Capital Market Review

Third Quarter, 2011

Summary

There was a lot of news during the third quarter -- the vast majority of it unfortunately negative. While an agreement to extend the U.S. debt limit was finally reached, the "sausage making" was in full view and the public did not like it. Standard and Poors downgraded the rating of U.S. debt to AA+ from AAA. There appears to be no common ground in Washington which creates all types of uncertainty and risk of significant policy changes. The European debt crisis became front page news. Lastly, U.S. economic conditions worsened leading many to claim another recession was at hand.

Needless to say, the markets did not like all of the uncertainty. Volatility spiked to very high levels. During the quarter, U.S. stocks returned -15.3%, U.S. bonds were up 3.8%, commodities returned -11.3%, and real estate returned -14.5%. Year-to-date, U.S. stocks are down -9.9%, U.S. bonds returned 3.8%, while commodities and real estate returned -13.6% and -5.7%, respectively.

We do not expect another recession to happen. While growth is subpar, it is occurring. On a variety of measures, we find the stock market attractive over a twelve-month holding period.

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Economic Conditions

The U.S. is in what many people are calling a "growth recession". Economic growth remains positive, but just barely. Headwinds to economic growth include little improvement to employment and real estate, the sovereign debt crisis, consumers paying down debt (instead of spending), and the uncertainty created by deep political divisions.

The good news is that corporations have strong balance sheets and are quite profitable. I believe if businesses were provided with a more certain tax and regulatory environment, in which they could make educated, multi-year decisions, we would see more hiring.

I'm not sure anyone could have predicted the drama that occurred in reaching agreement to extend the U.S. debt limit. In response to this daily, front-page battle, businesses seemed to retrench overnight and consumer confidence fell off a cliff. In downgrading U.S. debt, Standard and Poors used current political polarization as one of their reasons (they are rightfully concerned about the U.S.'s ability to make difficult, long-term financial decisions).

This political uncertainly will likely continue until the next election. However, Congress and the administration must soon find common ground on extending unemployment insurance benefits and extending the payroll tax holiday. If they do not, estimates are for a decline in real GDP of 1.7%, which would likely be enough to tip the economy back into recession.

Additional concerns about Greece and some of the weaker European nations just added to an already skittish market. While the Europeans are moving painfully slow, it appears that the most likely path is some form of "orderly" default on Greek debt (a Greek default is almost certainly going to happen -- the goal is to prevent contagion to some of the other weaker countries).

There will likely be some form of bank recapitalization with public money (similar to what the U.S. did at the time of the Lehman bankruptcy). At that time, in exchange for low-cost capital, banks had to increase their capital ratios and give various types of ownership interests to the "investing" entities. The process restored confidence to the U.S. banking system and the panic ended. U.S. taxpayers have since recouped all the funds invested to the banks plus a profit. What makes the European situation particularly difficult, and time consuming, is that it is only a monetary union (not a fiscal or political union). Individual countries still have substantial say over their own policies.

Longer term, do not expect a quick turnaround to robust economic growth. Professor's Reinhart and Rogoff (leading experts on financial crises) note that high levels of debt (like we currently have around the world) are historically associated with slower economic growth. It will take time (maybe five to ten years according to the paper) for countries to lower their debt burden and for higher levels of sustainable economic growth to resume. In the musical Joseph, it was seven years of feast followed by seven years of famine.

Stock Market

Stock markets – worldwide – did not respond well to the increase in uncertainty and slowing economic growth. The volatility index (VIX), or fear gauge, increased to levels not seen since 2008 and only a few times prior to that. With each headline coming out of Europe, it seemed the market would trade up or down by a few hundred points.

During the third quarter, U.S. stocks returned -15.3%, developed international returned -19.0%, and emerging market stocks returns -23.2%. Year-to-date, U.S., developed international, and emerging market returns are -9.9%, -15.0%, and -23.5%, respectively.

During the third quarter, the large stock return of -14.7% outperformed the mid- and small-company stock returns of -18.9% and -21.9%, respectively. Year-to-date, large stocks returned -9.3% while mid-cap stocks returned -12.3% and small-cap stocks returned -17.0%.

