

Capital Market Review

Third Quarter, 2012

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Summary

Europe appeared to make some progress on stabilizing the euro. While verbal backing and new programs gave a boost, implementation of austerity budgets will be difficult. In short, the euro is not free from danger.

Here in the U.S., the housing market is showing some sustained (but slow) improvement. Permits, sales, and prices are up and inventories are down. If homeowners can refinance at current interest rates, that will put additional funds into their pockets. We expect low economic and job growth, interest rate, and inflation conditions to persist. The uncertainty surrounding the fiscal cliff, other tax, healthcare, and regulatory policy is impeding businesses ability to hire and invest.

Stock markets reacted well to the perceived improvement in the European situation. During the third quarter, U.S. stocks returned 6.2%, and are up 16.1% on a year-to-date basis. U.S. stocks appear to be in the range of fair value. However, the positive trend in corporate fundamentals seems to have reached its peak.

U.S. bonds returned 1.6% during the third quarter and 4.0% on a year-to-date basis. Corporate bonds (both investment grade and high yield) have performed the best.

Economic Conditions

In the U.S., it appears that the housing market is, finally, starting to see sustained (but slow) improvement. Permits, and sales are both up strongly over the previous year while inventories are down. Even home prices have modestly increased. If homeowners who have not been able to refinance (due to an underwater mortgage) can do so at record low interest rates, that will put additional dollars in their pockets and will likely flow into the economy.

During the quarter, the Europeans made some progress with respect to the euro crisis. Leaders gave strong backing to keeping the euro intact and instituted a program that will allow the European Central Bank (ECB) to purchase an unlimited amount of sovereign debt from countries that have accepted a bailout and are in compliance with the bailout's terms. Germany's high court approved the European Stability Mechanism and there appeared to be some minor progress in creating a pan-European fiscal union. However, Europe is hardly free from danger. We expect that implementing the necessary plans will prove much more difficult. While the euro crisis may not currently be on the front page, we expect that it will be again.

The positive trend in corporate fundamentals may have peaked. There have been a number of third quarter earnings warnings across multiple sectors. For international companies, the rise in the U.S. dollar has not helped. We believe future sales and earnings growth will be harder to come by and will be more moderate than the recent past.

Overall, we do not see a major change in economic conditions over the next several months. Slow GDP growth, low inflation and interest rates, and insufficient job growth will likely continue. However, should the U.S. "fall" over the fiscal cliff, most believe we would enter into a recession. The uncertainty created with respect to tax, healthcare, and regulatory policy is truly impacting employers' ability to hire and invest.

Stock Market

Mario Draghi, president of the ECB calmed markets in late July when he indicated the ECB would do "whatever it takes" to save the euro, setting the markets up for a nice rally through August. Another bond buying program announced by the FED did not hurt either.

In the end, the stock market was up 6.2% during the third quarter, recouping all of the second quarter losses. Developed international and emerging market stocks had somewhat better performance being up 6.9% and

7.0%, respectively. Year-to-date, U.S. stocks are up 16.1% -- a quite strong, if not a "stealth" type of rally. U.S. stocks remain firmly ahead of the developed international return of 10.1% and the emerging market return of 9.4%.

Large stocks returned 6.3% during the third quarter ahead of the mid- and small-company stock return of 5.6% and 5.3%, respectively. Year-to-date, large stocks are up 16.3% while mid- and small stocks are up 14.0% and 14.2%.

Value stocks were the best performing investment approach with a third quarter return of 6.4% -- slightly ahead of core and growth investment approach returns of 6.2% and 6.0%. However, the growth investment approach year-to-date return of 16.6% has outperformed the core and value returns of 16.1% and 15.6%.

In terms of sector performance, Finance, Telecommunications, Consumer Discretionary, and Technology were the best performing during the third quarter. The Utility sector was the only sector with a negative return. Other sectors with below-average returns for the third quarter were Industrials and Consumer Staples.

Year-to-date, sector return differences are more pronounced. Telecommunication (25.9%), Technology (21.8%), Finance (21.6%), and Consumer Discretionary (21.4%) have all exhibited strong performance. Utilities (4.3%), Energy (7.6%), and Industrials (11.2%) have lagged.

On several different measures, compared to last year, valuations for U.S. stocks have risen and either stayed the same or fallen for developed international and emerging market stocks. Earnings growth prospects for developed international stocks are below that of the U.S. Emerging market earnings growth prospects, while ahead of the U.S., have significantly declined from last year.

