FARR, MILLER & WASHINGTON, LLC

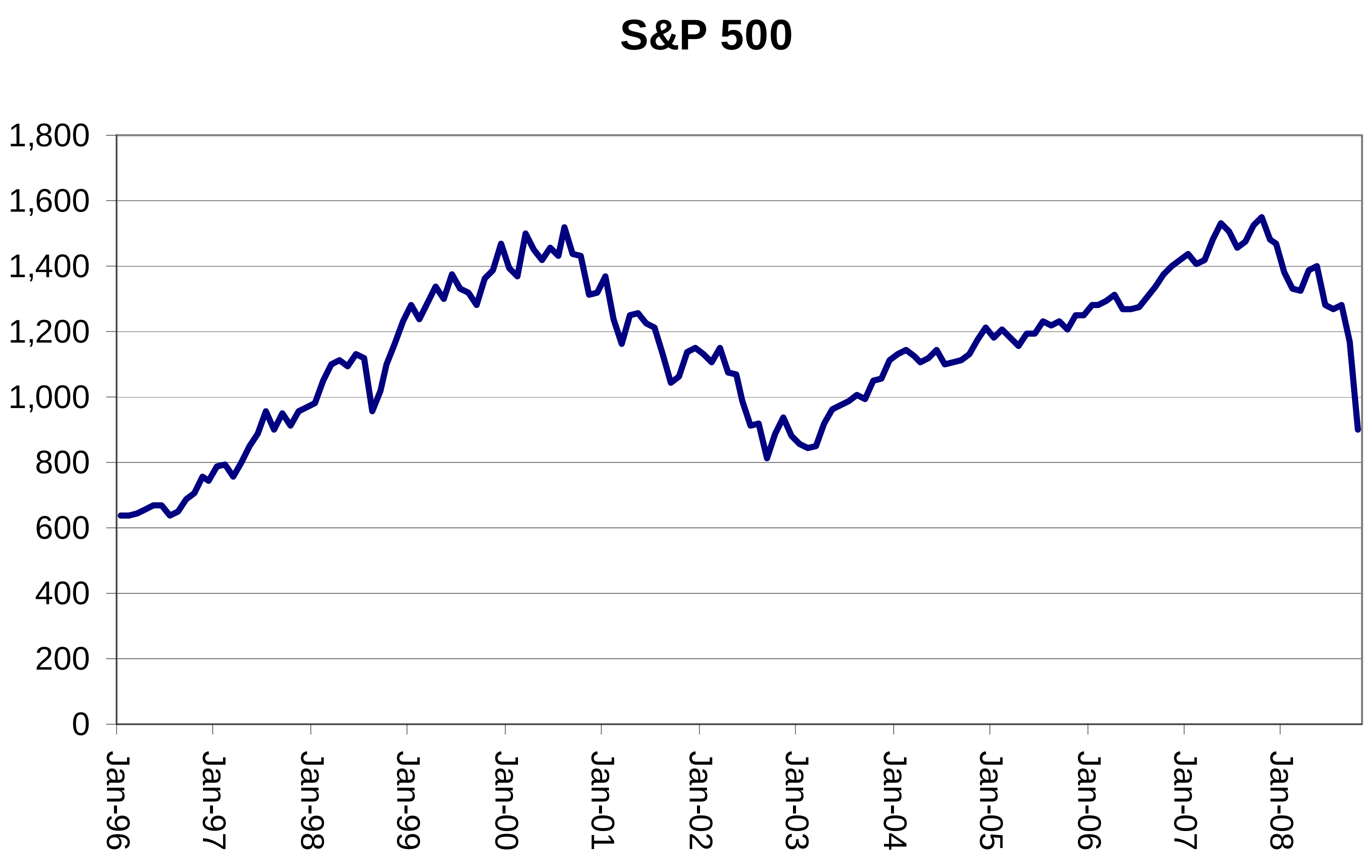
INVESTMENT COUNSEL

Overview of US Economy and Stock Market

November 3, 2008

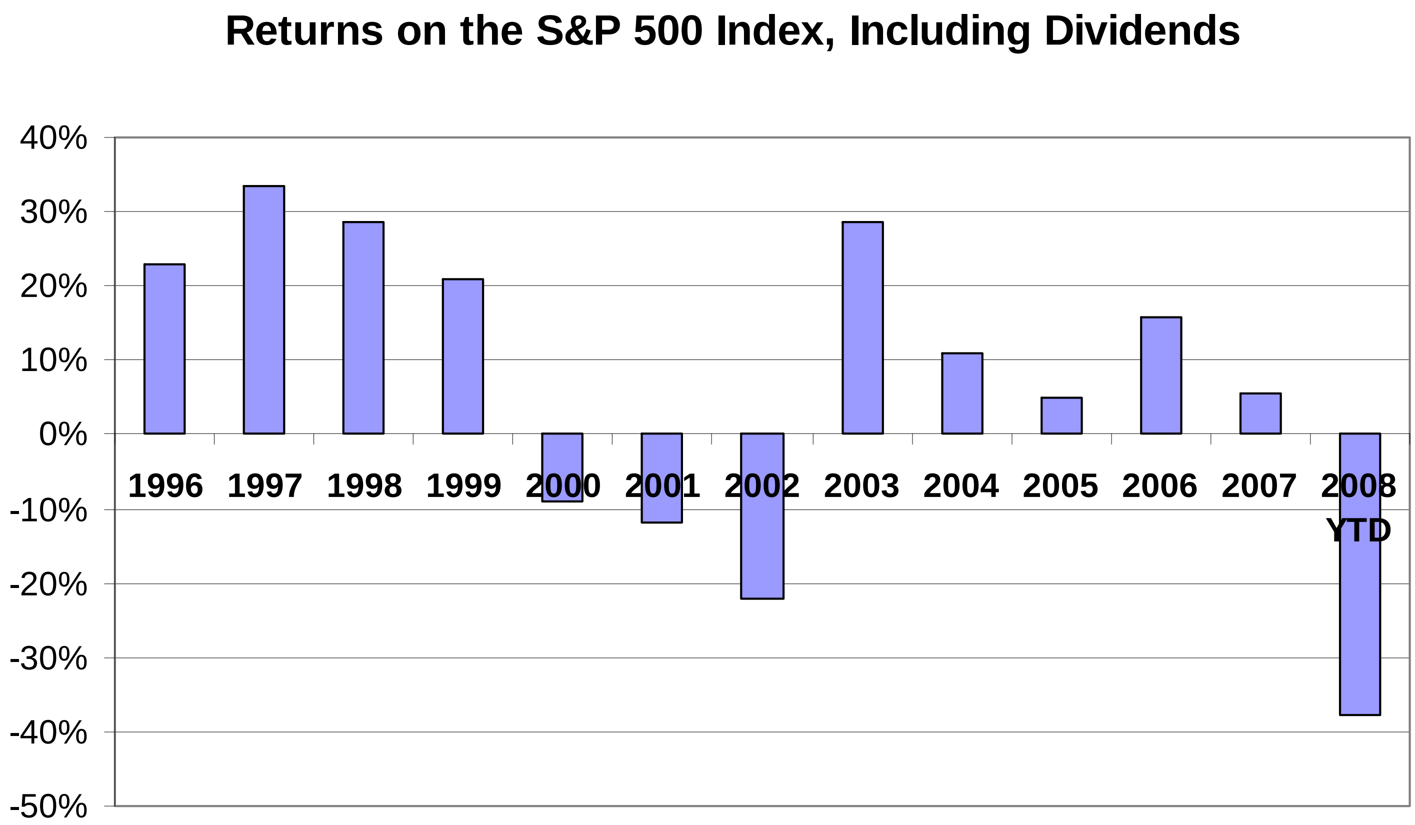
Michael K. Farr

Where We've Been



Source: Bloomberg

Where We've Been



Volatility Rules! Nevertheless, investors in the S&P 500 have realized an average annualized total return of about 5% since the end of 1995.

Source: Bloomberg

Economic Backdrop

What Drove the Stock Market Higher From 2003-2007?

1) **Oversold from the 2000-2002 market correction**

2) **Increased investor appetite for risk, which was a function of global liquidity**

3) **Collapse in bank lending standards, which led to bubbles in housing and consumer credit**

4) **Consumer spending binge driven in part by housing boom**

5) **Outsized earnings growth resulting from margin expansion**

6) **Strong rally in commodity-related stocks due to 5%+ global economic growth**

Low Interest Rates Were the Key!!!

Economic Backdrop

Higher Home Prices Benefited the Economy in Numerous Ways…

"Wealth Effect" + **Cash-Out Refinancings** + **Home Appreciation Replaced Retirement Savings** + **Job Creation in Construction, Finance, and Other**

=

$ ***Robust Consumer Spending*** **$**

Economic Backdrop

But the Bursting of the Housing Bubble Has Left Us with A Severe Hangover…

1) Housing Price Declines
   - Foreclosures ↑
   - Inventories of homes for sale ↑
   - Sales of new & existing homes ↓
   - New home construction ↓

2) Diminished Access to ALL TYPES of Consumer Credit
   - Tighter bank lending standards in response to higher credit losses
   - Discontinuation of exotic mortgage products such as pay-option ARMs
   - Banks conserving capital due to mortgage-related write-offs
   - Dislocation in securitization market
   - Increased regulatory oversight

3) Rising Unemployment in Response to Lower Consumer Demand
   - Consumer spending accounts for 70% of GDP
   - Reduced consumer demand causing companies to rationalize expenses through layoffs

4) Federal Government Intervention Opportunities Limited
   - Higher deficits
   - Running out of room to cut rates (Fed funds currently stands at 1.5%)
   - Entitlement spending increases loom
   - Higher interest rates in the future?

