please email us at info@davidsontrustcompany.com

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