While U.S. valuation measures may be higher than developed international and emerging markets, we do not find them excessive. Small company stocks have a price/earnings ratio (based on 2013 expected earnings) of 15.4x, compared with mid- and large-cap multiples of 14.9x and 12.5x. However, 2013 earnings growth estimates are too high and will likely come down (meaning the current 2013 price/earnings multiple is probably understated).

Overall, we believe the U.S. stock market is near fair value with the most attractive company size valuation

segments being large, mid, and small company stocks (in that order). The stock market certainly is not significantly undervalued. Without improving business conditions, leading to higher earnings growth, we do not foresee continued strong stock market performance. Based on fundamentals, we do not expect a significant decline either. At current levels, we think the market is more susceptible to unexpected geopolitical events.

Bond Market

Bond returns were positive during the third quarter, particularly in the non-U.S. markets (both developed international and emerging market) as well as the corporate sector within the U.S. market. Compared to last quarter, bond yields declined for all major sectors of the bond market. Developed international yields fell by approximately 1% while U.S. mortgage-backed bonds fell by 0.77%. Treasury securities saw the smallest yield decline and actually saw increases for longer maturity bonds. The maturity spread increased during the quarter as 10-year yields increased. The quality spread declined as fears of a recession did not materialize.

During the third quarter, the U.S. bond market returned 1.6%, below the developed international bond market return of 3.9% and the emerging market return of 6.6%. Year-to-date, the U.S. bond market returned 4.0%, substantially below the emerging market bond return of 14.2%, but slightly ahead of the developed international bond market return of 3.7%.

The corporate sector has, by far and away, been the best performing U.S. bond sector during both the third quarter and on a year-to-date basis. Investment grade corporate bonds returned 3.5% during the third quarter, outperforming mortgage-backed bond returns of 1.1% and government bond returns of 0.6%. Year to date, corporate bonds have returned 8.2%, outperforming the mortgage-backed and government bond returns of 2.8% and 2.1%, respectively.

In terms of the best-performing maturity segments, given the decline in interest rates this year, it is not surprising that long-term government bonds have outperformed intermediate- and short-term government bonds. Specifically, long-term bonds returned 3.1% during the third quarter, outperforming the 1.4% and 0.5% return of intermediate- and short-term bonds. On a year-to-date basis, the long-term bond return of 8.3%, outperformed intermediate- and short-term bond returns of 3.5% and 1.1%, respectively.

Other bond market segments have performed well during 2012. Specifically, high yield bonds, with a year-to-

date return of 12.1%, has outperformed all other bond segments with the exception of emerging market bonds. Inflation-protected and municipal bonds have produced year-to-date returns of just over 6%.

Stock Returns For Periods Ending September 30, 2012

	<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>1 Year</u>	<u>3 Year</u>
<u>Nationality</u>						<u>Developed Country</u>				
U.S. Market	6.2	16.1	30.2	13.3	1.3	U.S.	6.2	16.1	30.2	13.3
Developed Intl	6.9	10.1	13.8	2.1	-5.2	Canada	9.8	6.6	9.8	3.6
Emerging Market	7.0	9.4	13.9	3.1	-3.6					
<u>Size</u>						<u>Europe</u>				
Large	6.3	16.3	30.1	13.3	1.2	France	6.8	6.5	7.2	-7.1
Mid	5.6	14.0	28.0	14.3	2.2	Germany	13.9	17.2	20.2	0.1
Small	5.3	14.2	31.9	13.0	2.2	Italy	6.8	-0.4	-2.0	-16.6
Micro	8.0	26.0	42.5	14.0	2.6	United Kingdom	6.0	7.1	14.6	3.6
<u>Approach</u>						<u>Pacific</u>				
Value	6.4	15.6	31.1	11.8	-0.7	Australia	8.8	10.0	16.0	6.6
Core	6.2	16.1	30.2	13.3	1.3	Hong Kong	11.8	18.2	24.6	5.8
Growth	6.0	16.6	29.3	14.7	3.2	Japan	-1.8	0.1	-5.8	-3.2
<u>Sector</u>						<u>Emerging Market</u>				
Cons Discretionary	7.5	21.4	36.6	21.5	6.8	China	4.0	5.4	13.7	-2.0
Cons Staples	3.8	12.7	24.3	15.5	8.1	India	14.9	23.6	6.5	-0.3
Energy	10.1	7.6	27.1	12.7	1.0	Korea	9.8	14.6	21.4	8.6
Finance	6.9	21.6	34.8	3.0	-12.7	Czech Republic	8.9	0.8	-2.4	-8.7
Healthcare	6.2	17.8	29.5	14.2	4.8	Hungary	9.6	20.5	20.8	-9.3
Industrials	3.6	11.2	29.6	13.9	-0.6	Poland	8.3	18.2	12.5	0.8
Technology	7.4	21.8	32.4	15.0	4.8	Russia	9.0	7.4	12.7	2.8
Materials	5.1	12.0	29.2	9.9	0.0	Brazil	4.3	-5.6	1.5	-6.2
Telecomm	8.1	25.9	35.8	19.6	2.7	Mexico	6.5	20.6	31.9	14.0
Utilities	-0.5	4.3	12.9	12.2	2.4					

