Capital Market Review

Second Quarter, 2012

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Summary
Global economic activity is, once again, slowing. The fiscal troubles in Europe's peripheral countries have now expanded to Spain and Italy. Austerity measures will affect future economic growth for years to come. China's economy, which exports 8% of its GDP to Europe (the U.S. exports 3%) has significantly slowed and is starting to implement pro-growth policies. The U.S., for the third consecutive year, has entered its summer economic slowdown.

U.S. growth is dangerously slow at about 2%. Businesses are in strong financial shape. But with the sting of 2008 still fresh in executives' minds coupled with extreme uncertainty around Europe (will the Euro survive?) and the impending U.S. "fiscal cliff", we understand why executives are striking a cautious tone.

Stock markets did not react well to Europe's latest troubles but rallied late in the quarter. U.S. stock market returns were -3.2% for the second quarter and 9.3% year-to-date. The U.S. investment grade bond market continued to perform well, up 2.1% for the quarter.

We expect heightened volatility during the coming months.

Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Economic Conditions

Global economic activity is slowing. Significant weakness in Europe's peripheral nations are affecting economic growth for the core countries and major emerging market economies. China's economy, which is estimated to have 8% of its GDP exported to Europe, has significantly slowed and has implemented fiscal and monetary measures to try and restore growth. For the third consecutive year, the U.S. has entered its summer economic slump.

Greece may have been the spark that started Europe's financial crisis, but the more significant issues are with Spain and Italy. Due to a falling real estate market, Spanish banks are in financial trouble. Because European banks hold each other's debt, falling asset prices in a country the size of Spain impacts the banking system of many countries. As the solvency of each country's banking system gets brought into question, what started out as a private sector problem, morphs into a sovereign debt problem. Europe is in need of a "big bang" plan that addresses the banking system, sovereign debt, governance, and growth. It is difficult to see a way out without some sort of fiscal union. However, the political calculus necessary to make a fiscal union a reality is incredibly difficult.

Assuming the Euro-zone stays together, the shorter-term liquidity problems may be averted by European Central Bank actions. However, the underlying solvency problems are nowhere near fixed. The austerity measures being implemented throughout Europe will reduce economic growth expectations for years. In fact, as these policies begin to impact citizens that vote, one cannot underestimate the political implications (France has already elected a socialist president) and the staying power of any reforms.

The U.S. economy is growing but at a dangerously slow pace. Real GDP is expanding no faster than 2% at an annual rate and recent employment gains have been poor. Unless job growth improves, the unemployment rate will probably remain above 8% for some time.

The U.S. economy is not overly reliant on exports to Europe (about 3% of U.S. GDP). In fact, changes in the price of gasoline are more likely to have a more material impact on U.S. GDP. Regardless, while the direct links may be relatively small, the uncertainty and indirect links are significant as many major U.S. companies generate a meaningful amount of their revenue and profit from Europe.

Business managers do not know how to handicap a breakup of the Euro-zone and what it means for their business, customers, vendors, and the trail-off effects. With memories of the 2008 recession still fresh and, given the European and U.S. fiscal cliff uncertainty, it is understandable that business managers are being cautious with respect to hiring and growth plans.

The U.S. fiscal cliff has to do with two issues that occur at the end of this year -- the Bush era tax cuts expire and significant spending cuts are implemented to reduce the size of the deficit. If implemented, short-term economic growth would be impacted. An economy growing at just barely 2% probably could not withstand the shock and would likely slip into a mild recession. That short-term cost must be balanced against the longer-term benefits of starting to put our fiscal house "in order". Our policymakers will probably focus on the short-term (easy) approach and, after the election, will take action to delay some (or all) of the tax increases and reduce some (or all) of the spending cuts. In essence, kick the can down the road -- again.

At present, the recovery from the "Great Recession" continues, but at an extremely disappointing and frustratingly slow pace. Given the uncertainty around Europe and our own economic policies, it is quite clear that economic risks are heightened and are skewed to the downside.

Stock Market

For most of the second quarter, the stock market did not react well to the uncertainty and news around the European and U.S. economic situation. But, thanks to an end of the quarter rally, the losses were reduced.

During the second quarter, U.S. stocks returned -3.2%, developed international stocks returned -7.1%, and emerging market stocks returned -10.0%. Year-to-date, all three markets are in positive territory (thanks to strong first-quarter returns), with U.S., developed market, and emerging market stock returns of 9.3%, 3.0%, and 2.3%, respectively.