Growth stocks continued to outperform Value. During the third quarter, growth stocks returned -13.9% while Value stocks returned -16.6%. On a year-to-date basis, returns have been -7.9% and -11.9% to the Growth and Value styles, respectively.

Economically sensitive sectors such as Materials, Finance, Industrial, and Energy were the worst performing sectors during the third quarter with returns of -24.5%, -22.8%, -21.0%, and -20.5%, respectively. Utilities, Consumer Staples, and Technology were the best performing sectors with returns of 1.6%, -4.2%, and -7.7%. Year-to-date, Finance and Materials are the clear laggards with returns of -25.2% and -21.8%, respectively. Utilities, Consumer Staples, and HealthCare have been the best performing sectors with returns of 10.7%, 3.4%, and 2.5%.

To a degree, the equity market has already priced in a minor recession. During a recession, earnings typically fall by 15% (on average). Assuming a price/earnings multiple of 13x and 14x, and recessionary earnings, the market could decline by an additional -5% to -12%. If a recession is avoided and forecast 2012 earnings are achieved, returns could be in the 20% range or higher.

As an alternative to using price/earnings multiples we can capitalize earnings to develop a return estimate. Using this methodology, recessionary earnings would produce a -2.7% return and returns using 2012 forecast earnings (if they are achieved) would produce a return of over 20%.

In addition, during the quarter, stock dividend yields increased above the 10-year U.S. Treasury yield. According to Standard and Poors, this has only ocurred 20 times since 1953. In each instance, one-year forward, stock prices were higher (on average by 20%).

Our conclusion? There is not much downside left if an "average" recession occurs. And, if there is any upside economic surprise, that will likely benefit equity returns. Within the various company size segments, we believe that large-company stocks will outperform mid- and small-company stocks.

Bond Market

In early August, Standard and Poors downgraded the debt of the United States from AAA to AA+. The other two major bond rating agencies have not taken any action. After the downgrade, as a result of the European sovereign debt crisis and concerns about the strength of the U.S. economy, money flowed into U.S. Treasury bonds pushing interest rates lower (it is not often you get to pay lower interest rates after being downgraded).

Whether one agrees or disagrees with the action taken by Standard and Poors, one thing is clear – the current financial trajectory of the United States is not sustainable. While the issues do not have to be fixed today, the longer we wait, the more difficult the medicine will be to swallow.

The FED allowed its quantitative easing program to end in June, but has initiated a new program called Operation Twist. Between now and June of 2012, the FED will be selling $400 billion of short-term Treasuries and will use the proceeds to purchase longer-term bonds. While there is no new net money being created, the goal is to push the yields on longer-term bonds down -- creating more demand from longer-term borrowers (such as mortgages and business loans).

During the quarter, the U.S. bond market returned 3.8%, ahead of the developed international bond return of 1.5%, and the emerging market bond return of -2.1%. Year-to-date, bond returns are 6.7%, 6.2%, and 2.6% for the U.S., developed international and emerging market bonds, respectively.

During the quarter, long-term bond yields declined an amazing 1.36%, leading to long-term bond returns of 15.6%. At the end of the quarter, a U.S. Treasury bond investor would receive a whopping 3.0% for the next 30 years.

In terms of sector returns, government bonds returned 5.9% as a result of the "flight to quality" trade. Investment grade corporate bonds returned 3.0% while mortgage-backed bonds returned 2.4%. High yield bonds was the worst performing bond segment returning -6.1%.

Stock Returns For Periods Ending September 30, 2011

	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	-15.3%	-9.9%	0.6%	1.5%	-0.9%
Developed Intl	-19.0	-15.0	-9.4	-1.1	-3.5
Emerging Market	-23.2	-23.5	-18.1	3.8	2.5
Size					
Large	-14.7	-9.3	0.9	1.6	-0.9
Mid	-18.9	-12.3	-0.9	4.0	0.6
Small	-21.9	-17.0	-3.5	-0.4	-1.0
Micro					
Approach					
Value	-16.6	-11.9	-2.2	-1.6	-3.5
Core	-15.3	-9.9	0.6	1.5	-0.9
Growth	-13.9	-7.9	3.4	4.5	1.6
Sector					
Cons Discretionary	-13.0	-5.7	6.2	9.5	1.6
Cons Staples	-4.2	3.4	9.7	5.7	6.3
Energy	-20.5	-11.4	7.6	-1.2	3.4
Finance	-22.8	-25.2	-16.5	-14.7	-17.5
Healthcare	-10.0	2.5	6.3	3.5	1.2
Industrials	-21.0	-14.7	-4.6	-0.2	-1.4
Technology	-7.7	-5.8	3.8	7.6	3.3
Materials	-24.5	-21.8	-6.9	-0.6	1.1
Telecomm	-8.0	-1.5	5.7	8.0	1.5
Utilities	1.6	10.7	12.0	5.2	3.9

