

Glens Falls National

Bank and Trust Company

NEWSLETTER



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ECONOMIC SUMMARY

Recent economic data indicate that the U.S. economy is transitioning from “things are getting worse at a slower pace” to evidence, excepting the labor market, of sequential improvements. We have written previously that the U.S. economy, and markets, bottomed out in the first quarter of 2009, and recent reports substantiate this position.

Economic reports suggest that the U.S. economy will grow in this quarter. The Institute for Supply Management’s Manufacturing Index rose to 52.9 in August from 48.9 in July. Figures less than 50 indicate a contraction in activity; figures greater than 50 indicate expansion. Domestic auto sales, spurred by the government’s cash for clunkers program (CARS), marked the second consecutive month of growth; rising to an annualized rate of 10.2 million units. Even at this improved level, auto sales remain below the replacement rate; indicating potential for pent-up consumer demand and future sales growth. Auto production to fill depleted inventories should drive manufacturing and propel GDP growth in this quarter.

The unemployment rate rose to 9.7% in August from 9.4% in July despite initial jobless claims falling as did continuing

claims for unemployment benefits. Manufacturing job losses continue, with 63,000 manufacturing jobs lost in August compared to 52,000 lost in July. The Challenger, Gray & Christmas Index which measures announcements of large-scale job cuts, reported 13.84% fewer such layoffs in August of 2009 compared to the prior year period. The average hourly work week remained unchanged at 33.1 hours in August while average hourly earnings rose 0.3% month-to-month and 2.6% year-to-year. Non-farm productivity rose 6.6% in the second quarter of 2009; while unit labor costs fell 5.09% in the second quarter. As a whole, the above measures of the health of the labor market indicate that manufacturing job losses continue their established long-term trend, that large scale layoffs associated with structural economic changes as lessening, that due to economic conditions businesses continue to layoff workers and remain reluctant to hire, and that labor productivity continues to rise.

Housing continues to show signs of stabilization, and more recently improvement. In July, Housing Starts and permits were comparable to June’s measures. Existing Home Sales were up 7.2% in July compared to the prior

month and up 12.9% compared to the prior year period. For June of 2009, the Case-Schiller Composite Index, a measure of home prices in 20 large metropolitan areas fell 15.44% compared to a year ago; but marked an improvement over March 2009's results and exceeded consensus estimates. In June, the Case-Schiller Home Price Index rose to 141.86 from 139.84 in the prior month, indicating a sequential increase in home prices. These figures suggest the housing component of real GDP, real residential investment expenditures, will be less of a drag in the third quarter and may stop contracting by the fourth quarter of this year.

The Federal Reserve Federal Open Market Committee (FOMC) concluded their meeting on August 12th, leaving the federal funds target rate at a range of 0 to 25 basis points. Officials implied they were more optimistic about the economic outlook than they were in late June, stating "economic activity is leveling out," compared to last meeting's assessment that the economy was "contracting at a slower pace." The press release also stated that financial market conditions "have improved further in recent weeks." The weak spot remains the consumer as the FOMC reiterated that "household spending has continued to show signs of stabilizing but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth and tight credit." The statement commented that "businesses are still cutting back on fixed investment and staffing but are making progress in bringing inventory stocks into better alignment with sales."

Even with the improvement in the economy, the Committee appeared cautious regarding the strength of the recovery. Economic activity is "likely to remain weak for some time." "Economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." "The prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pressures, and the Committee

expects that inflation will remain subdued for some time." Supporting the expectation for subdued inflation was the surge in productivity in the second quarter, which translates into a drop in unit labor costs, and implies the absence of inflationary pressures.

The key is sustainability. With the Federal Reserve contemplating its first move toward extracting some of the monetary stimulus, it will be critical to see whether the recovery can continue its momentum. Consumer spending faces significant challenges, and this is of vital importance as household spending as a percent of GDP has been consistently well above its post-war median level of 71.5%, peaking at over 76.0% in 2006. It is now trending downward. Credit is not free-flowing. Consumer credit contracted at an annualized rate of 4.3% in the past two quarters, the sharpest two-quarter rate of contraction in the post-WWII era. Household leverage at the end of the first quarter was at a record high 21.9% of total household assets. Although households have a lot of work to do to get their balance sheets repaired, keep in mind that in the past year the factor driving up leverage has been the sharp decline in the market value of household assets. Household liabilities actually fell in three of the past four quarters ended the first quarter of this year. With the rise in the U.S. stock market since March and the slowdown in the rate of decline in house prices, combined with the pay down of household debt, household leverage is likely to begin moving lower soon.

There is concern being voiced that after the fiscal stimulus wears off, the economy will lapse back into recession. In the post-WWII era, once the U.S. economy has gained forward motion, it has maintained that forward motion until the Federal Reserve has intervened to halt it. We believe the earliest the Fed will begin to take action to brake the pace of nominal economic activity will be late-June 2010. If they begin to take action then, they will do so only tentatively.

