QUARTERLY ECONOMIC REVIEW OUTLOOK

INVESTMENT NEWSLETTER / THIRD QUARTER 2012

Executive Summary

This year, the proverb to sell in May and go away failed miserably. As consolation, the adage to not fight the Fed (...European Central Bank, Bank of Japan, People's Bank of China, Bank of England, Central Bank of Brazil, et al.) worked like a charm.

Following its July promise to do "whatever it takes," the European Central Bank (ECB) announced in September the willingness to buy an unlimited amount of bonds of struggling euro zone members. The program, dubbed Outright Monetary Transactions, or OMT, is focused on one to three year maturities and the ECB will not be senior to other creditors. One week later, the U.S. Federal Reserve pledged aggressive quantitative easing for an indefinite period of time. Throughout the quarter, investors bought on the rumors of these programs. In September, they bought again on the news.

It was a "risk-on" quarter and capital markets were universally positive. Equities across the globe rallied by mid to high single digits, high yield bonds were close on their tail, and commodities gained nearly 10%.

While attribution for the rally rests squarely on the shoulders of central bankers, the translation mechanism of their actions may be somewhat different than usual.

As discussed in the pages that follow, economic fortunes declined during the quarter. Furthermore, similar post-crisis monetary initiatives have both come up short of goals and suffered from diminishing returns. As a result, strong investment returns for the quarter were neither a reflection of economic improvement nor a vote of confidence in unbounded quantitative easing. More likely, investors were doing their best to side-step central bank driven financial repression. In short, monetary policies have dictated low, if not negative, real rates of return from an ever expanding list of investments. The paucity of return has pushed investors into riskier and riskier assets, the prices of which have become distorted. On that point, the Bank for International Settlements (BIS), the central bank for central bankers, warned the ECB, Federal Reserve, Bank of Japan, and Bank of England that they had reached the upper limit of their ability to boost economies. The BIS went on to warn these entities of heightened inflation risk and the potential of stoking asset bubbles.

> Strong investment returns for the quarter were neither a reflection of economic improvement nor a vote of confidence in unbounded quantitative easing.

To be fair, there were market moving positives, outside of monetary policy, that contributed to investment gains during the quarter. U.S. housing trends continue to be positive. Germany became more constructive on ECB bond buying and the country's constitutional court gave a thumbs up to the euro zone's new permanent bailout fund. And U.S. consumers came out of hiding to do a bit more of what they do best, shop.

Looking forward, there are a number of risks and challenges. Domestically, growth is tepid, the fiscal cliff looms, and the election introduces uncertainty. In Europe, recessions are deepening, debt troubles persist, and unpredictable policy decisions make the region impossible to forecast. Emerging markets, particularly China, are slowing and tensions are high in North Africa and the Middle East. As for the investment markets, fixed income yields are at all time lows, profit growth will be negative this earnings season, and a faint aroma of complacency is in the air.

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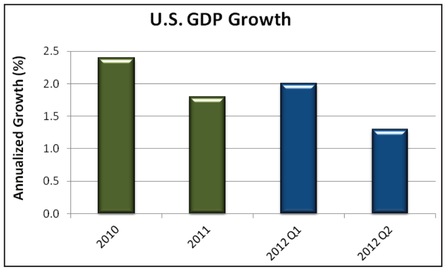
Economic Growth

Annualized U.S GDP growth was 1.3% in the second quarter. Compared to previous quarters, slower growth in consumer spending and diminished inventory gains were the key drivers of the lackluster result. A reduced pace of business spending was impactful as well



Data Source: U.S. Department of Commerce

The U.S. is expected to grow at an annualized clip of 2.0% in each of the year's final quarters for a total GDP gain of about 2.0% in 2012.

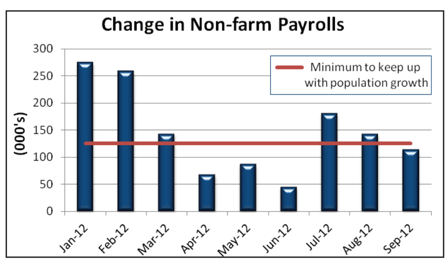
On an annualized basis, the euro zone contracted 0.7% in the second quarter following little movement in the first. The region has not grown since the third quarter of last year. Continued slowing in the third quarter means Europe is now in recession and the downward slide has accelerated. Business activity slowed in the euro zone each month this year and the unemployment rate has risen to 11.4%. A record level of 18.2 million people are now out of work in the region. Retail sales, manufacturing orders, industrial production, imports and exports, and sentiment of both businesses and consumers have all trended down. Annualized contraction in the euro zone is estimated to be 1.2% in the third quarter and 0.6% in the fourth.

