

Capital Market Review

Third Quarter, 2010

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Summary

Economic growth has lost momentum. While a double dip recession remains unlikely, the possibility has increased. Second quarter real GDP was 1.5%, about ½ the 3% pace experienced when the recession ended a year ago.

Interest rates declined during the third quarter and the 10-year Treasury bond now stands at about 2.5%. During the quarter, developed international bonds rebounded strongly from fears associated with the European debt crisis and returned 10.4%. Emerging market bonds continued their winning ways with a return of 8.2%, followed by the U.S. bond market return of 2.5%.

Stocks were quite volatile during the third quarter but strong returns in July and September offset poor returns in August. Overall, U.S. stocks returned 11.5% during the third quarter and are now in positive territory on a year-to-date basis. Developed international and emerging market stocks performed even better with returns of 16.5% and 17.2%, respectively. Commodities and real estate also had strong third quarter performance with returns of 11.6% and 13.3%, respectively.



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Economic Conditions

Most economic indicators are still positive -- but just less so when compared to three months ago. Leading indicators, retail sales, industrial production, and the Philadelphia Fed survey all fall into this category. Housing starts and sales of new single family homes have started to rebound after the expiration of the various real estate tax credits. Stock market volatility has been declining and investor sentiment appears to be slightly more bullish toward stocks.

Private sector job growth, while positive, remains anemic and needs to approximately double in order to begin reducing the unemployment rate. Unfortunately, businesses, while very profitable, remain extremely cautious due to general economic conditions as well as significant policy and regulatory uncertainty.

One of the greatest unknowns is with respect to the tax code. The Bush tax cuts are to expire at the end of this year unless Congress acts. While the most important aspects deal with individual income tax rates, capital gains, dividends, personal exemptions, the marriage penalty and the alternative minimum tax would all be affected if the Bush tax cuts expire.

There is wide agreement that allowing the tax cuts to expire makes little sense given the economy's fragility. Doing so would significantly increase the chances of a second recession. But that is where the consensus ends. Perhaps the best scenario is to extend the cuts for a year and re-visit the issue in 2011 under the assumption that the economy will be somewhat stronger. Stay tuned.

As a policy stimulus, the FED is discussing an additional dose of quantitative easing (purchasing long-term Treasury bonds to further lower interest rates), but the effectiveness of such a policy is questionable. The goal is to lower longer-term interest rates (such as mortgages) to encourage more real estate investment, stabilize stock prices, and encourage lending.

Stock Market

Developed and emerging market stocks were the best performing nationality categories during the third quarter. On a year-to-date basis, emerging market stocks remain the best performing category followed by the U.S. market.

Within the U.S. market, mid-cap stocks continued their dominance both during the quarter and on a year-to-date basis. The growth approach outperformed the value approach during the third quarter but, year-to-

date, returns are identical between the value, core, and growth approaches.

Telecommunications, Materials, Consumer Discretionary, and Industrial stocks were the best performing during the third quarter. Finance, Health care and Consumer Staples were the laggards.

Overall, the U.S. stock market appears to be fairly valued. However, we do believe there are pockets of opportunity. While expected earnings growth for large-cap stocks is lower than mid and small-cap stocks, so are the valuation multiples. In fact, on many valuation metrics, large-cap stocks are selling at a significant discount to mid- and small cap stocks. The challenge is one of timing as valuation discrepancies can exist for a long period of time.

Bond Market

During the third quarter, bond returns were particularly strong in the developed and emerging markets (as fears of the European debt crisis subsided) but were positive in the U.S. as well. Long-term bonds were the best performing maturity segment while corporate bonds were the best performing sector. High yield bonds also had strong third quarter results.

There has been significant discussion about a "bond bubble" meaning that bonds are in extremely over-valued territory. In our opinion, longer-term investors have cause to be concerned. We know that today, when adjusted for inflation, Treasury bond investors with less than five-years to maturity, are receiving a negative return (5-year Treasury yield of 1.28% versus inflation rate in the 1% to 1.5% range). If inflation begins to rise (and interest rates do not rise with it), more investors will be receiving a negative real (after inflation) return -- and investors will not tolerate that condition for long periods of time. In addition, the flows into bonds and bond mutual funds have rivaled the flows that went into internet stocks in the late 1990's -- and we know how well that turned out for investors. Unfortunately, fund flows tend to be a contrarian indicator.

I believe the bond bubble bursting in the next six months is unlikely given the lack of inflation and general state of the economy. However, our economy will eventually heal and interest rates will eventually rise. The question remains one of timing.

