



Hemenway Trust Company^{LLC}

Second Quarter 2011 Report

Dear Valued Client:

After a strong start in the first quarter, both the economy and financial markets cooled in the second quarter. The S&P 500 decreased 0.4% in price in the quarter, with the Dow Jones Industrial Average up 0.8%. The Russell 2000 declined 1.9%. The Dow Jones World Index ex-US declined 0.5%. The stock markets in the BRICs (the leading emerging markets) all declined, with Brazil down 9%, Russia 8.7%, India 2% and China 5.4% – all in their local currencies. Commodities also declined in price, with the DJ UBS Index down 6.7%. The price of oil dropped 11% in the quarter to \$95.42 per barrel. Bonds, however, had a positive return for the quarter. U.S. Treasuries overall returned 2.78%. High quality corporate bonds returned 2.59%, and high yield bonds returned 0.77%. The yield on the 10-year Treasury declined from 3.542% on March 31 to 3.160% on June 30. On a year-to-date basis, the stock market still had a positive return at quarter end and strong results for the 12-month period ending June 30, 2011. Year to date, the S&P 500 was up 5%, and the Dow Jones Industrial Average was up 7.2%. The Russell 2000 was up 5.6%, and DJ World Index ex-US was up 2.2%. For the 12-month period, the S&P 500 returned 28.5%, the DJIA 27.6%, the Russell 2000 36.8% and the DJ World Index ex-US 27.0%.

The subdued results of the equity markets this quarter reflected a deceleration in the rate of growth in the U.S. economy. U.S. GDP grew just 1.9% in the first quarter and clearly grew at a slower pace in the second quarter. At their June meeting, the Federal Reserve Board members reduced their expectation for 2011 growth from 2.9% to 2.7% and for 2012 reduced their expectation from 3.7% to 3.3%. Even those reduced expectations assume an acceleration of growth in the second half of 2011 to 3.6%, which seems overly optimistic. Key economic statistics continue to be positive, but less so than they had been earlier in the year. The Institute of Supply Management Manufacturing Index stood at 55.3% in June, up from 53.5% in May, but well below the rates at which it had been improving in the first quarter. The ISM Non-Manufacturing Index decreased from 54.6% in May to 53.3% in June, again, well below first-quarter rates. The Conference Board's Leading Economic Indicators stood at 114.7% in May, up eight-tenths of a point from the reading in April. Each of these measures indicated continued growth in the economy, although at a subdued pace.

A number of headwinds continue to slow the economy. Home prices continue to be an issue. The Case-Shiller Home Price Index in April showed a slight increase in U.S. home prices over March, the first increase in eight months. Nevertheless, prices remain very weak. As of April, the average home prices across the United States were back to the level where they were in the summer of 2003. Measured from their peaks in June or July of 2006 through April 2011, the 10-city and 20-city composites compiled by Case-Shiller had declined 32.6% and 32.8%, respectively. The decline in the value of their homes has taken wealth from U.S. consumers and reduced their ability and readiness to spend. Weak employment continued to be another major concern. After good job growth in February through April, employment growth slowed in May and June. The economy added just 18,000 jobs in June, well below expectations. The unemployment rate increased to 9.2%. This economic recovery has not added jobs at a pace fast enough to spark continued growth. The gloomy housing and employment statistics have affected consumer confidence. The Conference Board's measure of consumer confidence

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declined again in May, from 61.7% to 58.6%. Only 16.4% of the people surveyed had a positive view of the economy on a short-term basis. Relatively high energy and food prices also acted as a drag on consumer spending.

There continues to be concern about the ability of the weaker European economies to meet their sovereign debt obligations. The European Central Bank and other institutions have continued to work with Greece to help it solve its fiscal problems and to preserve the integrity of its sovereign debt. There are also concerns about the debt of Ireland, Spain and Portugal and, recently, Italy. Substantial amounts of the debt of these countries are held by European financial institutions. The concern is that a default on the debt would trigger a financial crisis among significant European banks and insurance companies. Although progress has been made in dealing with Greece's issues, it is too soon to know whether these solutions will be effective. The integrity of the sovereign debt of the United States is also threatened by the possibility that it will not be possible to reach an agreement to raise the debt ceiling, leading to a default.

In the midst of this fairly subdued background, U.S. companies have continued to do remarkably well. The S&P 500 companies had operating earnings of \$84.89 per share in 2010 and are expected to earn nearly \$100 per share in 2011, an 18% increase. The S&P projects earnings of \$113 per share in 2012. At June 30, on a trailing 12-month basis, the S&P 500 was selling at 14.9 times earnings. Based on 2011 expected earnings, the S&P 500 at June 30 was selling at a price of 13.3 times earnings, a reasonable valuation.

Looking forward, the key issue is whether the headwinds affecting the economy are temporary in nature or not. Weak housing and employment have been with us now from the inception of the recession. The slow housing recovery is anything but typical and reflects the major bubble in housing prices which we experienced in the period up to 2007. It is clearly taking a good deal of time to work through the housing excess and to deal with the debt taken on in headier times, the long and painful process of "de-leveraging." The lack of job growth is troubling. Corporate profits have snapped back very strongly and given corporations room to hire. However, that has not happened – at least not in numbers significant enough to make a major difference. The explanation seems to be the different experiences of large businesses, which have been able to recover rapidly, compared to smaller businesses, which have recovered much less quickly. Bank lending, an important source of capital for smaller business, has continued to decline, robbing smaller companies of the resources they need to grow and hire. Unless the growth of employment improves, the growth of the economy will continue to be slow and equity prices are likely to be weaker. In fact, after the announcement of June's employment numbers, the stock market sold off sharply and has continued to trend down. We expect stock market returns to be subdued until there are signs that the pace of growth has accelerated. We will continue to focus our investments on high quality companies with strong balance sheets able to withstand difficult times.

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