5) Credit/Liquidity Crisis

Economic Backdrop

What Were the Causes of the Credit/Liquidity Crisis?

1. Lack of Effective Bank Regulatory Oversight
   - Banks extended loans borrowers could not afford (ARM's, option ARM's, interest-only, no doc, etc)
   - Leverage at investment banks and other finance companies (AIG)
   - Proliferation of derivatives such as Credit Default Swaps (CDS)
2. Developments in the Securitization Markets
   - Banks no longer retained credit risk for loans they made
   - Lending standards broke down
3. Federal Reserve Flooded the System with Liquidity For Too Long
   - Fed held interest rates below 2% for 3 full years (2002-2004) after the technology bubble burst
   - Borrowers of all stripes increased debt loads
   - Investors seeking higher yields embraced complex mortgage-backed bonds and failed to perform due diligence
4. Greed and Malfeasance by Executives and Financial Services Firms
   - Despite clear warning signs, banks and investment banks continued to underwrite and securitize bad loans, and continued to sponsor leveraged buyouts doomed to failure

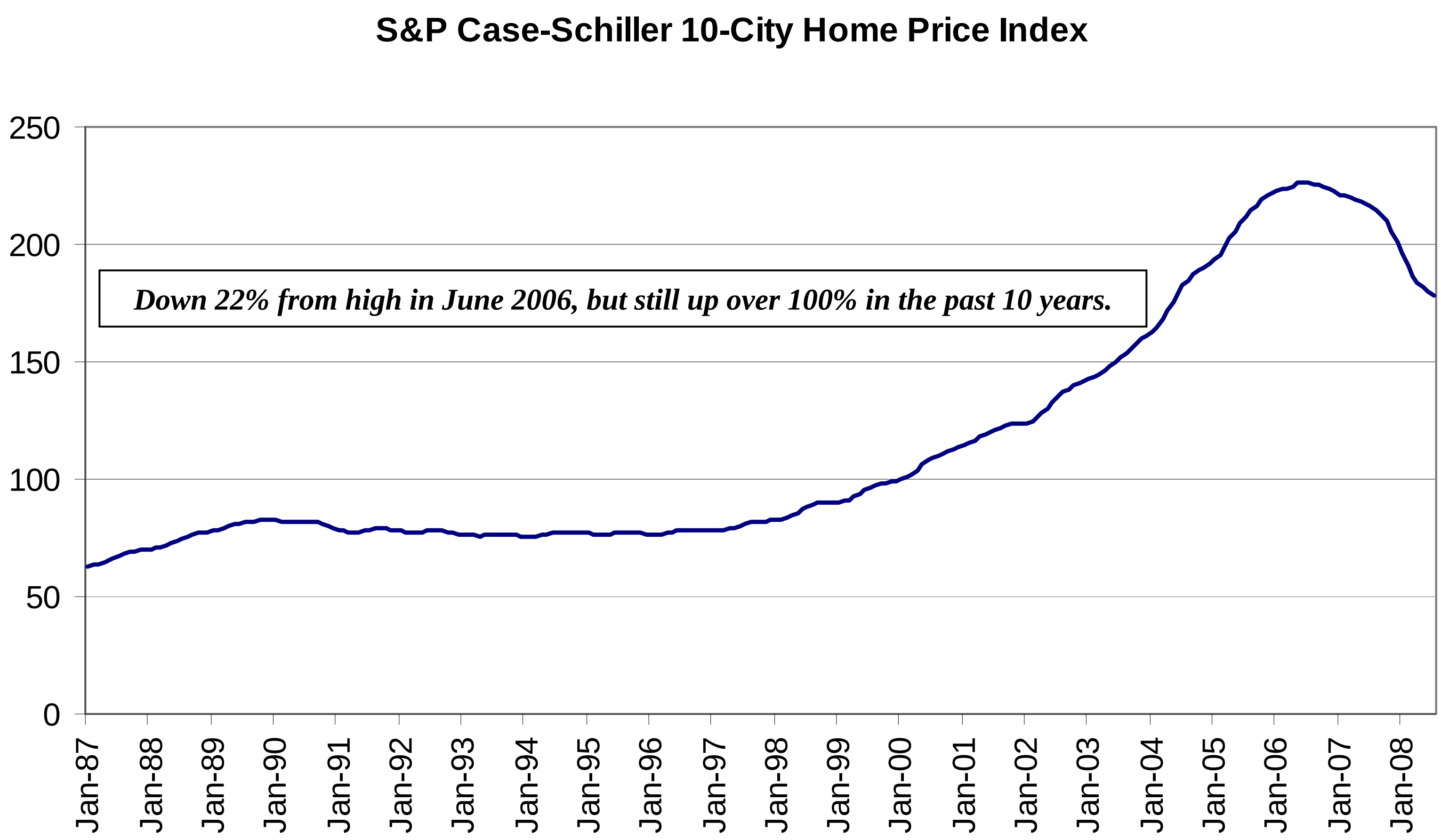
Economic Backdrop

Corporate Malfeasance

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

- Chuck Prince, former CEO of Citigroup on July 9, 2007

Economic Backdrop

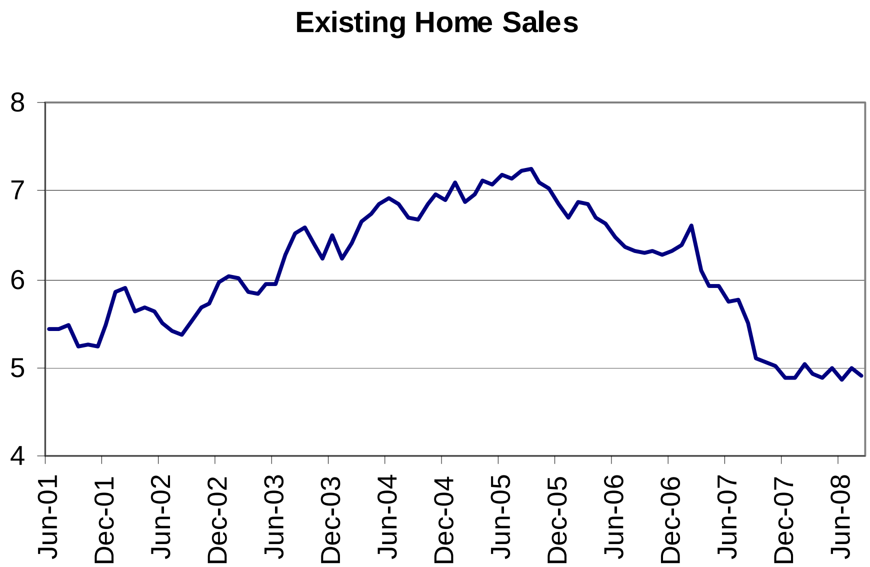


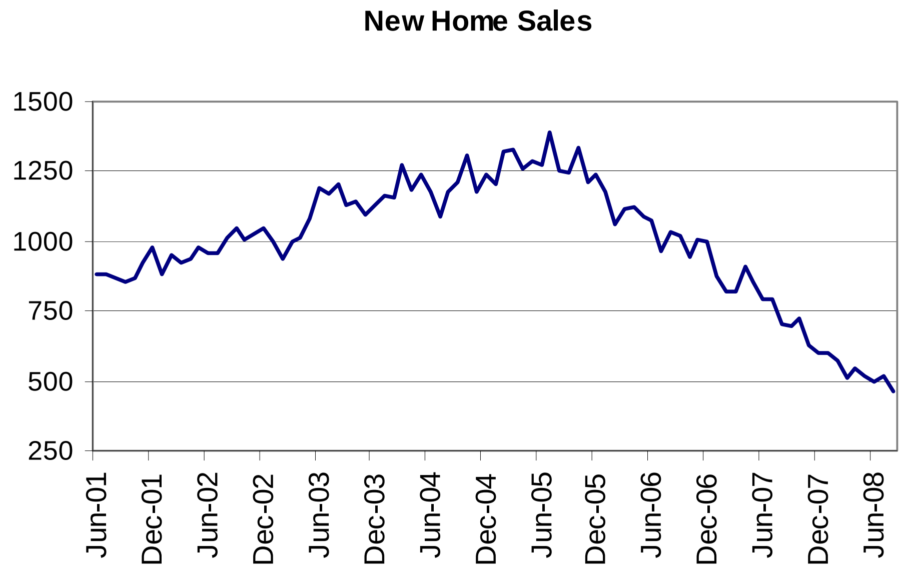
Housing price appreciation should more closely track growth in incomes

The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in metropolitan regions across the United States. These indices use the repeat sales pricing technique to measure housing markets. First developed by Karl Case and Robert Shiller, this methodology collects data on single-family home re-sales, capturing re-sold sale prices to form sale pairs.

