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ECONOMIC UPDATE

This summer's sharp global stock market correction was, in our view, driven by three major uncertainties: *Political dysfunction in the US* as evidenced by the debt ceiling debacle, *fear of a "hard-landing" in China*'s economy following a year of monetary tightening and, the *European debt crisis* which threatens to spill over into the global financial system and trigger a repeat of the 2008-09 meltdown. As events have since played out, a number of investors' worst fears have been somewhat allayed providing at least a temporary lift to the financial markets which daily remain hostage to headline risks.

US MALAISE

In the US, the latest readings of economic performance in September offer further evidence that the economy is stabilizing, albeit at a sub-trend pace, with GDP growth in the 2.0%-2.5% range -- slightly above our late summer forecast. Growth in the US, recorded as the summer wound down, largely stemmed from the expected reversal of temporary first-half drags, notably the disaster in Japan and disruptive storms in the US. Importantly, retail sales, the largest part of the economy, rose more than forecast in September, and industrial production advanced, a sign manufacturers are contributing to growth. This data eases concerns of a double-dip which to some seemed a distinct possibility just a few weeks ago.

Despite these encouraging numbers, in the current slow growth environment, business activity will simply not be robust enough to absorb all of the normal labor force growth. Fears of further job losses and the inability of our dysfunctional government to find solutions to the nation's housing and fiscal problems, largely explain why consumers remain skeptical about the durability of the recovery. New evidence of the public's malaise can be seen in the preliminary October index of consumer sentiment from the University of Michigan which fell to 57.5 from 59.4 a month earlier. This index averaged 89 in the five years leading up to the last recession which began in 2007. Importantly, only a small fraction of those surveyed expect conditions to improve anytime soon.

While recently reported jobs gains in September were a pleasant surprise for financial markets where sentiment had turned particularly downbeat, the reality is the labor market remains in crisis as overall economic growth continues to undershoot and structural challenges fester. Nearly 45% of the unemployed have been out of work for more than six months while the average duration of unemployment has now risen to a new record high of 40.5 weeks. The number of people working part-time has topped 9.25-million, a level exceeded only once previously -- earlier in this recovery.

Looking at it from a business perspective, it is not surprising that many companies have put hiring decisions on hold given the uncertainties they face regarding higher taxes, increased regulation, and employee health care costs.

Nevertheless, absent severe contagion from Europe, which we do not expect, the US economy will extend its below-trend expansion as cyclical forces favoring recovery will overcome the headwinds from the 2008-09 financial crisis which show few, if any, signs of abating. The long recession created a backlog of pent-up needs in business spending and demand for big-ticket consumer goods. Business spending on equipment and software has been particularly strong, supported by a number of effective policy decisions. September business sales, for example, have come in above expectations at a $13-billion annual sales rate, one of the best showings of the recovery. Advance retail sales reports for September, which account for 70% of GDP, show a 1.1% increase -- well ahead of estimates and the largest gain since February. And factory production climbed for a third consecutive month.

The most notable economic shortfalls have occurred in those sectors at the core of the economy’s restructuring. The combination of the severe housing downturn and the lingering effects of the financial crisis are still inflicting stresses driving balance sheet repair, hampering credit access and delaying a new construction cycle which could take years to materialize. Retrenchment among state and local governments is also a significant headwind as budget strains and reduced federal assistance are likely to persist, pulling down GDP growth for several years.

On balance, then, recent incoming data in the US have provided some relief that the economy is not falling back into recession and that cyclical forces are supporting modest job gains despite structural headwinds. Looking ahead, the most recent Institute for Supply Management Manufacturing and non-Manufacturing figures, both high frequency, forward-looking data, continue to

signal expansion. Also, both our firm's Economic Model and the Leading Economic Indicators (LEI) remain positive. Nevertheless, the recovery remains fragile and the most persistent areas of concern such as high unemployment and state and local government retrenchment continue unabated. The later underscores concern that fiscal cutbacks at the federal level could further constrain an already anemic recovery if it is focused too narrowly on short-term deficit reduction rather than long-term fiscal reforms

CHINA: EASING AHEAD?

China's manufacturing Purchasing Manager's Index (PMI) ticked up modestly in September to 51.2 compared to 50.9 in August and 50.7 in July, suggesting China's industrial activity continues to track a steady, moderate growth trend amid growing uncertainty over the global economy and lingering risks on demand from developed markets. Readings above 50 signal expansion. With economic growth moderating and global commodity process easing, major indicators regarding pipeline inflation pressures in China have been softening as expected. Still, policy makers probably still see inflation as a key concern with consumer inflation above 6.0% in September versus their 4.0% target for the year. Nevertheless, we have already reached the point where further monetary tightening may be viewed as unwise given the fragile nature of the global recovery. One factor underlying the recent bounce in Chinese equities may have been investors' anticipation of a shift soon by policy makers toward easing to avert a feared "hard landing".

