

Market & Wealth Management Update February 28, 2010

U.S. Markets Chippy in 2010 with Positive Earnings but Weak Economic Data

Global markets turned in a positive month in February, gaining 3.0% as measured by the S&P 500, after declining 3.5% in the month of January. The chart below shows the S&P 500 over the past three months, including the market's decline since the January 19th peak. Global markets have followed a similar path, with the exception of Europe, which has declined 8.0% this year because of concerns about sovereign debt and fiscal issues. In the U.S., stocks that rose the most in 2009 have struggled more in 2010, including the Technology and Materials sectors. While many analysts are touting fourth quarter 2009 earnings and revenues that came in above expectations, most are also cautious about ongoing headwinds for the global economy. Policy issues will remain a key factor in 2010, including whether the Federal Reserve will be able to remove its highly accommodative stance toward interest rates, whether the U.S. and Europe will have to reign in deficit spending to support both their economies and debt, and whether there will be passage of either health care or financial regulatory reform in the U.S. Both economic developments and government policies will weigh heavily on stock prices and interest rates in the months ahead.

Market Statistics		
February 28, 2010		
	Level	Year-to Date %
Dow Jones	10,325	-1.0%
S&P 500	1,104	-1.0%
NASDAQ	2,238	-1.4%
MSCI EAFE	1,497	-5.3%
Oil (WTI) \$79.66/bl		+0.4%
Gold \$1,118/oz		+2.1%
US Dollar Index		+3.1%
Barclays Agg Bond Index		+1.9%
Federal Funds Rate	0-0.25%	
6 Mos Treasury Bill	0.18%	
2 Year Treasury Note	0.81%	
5 Year Treasury Note	2.30%	
10 Year Treasury Note	3.61%	



Chart courtesy of Stockcharts.com

Global Policy Issues – Countries Delay Addressing Short-Term Issues, Increasing Long-Term Implications

Europe has been prominent in the news so far in 2010 because of Greece's high levels of debt and widespread speculation about the possibility of default. Greece has a fiscal deficit in excess of 12% of their Gross Domestic Product (GDP), a very high level. Concern that the country may not be able to repay its debts has taken center stage, as Euro-zone partners such as Germany and France were looked to for possible bailouts. However, these stronger countries are not in a position to rescue others without risking instability down the road from its own high level of deficits. Nor are other countries in Europe able to help. Meanwhile other European countries such as Portugal and Spain are also troubled with large deficits and heavy debts. Austerity measures to lower government spending are likely and could slow their economies even more.

While developments in countries such as Greece may not seem significant to the U.S. markets, how the situation is handled could set a pattern for what the U.S. may experience in the future with its own fiscal problems. Currently the U.S. federal deficit as a percent of GDP is 10% and total debt (not just the public portion) is 94% of GDP. Historically total debt levels above 90% have been significant drags on future economic performance. Equally important, we are watching closely whether participation in U.S. Treasury auctions by foreigners is changing as huge amounts of new debt are issued. Should foreigners become concerned that the U.S. is acting irresponsibly in its management of deficits, there may be a reluctance to buy as much of our new debt as in the past (historically



foreigners buy as much as 40% of new U.S. debt). The result of lower demand by foreigners would be higher interest rates required to entice investors to buy Treasury securities needed to fund our debt. Higher rates would be a negative both in the short term relative to any recovery in the economy as well as long-term with more and more debt required just to pay off current obligations of the government. While these issues encompass both near and longer-term matters, Greece is an example of what can happen if the level of concern rises.

We are closely watching the actions of the Federal Reserve with respect to policy matters on several fronts. First, the Fed is reportedly discontinuing its purchases of mortgage backed securities in the next month. This is important because they have purchased \$970 billion of such securities in the past year and a half, nearing their target of \$1.25 trillion, and in so doing they have helped keep mortgage interest rates down. Should the Fed stop this program, mortgage rates could rise, further restricting home sales. Secondly, some believe that the Fed may need to raise interest rates this year to thwart any risk of inflation. On both fronts, we believe the Fed will not be able to reduce stimulative measures. The economy is not likely to exhibit inflationary pressures with unemployment at 10% and we believe the housing situation will worsen before it improves, obviating the need to raise interest rates on any front. If anything, there may be a need to continue accommodative measures.

