Quarterly Update

July 2005

Brattleboro ◆ Burlington ◆ Rutland ◆ St. Albans ◆ Stowe

Financial Markets Summary & Outlook

Greg M. McConahey, Trust Investment Committee & Portfolio Manager

Through early July, the 2005 environment for investors has been challenging. First quarter corporate earnings exceeded expectations, intermediate and longer term interest rates are lower than expected and the U.S. dollar has strengthened against the euro and the yen. In a vacuum, these factors would seem to support higher stock prices. However, the bull market advance that began in October of 2002 is now 33 months old and the historical average duration for bull markets is 36 months. The broad based advance of 2003 and 2004 has given way to a market that has seen far fewer sectors advancing in 2005. The Federal Reserve Board has now raised both the Federal Funds Rate and the Discount Rate 2.25% since June 30, 2004. This measured increase was initially prompted partially in an attempt to slow down the roaring housing market and more recently to address inflationary concerns. Interestingly, fixed mortgage rates are still historically attractive and demand from baby boomers for retirement/second homes continues to support the housing market.

Federal Reserve interest rate tightening generally has a lagging impact on economic activity of 9 to 12 months. Given the historically low level from which the current tightening began, expectations are for domestic U.S. gross domestic product growth to continue to expand by 3-3.5% over the course of this year and next. This expected rate is down from 2004's 4.4%, but is superior to most other developed countries' own forecasted growth rates. Investors seem to be grappling with the question of whether the Fed can successfully navigate the desired slowdown without doing more serious damage to the economy? The yield curve has flattened over the last year with rates on short term Treasury Bills now over 3% and rates on 10 and 30 year Bonds between 4% and 4.5%. The slope of the yield curve and absolute level of longer rates seems to support the Fed's assertion that inflation is well contained on a longer term basis. A slowdown in the growth of the manufacturing sector is already upon us as evidenced by June's Institute of Supply Management's PMI reading of 53.8 compared to June of 2004 at 61.2. A reading above 50 indicates that the manufacturing economy is generally expanding; below 50 indicates that it is generally contracting.

The equity market would welcome a conclusion of the current tightening. Since the rate increases began last June, the S&P 500 Index has appreciated 5.5% in the face of record corporate profits. Based on work compiled by Crandall, Pierce & Company, since 1970, the S&P 500's annualized return during periods of rising rates was 1.8% while the market returned almost 7% during periods of declining rates. Recently investors have become more risk adverse in the face of a slowing economy, rising short term rates and increasing inflationary pressures. Our portfolios have benefited in this defensive climate by our decision to be slightly overweight in healthcare, consumer staples, industrials and energy while underweighting technology, consumer discretionary and utilities. We favor high quality large cap companies that are selling at reasonable valuations compared to their earnings growth prospects. Valuation levels for the S&P 500 Index are more reasonable with the price earnings ratio based on forward 12 month earnings at close to 16.

We remain cautiously optimistic about the prospects for the equity market over the balance of this year realizing that there will be concerns du jour such as hedge fund mismanagement, terrorist attacks or pension default issues that could derail this forecast. We remain hopeful that the Fed tightening will be concluded by this fall allowing for sustained economic expansion over the balance of this year and into 2006. We continue to believe that equities will outperform bonds this year, but are reminded of the rewards of staying patient as most of 2004's returns in the equity market were achieved in the last quarter of the year.

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Colleague Profile

Enosburg Falls, c. 1900

Mary Ann McDermott Reynolds

When we decided to profile everyone in the company, we didn't have a plan regarding who would be profiled first. Perhaps we should mix it up by location, type of job or other sensible reasons? This didn't happen. For the most part, the least reticent determined the order. So perhaps it is no accident that the Vermonters are now being profiled as we wind down the list. Aren't Vermonters more reticent, at least compared to those of us from New York?

As we do these profiles, we learn new things about people we have worked with for years. Sometimes, we even dispel stereotypes. We also discover how much we all have in common.We assumed at least two thirds of us chose Vermont because that's the percentage from out-of-state. What we are discovering is that ***all*** of us chose Vermont, natives and flatlanders alike. We assumed that some of us chose our professions because they provided a living wage to allow us to stay in Vermont. What we are discovering is that we all seemed to have chosen the work we do here because we like it.

So it is in this context that we are pleased to feature a self-professed "Vermont Girl": **Mary Ann McDermott Reynolds.** Mary Ann was born the middle child of five children in Enosburg Falls, VT, a farming community with a population of approximately 1,500. Like many towns in the northern part of the state, the town's cultural norms are influenced by Canada and immigration: French Canadian (17.5%), French (17.1%), United States (15.9%), English (14.2%), Irish (8.7%) and German (3.0%).

Hence the norm of tight-knit families who settle within an easy drive to the Sunday get-togethers. This, in part, accounts for why Mary Ann lives and works nearby, since family and friends are very important to her. Although she is strongly inclined to avoid parochialism, she is drawn, with mixed emotions, to the sameness of small town life while she yearns for other places to visit. Mary Ann loves to travel. It's one of her passions, which she has refined over the years: extensive research , never the same place twice, avoid large numbers of people, and not too much "*cement*". Rome only gets two days, Sienna three, and an obscure hill town, one week.

She likes traveling much the same way she likes work. As a trust administrator working primarily in our St. Albans office, she is drawn to the lack of repetition, and the intellectually stimulating parts of her job. Like traveling, each day is different and presents new experiences and challenges.

Mary Ann wandered into trust work. After graduating from Champlain College, she worked at a law firm, then as a teller at Peoples Trust in St. Albans and on to Franklin-Lamoille Bank where she eventually landed in the Trust Department. In 1992 she joined the Vermont National Bank Trust Department. Less than two years after the merger with Chittenden, she left to join us in opening our St. Albans office.

Mary Ann and her husband, John Michael, live in Sheldon, which is half way between Enosburg and St. Albans. She has two children and two grandchildren and does not see leaving Vermont in retirement (which fortunately is many years away).

Like most of us, she is drawn to the four seasons, but with a little twist that reflects the traveler in her: she is always looking forward to the next season and she loves the ever-changing landscape. This is a landscape that draws her to gardening, biking, Nordic walking, kayaking, and the family camp at Lake Carmi in the warm seasons, and snowshoeing, downhill skiing, and cross-country in the winter months.

When we interviewed Mary Ann for this article, we were struck by how much resonated with us; the love of the countryside; the love of the constancy of relationships found in small towns, and an awareness of the downside of sameness and repetition. She, like her colleagues, is energized by the rewards of helping her clients, and saddened when a parking lot replaces an open field.