CUTLER INVESTMENT GROUP LLC

Economic Update: recovery on the horizon

2nd Quarter 2009

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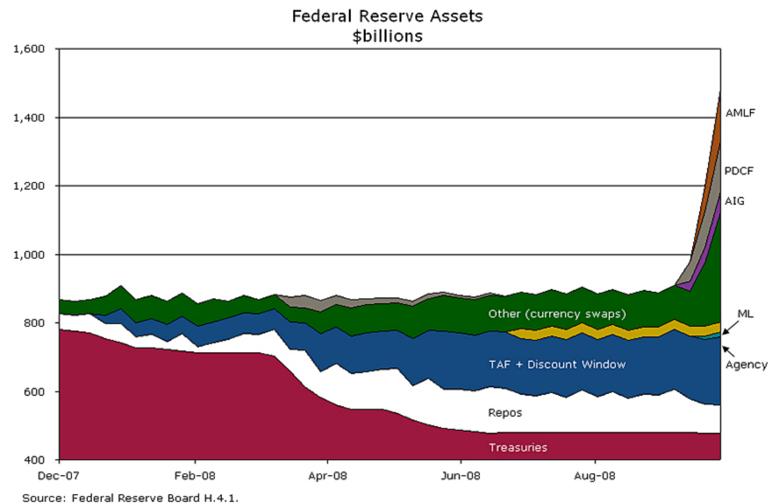
On March 9th, the major averages bottomed at nearly 25% below their December 31st levels. A month later, they had recovered to levels nearly flat year-to-date. This represents a phenomenal recovery in equities, and a technical bottom of the most recent bear market. The recent lows were reached at a point of extreme consumer pessimism, rivaling the panic that the markets experienced in November 2008. While it is not prudent to officially declare the direction of equities is straight up from here, it is helpful to examine the reasons for the recent rise.

Federal Reserve Policy

As the chart demonstrates, the aggressive moves of the Federal Reserve have been unprecedented. In the past, an expansion of the Fed's Balance Sheet has been correlated to higher levels of inflation. This is a risk that the current Open Markets Committee has downplayed, but one that we feel investors should not ignore. Exposure to inflation protected assets, such as equities, is a logical investment thesis based on the rapid growth in Federal Reserve assets.



Monetary Policy

With the nationalization of the secondary mortgage market, the massive expansion of deficit spending, and the various bailout packages, the Treasury has also taken an unprecedented approach to the current recession. (Perhaps unprecedented may be considered the "new precedent.") This government spending cannot be ignored, both from impact on the current economic recovery, and from the long-term effects of a larger debt burden. We would anticipate both a near-term economic recovery, as well as long-term dollar weakness to be the most transparent investable side effects of this policy. While the creditworthiness of the US Government remains most favorable, foreign borrowers have indicated their displeasure with the role of the dollar as the world's reserve currency. Today, the role of the dollar will not change. However, the higher debt load and the temptation to "inflate our way out of debt" may push the needle toward a declining dollar in the long-term.

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*"When you earn a dollar, it has gained your respect.
When you invest that dollar, the investment should reflect your respect."*
- Ken Cutler

ECONOMIC UPDATE CONTINUED...

Government Policy

Early in 2009, the Obama administration established an aggressive rhetorical stance toward the banking sector. Government Policy was viewed negatively by the equity markets. Criticism of the administration reached a crescendo near the market lows, as CNBC pundits became front page news. However, an easing of rhetoric, notably the unwillingness to nationalize the banking sector, has helped the market toward recovery. Recent bank stress tests conducted by the Treasury, have also helped restore investor confidence of the financial sector.

Business Cycles

Ultimately, the importance of business cycles should not be ignored when considering the reasons for the recent market recovery. The recent recession began in late 2007, and is now quickly approaching the longest post-WWII slowdown. Every previous slowdown in American history has reached an end, and this one will not be an exception. Investor gains when purchasing against periods of extreme pessimism have far exceeded those purchased during economic booms, and the recent uptick in stocks may reflect an early indication of investors anticipating better times ahead.

Today, the economy appears to be at an inflection point. Confidence is increasing; a variable that can snowball into further economic gains. While structurally the economy has changed, it appears the worst of this downturn has passed. Investors should remain diligent, but can invest with greater certainty than in recent months.

FIXED INCOME: INFLATION WORRIES?

During the First Quarter of 2009, the Barclays Capital Aggregate Index produced a total return of 0.12%. The Quarter ended on an up note for most of the fixed income market, but March was not able to save a generally disappointing three-month struggle. The big winner, unsurprisingly, was the Agency mortgage sector, as the massive buying by Ben Bernanke and the Central Bank pushed spreads tighter in that sector. The Fed's footprints can be found in most positive performance outcomes.

Over the course of the First Quarter, Treasury yields rose as historically low rates, the prospects of inflation, and a massive supply of Treasury issuances caused investors to look elsewhere for yield. The nervousness that resulted in an increase demand for US Treasury securities has, for the moment, waned and caused the long end of the yield curve to increase by 0.86% in the Quarter. All maturity sectors experienced a rise in rates, with the least coming in the two-year, as rates increased by a mere three basis points.

The yield curve, because of a greater increase in yields in the long-end of the yield spectrum, has steepened by 73 basis points between the 30-year Treasury Bond and the 3-month Treasury Bill. The greatest percentage yield spread increase occurred between the 10-year Treasury Note and the 30-year Treasury Bond, and that spread nearly doubled to 87 basis points from 46 basis points. This spread widening is directly related to the fear of future issuance and inflation worries. However, yields across the board continue to be historically low, especially the 3-month Treasury Bill, which still hovers in the 0.20% range.

