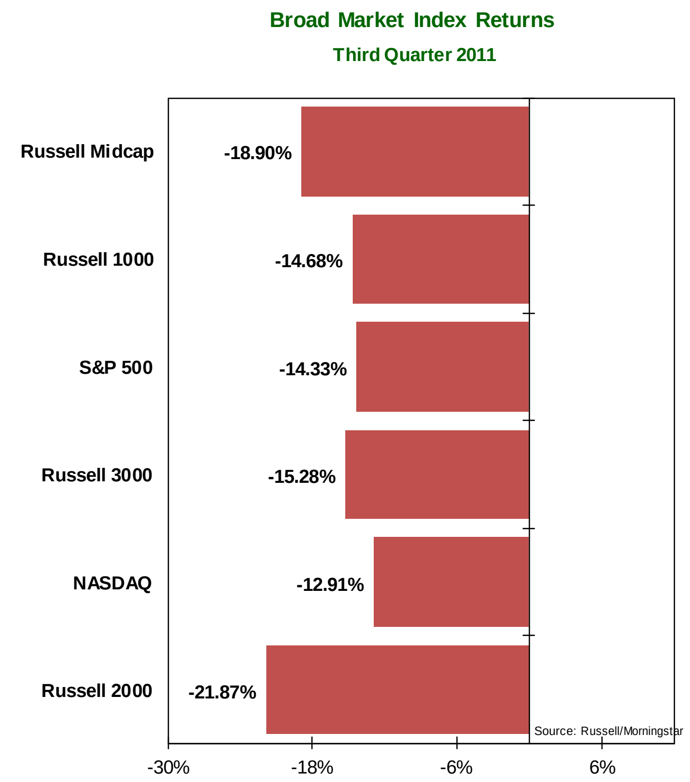
Third Quarter Market Summary

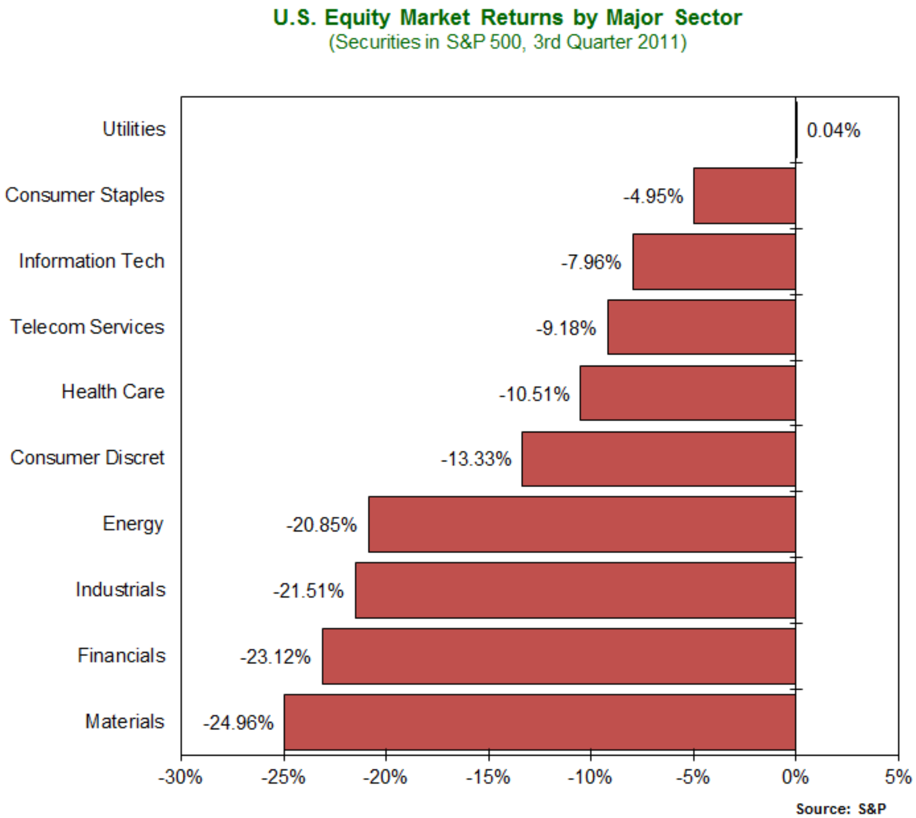
The Economy

The third quarter of 2011 proved to be very difficult on a number of fronts. From an economic perspective, the signs of a strengthening recovery that were evident in the first and part of the second quarters seem to have disappeared altogether in the third quarter. Economic data released during the quarter pointed to a continued slowdown in activity, and perhaps more importantly, business and consumer confidence declined dramatically. During the first quarter there were very few economists who believed the economy might fall back into a “double dip” recession, but in the third quarter the risk of recession heightened, with some economists assigning a probability of greater than 50%.



Another headwind in the third quarter occurred on the political front. Debate over the budget deficit was heated over the summer, as Republicans and Democrats wrangled over how to most effectively fund the government’s operations and raise the debt ceiling. The discussions were often rancorous, with neither side willing to compromise on their core positions. The Democrats and the Obama administration were adamant that deficit reduction had to be funded in significant part by increased tax revenues, while Republicans were equally as strident in holding to their position that fiscal responsibility must be achieved through spending reductions and not taxes. An agreement was reached at the last minute, but the hard decisions surrounding deficit reduction were deferred for consideration by a special congressional committee. Investors were not pleased by the tone of the debate and Washington's seeming inability to impose fiscal responsibility. Ratings agencies were not impressed either, and Standard & Poor's downgraded the AAA rating of U.S. debt, the first time in history that has occurred.

Yet a third factor impacting both the economy and financial markets in the quarter was the ongoing financial drama playing out in Europe. Greece was on the precipice of default, and may still do so, and several other euro zone members were also suffering financial distress. Meanwhile, the other countries in the euro zone debated just how to support a struggling member, with the more fiscally sound countries such as Germany balking at having to bail out the more profligate Greece. The euro zone's issues exposed fundamental problems with the euro as a currency, and during the quarter many analysts were predicting the eventual demise of the euro. While the probability of such a scenario currently seems low, it nevertheless has had a continuing effect on the global economy.



