

In our last market commentary “The European Debt Crisis – Real or Perceived Economic Threat,” we reviewed the possible consequences of an escalating debt crisis within the European Union (EU) and the impact it might have on the overall world economy. We concluded that while it is a very serious problem with its attendant “headline risk” to the equity markets, its potential consequences to the world economy were not sufficient to significantly alter our long-term investment posture for our clients. Specifically, we remain constructive on the long-term outlook for the equity markets, in general.

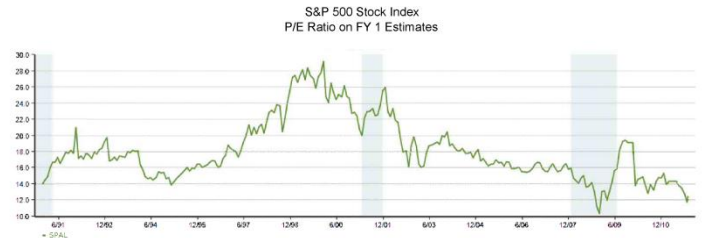
The European debt crisis resurfaced during the third quarter as it became apparent that Greece will go through some form of debt default and a further EU bailout will be necessary beyond what has been proposed so far. This, coupled with new economic data suggesting a slowing of the overall world economy, has revived fears that the US and Europe are heading back into recession. This unsettled the world equity markets in the third quarter with sharp market declines across most of the globe. The US market results for 2010 and 2011 are listed below:

Index	Percent Change (Price Only)				
	Full Year 2010	1st Quarter 2011	2nd Quarter 2011	3rd Quarter 2011	YTD 2011
S&P 500 Stock Index	12.8%	5.4%	-0.4%	-14.3%	-10.0%
Dow Jones Industrial Avg.	11.0%	6.4%	0.8%	-12.1%	-5.7%

Because of the severity of the equity sell-off in the third quarter, investor angst is high and, in some cases, overriding fundamentals. In order to assess future investment posture, we have reviewed major positive and negative forces which should have a bearing on the current market outlook. Our findings are detailed below:

POSITIVE FACTORS

Stock Valuations: US stocks are historically cheap. The following chart shows the price-earnings ratio for the S&P 500 Stock Index based on forward year earnings per share estimates, for the 20 year period 1991 – 2011.

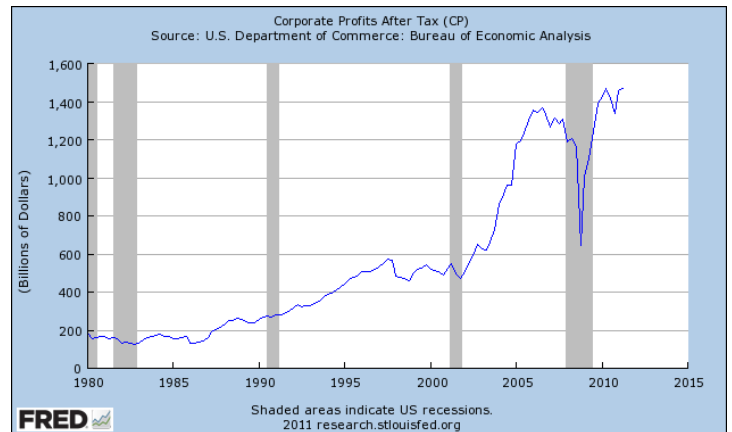


Source: Zacks Investment Research, Inc.

We think the chart is clear in showing that valuations are relatively low. The key comparisons are listed below:

P/E Ratio	20 Year Ranges
High (12/1999)	29.1X
Median	17.2X
Low (9/2008)	10.3X
Current (9/2011)	12.0X

Corporate Profits: At \$1.5 trillion, corporate profits are at record levels. The chart below shows historical profit levels from 1980 to present and the table shows estimated earnings for 2011 and 2012, with solid growth for both years.