Economy and Earnings – Consumer Situation and Employment Data Offset Reasonable Earnings News

U.S. economic growth for the fourth quarter 2009 was reported at a 5.9% annual rate in February, the fastest quarterly pace since 2003. While the headlines were positive and stocks rallied on the news, most recognized that the growth was influenced largely by inventories falling less rather than sales increasing more. More current reports of the economic picture appeared in February with the employment, housing and consumer confidence data showing softening. On the jobs front, weekly claims for unemployment insurance have resumed an upward trajectory, with nearly 500,000 people filing for jobless benefits in the latest week and over ten million people now collecting unemployment benefits. Further deterioration in the employment situation would further dampen hopes for an improvement in the economy. Mirroring this concern, the consumer confidence index dropped substantially in February, from a still recessionary level of 56.5 to an even weaker 46, the lowest reading since July of 2009. We also learned that consumers decreased their use of credit by \$102.6 billion in the last year, the most on record, as over-indebted Americans try to right-size their balance sheets in the face of more stringent lending by financial institutions. The housing situation has worsened anew so far in 2010, with existing home sales declining 7.2% and new home sales falling 11.0% in January. For sales of new homes, the drop was a new record low of 309,000 (annualized) compared to as many as 1.4 million annualized at the peak. Manufacturing activity has been improving as measured by new orders for durable goods and manufacturing surveys, but the consumer situation will have to stabilize before a solid recovery can take hold and eliminate any risk of a double dip recession.

Corporate earnings for the fourth quarter came out in January and February and overall results were positive relative to expectations. A total of 68% of companies in the S&P 500 beat expectations for the third quarter in a row. This quarter, for the first time, a large majority of companies (70%) beat revenue estimates. Earnings guidance for the full year increased only slightly, explaining in part the market's lukewarm response to results.

It's critical to understand that present consensus expectations for 2010 include a range of earnings growth of 25% to 35% over 2009 and another 20% for 2011. As the chart on the first page showed, stocks overall are now flat for the year and as stocks reported results in January and February, meeting expectations or barely beating them did not move prices higher on the positive earnings (or revenue) news. In particular, Technology and Materials stocks were down 4.5% in the first two months of the year, after leading the market in 2009. Stocks in more defensive sectors such as Health Care and Consumer Staples were down less.

Overall, the S&P 500 and its underlying stocks are valued at more expensive levels than we would prefer. Those who view the market as "cheap" base their view on earnings above \$75 per share for the S&P 500. Our view is that earnings will be \$60-\$65 per share, a small amount higher than 2009. At the market's price of 1,104, its P/E on our 2010 earnings is nearly 17 compared to its long-term average of 15. Bulls see a market valuation of 14 on a P/E basis and 12.5 looking out to 2011. If the bullish view were to come to fruition, earnings would have grown by at least the consensus of 30% in 2010 and another 20% in 2011. Given the economic climate we view this outcome as unlikely and therefore our more moderate earnings number. As the market showed in the first two months of 2010, earnings meeting or exceeding expectations were often not enough to send stocks higher.

Update on Interest Rates, Currencies and Commodities

Financial markets are watching closely the economic and policy developments noted above. Currency markets have been tracking the situation in Greece carefully, driving the U.S. currency higher, particularly vs. the euro, as seen in the chart below. Meanwhile oil prices rebounded in February after dropping at the start of the year based on demand from the winter heating season and renewed hope that the economic recovery would gain steam this year. Also, despite efforts by the Chinese government to slow down their roaring economy, commodity markets again regained some footing in February on hopes of strong global demand for goods such as oil.