Large-cap stocks have outperformed mid-and small stocks for both the second quarter and on a year-to-date basis. More specifically, large stocks have returned 9.4%, small stocks 8.5%, and mid stocks 8.0% for the first two quarters of the year.

Growth stocks did not outperform value stocks during the second quarter (-4.0% vs. -2.3%), but they have on a year-to-date basis returning 10.0% versus the value stock return of 8.6%.

Only three sectors produced positive returns during the second quarter -- telecommunications at 14.1%, consumer staples at 2.9%, and healthcare at 1.8%. Finance, technology, and energy sectors were the worst performing sectors with returns between -6.0% and -6.8%. On a year-to-date basis, telecommunication, finance, technology, and consumer discretionary sectors all have returns above 13% while the energy sector is the only sector with a negative return of -2.3%.

After the poor performance of emerging market stocks during the second quarter, their valuations became more competitive. The long-term growth story of emerging markets is still intact. However, since many of them are still export-driven, economic concerns in Europe and the U.S. remain a headwind. Regardless, longer-term investors may find the next few months a reasonable time to establish (or increase) a position.

Here in the U.S., 2012 earnings growth expectations have been significantly reduced (but we believe have further to fall -- particularly for mid and small-cap stocks). While forecast earnings growth of large stocks is not as high as mid and small-cap stocks, neither are the valuations. Overall, we believe the stock market is slightly undervalued. We believe this undervaluation is primarily concentrated in large-cap stocks.

Recent events in Europe and at home have, once again, raised the level of uncertainty around the stock market's short-term direction. It is entirely possible that stocks could get much cheaper before they start to appreciate. This brings us to the topic of volatility.

In recent years, the market has become more volatile than in the past. Between 1982 and 2007, the volatility of the S&P 500 was approximately 15%. Since 2008, volatility has increased to near 25%. While no single explanation fully captures the reasons for the increase, many believe increases in economic volatility are a major contributor.

Since 2008, developed market economic volatility has increased by several different measures. Many attribute this to the lingering impact of the financial bubble and accompanying deleveraging. This deleveraging is creating economic headwinds leading to less stable economies and more volatile markets. Unfortunately, it will likely take years for the deleveraging process to be "completed". We expect economic volatility to be above normal for the next several years and perhaps through the remainder of the decade.

Bond Market

During the second quarter, bond returns were positive as interest rates, generally speaking, declined. The U.S. bond market returned 2.1% while developed and emerging market bonds returned 0.5% and 2.8%, respectively. Year to date, U.S. bonds returned 2.4%, emerging market bonds 7.1%, and developed international bonds -0.3%. High-yield bonds returned 1.8% during the second quarter and 7.3% for the first half of 2012.

The quality spread (difference between Baa and ten-year treasury yields) increased during the quarter in direct response to increased economic concerns. The maturity spread (difference between the 10-and one-year maturity) narrowed during the quarter as yields on the 10 year bond fell by more than the yield on the one-year bond. Similar to the quality spread, the maturity spread can also be thought of as an indicator of future economic activity -- wider spreads imply higher expected economic growth.

Treasury yields remain extremely low and are below the rate of inflation for essentially all maturities except the 30 year bond. This condition is expected to exist for at least the foreseeable future. Investors should be careful in reaching for too much yield as higher yields generally indicate more risk in the underlying bonds.

Stock Returns For Periods Ending June 30, 2012

	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	-3.2	9.3	3.8	16.7	0.4
Developed Intl	-7.1	3.0	-13.8	6.0	-6.1
Emerging Market	-10.0	2.3	-18.2	7.2	-2.4
Size					
Large	-3.1	9.4	4.4	16.6	0.4
Mid	-4.4	8.0	-1.7	19.4	1.1
Small	-3.5	8.5	-2.1	17.8	0.5
Micro	-1.6	16.7	2.7	18.7	-0.1
Approach					
Value	-2.3	8.6	2.6	15.9	-2.1
Core	-3.2	9.3	3.8	16.7	0.4
Growth	-4.0	10.0	5.1	17.6	2.8
Sector					
Cons Discretionary	-2.6	13.0	10.7	25.8	3.9
Cons Staples	2.9	8.6	14.7	18.2	8.4
Energy	-6.0	-2.3	-8.2	12.7	0.9
Finance	-6.8	13.7	-2.7	8.7	-14.6
Healthcare	1.8	11.0	9.8	15.4	3.7
Industrials	-3.6	7.4	-1.2	20.2	-0.2
Technology	-6.7	13.3	13.7	18.3	4.6
Materials	-4.2	6.5	-7.2	15.3	-0.1
Telecomm	14.1	16.5	15.6	18.7	1.6
Utilities	6.6	4.8	15.3	14.7	2.9