S&P 500 Stock Index Earnings Per Share		
Estimates	2011	2012
Mean Estimate	96.66	105.34
Change Y/Y	16%	9%
High Estimate	99.34	112.84
Low Estimate	94.00	100.00
Total Estimates	10	10
# Up (4 weeks)	3	2
# Down (4 weeks)	1	1
PE Intraday	12.0	11.0

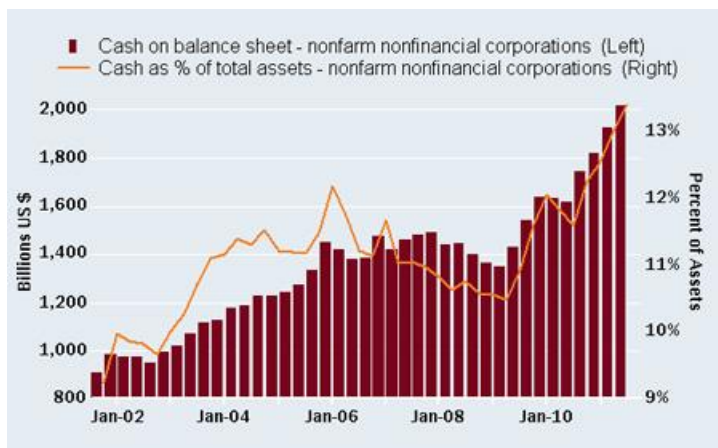
Source: Zacks Investment Research, Inc.

It is interesting to note from above that despite the negative economic news, more analysts have been increasing rather than reducing their earnings estimates in the past four weeks.

Corporate Balance Sheets are Robust

In September, the Federal Reserve released its quarterly **Flow of Funds** report with its myriad of economic data, including corporate liquidity.

As of June 30, 2011 US companies are holding more cash equivalents than at any point on record - \$2.05 trillion to be exact. That represents an increase of about 25% from a year ago, the largest-ever increase, in records going back to 1952. The chart below tracks cash from 2002, showing the build up since the last recession:

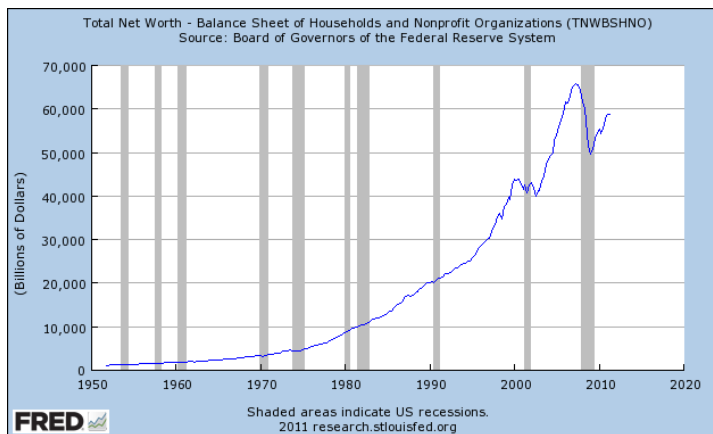


Source: FactSet, Federal Reserve. As of 9/23/11.

*Cash includes: check deposits & currency, commercial paper, foreign deposits, money market funds shares, mutual funds shares, time deposits & savings, and govt. agency & Treasury securities.

The liquidity build up is in large response to the severity of the last recession – but because of the extremely low returns on this capital, stockholders are demanding that it be ultimately used to increase hiring and investment or to make payments to shareholders in the form of dividends or share buybacks. This is already happening on the dividend front as we see direct evidence in our Dividend Growth Portfolio. (Dividends up 11.5% in the trailing 12 months)

Household Net Worth: Consumer net worth continues to show overall improvement from the 2009 recession levels as the following chart illustrates:



After reaching a peak of \$66.0 trillion in the first quarter of 2007, aggregate consumer net worth plunged 27% to \$49.6 trillion in the first quarter of 2009, the result of sharply lower stock prices and home values. Since then, net worth has recovered 18% to \$58.5 trillion as of June 30, 2011 – still 11% below its all time peak. Recovering stock prices and household debt reductions have been the driving force.

US Banking Industry: Since the financial panic of 2008 and 2009 (precipitated by the housing crisis) the US banking industry has been substantially recapitalized and is in a much stronger financial position. This is also true of the non-banking financials, including insurance companies, brokerage firms, etc. Lending standards have been tightened and the financial system, in general, appears to be back on an even keel.

Interest Rates/Monetary Policy: Interest rates are low and are staying low. The Fed has announced its intention to keep interest rates as low or lower through 2013 and to provide all economic stimuli necessary for positive growth. US Treasury yields and mortgage rates are at record lows, as shown by the chart below.