Economic Backdrop

Home Sales Have Dropped Sharply

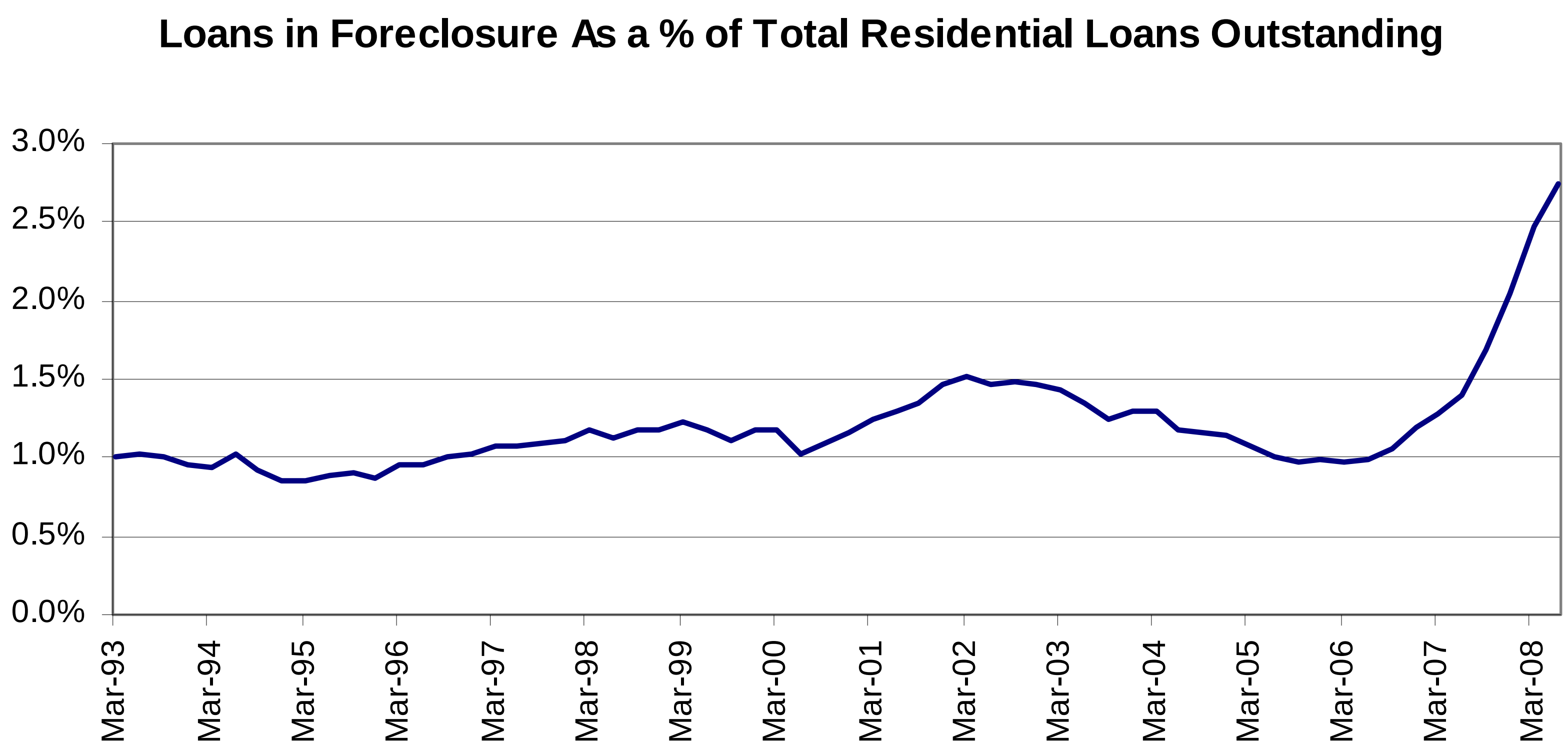




Source: Bloomberg

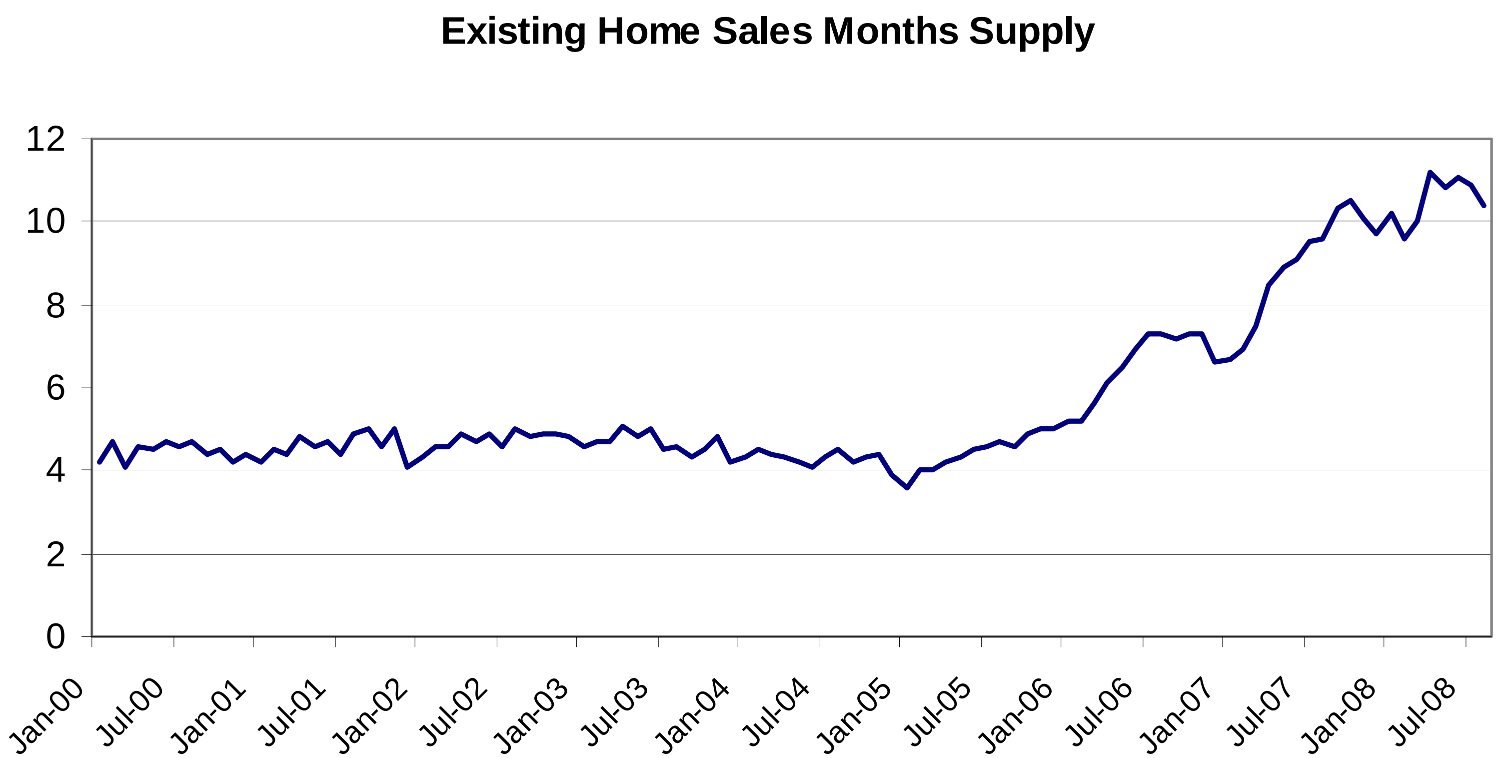
Economic Backdrop

Foreclosures are Surging as Loans Reset and Prices Fall



Source: Bloomberg

And the Growing Supply of Houses for Sale Foretells Further Price Declines Ahead…