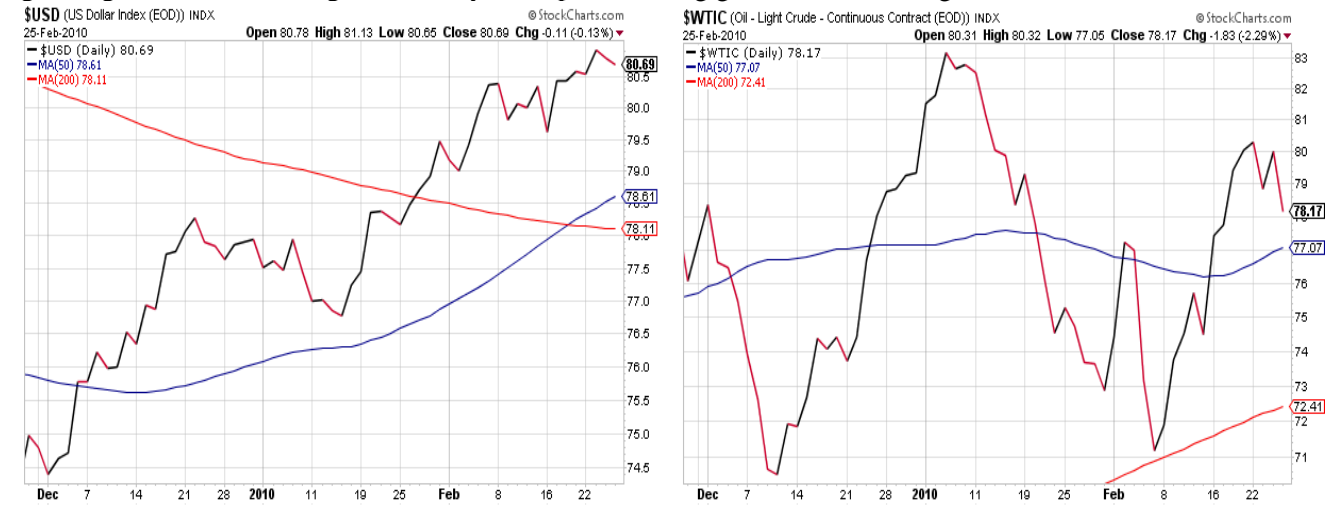


Chart courtesy of Stockcharts.com

With respect to interest rates, the Federal Reserve surprised the market in February with an increase in the discount rate (the rate banks pay the Fed for short-term borrowings). The move will have little impact on lending or borrowing activity, however. It did make many think that the Fed might start raising interest rates more broadly even several times this year. As discussed in the policy section, we view this as unlikely given the weak employment situation and Fed Chairman Bernanke made a speech shortly after the increase stating that rates would remain low for some time ahead. One implication of the low rates will be continued unfavorable rates on cash and short-term bonds for the months ahead, but with the prospect of higher rates over the next few years.

Investment Strategy

Our approach to the current market environment has been to remain biased toward more defensive stocks rather than cyclical issues, with an overall focus on the quality of companies' balance sheets and dividends. Allocations remain more balanced in their ranges of stocks and bonds. We are watching the trend in earnings relative to expectations closely, with particular focus on not just whether companies meet or exceed forecasts, but by how much and with what blend of revenue growth compared to cost-cutting. The hurdle for 2010 and 2011 is set fairly high on both earnings and revenue expectations, so the markets could be weak for stocks missing expectations.

Along with sales of stocks above target levels, we continue to keep a watch for new stocks that will create better reward to risk levels in portfolios. For fixed income, bond purchases even at lower rates remain necessary to maintain income levels and when paired with good dividend paying stocks in portfolios should be better than cash.

If you are interested in joining us for our new quarterly conference call & webinar program (at no cost), please contact Sam Featherstone at (207) 775-4920 for information on our April 28th call. In the meantime, we look forward to our next opportunity to visit with you and we appreciate your support and referrals to our company.

Christopher H. Lyford, CFA
Managing Director, Chief Investment Officer

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