



Perhaps it's overreaching for your investment advisor to offer you serenity. On the other hand, of what value is financial success if you can't sleep at night? In this quarterly update, you will get our best thinking on the economy and the volatile markets. It's important that we stay abreast of these things – it's our job. But in the long run, your best chance of reaching your financial and life goals – and being able to sleep at night – will come from having a sound financial plan and personal investment policy, and sticking to it.

A financial plan helps us organize our lives so that our lifestyle, educational, family, and philanthropic priorities are matched as closely as possible with our ability to fund them. It tells us the form in which our assets should be owned and how much insurance we need (or don't need.) It gives us guidelines as to how we should behave when we have inflows of new assets or the need for an expenditure. An investment policy is formulated in response to the plan. The policy tells us what we can reasonably expect from our investments and how much risk we will need to take. If we are uncomfortable with the risk, we are pointed back to the plan and asked to reconsider our priorities. Once the investment policy is in place, we understand that markets and asset classes ebb and flow, and we are comfortable with that. Several times a year, we rebalance our portfolios, taking profits from those asset classes that have outperformed and reallocating to those that have underperformed. It's a time-tested implementation of that simple piece of wisdom – buy low, sell high. When life circumstances change, we review our plan and our policy to see if it needs to be adjusted.

Choppy markets are no fun for any of us, but if we have planned properly and have an investment policy, we can weather the storm. We can help – just give us a call.

Alvin A. Clay III
Chief Executive Officer

ECONOMIC OUTLOOK

The turmoil in the housing and sub-prime credit markets continued to increase over the last six months, producing high market volatility and overall market pressure on domestic and international markets. Although the housing weakness has been largely reflected in the market's action to date, the illiquidity created in the mortgage backed securities market will likely remain with us until the securities are gradually unwound as they mature over the next several years. The incremental mortgage pressure is also expected to begin dissipating beginning in the fourth quarter of 2008 as sub-prime and adjustable rate mortgage step ups will begin to slow following four quarters of historically high levels.

The rapid action of the Federal Reserve and the Treasury Department to provide liquidity has been essential in bringing the economy through this problematic period with as little fundamental damage as possible. Estimates of write-downs within the mortgage backed securities and collateralized debt

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obligation markets continue to be in the area of \$500 billion, with a good portion of this loss resulting from mark-to-market pricing discounts reflecting the current illiquid market conditions. A substantial portion of these losses should be recouped by those investors holding higher grade securities to maturity. The second quarter earnings reports should mark the peak in further mortgage securities write-downs.

With the deterioration of the housing and mortgage markets having been the main concern during the first half of 2008, a magnified concern has been the sharp run up in commodity prices in general and crude oil prices in particular. These dramatic increases in energy and commodity costs are placing growing pressure on consumer spending trends and have heightened the potential for escalating inflation in the second half of the year and into 2009. Based on this, there is little likelihood of additional Federal Reserve interest rate cuts from the current level of 2% and gradual increases are expected.

In spite of the economic pressures created by the sub-prime illiquidity and higher commodity prices, the economic trends during the first half of 2008 remained modestly positive. During the first six months, Real GDP growth was estimated to have grown by 1.1% with a degree of the consumer spending pressure having been offset by the tax stimulus package implementation that began in late May. For the next six months, overall economic growth should remain modest with gradual improvement in financial liquidity accompanied by continued inflationary concerns.



THE ESTIMATES

For calendar year 2008, Real GDP growth is expected to remain in the area of 1.2%. Real Consumer Spending is expected to increase by 1.2%, while Government Spending should grow by 1.8% and Corporate Spending should increase at a rate approaching 2%.

Core inflation is expected to average 2.6% to 2.8% with gains in the overall Consumer Price Index potentially approaching 3.6%. Preliminary projections for 2009 call for continued modest positive momentum with GDP growing at a level of between 1.6% and 2%.

EQUITY MARKET

With overall corporate earnings expected to show a notable decline for 2008, it is interesting to note that the majority of the earnings damage is being concentrated within the financial services sector. In the first quarter of 2008, reported earnings for the market, as measured by the S&P 500, showed a return of -17%. Excluding the financial sector, however, first quarter growth would have been +5%. For the remainder of 2008 continuing positive support for economic growth will include: continued low real interest rates across the high quality maturity spectrum; a weak dollar that has increased the competitiveness of domestic goods in overseas markets; a continuing relatively low unemployment rate; strong and liquid balance sheets in the industrial sectors of the market; and stimulus from the stronger growth being enjoyed by our major international trading partners and major domestic corporations operating overseas.