	Qtr	YTD	1 Year
Developed Country			
U.S.	-3.2	9.3	3.8
Canada	-8.3	-2.9	-19.4
Europe	-7.5	2.4	-16.5
France	-11.0	-0.3	-29.9
Germany	-14.6	2.9	-27.2
Italy	-14.4	-6.8	-37.2
United Kingdom	-5.1	1.1	-9.3
Pacific	-6.4	4.2	-8.3
Australia	-6.0	1.1	-15.5
Hong Kong	-6.4	5.8	-11.4
Japan	-7.4	2.0	-11.0
Emerging Market			
China	-7.7	1.4	-18.7
India	-10.2	7.5	-26.1
Korea	-8.7	4.4	-15.2
Czech Republic	-15.3	-7.5	-31.3
Hungary	-10.4	9.9	-38.7
Poland	-7.2	9.1	-32.2
Russia	-16.9	-1.5	-28.7
Brazil	-20.0	-9.5	-29.7
Mexico	-1.9	13.2	-0.9
Mexico			

Stock Fundamentals As Of June 30, 2012

	United States		Developed		Emerging	
	Current	1 Year Ago	Current	1 Year Ago	Current	1 Year Ago
Price/Earnings Current	14.3	15.5	10.4	12.9	9.5	13.1
Price/Forecast Earnings	13.2	14.3	10.5	11.6	9.9	11.9
Price/Book	2.0	2.2	1.2	1.5	1.5	1.7
Price/Cash Flow	8.6	9.8	6.0	6.9	6.5	7.4
Price/Sales	1.2	1.3	0.7	0.9	0.98	1.30
Forecast LT EPS Growth	10.6	10.3	8.9	7.9	12.4	16.1

	Est. P/E Ratio		Est. EPS Growth		2012 Fair Value Returns			2013 Fair Value Returns		
	2012	2013	2012	2013	13x	17.5x	7% DR	13x	17.5x	7% DR
Large	13.2	11.6	6.8	14.0	-1.7	32.4	8.1	12.1	51.0	23.2
Mid	15.8	13.3	18.6	18.9	-17.6	10.9	-9.5	-2.1	31.8	7.6
Small	17.8	13.9	21.8	27.8	-26.8	-1.5	-19.6	-6.5	25.9	2.8

Bond Returns And Characteristics For Periods Ending June 30, 2012

	Returns				
	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	2.1	2.4	7.5	6.9	6.8
Developed Intl	0.5	-0.3	1.0	5.8	8.0
Emerging Market	2.8	7.1	9.8	13.1	9.2
Maturity					
Cash	0.0	0.0	0.1	0.1	0.8
Short-Term	0.2	0.6	1.1	2.3	3.7
Intermediate-Term	1.5	2.1	5.4	5.8	6.0
Long-Term	7.3	5.0	24.6	14.4	11.0
Sector					
Corporate	2.5	4.6	9.5	10.1	7.6
Government	2.6	1.5	8.3	5.7	6.6
Mortgage	1.1	1.7	5.0	5.4	6.7
Other					
High Yield	1.8	7.3	7.3	16.3	8.5
Inflation Protected	3.2	4.0	11.7	9.6	8.4
Municipal	1.9	3.7	9.9	7.6	6.0

U.S. Bond Yields	Qtr	Last Qtr	1 Year Ago
Fed Funds	0.16	0.13	0.09
Prime Rate	3.25	3.25	3.25
3 Month Treasury	0.09	0.08	0.04
1 Year Treasury	0.19	0.19	0.18
3 Year Treasury	0.39	0.51	0.71
5 Year Treasury	0.71	1.02	1.58
5 Year TIP	-1.05	-1.03	-0.38
10 Year Treasury	1.62	2.17	3.00
30 Year Treasury	2.70	3.28	4.23
Aaa Corporate	3.64	3.99	4.99
Baa Corporate	5.02	5.23	5.75
Barclays Aggregate	2.58	2.82	3.39
Barclays Credit	3.81	4.01	4.40
Barclays Treasury	1.76	1.84	1.97
Barclays Mortgage	2.95	3.27	3.33
Barclays Municipal	3.10	3.25	3.44
Barclays High Yield	7.28	7.32	8.25
Citi Intl Treasury	3.78	4.03	2.36
JPM Emerging	4.62	4.72	5.00