Stock Fundamentals As Of September 30, 2012

	<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	15.2	12.7	10.9	11.6	9.8	10.7				
Price/Forecast Earnings	14.4	11.9	11.5	10.2	10.5	11.0				
Price/Book	2.1	1.8	1.3	1.3	1.5	1.8				
Price/Cash Flow	9.1	8.1	6.3	6.3	6.6	6.4				
Price/Sales	1.2	1.1	0.8	0.8	1.0	1.1				
Forecast LT EPS Growth	10.7	10.3	9.2	2.0	11.7	16.4				
	<u>Est. P/E Ratio</u>		<u>Est. EPS Growth</u>		<u>2012 Fair Value Returns</u>		<u>2013 Fair Value Returns</u>			
	<u>2012</u>	<u>2013</u>	<u>2012</u>	<u>2013</u>	<u>13x</u>	<u>17.5x</u>	<u>7% DR</u>	<u>13x</u>	<u>17.5x</u>	<u>7% DR</u>
Large	14.2	12.5	5.4	13.0	-8.3	5.8	0.8	3.6	39.5	13.9
Mid	17.5	14.9	14.0	17.5	-25.5	-14.0	-18.1	-12.5	17.8	-3.8
Small	20.1	15.4	14.5	30.4	-35.2	-25.2	-28.8	-15.5	13.7	-7.1

Bond Returns And Characteristics For Periods Ending September 30, 2012

	<u>Returns</u>					<u>U.S. Bond Yields</u>	<u>Last 1 Year</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>Ago</u>
<u>Nationality</u>						Fed Funds	0.14	0.16	0.08
U.S. Market	1.6	4.0	5.2	6.2	6.5	Prime Rate	3.25	3.25	3.25
Developed Intl	3.9	3.7	3.4	4.7	7.1	3 Month Treasury	0.11	0.09	0.01
Emerging Market	6.6	14.2	19.6	11.8	10.1	1 Year Treasury	0.18	0.19	0.10
						3 Year Treasury	0.34	0.39	0.35
						5 Year Treasury	0.67	0.71	0.90
<u>Maturity</u>						5 Year TIP	-1.47	-1.05	-0.72
Cash	0.0	0.1	0.1	0.1	0.6	10 Year Treasury	1.72	1.62	1.98
Short-Term	0.5	1.1	1.4	2.0	3.3	30 Year Treasury	2.88	2.70	3.18
Intermediate-Term	1.4	3.5	4.4	5.2	5.7	Aaa Corporate	3.49	3.64	4.09
Long-Term	3.1	8.3	11.1	12.5	10.9	Baa Corporate	4.84	5.02	5.27
<u>Sector</u>						Barclays Aggregate	2.40	2.82	3.23
Corporate	3.5	8.2	10.1	8.7	7.9	Barclays Credit	3.57	4.01	4.28
Government	0.6	2.1	2.9	5.2	6.0	Barclays Treasury	1.68	1.84	1.74
Mortgage	1.1	2.8	3.7	5.0	6.4	Barclays Mortgage	2.50	3.27	3.34
						Barclays Municipal	2.94	3.25	2.99
<u>Other</u>						Barclays High Yield	6.94	7.32	7.87
High Yield	4.5	12.1	19.4	12.9	9.3	Citi Intl Treasury	3.03	4.03	2.90
Inflation Protected	2.1	6.2	9.1	9.3	7.9	JPM Emerging	4.38	4.72	5.10
Municipal	2.3	6.1	8.3	6.0	6.1				

