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Mid-Year Market Outlook

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As we look back over the last 18 months in the markets, the kindest word we can think of is tumultuous. It seems to cover a multitude of sins. Now at mid-year, we feel it is appropriate to look to the future and highlight some of the trends we are seeing and where we believe they will lead.

We believe we are in the early stage of a bull market. Although the stock market is in a consolidation period after its big rise coming off the March 9th lows, we believe it should end the year with high single digit or low double digit percentage gains. Near-term, it appears investor expectations for a rapid end to the recession have gotten ahead of the realities seen in the recent economic data. On the positive side, institutional investors continue to be anxious to use dips to put money to work, thus limiting the extent and duration of near-term market pullbacks.

We believe the economy has moved through the worst stages of the recession and although it continues to decline, the severity is clearly lessening. Stabilizing existing home sales, non-farm payroll losses and five months of improvement in the ISM Manufacturing Index support our position. We look for the economy to bottom out late in the third quarter or early in the fourth quarter of this year as consumers slowly return to the malls, business spending stabilizes and businesses begin replenishing inventories. We are even seeing some stabilization in rate of decline for auto and existing home sales and increasing pace of layoffs.

We do not believe second quarter earnings season will produce as many positive earnings surprises as were seen in the first quarter. While we expect earnings for most companies will remain well below last year's level, analysts appear to have adjusted their estimates from their ultra-cautious projections made ahead of first quarter earnings season to reflect a little more optimism. The increase in analyst estimates over the last 10 weeks has been a fundamental factor in the improved investor sentiment toward stocks.

We believe that investors are focusing on the likelihood of an economic recovery developing later this year and extending through 2010 and into 2011. Despite the current investor optimism, we believe the economic recovery will be slower than what we experienced following prior recessions, due to ongoing financial deleveraging and consumer credit constraints. This could contribute to the market consolidation we are currently seeing.

We believe the long-term global economic drivers include finding solutions to growing water, food and energy shortages, the increasing need for preventive healthcare and national, business, and personal security. We expect the technology sector will continue to provide the solutions to these problems, which should contribute to long-term strength in the sector.

Near-term, we see four areas of potential investor concern:

- Growing tensions in the Far East, centering on North Korea;
- The falling value of the dollar and the resulting rise in oil prices, which are based in dollars;
- Rising interest rates as the US Treasury floods the global capital market raising funds to finance the monster US budget deficit;
- Emerging federal policy initiatives concerning the independence of the Federal Reserve relative to its ability to act independently of the White House and Congress, and the proposed reforms of the healthcare and energy industries and overall financial regulations.

Longer-term, we are concerned about the ability of the government to reverse the monetary process and exit the various emergency stabilization programs. We see government actions as being inflationary, but its impact will probably be delayed until the economy achieves a decent rate of recovery, perhaps in 2011. The prospect of a \$2 trillion budget deficit still concerns us.

We suggest that clients use ETFs in order to gain broad sector or emerging market exposure. We continue to like companies with long histories of annual dividend increases and solid balance sheets. See your D.A. Davidson Financial Consultant to find the right investments for your situation.

We remain cautious toward most of the financials stocks. While we recognize the extent of their huge percentage moves since March 9th, we believe it is overdone given the residual credit and toxic asset problems. Financial stocks appear to be rolling-over under concerns that they could see poorer than expected earnings in the second and third quarters related to loan loss reserves, the huge amount of long-term debt and the recent, massively dilutive, equity offerings which could dramatically constrain future earnings growth.

We remain hopeful about the future and continue to believe that a recovery is in sight. As we have said many times, we would not want to bet against the long term strength of the American financial system and its ability to grow in the future.

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