Highlights

GDP

The Bureau of Economic Analysis released the third estimate of second quarter 2011 GDP, an upward-revised 1.3%, up from the prior estimate of 1.0%, and somewhat better than economists had expected. There have been a number of factors negatively impacting growth so far in 2011, including the Japanese earthquake and tsunami, high energy prices, the debt-ceiling limit negotiations and

S&P's downgrade of U.S. debt. These factors have contributed to a declining confidence on the part of businesses, which in turn has resulted in sluggish hiring. Consensus among economists is that GDP growth will continue to pick up in the second half of the year, and will approach 2.7% in 2012. But this forecast assumes that European policymakers will be able to resolve their debt crisis, and that U.S. policymakers will be able to come to agreement on deficit reduction.

HOUSING

The housing market showed few signs of emerging from its prolonged slump, but neither did it deteriorate significantly. Existing-home sales were unexpectedly strong in August, climbing 7.7% from the levels in July to an annualized rate of 5.0 million units. Median home prices were soft, however, falling 5.1% from year-ago levels. Lackluster sales of new homes somewhat offsetting the positive existing-home sales data. Sales of new homes fell 2.3% in August from July levels to an annualized rate of 295,000 units. Moreover, new home prices were down 8.8% from year-earlier levels. Housing analysts believe that the housing market will continue to meander at these levels until sometime in 2012, which is when growth and employment are expected to accelerate.

EMPLOYMENT

The employment situation became extremely weak in the third quarter, adding to the problems that began during the second quarter. The August employment report showed net job growth being flat, while only 85,000 jobs were added in July. The unemployment rate held steady in August at 9.1%, but that was little consolation in a continuing disappointing environment. Hiring ground to a halt during the quarter, as businesses took a conservative posture following the wrangling in Congress during debt ceiling negotiations. The economic slowdown and outlook for resolution to the economy's ails have prompted many economists to lower expectations for the employment outlook, with some now estimating that it will be 2013 before the labor market will begin generating 200,000 jobs per month, the level which will cause the unemployment rate to fall meaningfully.