10-Year Sovereign Bond Yields

Developed Mkts	Qtr	Last Qtr	1 Year Ago
United States	1.62	2.29	3.14
Canada	1.73	2.24	3.08
France	2.66	3.01	3.39
Germany	1.55	1.97	2.98
Italy	6.21	4.99	4.95
United Kingdom	1.75	2.47	3.24
Euro Zone	1.55	1.97	2.99
Australia	2.97	4.39	5.19
Hong Kong	1.02	1.50	1.96
Japan	0.81	1.03	1.10
Emerging			
Brazil	2.82	3.14	6.16
China	2.83	3.18	4.08
India	8.36	8.40	8.46
Russia	8.87	8.09	4.73

Spreads Versus 10-Year Treasury

	Qtr	Last Qtr	1 Year Ago
Aaa	2.02	1.82	1.99
Baa	3.40	3.06	2.75
Barclays Aggregate	0.96	0.65	0.39
Barclays Credit	2.19	1.84	1.40
Barclays Treasury	0.14	-0.33	-1.03
Barclays Mortgage	1.33	1.10	0.33
Barclays Municipal	1.48	1.08	0.44
Barclays High Yield	5.66	5.15	5.25
Citi Intl Treasury	2.16	1.86	-0.64
JPM Emerging	3.00	2.55	2.00
Maturity (10yr-1yr)	1.43	1.98	2.82
Implied Inflation	1.78	2.07	2.00

Commodity, Real Estate, & Currency Returns
For Periods Ending June 30, 2012

	Qtr	Ytd	1 Year	3 Year	5 Year
Commodity					
DJ UBS Commodity	-4.6	-3.7	-14.3	3.5	-3.7
CRB Commodity Spot	-4.3	-1.2	-13.6	9.7	2.8
CRB Fat & Oils	-1.3	-0.7	-14.9	15.8	6
CRB Foodstuffs	-0.3	0.9	-9.3	13.1	6.6
CRB Livestock	3.3	6.8	-5.4	19.5	6.2
CRB Metals	-11	-1.7	-20.9	10.4	-1.4
CRB Raw Industrials	-7	-2.6	-16.4	7.4	0.3
CRB Textiles & Fibers	-7.7	-7.6	-19.5	1.5	0.9
Agriculture					
Coffee	-15.9	-30.2	-38.9	5.5	7.4
Corn	-1.6	6.7	-2	15.9	12.2
Soybean	5.4	19.1	3.8	6.3	12.8
Sugar	-13.7	-21	-17.7	8.7	6.3
Wheat	-11.4	-11.4	-13.9	3.7	4.8
Energy					
Oil	-22.4	-16.4	-14.4	5.8	4.1
Unleaded Gas	-13	3.9	-5.7	8.8	2.7
Metals					
Aluminum	-13.7	-6.9	-26.3	5.9	-6.8
Copper	-12.3	-1.7	-18.1	14	-0.2
Gold	-4.6	-3.4	4.5	19.1	19.5
Nickel	-11	-9	-25.9	3.5	-16.8
Zinc	-8.8	-2.9	-16.9	6.1	-12.5
Real Estate					
MSCI U.S. Reit	3.8	14.9	13.2	33.1	2.6
MSCI World Reit	2.3	15.1	2.2	17.4	-3.6
Currency		**U.S. Dollar Returns**			
Euro	5.1	4.6	12.9	3.6	1.3
Japan	-3.8	2	-1.4	-6.4	-8.4
U.K.	1.6	0.2	4.1	1.7	4.8
Brazil	14.1	11.4	29.2	1.5	1.2
China	0.8	0.2	-1.7	-2.3	-3.6
India	11.1	6.8	24.8	5.5	6.6
Mexico	9.2	1	17.9	1.4	5.1