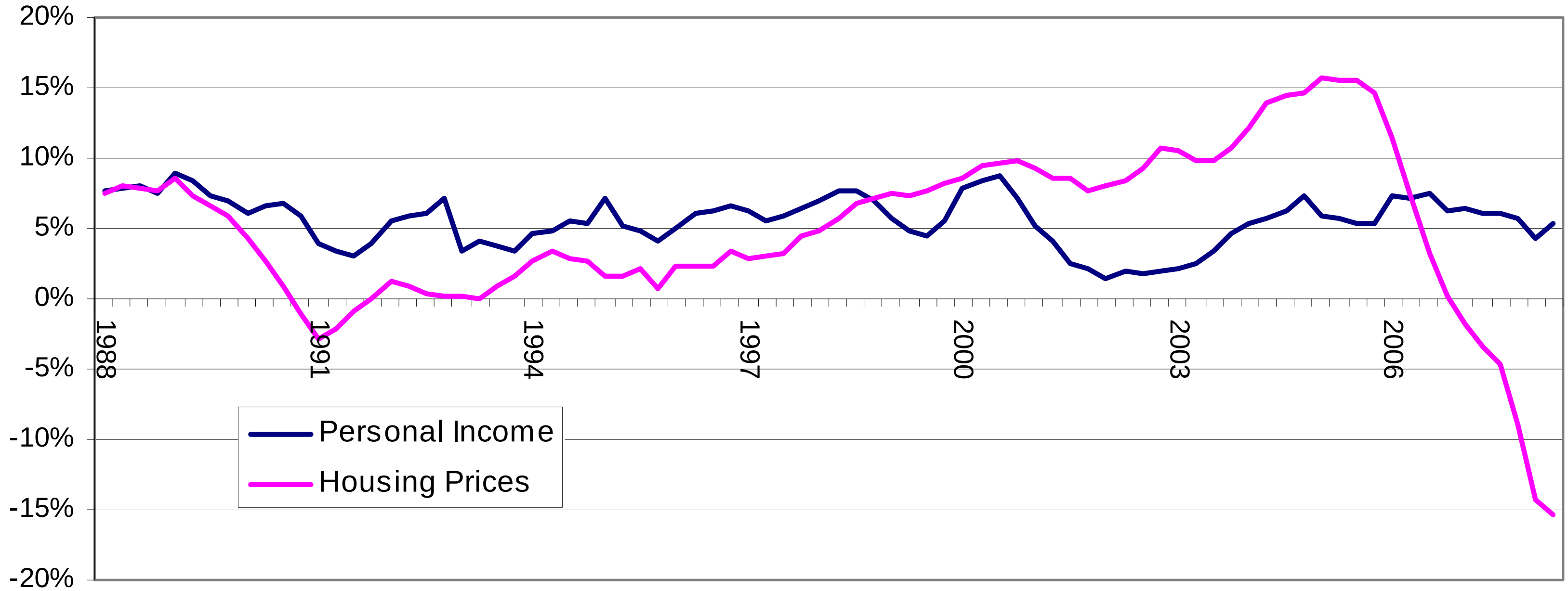


Source: Bloomberg

Economic Backdrop

Housing Prices are Now Adjusting for the several years in which they grew faster than incomes.

Growth in Personal Income & Housing Prices

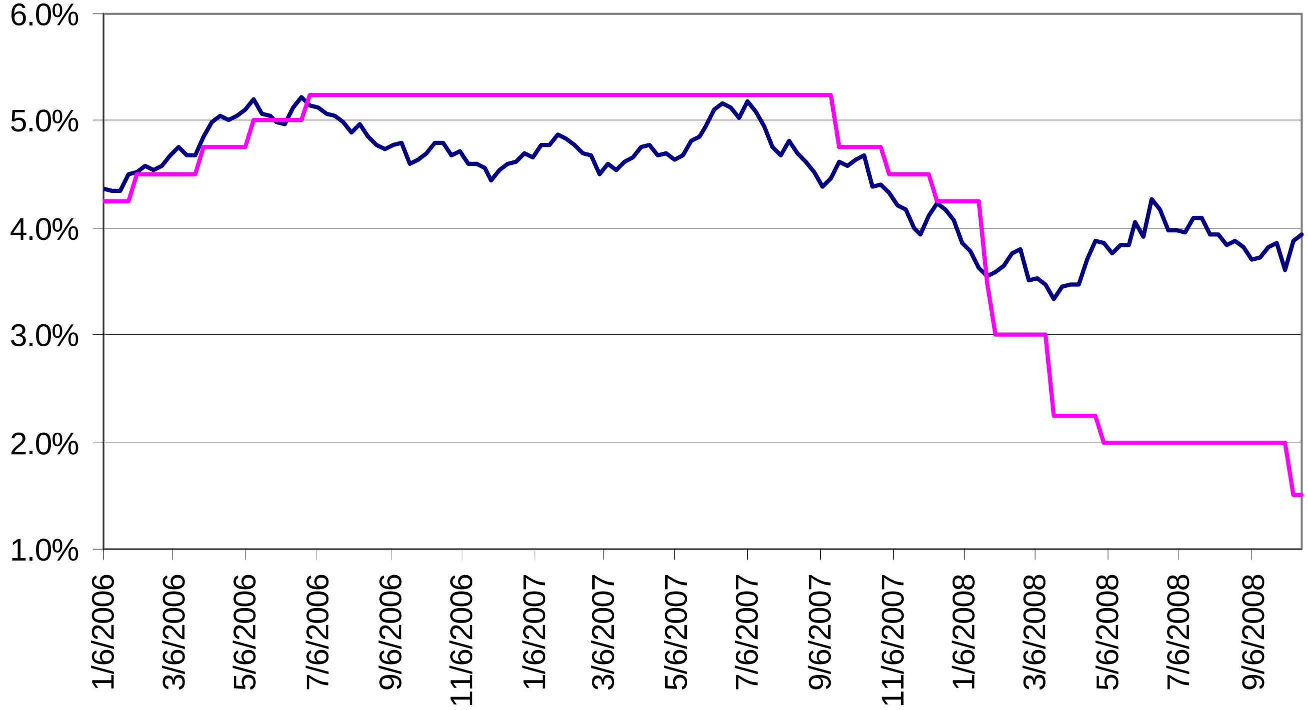


Source: Bureau of Economic Analysis and S&P Case-Shiller.

Economic Backdrop

In Anticipation of Weaker Growth, the Fed Has Been Easing…But Longer Term Treasurys have Decoupled

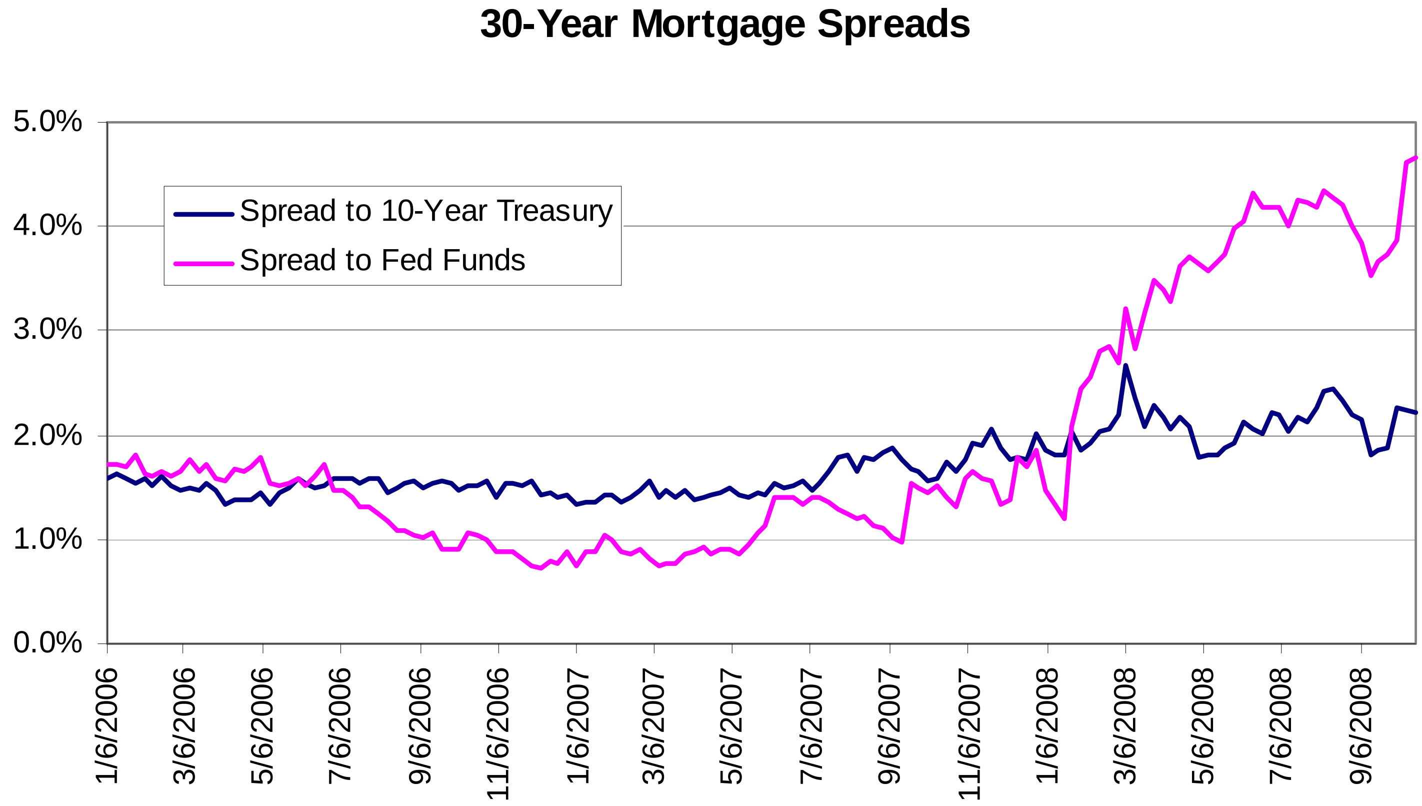
Yield on 10-Year Treasury and Fed Funds Target Rate