FED POLICY

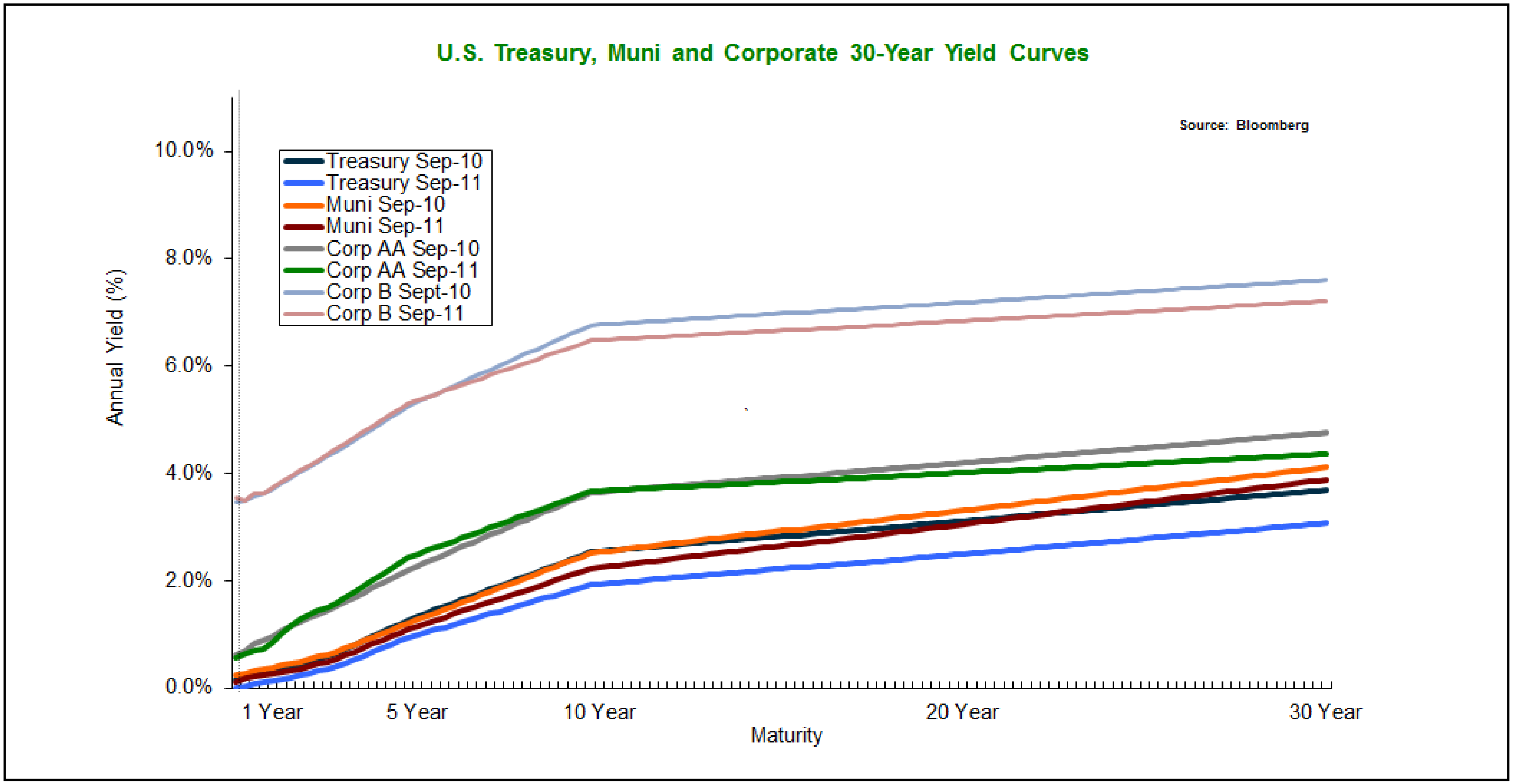
In September, the Federal Open Market Committee (FOMC) announced that it will leave monetary policy unchanged, and that it will embark on a new program – dubbed "Operation Twist" – in an effort to provide a spark to the flagging economy. With Operation Twist, the Fed will extend the maturities on its balance sheet by using the proceeds of maturing short-term paper to buy longer term issues. The goal is to help reduce long-term interest rates, which should aid the housing market. The announcement was met with a sell-off in the equity market, as the Fed also provided a rather downbeat outlook for the global economy. In addition, the FOMC earlier in the quarter abandoned the “extended period” language it had used to describe how long it might keep interest rates low. Instead, the FOMC opted to be more transparent by specifying that it would maintain the current level of 0% to 0.25% for the fed funds rate until mid-2013. Inflation remains of little concern to the Fed, but the stubbornly high unemployment rate remains an issue.