Stock Returns For Periods Ending September 30, 2010

	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>Ytd</u>	<u>3 Year</u>
<u>Nationality</u>						<u>Developed Country</u>			
U.S. Market	11.5%	4.8%	11.0%	-6.6%	0.9%	U.S.	11.0	2.5	-7.6
Developed Intl	16.5	1.1	3.3	-9.5	2.0	Canada	12.7	5.9	-2.8
Emerging Market	17.2	8.7	17.7	-3.7	10.2				
<u>Size</u>						<u>Europe</u>			
Large	11.6	4.4	10.8	-6.8	0.9	France	20.6	-7.9	-12.2
Mid	13.3	11.0	17.5	-4.2	2.6	Germany	16.6	-3.2	-12.3
Small	11.3	9.1	13.3	-4.3	1.6	Italy	19.2	-15.3	-19.3
Micro	8.7	11.4	8.9	-5.8	-0.5	United Kingdom	18.8	-0.3	-11.3
<u>Approach</u>						<u>Pacific</u>			
Value	10.1	4.8	9.2	-9.0	-0.4	Australia	22.0	1.0	-5.6
Core	11.5	4.8	11.0	-6.6	0.9	Hong Kong	21.1	14.7	-1.3
Growth	13.0	4.8	12.8	-4.3	2.1	Japan	5.0	1.2	-9.6
<u>Sector</u>						<u>Emerging Market</u>			
Cons Discretionary	15.2	13.3	23.6	-1.4	2.1	China	10.1	1.7	-4.8
Cons Staples	10.6	7.5	12.9	2.8	6.5	India	15.0	17.1	3.9
Energy	12.9	-0.8	4.7	-8.4	2.6	Korea	17.0	11.1	-5.3
Finance	4.3	0.5	-2.8	-23.3	-11.2	Czech Republic	15.3	-4.1	-10.5
Healthcare	8.9	-0.7	8.3	-2.8	1.4	Hungary	27.0	-1.4	-13.9
Industrials	14.3	13.3	19.4	-7.7	1.9	Poland	34.8	8.6	-13.2
Technology	11.8	0.0	10.7	-2.7	3.2	Russia	13.1	0.6	-14.4
Materials	17.8	2.7	10.2	-6.0	6.0	Brazil	21.0	1.1	7.0
Telecomm	21.0	10.8	19.1	-7.3	5.1	Chile	32.4	34.4	13.7
Utilities	12.3	4.3	11.9	-3.7	2.5	Mexico	11.2	8.4	-4.1

Stock Fundamentals As Of September 30, 2010

	<u>United States</u>		<u>Developed</u>		<u>Emerging</u>	
	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>
Price/Earnings Current	13.9	16.6	13.1	13.5	13.4	n/a
Price/Forecast Earnings	13.2	16.2	11.6	15.4	12.6	14.0
Price/Book	1.9	2.1	1.4	1.5	1.9	n/a
Price/Cash Flow	7.9	8.2	5.9	6.8	6.6	n/a
Price/Sales	1.1	1.1	0.8	0.7	1.2	n/a
Forecast LT EPS Growth	10.0	10.4	9.1	29.9	17.2	13.4
	<u>2010 Expected EPS</u>	<u>2011 Expected EPS</u>	<u>2011 EPS Growth</u>	<u>2010/2011 PE Ratio</u>	<u>Estimated Return PE Ratio = 15x</u>	
Large	\$82.75	\$93.96	13.5%	12.5x to 14.2x	5.7% to 20.1%	
Mid	43.44	53.16	22.4%	15.4x to 18.8x	-20.4% to -2.6%	
Small	17.46	23.01	31.8%	16.3x to 21.5x	-30.0% to -7.9%	

Bond Returns And Characteristics For Periods Ending September 30, 2010

	<u>Returns</u>					<u>U.S. Bond Yields</u>	<u>Last</u>		<u>I</u>
	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>Qtr</u>	<u>Year</u>
<u>Nationality</u>									
U.S. Market	2.5%	7.9%	8.2%	7.4%	6.2%	Fed Funds	0.19%	0.15%	0.07%
Developed Intl	10.4	8.3	5.9	9.2	7.7	Prime Rate	3.25	3.25	3.25
Emerging Market	8.2	14.2	16.1	10.3	9.1	3 Month Treasury	0.16	0.15	1.14
						1 Year Treasury	0.27	0.31	0.4
						3 Year Treasury	0.67	0.99	1.45
						5 Year Treasury	1.28	1.78	2.31
<u>Maturity</u>						10 Year Treasury	2.52	2.97	3.31
Cash	0.0	0.1	0.1	0.9	2.5	30 Year Treasury	3.69	3.94	4.03
Short-Term	0.9	2.9	3.3	4.6	4.7	Aaa Corporate	4.51	4.71	5.04
Intermediate-Term	2.8	7.4	7.8	6.9	5.9	Baa Corporate	5.58	6.09	6.17
Long-Term	5.8	16.7	13.6	10.2	7.3	Barclays Aggregate	3.54	3.68	4.09
						Barclays Credit	4.49	4.71	4.85
						Barclays Treasury.	1.97	2.00	2.44
						Barclays Mortgage.	3.58	3.69	3.53
						Barclays Municipal	3.59	3.71	3.68
						Barclays High Yield	10.16	11.36	12.4
<u>Other</u>						Barclays TIP	2.35	2.98	1.74
High Yield	6.7	11.5	18.4	8.7	8.4	Citi Intl Treasury	2.07	2.51	n/a
Inflation Protected	2.5	7.0	8.9	6.9	5.5	JPM Emerging	4.93	5.36	5.69
Municipal	3.4	6.8	5.8	6.0	5.1				