Source: Bloomberg

Economic Backdrop

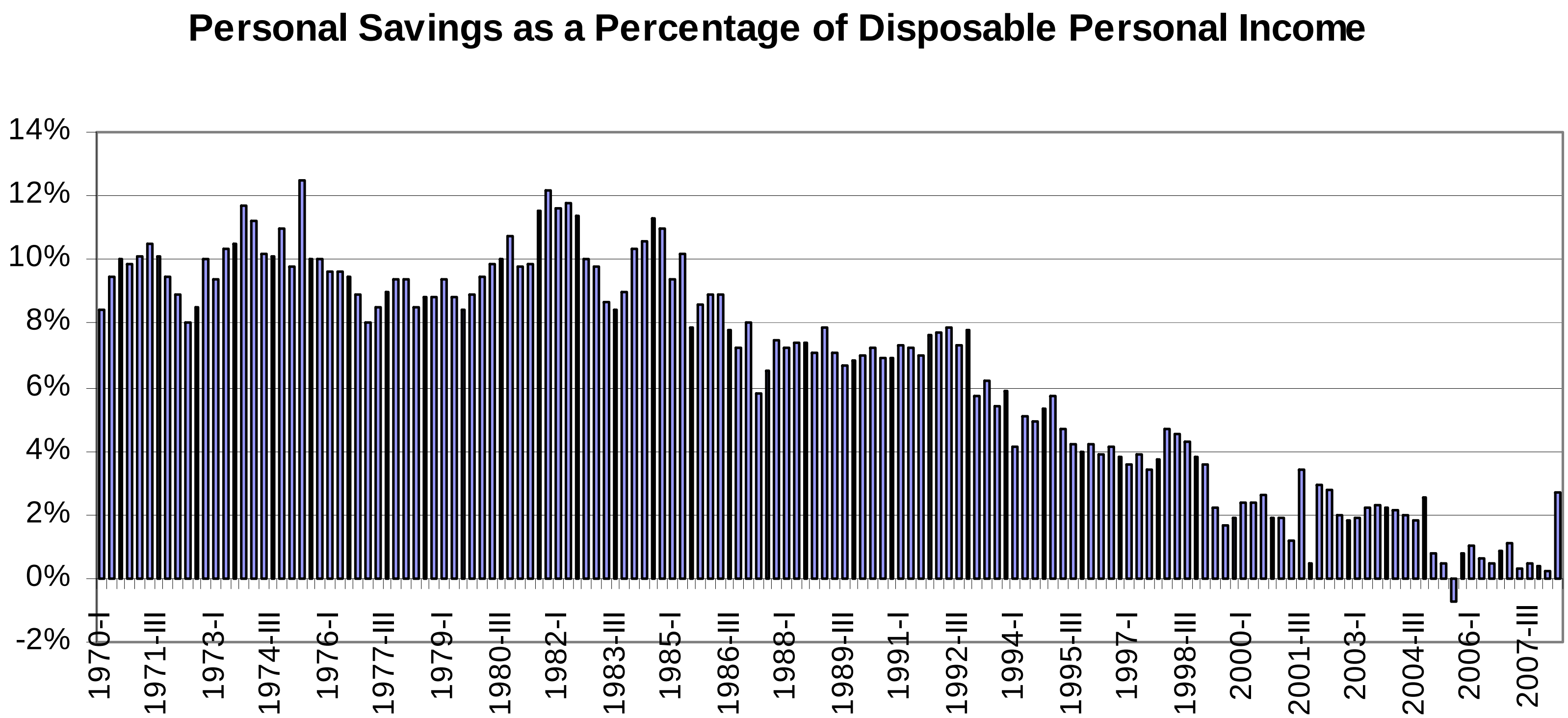
Mortgage Rates are Not Going Down (Despite Aggressive Action by the Federal Reserve and US Treasury), Reflecting Banks' Reluctance to Lend



Source: Bloomberg

Economic Backdrop

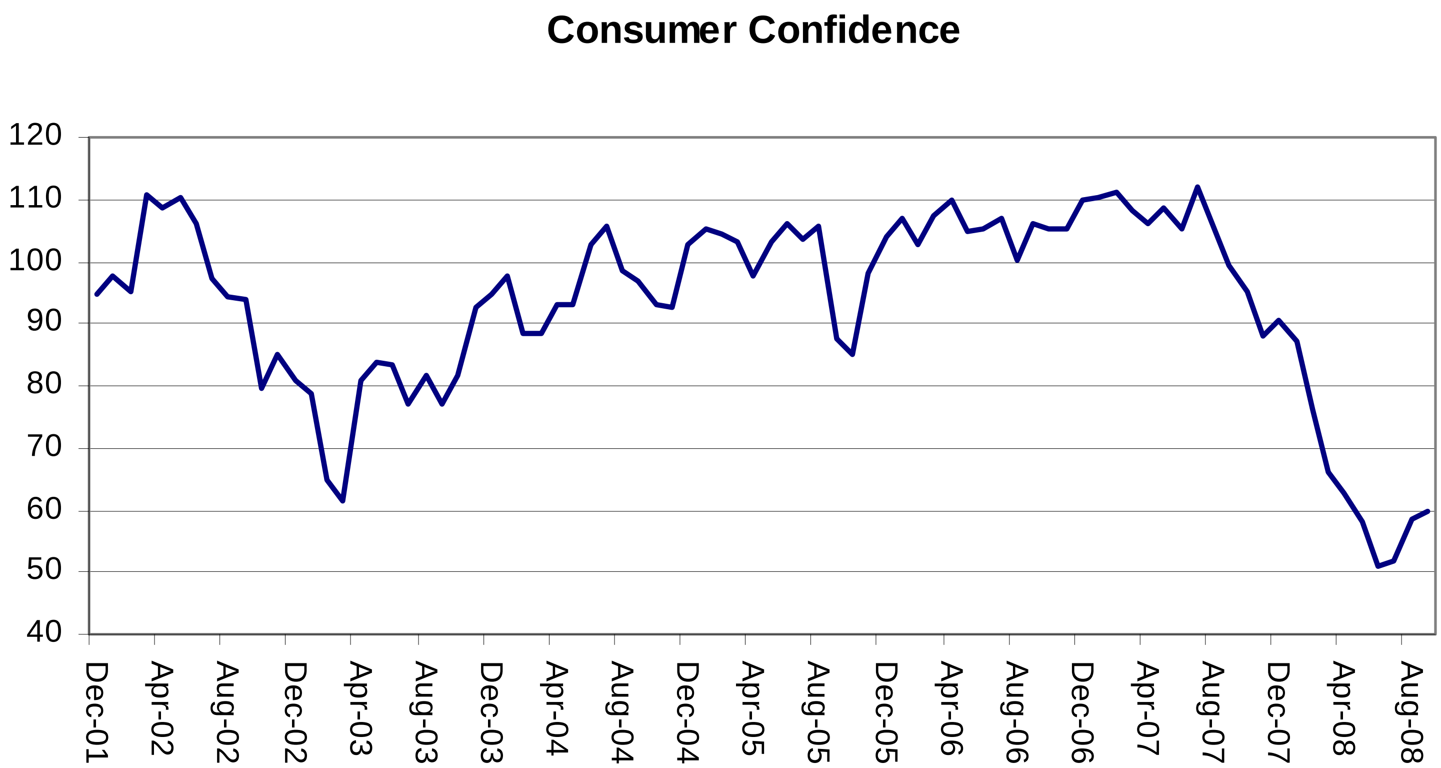
In the Absence of Home Price Appreciation, the Consumer Must Start Saving Again



Source: Bureau of Economic Analysis.

Economic Backdrop

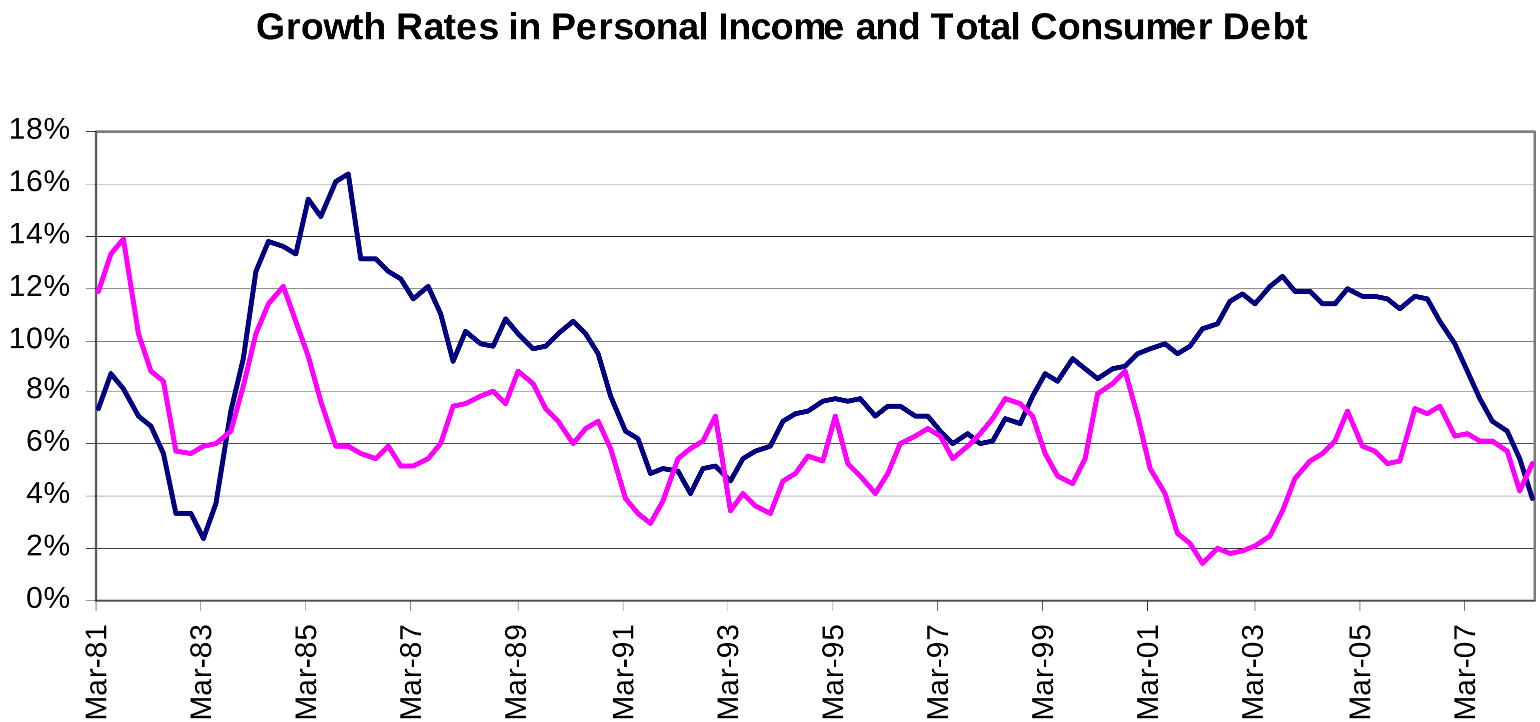
Partially in Response to the Drop in Home Prices, Consumer Confidence Has Been Falling and Now Stands at Close to Multi-Year Lows