The impetus behind Operation Twist is a concern that the Fed is not delivering on either side of its dual mandate: maintaining both price stability and full employment. The concern is so great that it is possible that the Fed will take further aggressive steps later this year, perhaps in the form of another round of quantitative easing. The Fed may also opt to move beyond the purchase of government obligations to buy credits and perhaps even equities. These moves are of course controversial, and three members of the Fed dissented on these latest steps.

Interest Rates

The fixed income market rallied strongly once again in the third quarter. The primary drivers of the rally were the continued slowing in the global economy, an increasing probability of a “double dip” recession, the ongoing euro zone financial distress, and an environment favoring risk aversion. Not even the downgrade of U.S. debt by S&P could crimp the advance of bond prices. As with the strong performance in the second quarter, the rally in the third quarter took traders and investors by surprise, as many had positioned portfolios for a decline in bond prices and a rise in yields. Several factors contributed to the market’s climb: 1) a stubbornly sluggish labor market that has been driven by a lack of confidence in the economic outlook; 2) internal European squabbling as to how to resolve the credit crisis engulfing some of the euro zone’s less fiscally stable members; and 3) a growing sense that the world and U.S. economies may be headed for another recession if fiscal houses are not put in order soon. The underlying thread to all of these issues seems to be a lack of clarity as to fiscal policy, both domestically and abroad. Should the select congressional committee tasked with resolving budget deficit issues make progress in the upcoming quarter, the market may respond by driving up yields.

The yields on Treasury securities declined significantly on a quarter-over-quarter basis, with yields falling across the maturity spectrum. The yield on the five-year Treasury declined 80 basis points from 1.76% from June 30th to 0.96% on September 30th, while the yield on the 10-year Treasury dropped 126 basis points from 3.18% to 1.92% over the same period. The yield on the 30-year Treasury declined by 148 basis points, from 4.38% to 2.90% during the quarter. The yield on the 3-month T-bill declined one basis point from 0.03% to 0.02%.