	Qtr	1 Year	3 Year
Developed Country			
U.S.	-15.3%	0.6%	1.5%
Canada	-21.1	-10.5	-1.3
Europe	-22.6	-11.8	-2.8
France	-31.8	-22.0	-10.2
Germany	-31.9	-16.9	-8.2
Italy	-32.9	-29.4	-17.5
United Kingdom	-19.7	-12.3	-4.4
Pacific	-11.7	-4.3	2.4
Australia	-22.0	-0.9	-3.8
Hong Kong	-23.3	-22.2	3.7
Japan	-9.4	-4.4	-2.8
Emerging Market			
China	-28.6	-28.7	0.8
India	-21.8	-27.5	6.0
Korea	-25.9	-10.3	7.5
Czech Republic	-24.1	-13.6	-12.0
Hungary	-44.1	-39.1	-17.7
Poland	-36.7	-27.8	-13.2
Russia	-32.8	-15.4	-6.0
Brazil	-30.1	-30.8	-1.5
Chile	-27.8	-25.1	10.4
Mexico	-22.0	-10.0	1.4

Stock Fundamentals As Of September 30, 2011

	United States		Developed		Emerging	
	Current	1 Year Ago	Current	1 Year Ago	Current	1 Year Ago
Price/Earnings Current	12.7	13.9	11.6	13.1	10.7	13.4
Price/Forecast Earnings	11.9	13.2	10.2	11.6	11.0	12.6
Price/Book	1.8	1.9	1.3	1.4	1.8	1.9
Price/Cash Flow	8.1	7..9	6.3	5.9	6.4	6.6
Price/Sales	1.1	1.1	0.8	0.8	1.1	1.2
Forecast LT EPS Growth	10.3	10.0	2.0	9.1	16.4	17.2

	Est. P/E Ratio		Est. EPS Growth		2011 Forecast Returns			2012 Forecast Returns		
	2011	2012	2011	2012	15x	20x	7% DR	15x	20x	7% DR
Large	11.6	10.3	16.2	13.2	29.1	72.1	22.9	46.1	94.7	39.1
Mid	15.0	12.0	19.0	24.3	0.3	33.8	-4.5	24.7	66.2	18.7
Small	16.5	12.8	26.9	29.2	-9.0	21.3	-13.3	17.6	56.8	12.0

Bond Returns And Characteristics For Periods Ending September 30, 2011

	Returns					U.S. Bond Yields	Qtr	Last Qtr	1 Year Ago
	Qtr	Ytd	1 Year	3 Year	5 Year				
Nationality						Fed Funds	0.08%	0.07%	0.19%
U.S. Market	3.8%	6.7%	5.3%	8.0%	6.5%	Prime Rate	3.25	3.25	3.25
Developed Intl	1.5	6.2	4.7	9.0	8.3	3 Month Treasury	0.02	0.02	0.16
Emerging Market	-2.1	2.6	0.8	11.6	7.7	1 Year Treasury	0.11	0.19	0.27
						3 Year Treasury	0.43	0.79	0.67
Maturity (Government/Credit)						5 Year Treasury	0.98	1.70	1.28
Cash	0.0	0.1	0.1	0.2	1.6	5 Year TIP	-0.56	-0.30	-0.02
Short-Term	0.3	1.4	1.3	3.6	4.2	10 Year Treasury	1.99	3.14	2.52
Intermediate-Term	2.4	4.9	3.4	7.0	5.9	30 Year Treasury	3.03	4.39	3.69
Long-Term	15.6	19.4	12.7	14.9	9.4	Aaa Corporate	4.10	5.13	4.51
						Baa Corporate	5.38	5.89	5.58
Sector (Intermediate Maturity)									
Corporate	3.0	6.5	4.6	11.7	6.7	Barclays Aggregate	3.23	3.39	3.54
Government	5.9	8.1	5.6	6.4	6.6	Barclays Credit	4.28	4.40	4.49
Mortgage	2.4	5.3	5.6	7.0	6.7	Barclays Treasury	1.74	1.97	1.97
						Barclays Mortgage	3.34	3.33	3.58
Other						Barclays Municipal	2.99	3.44	3.59
High Yield	-6.1	-1.4	1.8	13.8	7.1	Barclays High Yield	7.87	8.25	10.16
Inflation Protected	4.5	10.6	9.9	8.1	7.1	Citi Intl Treasury	2.90	2.36	2.07
Municipal	3.8	8.4	3.9	8.1	5.0	JPM Emerging	5.10	4.97	4.93