Source: Bloomberg

Economic Backdrop

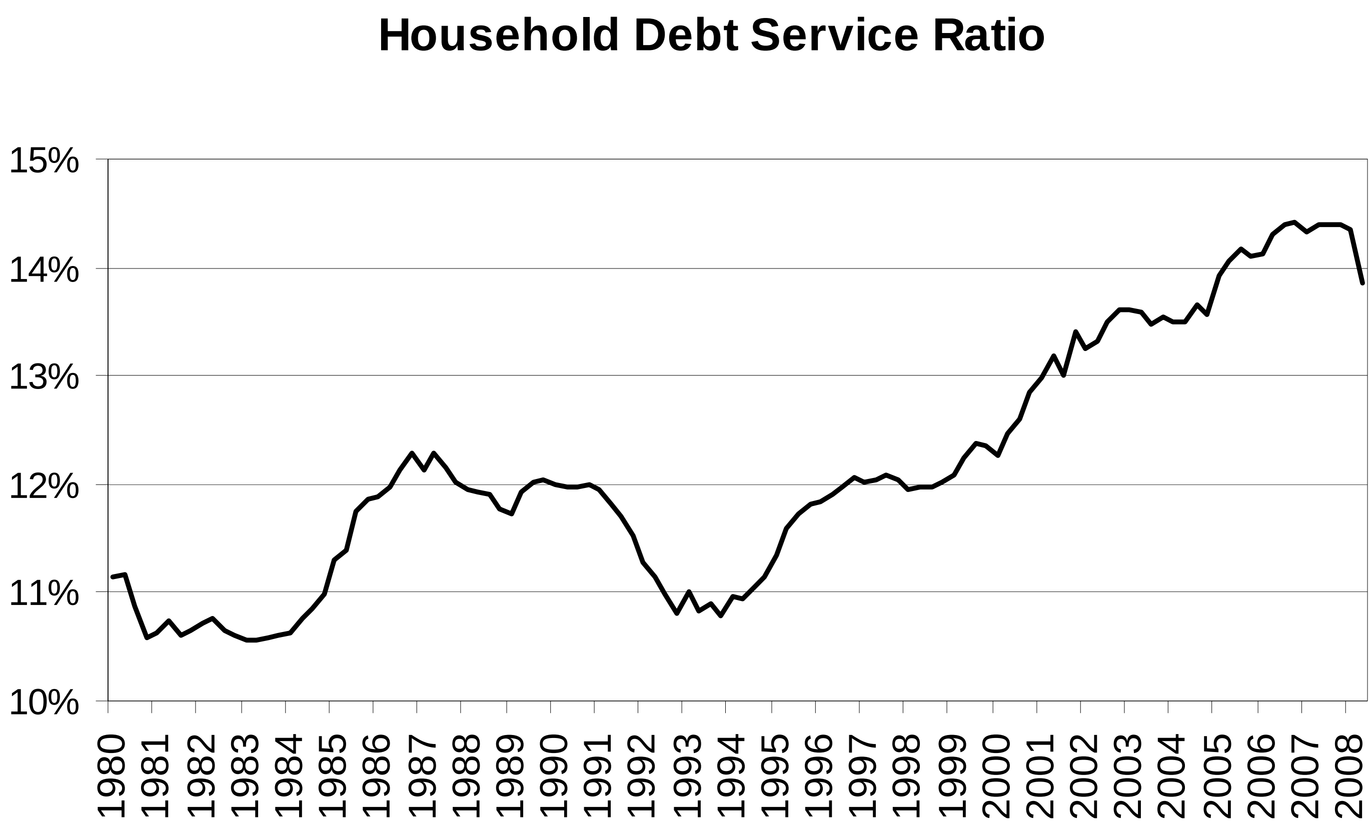
Debt Has Been Growing Much Faster Than Incomes



Total consumer debt includes mortgage debt, revolving debt, and non-revolving installment debt.

Source: Federal Reserve and Bloomberg.

And Debt Servicing Has Become a Much Bigger Burden on Household Budgets

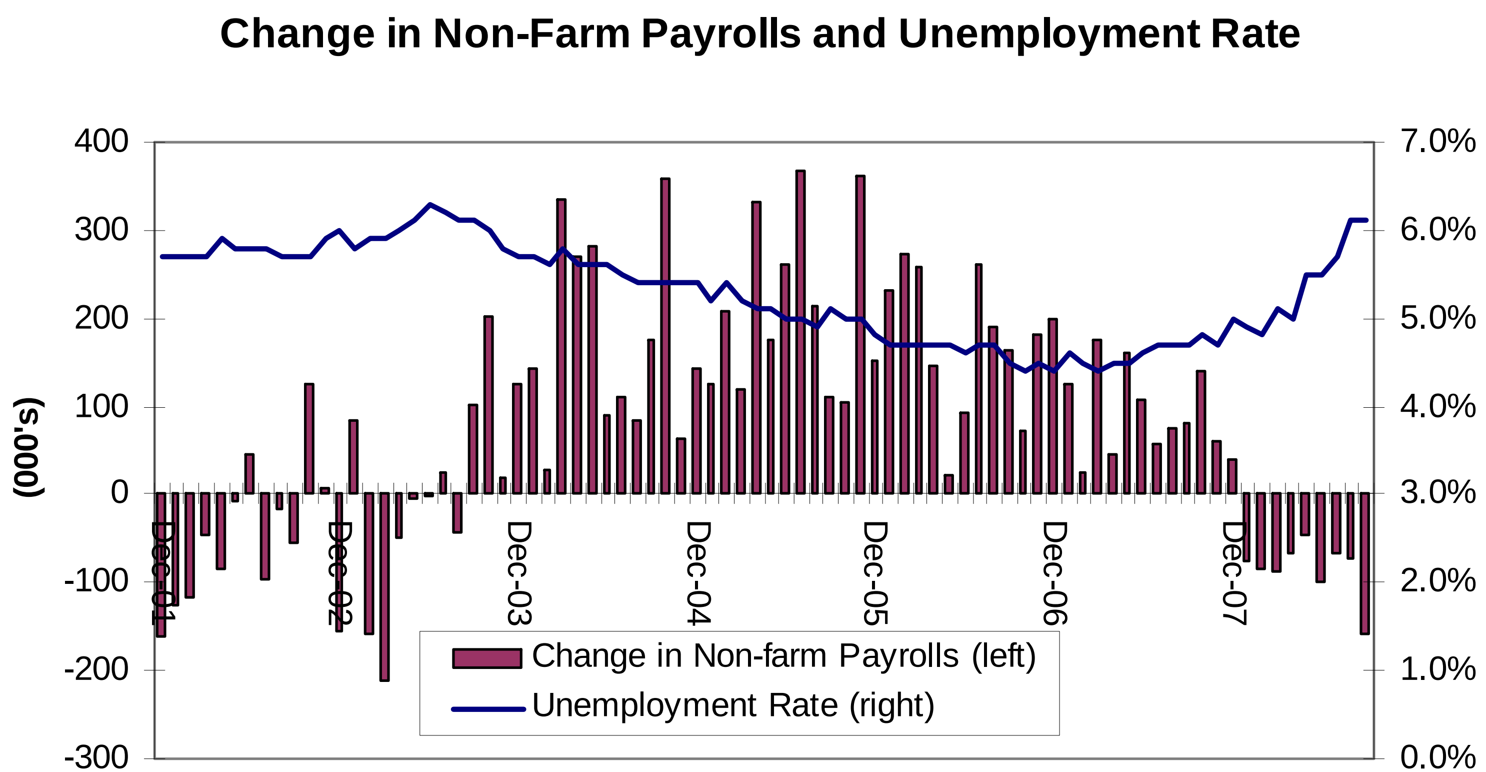


The Household Debt Service Ratio is an estimate of the ratio of debt payments to disposable personal income. Debt payments consist of the estimated requirements on outstanding mortgage and consumer debt.

