

A New Beginning

As time passes we have more information that supports our belief that both the U.S. and global economies have bottomed and are in the early stages of recovery. In the United States the credit crisis appears to have abated as evidenced by a number of factors. First, it has been several months since we have experienced an unexpected announcement of a major financial institution in financial trouble. In fact, ten major financial institutions have recently repaid the U.S. Government the money that they were required to accept earlier this year. Also, many of these same institutions sold common stock and bonds to investors to obtain the money to pay back the U.S. Government. We view this as another sign that investor confidence is returning as the credit markets repair.

Credit markets have stabilized and improved. The spread between investment grade corporate bond yields and U.S. Government bond yields of similar maturity have narrowed. There is more activity and liquidity in all qualities of corporate bonds. Valuations of the once considered toxic assets have also improved, as have their liquidity. The flight to quality has abated as reflected in the higher yields now available in intermediate and longer term U.S. Government bonds. This reflects a shift in demand to lesser quality issues below that of U.S. Government bonds. Today, prices of U.S. Government bonds have declined from their highs of earlier in the year and now offer more reasonably attractive yields. The yield curve continues to be steep, with little or no yield available for maturities of less than one year, and almost a 4% yield for 10 year maturities. We believe that this reflects the belief that inflation will be low over the shorter term, and gradually rise as the economy improves in the longer term.

Beyond the repricing of the credit markets there is improvement in the housing market. The decline in housing starts has bottomed and begun to improve in several parts of the country. Inventory of unsold houses has been reduced, which has stabilized home prices at lower levels. Consumer confidence has also improved as reported in the most recent surveys. The decline in retail sales has slowed and even grown for those retailers who have managed their business well.

This bottoming and improvement has been achieved without much benefit from the economic stimulus package put in place earlier this year. As the benefits of significant increases in government spending begin to spread throughout of the economy, it will add further impetus to the economic turn. Many of these same positive signs are appearing globally. The major economies of the Far East are improving earlier and faster than that of the U.S. However, the European economies seem to be lagging behind the turn experienced in the U.S. The slower improvement in Europe reflects the hesitancy of those governments to act as quickly and forcibly as others acted. On balance, the global economy appears to have bottomed and is in the early stages of an

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economic advance. We believe global economic growth going forward has a sounder basis than in prior recoveries that could provide for a more sustainable growth over a longer period of time.

Many economists have recently been concerned about the prospect that inflation will accelerate to unacceptable levels as the global economies improve. It was just a short time ago that many were concerned about deflation and its negative impact on the global economy. We are not as concerned about the prospects for higher levels of inflation as are others. We believe the governments of the leading economies have demonstrated a keen ability to use both fiscal and monetary policy to control excesses that develop in their economies. With a heightened concern over the prospects of higher levels of inflation, it is unlikely that it would be achieved. There is a large amount of excess capacity and unemployment that will mitigate the ability to raise prices. We are more concerned with unexpected events that could develop, which might destabilize an economy. The risk is more about what we are not prepared for, and unaware of, than what we expect. Looking back at the most recent past, it is the unexpected depth, breath and severity of the credit crisis that destabilized the global economy. The expected events in most cases can be managed. It is the unexpected that we must continually be sensitive to and attempt to anticipate.

Both the stock and bond markets have responded favorably to the improving global economic outlook. As more confidence develops on the part of the consumer and business, we would expect the financial markets to continue to respond favorably. Our belief is that not only have economies endured a “healthy house cleaning”, so have the financial markets. With the enactment of stronger regulation and oversight as well as reasonable levels of valuation, the markets are well positioned to begin a long period of positive and sustainable growth. This will take the form of improving earnings as well as the valuations placed on the earnings. As in all recoveries there will be periods of hesitation and set back. We have learned to recognize and endure these set backs as a process of adding strength and substance to the longer term rise.

Have a pleasant summer.

Investment Policy Committee

Abner, Herrman & Brock Asset Management

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