

September 2011

## QUARTERLY REVIEW AND OUTLOOK

The past three months can best be described as tumultuous for investors in all world markets. The persistence of the European sovereign debt concerns, the rancorous deliberations over the U.S. debt ceiling and the subsequent downgrade of our credit rating, and disappointing economic data from the U.S. and many other developed and emerging nations all combined to create extreme volatility and widespread price declines in equity markets.

Perhaps more disturbing than the stream of bleak data and events were the sharp drops of consumer, business, and investor confidence in the willingness and ability of elected and appointed officials to address the issues in a comprehensive manner and to provide credible policies for containing the financial risks and supporting and broadening economic growth incentives. The concern is that this broad-scale decline in confidence will have an impact on economic activity and planning, encompassing consumer big-ticket purchases, housing, business spending for equipment and inventories, employment, and investor willingness to increase holdings in equities and longer maturity securities.

In the U.S., worries about a reversion to recession were recently underlined by the sharp reduction in Q1 GDP growth and the lowered estimate of Q2 results along with the latest data regarding initial unemployment claims and new jobs creation. While we have to respect the recent trends and be alert to evidence of further deterioration, there continue to be sectors of economic strength which seem capable of sustaining positive aggregate GDP direction in the months ahead. In the consumer area, personal spending continues to increase with recovery in autos and broad-based gains in the retail trade segment. In the industrial sector, manufacturing growth has moderated, but continues to be positive with gains continuing in both durable goods orders and total output. Business equipment and technology software remain bright spots. Consequently, we think a slide into recession is unlikely in the quarters ahead; however, a pick-up in housing and employment would provide some welcome impetus for the longer term.

The European debt dilemma has again become more threatening. The recognition that many commercial banks may require increased capital to buffer potential losses on sovereign debt holdings has resulted in much tighter funding conditions in short-term markets and strains among financial counter-parties. While competing national interests complicate the application of unified policies in the Eurozone, there are signs of positive developments and actions that may be taken.

The governments in the weaker countries are taking stringent steps to deal with their deficit and spending issues in order to maintain their funding agreements. The European Central Bank has the ability to reduce short-term interest rates, increase system liquidity, and provide support for individual banks. The stronger nations recognize the risks of a sovereign default or a break-up of the Euro and are striving to formulate and coordinate policies to stabilize the short-term pressures and provide effective longer term structural reforms. And, in an interesting bit of economic irony, the largest developing nations may provide a financial lifeline to the Eurozone by directing a portion of their large capital reserves to investments in Euro sovereign debt issues, thereby shoring up major end markets for their important exports.

In the developing nation arena, investor attention continues to be intensely focused on China. For much of this year, there has been unease about the pace of economic growth because of tightening monetary policy and bank reserve regulations. The most recent data has been encouraging, however. Both imports and exports continue to expand, industrial production and domestic loan growth remain healthy, inflation has begun to recede, and the central bank has condoned some appreciation in the currency. The outlook is still for 8%-9% GDP growth in 2011 and 2012, with positive implications for a number of industries including natural resource producers, technology systems and industrial and construction equipment.

Returning to the U.S. and our domestic markets, equities have been under pressure since late April while investment-grade fixed income securities have benefited as “safe haven” investments owing to economic concerns and political uncertainties. In our view, major portions of the equity market have gone a long way since the spring to pricing in a potential recession in GDP and a fall-off in corporate profits. Given the backdrop of economic sluggishness, it is prudent to expect a slowing in the rate of growth and the possibility of a moderate decline in 2012. But, earnings are unlikely to collapse in the aggregate, as operating margins are under tight control, inventories are lean, and cash flows are strong. Our focus will remain on business sectors and geographic areas of sustainable relative growth potential.

As noted, our markets are highly sensitive to policy initiatives and developments, both in Washington and Europe, with particular emphasis on the progress and outcome of the twelve member congressional committee on deficit reduction. While the strains of political partisanship are serious and expectations among investors are modest, any signs of structural tax or budgetary reforms could provide a positive boost to investment markets. There are vast amounts of cash reserves in low-yield fixed income issues and money market funds that could revert to equities if conviction in direction is restored.

The U.S. is still a relatively youthful and vibrant country with strong and leading franchises in technology, specialty medical products, and capital equipment worldwide. The U.S. remains a great engine for innovation and growth, and there are many companies which have the experience, product breadth, financial strength, and geographic exposure to prevail and prosper during this period of economic and political tension and volatility.

With regard to fixed income instruments, it’s hard to argue with success, particularly as it applies to U.S. Treasury issues. While we grant that Treasury notes and bonds will continue to draw investments flows, we, nevertheless, judge that the most attractive sector for reasonable current income and relative safety of principal continues to be intermediate maturity, high-grade corporate securities.

In summary, we are maintaining our basic portfolio structures, believing that companies with demonstrable operational advantages and exceptional financial strength offer solid investment return potential. We do recognize, however, that market conditions will likely continue to be volatile, so we have trimmed some positions to provide cash reserves for possible future purchases as opportunities arise.