As for other areas of the world, leading indicators of the Organization for Economic Co-operation and Development (OECD) point to a continuing slowdown in most major economies in coming months.

In agreement with the OECD, the International Monetary Fund (IMF) cut its global growth forecast for 2012 to 3.0% and urged policymakers to take bolder action. The organization cut growth estimates for Brazil, India, and China and warned of the potential for a hard landing in the latter nation. For context, Brazil has nearly stalled and is growing slower than the U.S., India's 5.3% growth in the first quarter was the weakest in nine years, and China's growth has slowed for five quarters in a row to the slowest rate in three years. China's full 2012 growth, expected to be 7.5%, will be the slowest since 1990! Lastly, Japan, the fourth largest economic entity in the world, may have contracted in the third quarter and fears are the country may be back in recession later this year.

Employment

Job growth picked up in the third quarter following a thoroughly disappointing showing in the second.

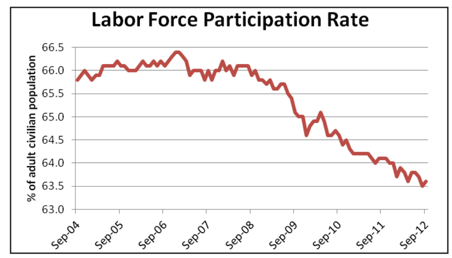


Data Source: U.S. Department of Labor

The uptick is an improvement and recent gains have been more respectable. That being said, the trend is down and average monthly gains this year are running 5% below last year's pace. Furthermore, as the red line depicts, the pace of expansion is only sufficient to keep up with population growth. Barring much more substantial job gains, no progress can be made on unemployment.

At first blush, the previous seemingly bold statement may not square with the government's recently released payrolls report for September. In that report, the unemployment rate broke below the 8% barrier for the first time since January 2009. Interestingly, the unemployment rate during that inauguration month nearly four years ago, 7.8%, was identical to last month. In reality, labor market progress has been far less than, well, neutral.

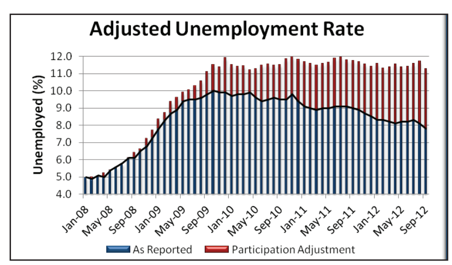
The following graph shows the percentage of the adult population engaged in the labor force.



Data Source: U.S. Department of Labor

The decline shown is critically important because people that leave the labor force are not factored into the majority of labor market statistics. They simply no longer count….in the stats anyway.

An alternative, perhaps more enlightening, view of the labor market can be achieved by holding the participation rate constant at the prerecession level. The effective unemployment rate is illustrated in the following graph.



Data Source: U.S. Department of Labor, Summit Calculations

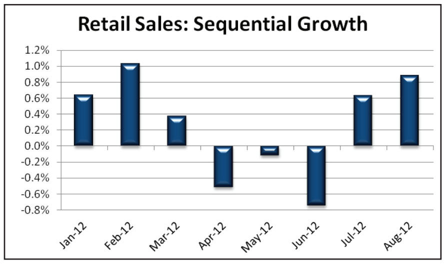
The blue bars and black line represent the government's reported unemployment rate. The red bars adjust for the people that have left the labor force, presumably due to a dearth of opportunities.

Rather than peaking at 10.0% (as reported) and falling to a current level of 7.8%, the analysis shows unemployment peaked at something closer to 12.0% and has not been below 11.0% in over three years. Likewise, the total number of unemployed individuals is closer to 18.2 million versus the 12.1 million reported.

The labor market outside of the U.S. has challenges as well. The OECD warned the rate of unemployment in developed economies will remain high for longer than previously expected with a growing number of workers finding themselves permanently marginalized in the job market. The total unemployment rate in the 34 OECD nations as of July was 7.9%, representing nearly 48 million people. In Europe, euro zone unemployment continues to hit new records. As of August, 18.2 million people were unemployed for an overall rate of 11.4%. Over 25 million individuals are unemployed across the European Union as a whole.