With interest rates across the yield spectrum remaining at or near historical lows, it is difficult to look for any meaningful return potential from an increase in the duration of the portfolio. Consequently, we continue to pursue a duration strategy that either matches the duration of the index or is lower.

EQUITY INCOME COMMENTARY

A LOOK AHEAD

After a banner 2008, outperforming the S&P 500 by nearly 10%, Cutler's Equity Income product experienced a moderate mean reversion during the first quarter of 2009. There were a number of factors contributing to this slight underperformance, notably:

1) Portfolio repositioning in economically sensitive securities during the second half of 2008 and early 2009
2) A sell-off of previous "winners" in the financial sector
3) A dearth of dividend cuts from defensive managements

Looking closer at these performance drivers, our belief is that the greatest impact came from recent portfolio repositioning. Cutler maintains a market outlook for a near-term economic recovery, either in the second half of 2009, or early 2010. We view the recovery as driven by cyclical and inflation sensitive securities such as the Energy and Materials sectors. In the past 12 months, companies such as Nucor, Halliburton, Vulcan Materials, and DuPont have been purchased to benefit from this potential investment trend. Other holdings, such as Honeywell and Texas Instruments, have been purchased for attractive valuation or dividend yielding opportunities. During the dramatic sell-off during Q1, 2009, defensive sectors outperformed the broader market, and the portfolio has been increasingly positioned for a recovery versus continued economic malaise.

In addition, some of the strongest performing banks in 2008 were unable to continue their outperformance during the first quarter of 2009. Companies such as JP Morgan, US Bancorp, and Wells Fargo, all January 1, 2009 portfolio holdings, underperformed and cut their dividends. As is Cutler's policy, portfolio holdings must maintain dividend payments for at least 10 years, in order to provide assurance in the soundness of the company's business model. These holdings will all be sold at the discretion of management and shares will not be increased within our model during the evaluation period. Ultimately, the strategy will look beyond the national banks if it is deemed wise to maintain a market-level Financial sector exposure.

Top Five Strategy Holdings Q1-2009

Holding	Weight
IBM	4.72%
Consolidated Edison	4.60%
Chevron	4.45%
ExxonMobil	4.25%
Archer-Daniels-Midland	3.94%

Finally, as highlighted above, the markets have seen numerous dividend cuts recently. Pfizer, a former portfolio holding, cut its dividend to finance the acquisition of Wyeth. Dow Chemical cut its dividend due to a botched partnership with the Kuwaiti government and an ill-conceived purchase of Rohm & Hass. This holding was also removed. The unusual number of dividend cuts is reflective of the current unusual economic circumstances. In the past, dividend cuts were typically viewed as unfriendly to shareholders, and we believe they are an essential indicator of a company's future prospects. Companies that are able to maintain or increase their dividends during today's economy are well managed and, in Cutler's view, will be the best long-term investments in the market.This dividend-based approach to investing has held up during multiple market cycles, and we believe that the Equity Income portfolio remains well positioned for our moderately optimistic economic outlook.

Global Market Update

A strengthening dollar

Except for Norway's currency, the U.S. dollar advanced against all developed currency markets for the quarter. The greenback appreciated 8.2% relative to the Japanese yen, and the deepening global recession and stronger yen continued to damage the corporate profitability of the export-dependent economy. In fact, the MSCI Japan index was down 9.1% for the quarter and left the Japanese banking system weakened as they retain cross-shareholdings. The British pound, having been strongly correlated to the state of the global financial system, depreciated marginally relative to the U.S. dollar during the quarter. As evidenced by the widespread fall in their currencies, most Central and Eastern European countries such as Poland, Hungary, and the Czech Republic, were not discriminated against during the quarter despite some countries within the bloc being better able to withstand the economic and credit shocks and having relatively better public finances and debt levels.

Being less enthused about engaging in massive stimulus policies, Continental Europe has been left isolated. Efforts to date have been mostly aimed at providing unlimited liquidity to its banks as European companies have traditionally received the majority of their funding from those institutions. However, the possibility of quantitative easing was still left open should the economy deteriorate further. Some European countries, such as Germany, have pushed through stimulus packages, but nowhere resembling that of the U.S. Germany remains unwilling to bailout its banks by taking over or guaranteeing losses on toxic assets. Noteworthy is that the rush by governments around the world to finance their ever growing deficits will create a situation where they compete against one another for limited available funding.

Besides historical rate cuts, the U.K. also embarked on several schemes to alleviate the stress in the financial system, of which the three most notable are bank recapitalizations, quantitative easing, and a government-guarantee insurance program. The insurance program, while minimizing up-front costs to the government, creates potentially large contingent liabilities, but more importantly, it alleviates the amount of capital banks must hold by improving their capital position. This may ultimately lead to increased consumer and business lending. The Bank of England has signaled that it is determined to make its quantitative easing program work at any cost. Indirect stimulus is also being provided by the persistently weak U.K. pound as its exports become more competitive globally.

Global portfolios remained positioned to favor North American equities, as relative valuations domestically have been consistently attractive. Developed economies have weathered the economic turmoil versus emerging economies, and deep value in countries such as the US, Japan, and France has a favorable risk/reward in today's investing climate.

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