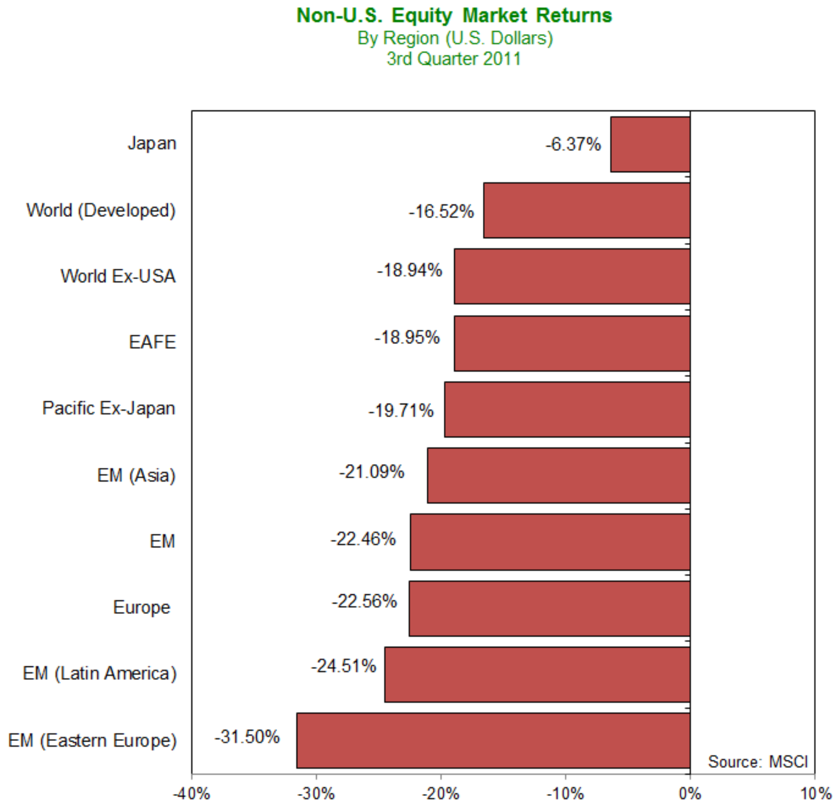


The credit segment of the market was a study in contrasts, as the short end of the yield curve experienced a rise in rates while the longer end witnessed a drop in yields. The yield on the BarCap 1-3 credit index rose 28 basis points, from 1.54% on June 30th to 1.82% on September 30th. Intermediate credit yields declined, with the BarCap 7-10 year index declining from 4.45% to 4.08% during the quarter. As is normally the case, the high yield segment of the market traded more in sympathy with equities than with fixed income. The BarCap U.S. Corporate High Yield index yield rose substantially, to 9.63% from 7.67% at the end of the last quarter. Municipal bonds rallied during the quarter. The BarCap Municipal Bond Index yield declined 47 basis points to 3.02% from 3.49% at June 30th.

Equities

Stocks began the quarter rather innocuously, but by the end had suffered their worst quarterly decline since the first quarter of 2009. Risk aversion was at the top of investors' minds, particularly as the quarter wore on. Once again, the primary drivers of the market's swoon were the same ones affecting the overall economy, with the global economic slowdown, European financial distress and domestic political infighting serving as the main culprits. With such a backdrop, investors adhered to a "risk-off" mentality, opting to let the volatility play out before taking on risk in their portfolios. To complicate matters, emerging markets economies began to falter during the quarter, causing those stock markets to suffer, and further exacerbating losses those in developed countries' markets.

For the quarter, the Russell 1000 Index of large capitalization stocks posted a total return of -14.68%. On a year-to-date basis, the Russell 1000 has declined -9.25%. Small capitalization stocks, as represented by the Russell 2000 Index, bore the brunt of the market's sell-off during the quarter, posting a loss of -21.87%. Year-to-date, the Russell 2000 index has declined -17.02%. Growth stocks outperformed value oriented issues in the large capitalization segment, but value outperformed growth in the mid cap and small cap areas. The Dow Jones Industrial Average declined by -12.10% during the quarter.



International stocks generally underperformed U.S. equities. The MSCI EAFE index of developed markets stocks declined -18.95% during the three months. On a year-to-date basis, the EAFE is down -14.62%. As noted above, emerging market stocks did not fare very well against either international developed markets equities or U.S. stocks, largely due to the slowing of emerging markets economies. The MSCI Emerging Markets Index declined -22.46% in the quarter, and is down -21.66% on a year-to-date basis.

The outlook for stock prices remains no more clear than it did at the beginning of the third quarter. Many analysts view the combination of attractive valuations and corporations' continuing strong profitability and financial strength as presenting an excellent buying opportunity. However, others predict that it will be difficult for the economy to avert a double-dip recession, and that at best, the market will remain extremely volatile. Almost all agree, however, that the economy's - and stock market's - best chance for sustained recovery is if there is meaningful progress made on the budget deficit and fiscal fronts. If Washington can assemble a deficit reduction passage that addresses the country's longer term fiscal issues without sacrificing growth in the short run, the market may be poised to rally.