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ECONOMIC UPDATE - -BEYOND THE FISCAL CLIFF: NEW LEGS

While we have recently seen a number of economic indicators showing better than expected performance, the bulk of the data portray an economy mired in a subpar 2% growth trajectory. Housing continues to show steady improvement and consumer spending, underpinned by strong auto sales, has firmed. Meanwhile, business spending, which has added significantly to the recovery, has slowed sharply in recent months. Employment appears to be rising moderately and the financial markets are supported by highly accommodative central bank policies likely to persist for a considerable period ahead. Inflation is not a significant issue given the substantial unused labor and manufacturing capacity in the economy. Given these conditions, if, as we expect, the "fiscal cliff" is avoided over year-end, business and consumer confidence should revive giving the recovery new legs into the New Year.

EMPLOYMENT

The release last week of September employment data showed a relatively modest 114,000 jobs gained despite the fact the headline unemployment rate registered its sharpest drop in nearly two years. This disparity and the resulting confusion stems from the way the two figures are calculated. The monthly payroll number is derived from a survey of about 141,000 business *establishments and government agencies* while the unemployment rate is based upon a separate survey of about 60,000 individual *households*. The *establishments* survey is larger and more stable. Since the start of 2011, payrolls have increased by an average of 169,000 workers per month – barely enough to absorb workers newly entering the labor pool seeking employment. This growth, though slow, has been consistent.

The *household* survey is more volatile month-to-month. The unemployment rate has fallen to 7.8% from over 9% during the past year but rather than decline smoothly, this rate has fallen fitfully and, in some months, has actually reversed course. The *household* survey's total of people employed has been even choppier. For example, in August the survey showed the number of employed Americans fell

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by 119,000. In September, the number jumped 873,000 - - most of these in less than full-time positions - - according to the survey.

Despite the month-to-month disparities, the results of the two surveys have been consistent over longer periods of time. In fact, over the past year, they show almost identical jobs growth. This suggests the strong September *household* survey, which has become a talking point in the Presidential campaign, likely overstated the jump in employment whereas the July and August surveys probably understated the number of people employed. This is consistent with what the *establishments* survey is showing – slow but relatively steady jobs growth.

Interestingly, there may be a less-than-obvious driving force behind the *household* survey report. The ending of emergency unemployment insurance benefits in recent months could explain some of the rise in employment and drop in the unemployment rate. Extended benefits for the long-term unemployed have been phased out completely since May and the hurdles for qualifying for emergency benefits have been increased. The result has been that the number of long-term jobless workers participating in these programs has fallen off dramatically. The two programs combined have lost 865,000 people from their rolls since May raising the possibility that the phasing out of these programs has lowered the unemployment rate as these workers left the workforce, not the creation of new jobs.

Looking beyond the September jobs numbers, the employment situation remains a grim headwind to stronger economic growth. For example, less than one in five job seekers found work last month underscoring the poor prospects for the country's 12 million unemployed workers. For workers unemployed for an extended period, progress in finding employment has been very slow. For most of the 1990's and 2000's between 25% and 30% of job seekers found work in a given month, and most found work within three months. Even during the recessions of 1990 and 2000 at least 20% of the unemployed found jobs each month. During the recent recession, however, that figure dropped to 16%, and at one point more than 45% of the unemployed had been out of work for more than six months. Both numbers have since improved, but only moderately with just 19.3% of unemployed workers finding jobs last month. About 4.8 million people – 40% of all the unemployed – have been looking for work for more than six months. Discouraged unemployed workers are now more likely to drop out of the labor force than to find work. The 144,000 jobs created in September will, therefore, do little to make a dent in the estimated 23 million total of unemployed or underemployed.

BUSINESS AND CONSUMER SPENDING

Business spending, which has been a source of strength in the recovery, appears to have stalled in recent months as businesses await clearer signals on fiscal policy and political direction. Weak advance August data on durable goods orders, slowing factory orders and shipments numbers confirm that core segments of business capital spending have slowed abruptly. As a consequence, equipment and software spending, which has contributed an average of about 0.6 percentage point to quarterly GDP gains in the recovery thus far, may be little changed in the second half of the year.

