CUTLER INVESTMENT GROUP LLC

Equity Market Update

Second Quarter 2008

The first quarter of 2008 was a test of market volatility that culminated with the dramatic acquisition of Bear Stearns. This market event was historic, not only from the rapid deterioration of a storied Wall Street franchise, but also from the Federal Reserve's heavy hand in a private transaction. Ultimately, the Fed's actions helped boost confidence, as debt investors were given an implicit guarantee that even highly leveraged investment banks could be deemed "too big to fail." While most economists have forecasted that the US is currently in recession, there are reasons to remain positive.

Reason #1: Non-financial companies grew earnings about 9% in the first quarter. As a financial expert recently noted, "this is not a P&L recession, it is a balance sheet recession". This alone gives quite a bit of confidence in equities, especially those with substantial global exposure. With a weakening dollar, exporting companies have increased their pricing power and are earning more money when overseas earnings are adjusted for their US-dollar based financial reporting.

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Reason #2: Earnings and dividends continue to grow in most of the market, and valuations are attractive. Stocks are trading at 14 times estimated price-to-earnings, which is near historical averages. Dividend yields are up near 2.2%, while one year ago they were 1.8%. Financial earnings have been historically poor this year, but we feel that these will begin to normalize on a forward basis. With overall market earnings growth, prices will have to adjust higher to maintain these long-term average levels.

Reason #3: Liquidity is creeping back into the markets. The target Federal Funds rate is currently 2.0%. One year ago, it was 5.25%. Many forecasters are calling for further Fed cuts, which will stimulate further economic activity. While the risk of higher inflation and a weakening dollar are accelerated by such policies, the short-term result will likely be a softening of the current tight credit markets. We would anticipate a "re-winding" of interest rates to rapidly follow a stabilizing of the housing market, perhaps as early as first quarter 2009.

Overall, we seek to manage portfolios for long-term investment performance. Times of economic stress provide opportunities for patient investors to identify strong opportunities. The current market is no exception, and at Cutler, we feel that long-term investment value abounds.

This Issue:

- Equity Market Update
- Fixed Income Update
- International Update
- The Spirit of Global Competition
- emPlan Launches
- Our New Office

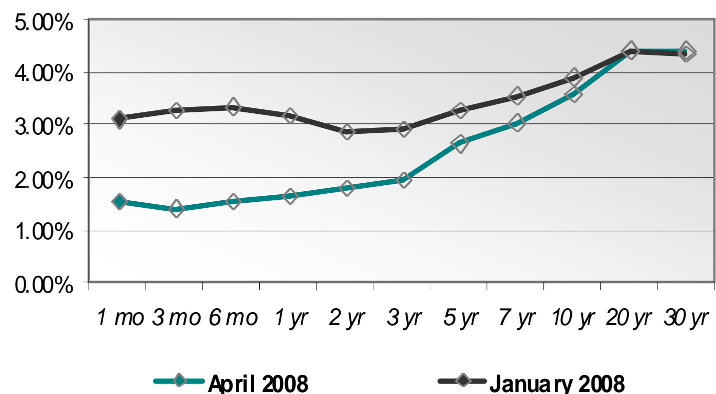
[It's not such a big world when you look at it our way]

Fixed Income Update

Where will rates go from here?

Over the course of the first quarter, interest rates fell across the entire yield curve fueled by multiple cuts in the Federal Funds rate, a flight-to-quality, and the fear of a slowing economy. The quarter ended with the 3-month Treasury Bill yielding only 1.32%, a rapid decline of nearly 2%. Although all maturities experienced declines, interest rates in the short-end of the yield curve fell much more than those in the long-end of the yield curve.

The first quarter of 2008 could not halt the credit erosion that began in mid-2007, with a multitude of factors snowballing and forcing a dramatic market correction in the credit markets. Liquidity has been severely impaired in the cash markets, new issuance has slowed (dramatically in the CMBS market), and both Treasury and swap spreads have aggressively continued to widen from what had been historically tight levels in early 2007. The market's re-pricing of risk extended beyond the initial subprime related securities. This "credit recession" of the first quarter of 2008 will go down as the worst quarter for the U.S. Aggregate Index in history on an excess return basis (index returns minus risk free returns were -1.83%).



At Cutler, we continue to manage bond portfolios very conservatively, and have largely maintained a defensive cash position. We are anticipating a pause in the Federal Funds rate. Housing resets will continue for the near future, and therefore we are taking a cautious and opportunistic approach to fixed income portfolios.

International Update

While there has been quite a good deal of focus on the domestic economy, global markets have not been immune to the credit crunch. The synthetic credit vehicles created on Wall Street were effectively exported to financial institutions around the globe. We have seen major write-downs at stalwart institutions ranging from HSBC to Royal Bank of Scotland. Less high quality institutions have in some cases collapsed, as happened with Northern Rock in Great Britain. Even so, European growth has been robust in the current market, and has been one of the few bright spots in the global economy. Persistent inflation has held European interest rates constant at 3% since June 2007, while much of the world has been cutting aggressively.

The weaker dollar has also had a substantial impact on global markets. Many countries "peg" their currency to the dollar, meaning that as the dollar weakens, inflation has been imported into their country. This has created imbalances and increased global volatility. On January 21st, triggered by big losses at Societe Generale, European shares lost $350 billion in market value, an amount equivalent to the GDP of Hungary and Greece combined. India's Sensex lost over 13% in that two-day period, while the US markets were closed for Martin Luther King Day. The US Federal Reserve Bank responded to this volatility with an emergency 75 basis points interest rate cut, one of the most dramatic interest rate cuts on record.

While international markets have had large swings, there are opportunities that exist in the current markets. Growth in emerging economies will continue, and the challenge remains prudently identifying strong values in fast growing countries.