Current Economic & Financial Conditions

	Percent Change					
	3 Month	3 Month Annualized	6 Month	6 Month Annualized	1 Year	Data As Of
Gross Domestic Product	0.5	1.9	1.2	2.4	2.0	March/2012
Leading Economic Indicators	0.5	2.1	1.9	3.9	1.7	May/2012
ECRI Weekly Leading Index	-3.7	-14.0	1.5	3.0	-4.0	June/2012
Commercial and Industrial Loans At All Commercial Banks	3.6	15.0	7.5	15.5	13.9	June/2012
Retail Sales	-0.2	-0.7	1.4	2.9	5.0	May/2012
Retail Sales (Excluding Food Service)	-1.3	-5.1	0.6	1.2	3.5	June/2012
Real Disposable Personal Income	0.7	2.6	0.9	1.9	1.1	May/2012
Industrial Production	1.0	4.0	1.6	3.1	4.7	June/2012
ISM Manufacturing: Purchasing Managers Index	-6.9	-25.0	-6.4	-12.4	-10.9	June/2012
4-Week Moving Average of Initial Claims	6.4	28.2	2.5	5.0	-8.7	June/2012
Hires: Total Private	-1.6	-6.2	1.9	3.9	3.6	May/2012
Job Openings: Total Private	2.7	11.1	11.0	23.2	17.1	May/2012
Consumer Price Index	-0.2	-0.8	0.7	1.4	1.7	June/2012
Consumer Price Index Less Food and Energy	0.6	2.6	1.2	2.4	2.2	June/2012
New One-Family Houses Sold	0.8	3.3	12.8	27.3	19.8	May/2012
Median Sales Price of Homes Sold	5.0	21.6	3.9	7.9	2.3	March/2012
S&P 500 Earnings	-0.9	-3.6	-1.0	-1.9	6.0	March/2012
CRB Commodity Spot Index	-4.3	-16.1	-1.2	-2.4	-13.6	June/2012
Spot Oil Price (West Texas Intermediate)	-22.4	-63.7	-16.4	-30.1	-14.4	June/2012
Gold Price	-3.8	-14.5	N/A	N/A	6.2	June/2012

	Actual Value / Diffusion Index				
	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	Data As Of
Phili Fed: General Activity - vs. Prior Month (Diffusion)	-16.6	12.5	6.8	-4.1	June/2012
Phili Fed: General Activity - 6 Months Ahead (Diffusion)	19.5	32.9	40.0	3.7	June/2012
Chicago Fed: National Activity Index	-0.5	0.2	-0.3	-0.3	May/2012
St. Louis Financial Stress Index	0.3	0.1	0.7	0.1	June/2012
Loan Officer Net % Tighter Criteria Consumer Loans	-11.6	-11.6	-7.9	-20.5	June/2012
Loan Officer Net % Willingness to Make Consumer Loans	23.6	11.5	18.8	28.8	June/2012
Consumer Sentiment	79.3	75.3	64.1	74.3	May/2012
Manpower Employment Outlook (Net % Hiring)	9.0	7.0	8.0	9.0	May/2012
Unemployment Rate	8.7	8.6	9.0	9.7	June/2012
University Of Michigan Inflation Expectations	3.1	3.9	3.1	3.8	June/2012
S&P 500 PE	16.1	14.3	13.7	16.3	March/2012
S&P 500 Earnings Yield	6.2	7.0	7.3	6.1	March/2012
S&P 500 Earnings Yield Less 10 Year Yield	4.1	5.0	5.3	2.7	March/2012
AAII Survey: Stock Allocation	58.8	60.7	56.1	59.5	June/2012
AAII Bull/Bear Investor Sentiment Spread	-15.7	17.0	9.8	8.1	June/2012
AAII Percent Bullish 8-Week Average	28.8	44.4	38.2	30.3	June/2012
CBOE Volatility Index	17.1	15.5	23.4	16.5	June/2012
3 Month Treasury	0.1	0.1	N/A	N/A	June/2012
1 Year Treasury	0.2	0.2	0.1	0.2	June/2012
5 Year Treasury	0.7	1.0	0.9	1.6	June/2012
10 Year Treasury	1.6	2.2	2.0	3.0	June/2012
30 Year Treasury	2.7	3.3	3.0	4.2	June/2012
5 Year TIP	-1.1	-1.0	-0.8	-0.4	June/2012
10 year TIP	-0.5	-0.1	N/A	0.8	June/2012
30 Year TIP	0.5	0.9	0.8	1.8	June/2012
Bond Buyer 20-Bond Municipal Bond Index	3.9	3.9	4.0	4.5	June/2012
ML BBB	4.0	4.1	4.6	4.5	June/2012
ML High Yield	7.4	7.3	8.3	7.4	June/2012
ML AAA-A Emerging Market	3.0	3.3	3.6	3.6	June/2012

A diffusion index is the difference between the percent of respondents expecting an increase less those expecting a decrease.