10-Year Sovereign Bond Yields

Developed Mkts	Qtr	Last Qtr	Sep 2010
United States	1.87%	3.14%	2.54%
Canada	2.16	3.08	2.86
France	2.60	3.39	2.70
Germany	1.76	2.98	2.34
Italy	5.73	4.95	3.87
United Kingdom	2.40	3.24	3.07
Euro Zone	1.77	2.99	2.34
Australia	4.21	5.19	5.10
Hong Kong	1.29	1.96	1.94
Japan	0.97	1.10	1.00
Emerging			
Brazil	12.00	N/A	N/A
China	4.02	4.08	3.02
India	8.48	8.46	8.16
Russia	4.73	4.73	5.37

Spreads Versus 10-Year Treasury

	Qtr	Last Qtr	1 Year Ago
Aaa	2.11	1.99	1.99
Baa	3.39	2.75	3.06
Barclays Aggregate	1.24	0.25	1.02
Barclays Credit	2.29	1.26	1.97
Barclays Treasury.	-0.25	-1.17	-3.75
Barclays Mortgage	1.35	0.19	1.06
Barclays Municipal	1.00	0.3	1.07
Barclays High Yield	5.88	5.11	7.64
Citi Intl Treasury	0.91	-0.78	-0.45
JPM Emerging	3.11	1.83.	2.41
Maturity (10yr-1yr)	1.88	2.95	2.25
Implied Inflation	1.54	2.00	1.30

Commodity, Real Estate, & Currency Returns
For Periods Ending September 30, 2011

	Qtr	Ytd	1 Year	3 Year	5 Year
Commodity					
DJ UBS Commodity	-11.3%	-13.6%	0.0%	-5.7%	-1.1%
CRB Commodity Spot	-8.5	-3.1	3.4	6.9	7.9
CRB Fat & Oils	-4.7	15.7	14.1	9.0	15.7
CRB Foodstuffs	-5.1	4.4	6.1	7.1	11.4
CRB Livestock	-1.7	21.0	21.2	9.9	10.9
CRB Metals	-16.9	-14.1	-1.4	8.7	6.1
CRB Raw Industrials	-10.8	-8.1	1.6	6.8	5.5
CRB Textiles & Fibers	-9.5	-11.9	-5.2	6.6	4.2
Agriculture					
Coffee	-0.8%	16.1%	24.1%	25.2%	20.3%
Corn	4.9	38.8	64.0	10.1	24.9
Soybean	-0.8	12.9	31.3	6.6	20.2
Sugar	11.8	3.4	11.5	19.6	13.2
Wheat	1.8	16.7	30.1	0.4	13.1
Energy					
Oil	-11.1%	-3.9%	13.7%	-6.3%	6.0%
Unleaded Gas	-3.7	13.2	27.2	-1.5	8.2
Metals					
Aluminum	-10.3%	-2.7%	5.6%	-3.1%	-1.6%
Copper	-8.5	-9.3	7.4	6.0	1.7
Gold	15.9	27.4	39.4	28.8	24.3
Nickel	-9.1	-15.4	-10.2	4.6	-7.3
Zinc	-7.1	-9.3	-3.5	6.0	-9.4
Real Estate					
MSCI U.S. Reit	-14.5%	-5.7%	1.3%	-1.7%	-2.6%
MSCI World Reit	-16.6	-12.7	-6.4	-0.9	-4.8
Currency		**U.S. Dollar Return**			
Euro	4.5%	-4.0%	-5.0%	1.4%	-1.6%
Japan	-4.5	-7.8	-8.9	-10.3	-8.1
U.K.	2.7	-1.2	-1.2	4.2	3.5
Brazil	10.2	2.9	1.6	-1.1	-4.2
China	-1.3	-3.9	-5.2	-2.2	-4.2
India	6.3	5.6	3.8	1.5	0.7
Mexico	10.5	5.3	2.0	7.0	3.5