10-Year Sovereign Bond Yields

Spreads Versus 10-Year Treasury

<u>Developed Mkts</u>	<u>Qtr</u>	<u>Last 1 Year</u>			<u>Qtr</u>	<u>Last 1 Year</u>	
		<u>Qtr</u>	<u>Ago</u>			<u>Qtr</u>	<u>Ago</u>
United States	1.62	1.62	1.87	Aaa	1.77	2.02	2.11
Canada	1.75	1.73	2.16	Baa	3.12	3.40	3.29
France	2.21	2.66	2.60	Barclays Aggregate	0.68	1.20	1.25
Germany	1.45	1.55	1.76	Barclays Credit	1.85	2.39	2.30
Italy	5.29	6.21	5.73	Barclays Treasury	-0.04	0.22	-0.24
United Kingdom	1.75	1.75	2.40	Barclays Mortgage	0.78	1.65	1.36
Euro Zone	1.45	1.55	1.77	Barclays Municipal	1.22	1.63	1.01
Australia	2.98	2.97	4.21	Barclays High Yield	5.22	5.70	5.89
Hong Kong	0.78	1.02	1.29	Citi Intl Treasury	1.31	2.41	0.92
Japan	0.78	0.81	0.97	JPM Emerging	2.66	3.10	3.12
<u>Emerging</u>				Maturity (10yr-1yr)	1.54	1.43	1.88
Brazil	9.57	2.82	12.00	Implied Inflation	2.17	1.78	1.63
China	3.16	2.83	4.02				
India	8.17	8.36	8.48				
Russia	8.17	8.87	4.73				

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

	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
<u>Commodity</u>					
DJ UBS Commodity	9.7	5.6	6.0	5.3	-3.0
CRB Commodity Spot	4.5	3.3	-1.2	10.2	3.1
CRB Fat & Oils	5.9	5.1	-5.5	20.3	7.1
CRB Foodstuffs	3.0	3.9	-1.6	13.9	6.6
CRB Livestock	-3.0	3.5	-6.7	19.3	6.0
CRB Metals	10.1	8.2	4.9	10.4	-0.6
CRB Raw Industrials	5.6	2.9	-1.0	7.6	0.8
CRB Textiles & Fibers	2.8	-5.0	-8.6	1.8	0.8
<u>Agriculture</u>					
Coffee	5.8	-26.1	-34.8	7.2	7.0
Corn	15.4	25.4	15.2	31.3	17.4
Soybean	17.3	41.7	33.6	18.7	14.8
Sugar	-10.8	-29.5	-34.4	-2.0	4.2
Wheat	26.7	18.1	12.6	23.7	4.7
<u>Energy</u>					
Oil	14.9	-3.9	10.6	10.9	3.5
Unleaded Gas	12.3	16.6	9.9	14.8	6.4
<u>Metals</u>					
Aluminum	9.5	2.0	-10.0	4.0	-2.9
Copper	8.9	7.0	-2.6	9.3	1.1
Gold	9.3	5.6	-1.5	20.5	19.6
Nickel	4.1	-5.3	-15.2	-0.2	-10.2
Zinc	8.3	5.2	-3.2	2.3	-7.0
<u>Real Estate</u>					
MSCI U.S. Reit	0.0	14.9	32.4	20.5	2.1
MSCI World Reit	6.1	22.2	29.9	12.2	-3.1
<u>Currency</u>					
	<u>U.S. Dollar Returns</u>				
Euro	-2.7	2.1	6.3	4.0	1.5
Japan	-1.3	0.6	1.9	-5.0	-7.4
U.K.	-3.5	-3.3	-2.2	0.4	4.4
Brazil	-1.1	10.2	15.8	3.7	1.3
China	-0.6	-0.3	-1.0	-2.5	-3.4
India	-2.1	4.5	14.8	4.3	6.4
Mexico	-7.0	-6.0	-0.9	-1.2	3.2