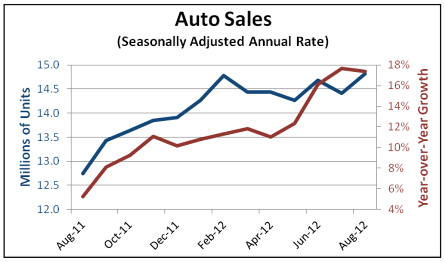
The Consumer

Real estate gains and rising stock markets in the third quarter helped to reverse somber consumer attitudes from the previous quarter. Sequential retail



Data Source: U.S. Census Bureau

sales growth resumed in July and back to school sales were reasonable.



Data Source: U.S. Bureau of Economic Analysis

Consumer confidence jumped in September and auto sales, a bastion of strength this year, continued on a favorable path.

Manufacturing and Service

While the consumer showed strength over the summer, the same cannot be said for manufacturing. The Institute for Supply Management's Manufacturing Index showed a contraction in June for the first time in three years. Exports fell and new orders declined at the fastest pace since the aftermath of the September 11th terrorist attacks. Through August, the index showed three consecutive months of manufacturing decline in the U.S.

Additional manufacturing metrics confirmed weakness. Industrial Production dropped sharply in August by an amount last seen in March 2009. The Philadelphia Fed's Manufacturing Index showed a larger than expected contraction in August. Lastly, the Empire State Manufacturing Survey reported general business conditions for manufacturers declined for a second consecutive month in September to the lowest level since April 2009.

Manufacturing weakness has not been isolated to the U.S. As of September, euro zone manufacturing had contracted for 14 months in a row. Depending on the index used, Chinese manufacturing has been in contraction between two and 11 months. New orders, exports, and imports have all been disappointing in China. Furthermore, August data for the country showed a pace of contraction comparable to March 2009. The stories are similar for other nations including South Korea, Taiwan, Brazil, and, more recently, Japan.

Real Estate

The value of American's real estate holdings jumped $400 billion in the second quarter and the housing market continues to improve. For example:

- **Prices** - According to Case-Shiller data through July, home prices had risen sequentially for six straight months for a year-to-date gain of 3.9%. Nearly all geographic markets had price gains in each of the past four months.
- **Volumes** - In August, transaction volume of new homes was up 28% from the previous year while sales of existing homes rose 10% over the same period.
- **Inventories** - Existing home inventories are at 5.7 months of supply (healthy) and new home inventories are at 4.5 months of supply (low). On a year-over-year basis, building permits have been up in excess of 20% every month this year.
- The National Association of Home Builder's Index hit its highest level in over six years in September following its biggest jump in nearly a decade in July.

Housing market strength may have staying power as a result of the diversity of its drivers. These include:

- Low mortgage rates and a sympathetic Fed focusing a third round of quantitative easing on mortgage securities.

- Record low inventory levels of new homes dating back to the start of records in 1963.
- The lowest rental vacancy rate, 4.7%, in a decade and only the third quarter in 30 years when vacancies have dipped below 5%.
- Widespread rent increases including all 82 markets tracked by Reis, Inc.
- Private equity and other institutional investors assembling substantial portfolios of residential real estate properties.
- A rising sense of urgency among buyers as it no longer pays to wait for lower prices.

Housing is not without challenges. Household formation rates are uncertain due to high unemployment among young adults. Rising prices also reduce the acquisition appetite of institutional investors while increasing the incentive of more sellers to come to market.

Monetary and Fiscal Policy

During the quarter, Federal Reserve Chairman Ben Bernanke painted a bleak picture of the U.S. economy. The pace of business investment had slowed, with further weakness anticipated, and he described the employment situation as "grave." Although housing had shown modest improvement, Bernanke's view was that tight credit and other factors would impede progress. He pointed to the euro zone debt crisis as an ever-present challenge and warned of the severe impact on economic growth in 2013 from the fiscal cliff. The Chairman set the stage for a third round of quantitative easing.

Launched at the Fed's meeting in early September, QE3 will initially target the purchase of $40 billion of agency mortgages each month for an indefinite period of time. The Fed also extended the duration of its low policy rate well into 2015. The central bank made it clear they were targeting a much lower unemployment rate before easing off of the accelerator. Pointing to the failure of QE2 to come even close to expressed targets, private economists have voiced skepticism as to the benefits of yet more Fed buying.