Summary of Current Economic & Financial Conditions

	Percent Change					
	3 Month % Change	3 Month % Change Annualized	6 Month % Change	6 Month % Change Annualized	1 Year % Change	Data As Of
Gross Domestic Product	0.33	1.33	0.42	0.84	1.63	June
Leading Economic Indicators	1.22	4.97	2.38	4.81	5.54	August
ECRI Weekly Leading Index	-6.97	-25.11	-6.80	-13.13	-2.60	October
Personal Income	0.24	0.96	1.38	2.78	4.45	August
Retail Sales	1.86	7.67	2.20	4.46	8.07	September
Retail Sales Excluding Motor Vehicles	1.47	6.03	2.30	4.65	7.96	September
Industrial Production	1.13	4.59	1.69	3.40	3.32	August
Number of Unemployed	-0.67	-2.67	3.32	6.76	-5.11	September
Announced Layoffs	179.33	5,987.52	178.68	676.62	211.51	September
Output Per Person	0.10	0.41	-0.41	-0.83	1.05	June
CPI - All Urban Consumers	0.65	2.63	1.80	3.63	3.76	August
Personal Consumption Expenditures	0.17	0.68	0.69	1.38	2.24	June
PPI - Finished Goods	0.10	0.42	1.70	3.43	6.51	August
CRB Commodity Spot Index	-3.60	-13.63	-3.81	-7.48	19.52	August
Gold Price	16.24	82.60	27.91	63.60	44.41	August
Oil Price	-14.80	-47.31	-3.63	-7.12	12.38	August
Housing Starts	3.26	13.67	10.23	21.51	-5.78	August
New Single Family Home - Sales	-4.22	-15.84	4.98	10.21	6.12	August
New Single Family Home - Median Price	-0.02	-0.08	-1.29	-2.56	-7.55	August

	Actual Value / Diffusion Index				
	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	
Phili Fed Survey - General Activity - 6 Months Ahead	21.40	2.50	63.00	28.20	September
Phili Fed Survey - New Orders - 6 Months Ahead	21.60	7.90	60.10	23.10	September
Consumer Sentiment	55.70	74.30	77.50	68.90	August
ISM Purchasing Managers Index	50.60	53.50	61.40	55.18	August
Capacity Utilization - Total	77.40	76.64	76.99	75.72	September
Unemployment Rate	9.10	9.20	8.80	9.60	September
AAII Percent Bullish Investor Sentiment 8 Week Average	33.05	36.00	37.49	47.41	October
AAII BullBear Investor Sentiment Spread	-10.48	6.42	7.25	29.63	October
S&P 500 PE	14.94	17.13	17.21	15.90	October
S&P 500 PE Using 10 Year Average Earnings	19.39	22.60	23.14	21.23	October
VIX - Volatility Index	31.62	15.45	18.35	26.05	August
3 Month Treasury Yield	0.02	0.02	0.10	0.16	September
1 Year Treasury Yield	0.11	0.19	0.30	0.27	September
5 Year Treasury Yield	0.98	1.70	2.21	1.28	September
10 Year Treasury Yield	1.99	3.14	3.47	2.52	September
30 Year Treasury Yield	3.03	4.39	4.52	3.69	September
Aaa Corporate Bond Yield	4.10	5.13	5.16	4.51	September
Baa Corporate Bond Yield	5.38	5.89	6.06	5.58	September
Quality Spread (Baa - Aaa Bond Yield)	1.28	0.76	0.90	1.07	September
Term Spread (10 Year - 1 Year Treasury Yield)	1.88	2.95	3.17	2.25	September
Real Yield Spread (10 Yr TBond- 1 Yr Expected Infl)	-0.71	0.44	0.77	0.32	September