EURO ZONE CRISIS

France and Germany appear to be nearing a broad agreement on a plan intended to shore up financing for the bloc's troubled members and additional capital for its undercapitalized banks. While there have been no formal announcements on crucial details, and the outcome of the necessary compromises could result in a plan that falls short of widespread hopes for a dramatic response to the sovereign-debt crisis, the plan appears to be built on three central principles: The new bailout for Greece, an effort to bolster the banks hit by Greek losses (and possible Italian and Spanish losses), and additional ammunition for the bailout fund to provide a convincing backstop.

Officials are rewriting a July 21st agreement that would subject Greek bond investors to bigger cuts (possibly as much as 50%) in the value of their holdings. Euro Zone members are trying to boost the firepower in their $606-billion European Financial Stability Facility (EFSF) potentially through an insurance

program to guarantee investors some protection against losses in European debt. And, National governments must shore up banks that hold Greek debt that has fallen in value. Countries are nearing an accord to set new capital thresholds. Leaders hope to have details of the plan by October 23rd, or, at the latest, by early November. Stay tuned.

In summary, despite our housing and unemployment problems, and dysfunctional political leadership, the US economy is likely to muddle through this year with a sluggish, below-trend, recovery. More of the same is expected for 2012. We do not expect a recession in the US based upon data in hand. China's policymakers may soon relax their year-long monetary tightening as inflation becomes less of a concern and their economy cools. A "hard landing" will be averted. In the Euro Zone, market pressures have forced EU leaders to move toward decisions which will eventually force recapitalization of the major banks and ringfencing their balance sheets, to avoid a 2008-09-like financial contagion. How the sovereign debt crisis is eventually worked out remains unclear. Progress has been made. Expect a messy process with many twists in the road causing uncertainty for the Euro Zone's economy which may have already dipped into a shallow recession. Longer term, a viable fiscal union must be forged to assure financial stability in the Euro Zone.

EQUITY INVESTMENT POLICY

Less than three weeks ago, the US stock market was in disarray, completing an 18% correction from its Spring recovery high, as the fears of another 2008 scenario was about to be played out. Investors took cover in safe, low-yielding short-term fixed income securities, and, in some cases, cash. Few stock market sectors were spared the carnage. Investor sentiment had reached a low ebb as evidenced by sharp outflows from both domestic and foreign equity mutual funds and exchange traded funds (ETFs). Short interest reached levels not seen since the 2008-09 financial crisis. Sentiment indicators, such as the AAII Sentiment Survey and the Investors Intelligence Survey registered high levels of caution. The CBOE Volatility Index (VIX) reached a 47% reading reflecting the almost universal bearishness. US equities had retreated to a point where valuations based upon expected earnings, book values, and dividend yields approached generational lows.

In retrospect, the turning point for investor psychology was a statement from Euro Zone ministers on October 3rd that they would within 30 days have a plan for aiding the ailing Euro Zone banks which had been the uppermost of investors' concerns. Soothing comments by Fed Chairman Bernacke on the 4th also helped

calm fears. In addition, the release later that week of better than expected US employment and initial jobless claims figures supported the market's advance as have encouraging economic data out of China, strong US retail sales and growing manufacturing for September.

As of today, global stock markets have rebounded sharply from their intraday low on October 4th through Friday, October 14th:

	Percent Change
Dow Jones Industrial Average	+11.9%
S&P 500 Index	+14.0%
NASDAQ Composite	+14.3%
Russell 3000 Index	+14.6%
EFA (Developed Foreign Markets)	+14.7%
EEM (Emerging Markets)	+18.5%

With markets oversold and investors having aggressively raised cash and shorted the market, it did not take a lot to trigger a significant rally. Are we out of the woods? Probably not. Volatility remains high as the Dow Jones Industrial average has shown moves (both up and down) of more than 100 points during 57 of the last 58 sessions. But stocks are cheap under any scenario other than a meltdown, which we see as unlikely. There is clearly room for the stock market to work its way higher, but not without a good deal of volatility as headlines reliably drive markets in periods of high uncertainty. Given the statistical cheapness of stocks, we recommend clients maintain their fully invested positions despite the likelihood of sharp pullbacks and advances in the period ahead. We continue to favor economically sensitive companies most impacted by the market's washout. Portfolios remain tilted toward *growth* shares. Roughly 15% of clients' equity money is allocated to emerging markets and companies domiciled outside the US in developed countries.

FIXED INCOME POLICY

During the stock market's late summer/early fall meltdown, US Treasury bonds acted as a "safe" haven for cash withdrawn from equities and other risk assets. In fact, demand for 10-year US Treasury bonds was so overwhelming that it drove yields on these obligations from a high of 3.22% on July 1, to a low of 1.67% on September 23, an amazing and unprecedented descent in yields. Almost as surprising has been the subsequent rise in yields on these same 10-year Treasuries -- from 1.67% to 2.25% currently -- as investors rotated back into equities and risk assets from safe haven bonds. We expect rates to continue to move irregularly higher as investors reposition their portfolios away from safe haven US Treasuries.

Despite the recent rise in yields, we continue to view bonds generally as relatively unattractive when compared with the dividend yields and inflation protection of equities. We have, therefore, avoided purchasing longer-dated bonds, instead preferring corporate obligations with maturities generally shorter than three years for the bond portion of portfolios under our management.

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