Source: Federal Reserve.

Economic Backdrop

Also Partially as a Result of Housing, the Economy's Ability to Generate New Jobs Has Deteriorated



Source: Bloomberg

Economic Backdrop

So Where Are We Now?

1. **Credit Crunch Ongoing**
2. **Consumer Confidence & Spending Weakening**
3. **Housing Price Deflation Continues**
4. **Unemployment Rising**
5. **Access to Capital Markets Shut Off**
6. **Consumer Lending Standards Tightening**
7. **Endless Government Intervention**
   - **TAF**
   - **Bailouts of individual firms**
   - **Increase in FDIC insurance**
   - **Money market and CP support**
   - **Tax cuts**
   - **TARP ($700 billion)**
   - **Direct investments in US banks**
   - **Guarantee interbank loans???**

= Recession

The Result: Stocks Have Fallen 39% from their Highs in October 2007

Economic Backdrop

Recessions:

- **Recessions are defined by the National Bureau of Economic Research (NBER) as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales .”**
- **Recessions are usually officially declared well after the fact (a few months) by the NBER**
- **We believe we already are in a recession**

Economic Backdrop

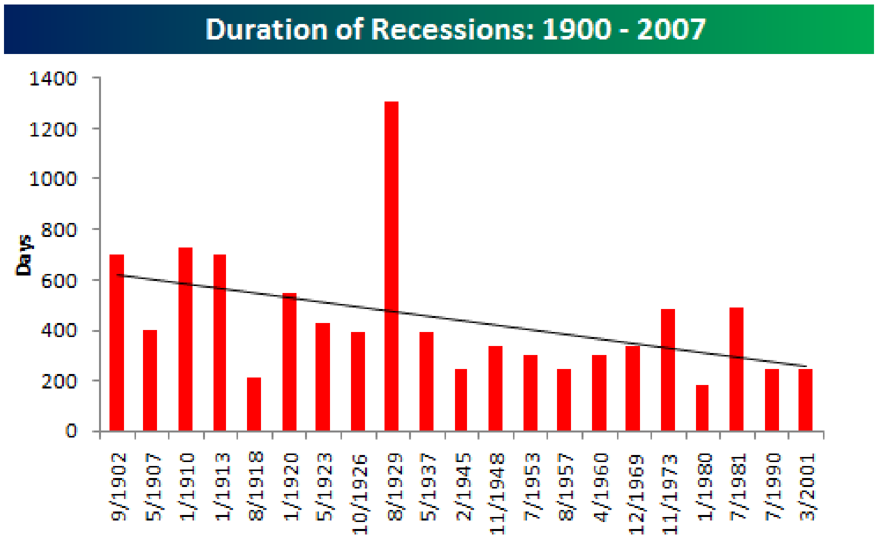
Recessions of the 20th Century

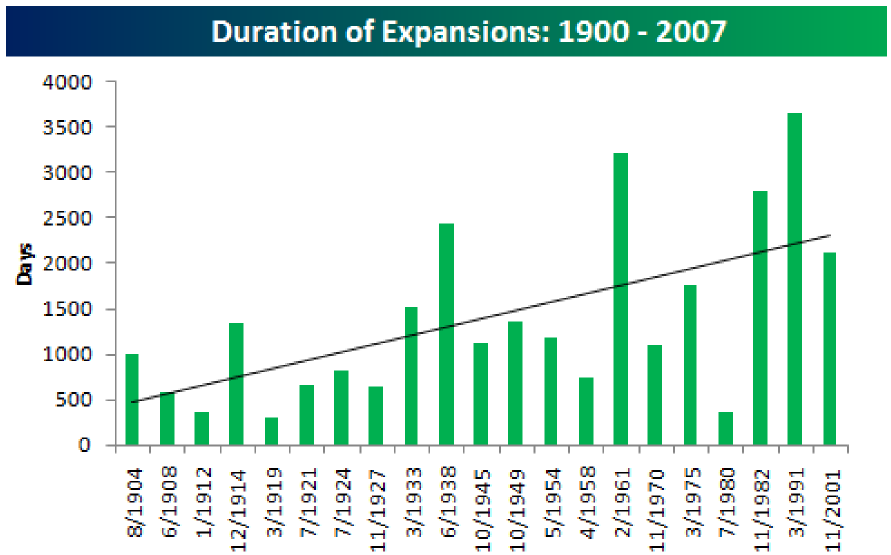
Date	Duration in Months
Sept. 1902-Aug. 1904	23
May 1907-June 1908	13
Jan. 1910-Jan. 1912	24
Jan. 1913-Dec. 1914	23
Aug. 1918-March 1919	7
Jan. 1920-July 1921	18
May 1923-July 1924	14
Oct. 1926-Nov. 1927	13
Aug. 1929-March 1933	43
May 1937-June 1938	13
Feb. 1945-Oct. 1945	8
Nov. 1948-Oct. 1949	11
July 1953-May 1954	10
Aug. 1957-April 1958	8
April 1960-Feb. 1961	10
Dec. 1969-Nov. 1970	11
Nov. 1973-March 1975	16
Jan. 1980-July 1980	6
July 1981-Nov. 1982	16
July 1990-March 1991	8
March 2001-Nov. 2001	8
Average	14

Source: National Bureau of Economic Research.

Economic Backdrop

Recessions have been getting shorter, and expansions have been getting longer…





Federal Government and Federal Reserve have more tools and have learned how to address problems earlier.

Source: Graphs taken from SeekingAlpha.com using National Bureau of Economic Research data.

Stock Market Outlook

S&P 500 Performance After Recession Lows

S&P Low Date in Recession	% Gain, Trading Days Later: 63	126	189	252
June 13, 1949	14.5%	19.2%	26.6%	33.7%
September 14, 1953	9.9%	17.7%	27.5%	38.5%
October 22, 1957	6.1%	9.8%	19.0%	31.5%
October 25, 1960	15.9%	25.2%	27.6%	30.9%
May 26, 1970	16.9%	20.8%	38.7%	44.5%
October 3, 1974	13.5%	29.9%	51.5%	34.6%
March 27, 1980	18.3%	31.1%	39.1%	37.1%
August 12, 1982	37.8%	41.6%	61.1%	57.7%
October 11, 1990	6.7%	28.8%	28.7%	28.8%
September 21, 2001	18.0%	17.2%	2.8%	-13.7%
Average	15.8%	24.1%	32.3%	32.4%

The average US recession since the late 1940s has lasted 10 months, and stocks typically hit their low point about three months before the recession ends.

Source: Van Kampen Investments using data from Ned Davis Research, 2008.

Stock Market Outlook

A "Bear Market" is typically defined as the period of time beginning with a 20% decline in the market and ending when the market bottoms out and begins heading up again.

Bear Market	Duration (Months)	% Decline
Sept, 1929 - June, 1932	33	87%
July, 1933 - Mar, 1935	20	34%
Mar, 1937 - Mar, 1938	12	55%
Nov, 1938 - Apr, 1942	41	46%
May, 1946 - Mar, 1948	22	28%
Aug, 1956 - Oct, 1957	14	22%
Dec, 1961 - June, 1962	6	28%
Feb, 1966 - Oct, 1966	8	22%
Nov, 1968 - May, 1970	18	36%
Jan, 1973 - Oct, 1974	21	48%
Nov, 1980 - Aug, 1982	21	27%
Aug, 1987 - Dec, 1987	4	34%
July, 1990 - Oct, 1990	3	20%
Mar, 2000 - Mar, 2003	35	49%
Averages	18	38%
October, 2007 - ?	**12**	**46%**

Intra-day low on Oct 10

Investors appear to have gotten ahead of the recession this time.

Source: Dividend Growth Investor.

Stock Market Outlook

Three Best Periods to Enter the US Stock Market Since 1926

Date	Subsequent 5-Year Return	Coincident Event
May, 1932	367%	Great Depression
July, 1982	267%	Worst Recession in Past 25 Years
December, 1994	251%	Most Dramatic Fed Tightening in Past 20 Years

Is now one of these times???

Source: Fidelity Investments.

Stock Market Outlook

Are Stocks Attractive Now?