Our expectations are that the CARS program, and a rebuilding of depleted inventories will result in positive economic growth in the third quarter of 2009. This growth however, must be tempered by the reality that it will be the result of temporary and transient influences. We expect that the economy's growth will remain subdued as a result of suppressed consumer spending due to unemployment rate of 9.7%, impaired confidence, continued de-leveraging of U.S. households, reluctant lenders and more importantly, reluctant borrowers and investors.

By Peter M. Capozzola, CFA

FIXED INCOME OUTLOOK

The Federal Reserve Federal Open Market Committee (FOMC) next scheduled announcement is on September 23, 2009. We expect no change in the Federal Funds Target Rate, currently 0-0.25%, and anticipate the FOMC will issue continued guidance along the line that the Federal Funds Target Rate will remain low for some time, that the economy is showing signs of stabilization and possibly an emerging recovery, and that the FOMC will remain vigilant in regard to both inflation and deflation.

We do not anticipate any increase in the Federal Funds Target Rate well into 2010. Despite a recent run-up in energy and other commodities, inflation is expected to remain subdued for some time as a consequence of slack labor and production resources. Our conviction is strengthened by an appreciation that the Federal Reserve will at some point unwind its liquidity injection programs and that such action will diminish the threat of inflationary pressures taking hold.

Over the course of the last month, the yield on 10 year U.S. Treasury bonds continued to

fluctuate, reflecting the uncertainty of the sustainability of the economic recovery and associated inflation expectations. We continue to expect that for the remainder of 2009 the 10 year U.S. Treasury yield will remain range-bound rather than rise significantly based on our forecast of modest economic growth and the inflation-muting influence of slack resources.

Corporate and U.S. Government Agency credit spreads continued to narrow over the last month. We believe that non-financial corporate bonds remain attractive and afford an opportunity for enhanced yields. Additionally, FDIC insured corporate bonds should be viewed as an attractive opportunity relative to U.S. Treasuries for those fixed income investors seeking a high degree of safety.

Where practical, and not a disruption to either client liquidity needs or Investment Objectives, we recommend that anticipated proceeds of upcoming bond maturities be "pre-invested" given the slope of the yield curve and our expectation that money market yields will remain low.

We anticipate a moderately-paced economic recovery. Taking note of lax labor and capital resources, we do not anticipate that significant inflationary pressures will emerge despite the simulative monetary and fiscal actions taken to date. We consider the possibility that a flattening yield curve will emerge likely and consequently recommend modestly extending the average duration of fixed income portfolios beyond that of their respective benchmarks.

While yields on Treasury Inflation Protected Securities (TIPS) currently indicate minimal inflationary expectations, we consider TIPS a prudent and undervalued investment as we expect future inflation, while modest, to exceed the level priced into TIPS at this time.

By Peter M. Capozzola, CFA

EQUITY OUTLOOK

The S&P 500 returned 3.6% in August and is now up nearly 15.0% year-to-date. The standout for 2009 thus far, emerging market equities, have now racked up 53.0% returns. Commodities are catching up nicely too. The Dow Jones-UBS Commodity Index is up 7.4% for the year. Oil has risen above \$70 per barrel on the back of stronger-than-expected global economic data and a weaker U.S. dollar.

While the pace of global economic recovery has accelerated in the near term, the long-term drivers of sustainable growth remain less clear. A bounce in economic growth was expected by year end, especially after the drop in inventories and production over the last nine months, but the pace of the recovery is exceeding most forecasts. Due to improved expectations for auto sales, third quarter GDP growth is now expected. Other positives include a steady and modest improvement in the manufacturing Institute for Supply Management Index and the less negative labor market data. But, consumers have embarked upon a long-term de-leveraging process, tighter risk controls and regulations will likely limit credit availability to levels below historical norms, rising energy prices could stifle consumer income and spending, income growth has stagnated, and the unemployment rate is likely to continue to rise. Generally improving economic data cannot fully compensate for the millions of jobs that have been lost since December of 2007.

A more optimistic Federal Reserve sets the stage for expected removal of various stimulus tools from the system. Deflation is less of a concern based on recent economic data, and inflation concerns are emerging. A well-articulated exit strategy from the Fed will be welcomed by the market. We think many investors are predicting the risk of much stronger-than-expected inflation in the long-run. Our exposure to commodities and TIPs provides some insurance against this inflation risk.

With regard to commodities and global economic growth, it is worth noting that the individual economic statistics in the U.S., such as the number of people unemployed, is increasingly less important in a global market. U.S. consumers are not the only ones who want and need oil, copper, and iron ore - so does the rest of the world. Also, as large holders of U.S. Treasuries, overseas consumers are more concerned about the value of the dollar than we are. We believe the global economic recovery may be driven by emerging market economies, such as Brazil, Russia, India, and China.

By Peter M. Capozzola, CFA

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