10-Year Sovereign Bond Yields

Spreads Versus 10-Year Treasury

<u>Developed Mkts</u>	<u>Qtr</u>	<u>Last</u>	<u>Dec</u>		<u>Qtr</u>	<u>Last</u>	<u>I</u>
		<u>Qtr</u>	<u>2009</u>			<u>Qtr</u>	<u>Year</u>
United States	2.54%	3.11%	3.80%	Aaa	1.99	1.74	1.73
Canada	2.86	3.23	3.75	Baa	3.06	3.12	2.86
France	2.70	3.07	3.61	Barclays Aggregate	1.02	0.71	0.78
Germany	2.34	2.64	3.38	Barclays Credit	1.97	1.74	1.54
Italy	3.87	4.03	4.05	Barclays Treasury.	-0.55	-0.97	-0.87
United Kingdom	3.07	3.43	4.14	Barclays Mortgage	1.06	0.72	0.22
Euro Zone	2.34	2.69	3.38	Barclays Municipal	1.07	0.74	0.37
Australia	5.10	5.33	5.74	Barclays High Yield	7.64	8.39	9.09
Hong Kong	1.94	2.31	2.55	Barclays TIP	-0.17	0.01	-1.57
Japan	1.00	1.15	1.33	Citi Intl Treasury	-0.45	-0.46	n/a
				JPM Emerging	2.41	2.39	2.38
<u>Emerging</u>				Maturity (10yr-3yr)	1.85	1.98	1.86
Brazil	6.16	6.16	6.16				
China	3.02	3.10	3.71				
India	8.16	8.12	7.72				
Russia	5.37	5.72	8.01				

Summary of Current Economic & Financial Conditions

	Percent Change					Data As Of
	3 Month % Change	3 Month % Change Annualized	6 Month % Change	6 Month % Change Annualized	1 Year % Change	
	Gross Domestic Product	0.43	1.72	1.35	2.72	
Leading Economic Indicators	0.18	0.73	2.04	4.12	7.30	August
ECRI Weekly Leading Index	0.92	3.74	-7.03	-13.56	-4.57	September
Consumer Sentiment	-6.39	-23.20	-6.39	-12.36	4.87	August
Retail Sales	0.45	1.81	1.98	4.01	3.73	August
Retail Sales Excluding Motor Vehicles	0.86	3.50	1.12	2.25	5.04	August
Industrial Production	0.87	3.53	3.04	6.17	6.21	August
ISM Purchasing Managers Index	-3.20	-12.21	-8.72	-16.69	3.82	September
Number of Unemployed	-0.75	-2.98	-0.07	-0.15	-0.89	August
Announced Layoffs	-5.61	-20.61	-45.05	-69.81	-44.05	September
Output Per Person	0.17	0.68	1.38	2.79	4.86	June
CPI - All Urban Consumers	0.43	1.72	0.26	0.51	1.20	August
PPI - Finished Goods	0.06	0.22	0.50	1.01	3.04	August
KR-CRB Futures Index	8.29	37.52	3.85	7.85	19.55	August
Gold Price	2.96	12.37	14.02	30.00	27.37	September
Oil Price	-0.05	-0.21	-7.30	-14.07	8.42	September
Housing Starts	1.70	6.98	-1.16	-2.30	2.22	August
New Single Family Home - Sales	2.13	8.79	-17.00	-31.11	-28.89	August

Actual Value / Diffusion Index

	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	
Phili Fed Survey - General Activity - 6 Months Ahead	26.30	40.20	52.00	46.10	September
Phili Fed Survey - New Orders - 6 Months Ahead	20.70	39.70	45.20	45.50	September
Capacity Utilization - Total	74.70	74.02	72.36	69.97	August
Unemployment Rate	9.60	9.70	9.70	9.70	August
Manpower Employment Outlook Survey	5.00	6.00	0.00	0.00	December
AAII Percent Bullish Investor Sentiment	42.53	43.87	30.11	20.94	September
AAII Percent Bearish Investor Sentiment	31.61	31.61	42.47	57.07	September
AAII - Stock Allocation Survey	55.20	52.90	59.10	55.10	September
S&P 500 PE	17.30	16.09	19.01	42.12	October
VIX - Volatility Index	26.05	32.07	19.50	26.01	August
3 Month Treasury Yield	0.16	0.15	0.16	0.11	September
1 Year Treasury Yield	0.27	0.31	0.44	0.40	September
5 Year Treasury Yield	1.28	1.78	2.60	2.31	September
10 Year Treasury Yield	2.52	3.20	3.73	3.31	September
30 Year Treasury Yield	3.69	3.94	4.75	4.03	September
Aaa Corporate Bond Yield	4.51	4.71	5.37	5.04	September
Baa Corporate Bond Yield	5.58	6.09	6.36	6.17	September
Quality Spread (Baa - Aaa Bond Yield)	1.07	1.38	0.99	1.13	September
Term Spread (10 Year - 1 Year Treasury Yield)	2.25	2.89	3.29	2.91	September
Real Yield Spread (10 Yr TBond- 1 Yr Expected Infl)	-0.18	0.40	1.03	1.11	September