Fiscally, the prevailing government stalemate has not been lost on Moody's, which recently cautioned of the potential of a U.S. debt downgrade in coming months. Republicans refuse to raise taxes and Democrats are protecting Medicare and Social Security. As for the fiscal cliff, Republicans want to extend all Bush tax cuts for one year, while Democrats want to extend them only for couples making less than $250,000. Meanwhile, U.S. federal debt recently hit $16 trillion, or 103% of GDP. Hopefully, following the elections, extreme partisanship will ease and pave the way for a more productive government. Avoidance of the approximate 3% GDP hit from the fiscal cliff would be a good start.

International monetary policy was highly accommodative during the quarter. The ECB cut its policy rate to 0.75%, a historic low, and as previously discussed, announced a plan to contain excessive yields of member countries. Brazil, growing at its slowest rate since 2003 and at the worst pace among the nine largest economies in the western hemisphere, eased aggressively. China, faced with declining foreign investment and a manufacturing sector mired in contraction, cut its main rate for a second time and vowed to ramp up state spending to counter a decline in growth. The Banks of England and Japan both expanded quantitative easing and other nations, such as Denmark and Australia, cut rates.

On the fiscal side, austerity measures abounded in the euro zone and Germany's constitutional court approved Europe's new permanent bailout facility. Once established, among other things, this bailout fund will be able to directly capitalize troubled regional banks. One caveat, however, is a single bank supervisor must first come online. Unfortunately, various European leaders have indicated the structuring of that supervision will take "a long time."

Continued IMF funding of Greece will almost surely require debt forgiveness of some sort.

Pointing to a deep recession and elusive privatization revenues, Greece admitted it is off track on its fiscal pledges and has fallen behind on targeted budget cuts. The nation's request for a two year extension to achieve budget targets was received unfavorably by both Germany and the IMF. Greece's economy will contract 7% this year and will likely continue to decline through 2014. Inspectors from the ECB, IMF, and EU are currently assessing Greece's 2013 and 2014 fiscal plans prior to disbursement of the next tranche of financial aid. Although rarely discussed, continued IMF funding of Greece will almost surely require debt forgiveness of some sort. This could prove a major stumbling block in the near-term.

Spain, experiencing its second deepest recession in history and an unemployment rate in excess of 25%, negotiated to extend the timeline to cut its deficit to 3% by one year, to 2014. Meanwhile, the nation's 2011 deficit was revised higher (for the second time) and significant slippage this year will result in a deficit of 7.4%. This compares to an original target of 4.4% and a revised target of 6.3%. Total debt to GDP for Spain is forecast to hit 85% this year and rise to 91% next year. Considering the pace of economic contraction, the metric will rise higher than that.

On the cusp of a debt downgrade to junk status, Spain beseeched the ECB throughout the quarter to buy its sovereign bonds in the open market to help contain rising yields. This action will only be implemented once Spain makes a formal sovereign bailout request. Although this request and subsequent ECB action are essentially assured, a favorable outcome for Spain is not. The nation's economy is contracting faster than prior forecasts, deficit targets have proven elusive, home prices have plummeted and continue to drop, bad loans at banks have risen every month for over a year, and reliance on emergency ECB loans has soared following sizable capital outflows from banks.

Italy's debt has been downgraded several times over the past year and the nation has delayed a balanced budget until 2015, two years later than originally expected. This highly indebted nation is vulnerable to a sharp increase in borrowing costs and a loss of access to debt markets. The timing and resolution of Spain's issues will weigh heavily on Italy's fate.

The Election

Presidential - Ohio, Virginia, and Florida are key battleground states for the candidates. Romney must carry at least two and perhaps all three to be elected. As for Ohio, no candidate since JFK has claimed the Oval Office without the state and no Republican ever has. Leading into the first presidential debate, polls showed tightening in a race that had previously favored Obama. Pundits believe Romney's superior showing at the first debate enabled him to gain ground. At four weeks out and with two debates remaining, the race is too close to call.

Senate - At the start of the campaign, odds of the Republicans retaking the Senate were 65 - 70%. During the season, however, several races became unexpectedly competitive. This turn of events calls into question the possibility that the Republicans will pick up enough seats for a majority. The odds of a Republican Senate majority have dropped to 45%.

House -The prospect of the Republicans losing their majority in the House is remote.