BEIJING OLYMPICS

With the Olympic torch now making its way around the globe, now is an excellent time to examine the current state of China and what we feel is a paramount time period in the country's economic development. After spending nearly 10 years living in China, our company President, Matthew Patten, has a unique perspective on the country's impact on the world economy. When he first worked in China in 1995, the country represented an emerging economy with most investors apathetic as to how China would impact the 21st Century. By 2005, China had grown to represent 10% of the world's economy. Some estimates even have China's GDP exceeding the US by 2020, although the per capita income will remain lower than the US for quite some time. Cutler continues to view China from the perspective of an investor, remaining politically agnostic to often controversial government policies.

China's growth story is not new

Over the past few years, Matthew has given many speeches addressing China's positive impact on the US economy due to China buying around $500 billion of US Treasuries. This capital inflow has contributed to lower global inflation. Recently, China's expansive growth has created demand for commodities leading to higher inflation. This expansion has also increased multi-national company earnings, as over half of S&P 500 earnings are now outside the US.

However, today China is in transition. China's economy has historically had remarkably differentiated economic periods. In the pre-industrial era, leading up to the 1820's, China was the world's largest economy. Representing nearly 30% of world output, China was a leader of agricultural production. The country declined rapidly, as political instability ensued when the Communist Party was formed in 1921. This eventually bottomed with the onset of the Cultural Revolution. For over 30 years, China followed the slow-growth socialist model of the USSR. In the late 1970's, under the leadership of Deng Xiaoping, China began reforms (around Nixon's visit in 1978).

Today, the reforming era is ending. For three decades, China has opened its economy, highlighted by entrance into the WTO in 2002. With the arrival of the Olympics, China is no longer an emerging economy. China is now the world's second biggest economy. A post-Olympics China will look much different than today, and these changes are worth an investor's investigative look.

The biggest change will be a slowdown of the unparalleled infrastructure build-out. The Chinese government has been rapidly building infrastructure in anticipation of welcoming the world to this summer's Olympics. This has driven a remarkable appetite for commodities. The chart to the right shows recent estimates of China's commodity consumption. This spike in consumption is providing greater inflation pressure on a global scale. A slowdown of China's build-out will help alleviate some of these pressures, and we anticipate medium-term global inflation growth will peak in 2009.

China's % of world consumption	
Cement	38%
Copper	20%
Aluminum	23%
Coal	30%
Steel & Iron ore	27%
Pork	50%
Fish	30%
Rice	33%

The second shift in China will be away from an outsourcing economy to a consumer-based economy. As an economy grows, labor becomes increasingly scarce, and the cost advantages for labor relocation decrease. Today, multi-nationals are looking at China less as a source of manufacturing production and more as a lucrative consumer market (South East Asia has become the location du jour for such outsourcing changes, albeit on a much smaller scale). American brands have substantial cache with Chinese consumers, and the government's relative openness has created an opportunity to capture this huge market. Today, US companies are competing for these consumers and continue to position for market share.

Finally, China will provide stability to the global financial markets. With an increasing percentage of the global economy, the world will be less dependent on the US economy to drive global growth. A counterweight to the US is not necessarily a negative for investors. For example, a strong China today can boost earnings and exports during a period of domestic weakness. This can smooth earnings and reduce overall investor risk. As we seek opportunities in the stock market, understanding these correlations becomes an increasingly important task. We believe China is a key piece of this puzzle, and will continue to have a lasting impact on equities around the globe.

Cutler emPlan

Cutler emPlan Launches

Cutler's Equity Income strategy has been a mainstay for most of our clients for over 25 years. Its conservative, dividend focus is designed to be defensive during turbulent markets such as we have seen in the first quarter of 2008. This is an appropriate strategy for many investors, but Cutler recognizes that there are clients who are seeking either a more aggressive or a more conservative allocation to supplement our Equity Income product. This is particularly true of our 401k clients who wish to offer several investment alternatives to employees.

What is the Cutler emPlan?

Cutler has developed an innovative solution for high net worth and employer sponsored plans to combine our proven Equity Income strategy with additional investment strategies under one investment platform. We call it the Cutler emPlan. Since the founding of Cutler in 1977, there has been growing interest in self-directed defined contribution plans vs. the traditional defined benefit or employer directed defined contribution plan. As a result, new investment vehicles have been developed in the marketplace, which allow for participation in the broader markets with relatively low cost.

Exchange Traded Funds (ETFs) were introduced in 1993 and are a passive approach to participating in various markets. They act similarly to mutual funds but with lower fees: ETFs are style and strategy based, and act as baskets of securities which trade throughout the day rather than only once per day like traditional mutual funds. By selecting various ETF strategies in conjunction with our actively managed Equity Income portfolio, we are able to structure portfolios for our clients that exactly meet their investment needs; providing broad market diversification (portfolios often referred to as "target date" or "lifestyle" portfolios) and reducing fees.

These portfolios are especially appropriate for our corporate clients. **Imagine a lower cost 401k that combines our Equity Income portfolio, daily valuations, web account access, and simplified administration! The responsibility for investment selection rests with the employees, thus "emPowering emPloyees" and increasing 401k participation.**

We're moving to our new office

Last year we broke the news to you that we are renovating an historic school building in Jacksonville, Oregon (just west of Medford) for our company headquarters. It has been an exciting nine months since first reporting to you and we are now on the verge of moving in. Effective immediately, all mail should be sent to our new address listed below. Please note that our phone number will not change. To read about the historic renovation, please visit www.bighamknoll.com.

Cutler's new office location. (Jacksonville School 1908)

Headquarters • 525 East E Street • Jacksonville, Oregon 97530

(541) 770-9000 • (800) 228-8537 • FAX (541) 779-0006

info@cutler.com • www.cutler.com