In contrast to the sharp slowdown in business spending, consumer outlays appear to be close to a 2% growth track through the third quarter. Importantly, September light vehicle sales posted their best levels of the recovery-to-date at a near-15 million annual rate - - an important sign the recovery retains momentum as auto purchases represent not only the largest discretionary item in household budgets but are also among the most credit-sensitive. The steady rebound in car sales attests to underlying cyclical strength (i.e. pent up demand) of the overall economic recovery.

The recovery in auto sales, has, in our view, been driven by an improving sense of consumer's financial well being. Along with headline increases in consumer confidence, data has reflected a gradual improvement in personal finances. And, for the first time since the housing bust, there has been a clear turn in sentiment that home prices have bottomed, a favorable indicator not only for home sales but also for consumer spending in general.

On balance then, while the tone of business may have improved a bit, recent developments do not point to any new momentum in the recovery. The labor market appears to be on the same moderate pace that hiring surveys have been suggesting despite a roller coaster of sharp swings month-to-month all year. The steadier trend is reflected in continued modest consumer spending and there are some encouraging signs that distressed sectors such as housing are either stabilizing or improving. To the extent that business spending has retrenched very suddenly, the broader backdrop suggests this may be the by-product of unusual circumstances unique to this period. Resolving these, especially getting beyond the election and the "fiscal cliff" may do more than any one development - - including QE3 - - to set the recovery's path ahead.

ECONOMIC MODEL

Beyond the economic data we parse, both our firms proprietary Economic Model and the Leading Economic Indicators (LEI) continue to reconfirm the economic recovery. After largely moving sideways for several months, the Economic Model has resumed its upward course. There is no recession on the horizon. While the model is not a stock market timing tool, its direction often provides valuable insights allowing us to tilt stock portfolio composition to reflect the changing business outlook.

INVESTMENT POLICY

There has been no change to our fixed income investment policy. Bond yields remain at unacceptably low levels, vulnerable we believe to longer term inflationary risks stemming from ultra-easy central bank policies and profligate government spending. We have, therefore, structured portfolios with a short ladder of corporate (or municipals where appropriate) bonds maturing in fewer than four years. Target portfolio durations are currently 1.8 - - well below the benchmark.

Stock markets around the world continued to recover in September. Year-to-date returns shown below are impressive, particularly when compared with the yields of riskless alternatives or high grade fixed income securities.

Equity Indices	2012 Year-to-date*
S&P 500	+15.8%
NASDQ Composite	+19.5%
Developed Markets - EFA	+ 8.7%
India	+26.9%
Germany	+23.6%
France	+ 7.8%
Japan	+ 4.8%
Emerging Markets - EEM	+ 9.6%
Korea	+ 8.5%
China	-3.8%

***Principal change through 10/8/12**

Given the strong US stock market performance, the outcome of the Presidential election and other upcoming events, including soon-to-be-released third quarter corporate profits and guidance, could be taken as disappointments and markets might retrace their recent gains. Corrections of 5% to 10% + are inevitable. Nevertheless, with individual investors' high cash balances earning next-to-nothing, institutional portfolio equity ratios at generational lows, stock valuations well below their median for the past decade and prospective returns from stocks well above those expected from bonds, US equities remain very attractive on both an absolute and relative basis when viewed from a longer term perspective. US stocks remain two P/E multiples cheaper than they were at the market low in Q1 2009. Clients' equity portfolios are, therefore, fully invested relative to their maximum target allocations.

We continue to favor companies likely to produce above average earnings growth in the slow growth environment we forecast. We have emphasized *growth* over *value* shares. Companies with moderate but growing dividends are particularly attractive. Banks, selling at a fraction of their tangible book values, represent the largest exposure among *value* shares held.

Beyond our exposure to US equities, our investment platform includes both developed and emerging market equities, currently weighted more heavily toward the rapidly growing emerging market segment.

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