Clearly, the most pressing issue following elections will be the fiscal cliff. Quite simply, the government will get together to identify an amicable resolution or a recession will occur. Aside from that acute issue, regardless of election outcomes, the current set of economic challenges will not be easily resolved. Furthermore, polls suggest neither party will achieve a sweeping mandate. That means divided government and an unlikely chance for dramatic governmental change. Obamacare, Dodd-Frank, and current Federal tax policy would survive with little to no change in that setting. Likewise, little progress is likely on debt, deficits, rising healthcare costs, and ever growing entitlements. These problems will be "kicked down the road" to be dealt with later. The future, as a result, will look much like the present for some time to come.

Capital Markets Review and Outlook

Overview

Suggestions by the Federal Reserve and the European Central Bank of forthcoming aggressive monetary easing drove risky assets sharply higher during July and August. Both central banks proved good to their word in early September as each unleashed unbounded bond buying programs within one week of each other. Investment markets rallied further on the news.

Capital Market Returns

	3rd Qtr 2012	Year-to-Date
U.S. Treasury Bills	0.0 %	0.0 %
Barclays Aggregate Bond	1.6 %	4.0 %
Barclays Municipal Bond	2.3 %	6.1 %
Wilshire 5000	6.2 %	16.1 %
S & P 500	6.4 %	16.4 %
MSCI ACWI ex. U.S.	7.5 %	10.7 %
MSCI EAFE (Int'l Equities)	6.9 %	10.1 %
MSCI EM (Emerg. Mkts)	7.7 %	12.0 %
DJ UBS Commodity Index	9.7 %	5.6 %

Data Source: Morningstar

Prior to getting caught up in the excitement, consideration of each program's details is in order. The ECB will buy unlimited quantities of sovereign debt in the secondary market to help contain unsustainable yields of troubled nations. Said purchases will only take place following a nation's formal request for bailout aid. Interventions will also be sterilized - a fancy term meaning no net monetary expansion. To wit, this is not expansionary monetary policy. Furthermore, zero bonds have been acquired to date because Spain, the first likely contestant, abhors the prospect of being subject to the fiscal whims of the IMF. Their reticence in requesting aid is only strengthened by the encouragement of Germany, which believes Spain is better off without all of the help. Sooner or later, the markets may take a dim view of the big splash in what could be a small bucket. In any event, no amount of liquidity, or yield relief in this case, will fix the solvency problems outlined earlier in this newsletter.

As for the Fed, a third round of quantitative easing, limitless or not, is unlikely to do much to stimulate economic growth in an environment where interest rates are already extremely low. Besides, the fundamental problem is not the cost of debt in the first place. Rather, the issue is a *lack of demand by* certain borrowers along with a *lack of supply for* others. How can this be known? One need only follow the roadmap to failure of a similarly named program, QE2.

Fixed Income Markets

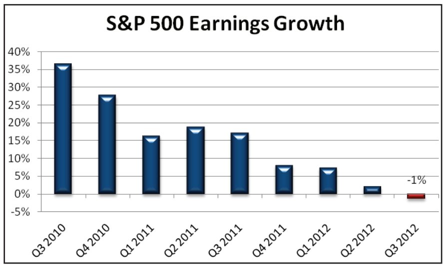
In the "risk-on" quarter, lower quality junk bonds outperformed their investment grade counterparts by about 3%.

Bond issuance soared during the quarter as borrowers took advantage of cheap debt and high demand. Various issuance records were set as investment grade yields hit a four decade low and junk bond yields hit the lowest level ever. By quarter end, high yield spreads had contracted by 70 basis points and the 10-year Treasury yield ended right where it started.

Equity Markets

Stocks rose by mid to high single digits for the quarter and dollar weakness boosted international equity returns by about 2%. Large caps bested small caps while value and growth returns were comparable. On a year-to-date basis, all major stock categories were up by double digits.

Juxtaposed against third quarter and year-to-date gains, stock fundamentals appear somewhat lacking. As the following graph illustrates, third quarter earnings are expected to decline for the first time since 2009.



Data Source: Standard & Poor's

Profit margins are near the peak and 30% above the 25 year average. The ratio of negative to positive earnings guidance has not been this high since the third quarter of 2001 and overseas operations have been soft. To name a few, Ford, Nike, McDonalds, Caterpillar, FedEx, and Dow Chemical have all expressed cautious outlooks due to the European debt crisis and slowing in China. Lastly, insider sales have outnumbered buys by a ratio of six to one and the market's fear gauge, the VIX, is sitting near a five year low. A low VIX could indicate either blue skies ahead or a fair amount of investor complacency. Time will tell.

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