Earnings estimates are still way too high, but we still see a lot of value at these levels…

	S&P 500 Operating Earnings for 2009	Multiple	Earnings Yield
Current Estimate	$94.96	9.5x	11%
25% Haircut	$71.22	12.6x	8%
35% Haircut	$61.72	14.6x	7%
50% Haircut	$47.48	19.0x	5%

Compare to yield on 10-year Treasury Bond of about 3.7%

Low Interest Rates and Reasonable Valuations Provide a Favorable Backdrop for When Credit Conditions Improve

Stock Market Outlook

Reasons for Optimism:

1. **Stocks were not in bubble territory before this decline began – the bubbles were in the housing and credit markets**

2. **The 40% decline in stocks so far since October 2007 already exceeds the average bear market decline over the past 80+ years**

3. **Stocks generally bottom out before a recession ends (3 months, on average) and historical returns from this bottoms have been outstanding**

4. **Warren Buffett is buying right now**

5. **A decade of suffering like the Great Depression is unlikely because the federal government has learned from its mistakes and has too many tools at its disposal (deposit insurance, aggressive fiscal and monetary policy)**

Stock Market Outlook

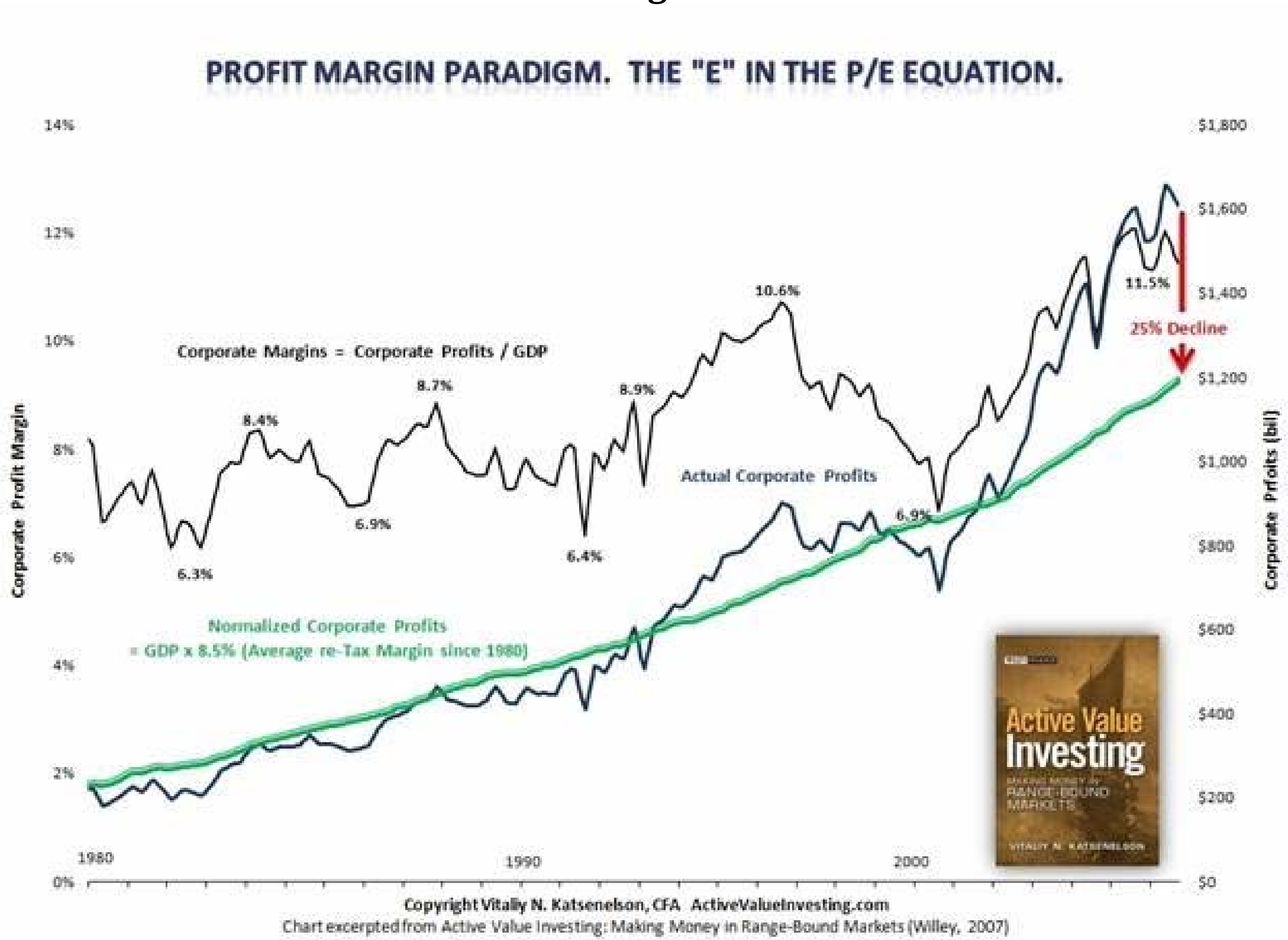
Bottom Line:

1. **Nobody can effectively time the markets**
2. **Stocks have outperformed every major asset class over any 20 year period**
3. **Long-term investors are very likely to be rewarded, but only if they stay invested**

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

- Warren Buffett, widely considered the greatest investor of our time

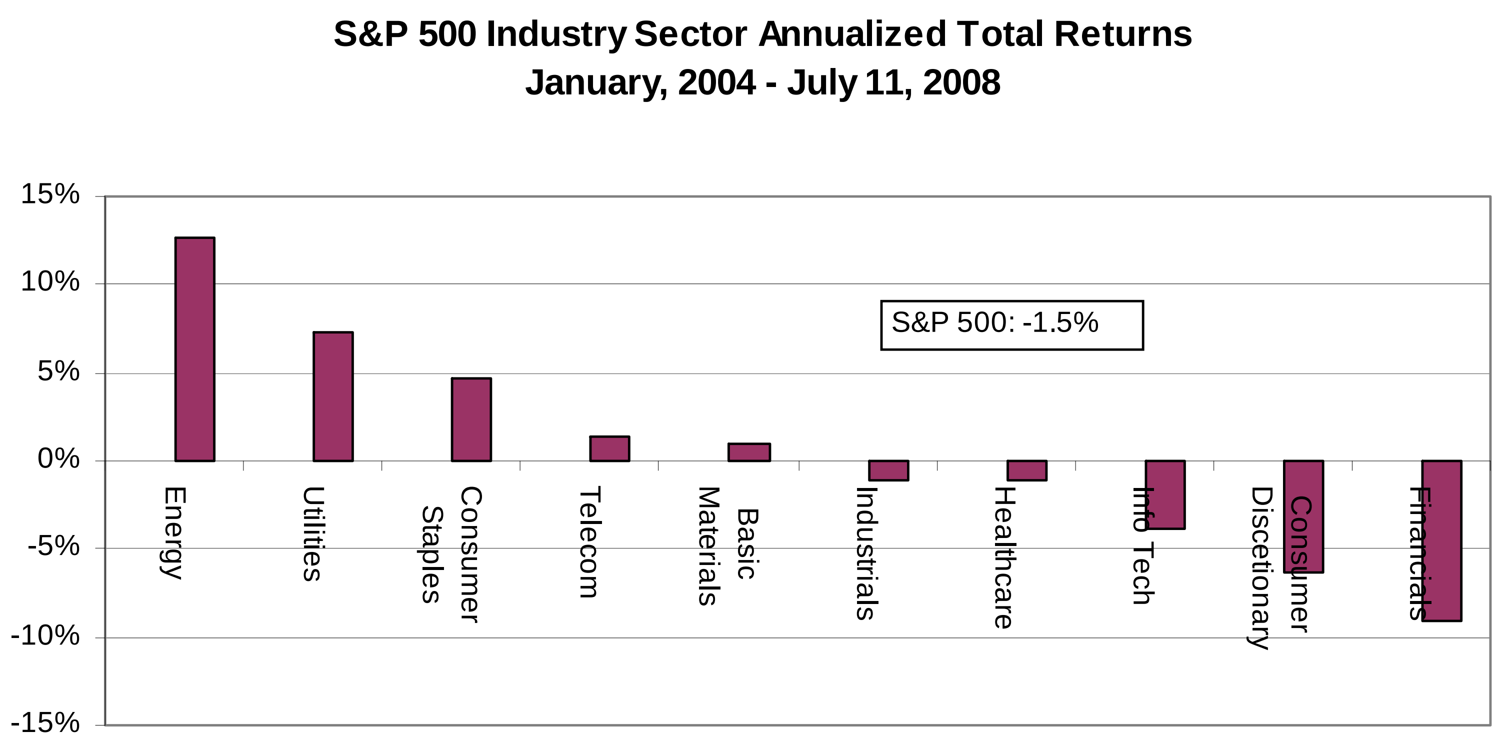
But a Reversion to the Mean for Profit Margins Could Take Time….



Source: ***Active Value Investing: Making Money in Range-Bound Markets***, **by Vitality Katsenelson.**

Stock Market Outlook

Despite the Recent Sell-Off, the Best-Performing Sectors in Recent Years Have been Highly Dependent on Surging Commodity Prices and Declining Interest Rates



Includes reinvested dividends.

Going forward, we favor the sectors that have underperformed and are not dependent on commodity prices and/or low interest rates.

Source: Bloomberg

Stock Market Outlook

In This Environment, We Continue to Favor Companies with…

- **Outstanding Track Records and Defensible Market Positions**
- **Highly Visible Earnings and Cash Flow**
- **Exposure to International Markets**
- **Seasoned Management Teams**
- **No Dependence on Commodity Price Increases or Falling Interest Rates**
- **Rock-Solid Balance Sheets (Low debt, no dependence on capital markets financing)**

Surprisingly, These Types of Quality Companies Have Been Underperforming the Market for Years!!!