Current Economic & Financial Conditions

	Percent Change					Data As Of
	3 Month		6 Month		1 Year	
	3 Month	Annualized	6 Month	Annualized		
Gross Domestic Product	0.3	1.3	0.8	1.6	2.1	June/2012
Leading Economic Indicators	-0.1	-0.4	0.4	0.8	2.1	August/2012
ECRI Weekly Leading Index	3.8	16.3	-0.3	-0.6	5.2	September/2012
Commercial and Industrial Loans At All Commercial Banks	2.1	8.6	5.6	11.6	12.9	September/2012
Retail Sales	3.3	13.9	1.7	3.5	5.3	September/2012
Retail Sales (Excluding Food Service)	3.3	13.9	1.7	3.5	5.3	September/2012
Real Disposable Personal Income	0.0	-0.1	0.8	1.6	1.8	August/2012
Industrial Production	-0.3	-1.3	0.6	1.2	2.8	September/2012
ISM Manufacturing: Purchasing Managers Index	3.6	15.3	-3.6	-7.0	-1.9	September/2012
4-Week Moving Average of Initial Claims	-2.8	-10.7	3.4	7.0	-8.5	September/2012
Hires: Total Private	-2.1	-8.3	-1.0	-2.0	3.9	August/2012
Job Openings: Total Private	-2.8	-10.9	0.9	1.8	13.3	August/2012
Consumer Price Index	1.2	5.0	1.0	2.0	2.0	September/2012
Consumer Price Index Less Food and Energy	0.3	1.2	0.9	1.9	2.0	September/2012
New One-Family Houses Sold	1.1	4.4	1.9	3.9	27.7	August/2012
Median Sales Price of Homes Sold	-1.3	-5.1	6.4	13.3	3.2	June/2012
S&P 500 Earnings	0.9	3.8	2.8	5.6	6.6	June/2012
CRB Commodity Spot Index	4.5	19.5	0.1	0.1	-1.2	September/2012
Spot Oil Price (West Texas Intermediate)	14.9	74.5	-10.8	-20.4	10.6	September/2012
Gold Price	11.1	52.4	6.8	14.1	9.6	September/2012

	Actual Value / Diffusion Index				Data As Of
	Current	3 Months	6 Months	1 Year	
	Value	Ago	Ago	Ago	
Phili Fed: General Activity - vs. Prior Month (Diffusion)	-1.9	-16.6	12.5	-12.7	September/2012
Phili Fed: General Activity - 6 Months Ahead (Diffusion)	41.2	19.5	32.9	25.2	September/2012
Chicago Fed: National Activity Index	-0.9	-0.2	0.2	-0.4	August/2012
St. Louis Financial Stress Index	-0.2	0.3	0.1	1.0	September/2012
Loan Officer Net % Tighter Criteria Consumer Loans	-10.9	-11.6	-11.6	-9.3	September/2012
Loan Officer Net % Willingness to Make Consumer Loans	21.7	23.6	11.5	26.9	September/2012
Consumer Sentiment	74.3	79.3	75.3	55.7	August/2012
Manpower Employment Outlook (Net % Hiring)	10.0	9.0	7.0	8.0	August/2012
Unemployment Rate	8.3	8.7	8.6	9.8	September/2012
University Of Michigan Inflation Expectations	3.3	3.1	3.9	3.3	September/2012
S&P 500 PE	16.2	14.9	15.8	13.7	September/2012
S&P 500 Earnings Yield	6.2	6.7	6.3	7.3	September/2012
S&P 500 Earnings Yield Less 10 Year Yield	4.5	5.1	4.2	5.3	September/2012
AAII Survey: Stock Allocation	60.1	58.8	60.7	57.8	September/2012
AAII Bull/Bear Investor Sentiment Spread	-0.4	-15.7	17.0	-14.3	September/2012
AAII Percent Bullish 8-Week Average	36.6	28.8	44.4	32.8	September/2012
CBOE Volatility Index	15.7	17.1	15.5	43.0	September/2012
3 Month Treasury	0.1	0.1	0.1	N/A	September/2012
1 Year Treasury	0.2	0.2	0.2	0.1	September/2012
5 Year Treasury	0.7	0.7	1.0	0.9	September/2012
10 Year Treasury	1.7	1.6	2.2	2.0	September/2012
30 Year Treasury	2.9	2.7	3.3	3.2	September/2012
5 Year TIP	-1.5	-1.1	-1.0	-0.7	September/2012
10 year TIP	-0.7	-0.5	-0.1	0.1	September/2012
30 Year TIP	0.4	0.5	0.9	1.0	September/2012
Bond Buyer 20-Bond Municipal Bond Index	3.7	3.9	3.9	4.0	September/2012
ML BBB	3.5	4.0	4.1	4.6	September/2012
ML High Yield	6.6	7.4	7.3	9.5	September/2012
ML AAA-A Emerging Market	2.5	3.0	3.3	3.7	September/2012

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