As in any year, financial, economic and geopolitical uncertainties have affected investor expectations and subsequently the overall direction of the financial markets. Based on consensus earnings figures, the market, as measured by the S&P 500, is currently selling at 14 times projected 2009 earnings of \$94. While general economic growth is projected to be relatively modest over the next twelve months, earnings comparisons should show improvement and financial market illiquidity should begin to unwind moving into the fall. Continuing earnings gains from the industrial sectors should be aided by

significant improvement in the financial sector as market pressures ebb and year-over-year comparisons accelerate from depressed prior year levels.

In the first quarter the general market declined by roughly 10%, most of which was recaptured in early spring but only to be given back in June. The market's current correction may not have completely run its course at current valuation levels, but there are a number of well positioned, financially sound companies that have been revalued at very attractive levels based on the generally negative psychology that has been derived from the sub-prime financial market correction. Over the year ahead the market is expected to show a gradual improvement in overall performance based on improving economic and earnings trends, as well as improving investor confidence. However, superior performance is going to be dictated by the selective use of companies that have the ability to show consistent solid earnings gains in the face of slow economic momentum and heightened financial and geopolitical uncertainty. *continued >*

Estate Planning Corner

Importance of Fiduciary Selection

During the estate planning process, one of the most important decisions to be made is which one or more people or corporations you will name as a fiduciary. In short, a fiduciary is someone you name to act on your behalf. Usually, the power you grant to a fiduciary becomes effective upon your inability to act yourself (e.g. your death or incapacity).

Depending upon the document or issue involved, the fiduciary may be appointed to handle your financial or personal affairs. The three most common fiduciary appointments for financial affairs are (i) Executor, (ii) Trustee and (iii) Agent under a power of attorney. The two most common appointments for personal affairs are (i) in the event of your death, the naming of a Guardian for your minor children and (ii) in the event of your incapacity, the naming of a Surrogate to make health care decisions for you.

While each of these appointments should be addressed separately, the common thread is trust – trust that the individual or corporation you name will make the right decision given the circumstances which confront them. Oftentimes, you may want the fiduciary to have an understanding of what you would have done if you were able to intercede. Along these lines, you should consider telling the fiduciaries you name your feelings and thoughts while you are able. You should also consider specifying these intentions in the underlying document whereby the fiduciary is appointed.

However, you need to be realistic. It is simply impossible to predict and provide direction for every potential issue which a fiduciary may someday face. Thus, it is important that you trust their judgment.

It is also important to periodically review your planning documents and consult with your attorney to ensure your fiduciary appointments remain as desired. For example, a fiduciary you named may have moved, had a change in their circumstances, or the personal or professional relationship between you may have become more distant.

Davidson Trust Company has fiduciary powers and we are happy to serve as your Executor and Trustee. Some of the advantages to naming Davidson Trust Company as your corporate Executor and Trustee include the depth of our knowledge and experience, independence, objectivity, continuity of service, investment capabilities, administrative reliability and willingness to serve with other family or independent individual Executors and Trustees.





INTEREST RATES

The Federal Reserve has made it quite clear that they are shifting their focus more toward inflation risk. The problem with the inflation risk this time around is that we are definitely not alone in the battle. This is a global battle that can only be won with intergovernmental cooperation.

Demand from BRIC (Brazil, Russia, India, and China) countries on the world's resources has been increasing at a rapid pace. The United States has been spending dollars globally and those other countries need a place which is more stable than their own currencies or debt markets to spend or invest those dollars. We have been exporting our inflation for years in the form of purchasing foreign goods and services. Well, it's back and has turned into quite a lion.

Remember, the markets trade on perception. If the perception is that the Fed is going to have to raise rates by 75 basis points (.75%) by year-end to fend off looming inflation, then the longer Treasury securities will become cheaper in anticipation of the Fed's next movement(s), increasing the yields that they offer. This attracts more foreign buyers if there is also the perception that the dollar is stabilizing against their home currency. This was substantiated by the surge in demand for US securities by foreign buyers this past month.

Our expectation for rates in the immediate future is for the Fed to maintain a 2% rate over the summer with a good possibility of beginning to push up short rates this fall. In the 10-year area, we have been observing the flattening of the Treasury curve and the increase in rates from 3.30% on 3/17/08 to a high of 4.27% on 6/16/08 as the market exited corporate bonds in a flight to quality and safety in Treasuries. 10-year Treasuries should range between 4.80% and 5% by year-end. Corporate bond yields will continue to widen and narrow on headlines. We look forward to a calmer 2009 and global central bank cooperation.

AT THE FIRM

We would like to welcome *Jeffrey M. Bagley, CFA* as the newest member of our portfolio management and research team. Jeff brings over sixteen years of experience in investment management and will be covering the Healthcare and Industrials sectors. We are also pleased to announce that *Lisa A. Miles* has joined the firm as our Assistant Controller. Lisa has over twenty years of experience in the accounting field and will be assisting our CFO.

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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