EFFECTIVE MORTGAGE RATE AND THE TEN-YEAR TREASURY YIELD

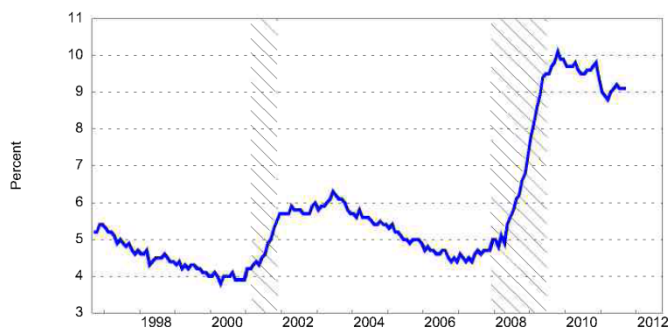


Note: Effective Mortgage Rate (Black), Ten-Year Treasury Yield (Blue)
 Note: Average effective rate on fixed-rate, 30-year conventional mortgages
 Source: Freddie Mac and U.S. Department of the Treasury

NEGATIVE FACTORS

Unemployment: US joblessness continues at unacceptably high levels with little immediate improvement in sight. The following chart depicts unemployment rates over the past 15 years.

CIVILIAN UNEMPLOYMENT RATE
Seasonally Adjusted

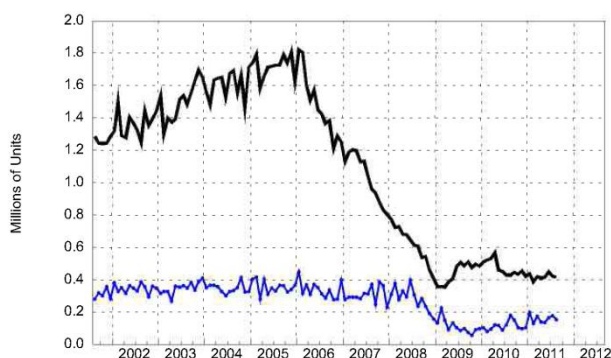


Source: Bureau of Labor Statistics

It should be noted that unemployment is a lagging economic indicator. It took nearly four years to recover from the high levels of the 2001-2002 recession.

Housing: The housing price collapse, which began in 2007, continues to be a drag on the economy and consumer psychology. Despite low mortgage rates, bank lending practices have tightened considerably since 2009 and consumers are still de-leveraging. The general consensus is that housing may bump along the bottom for the next year or two. The chart of housing starts over the past ten years, shown below, illustrates this point.

HOUSING STARTS
Seasonally Adjusted Annual Rate



Note: Single Family (Black), Multiple (Blue)
Source: Census Bureau

US Fiscal Policy at a Crossroads and the Political Standoff:

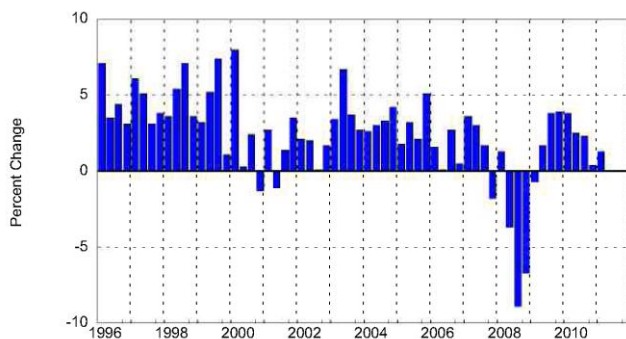
The level of political rhetoric is rising as campaigns begin in earnest for the 2012 elections. The ongoing standoff in

Washington is undermining the confidence of American businesses and consumers. The debt ceiling debacle this summer and the S&P downgrade of the United States credit rating was an absolute embarrassment both here and abroad. The fiscal crisis is real and cannot be pushed down the road as it has been for years. The world is looking to the US for leadership, but to date it is lacking.

While gridlock is generally viewed favorably by the markets, the current environment has many issues being discussed that affect the ability of businesses to make long-term plans. At the same time, many of the decisions that have been made have largely been viewed as anti-business. It simply appears that both parties are avoiding long-term solutions in favor of short-term, less controversial remedies (e.g. "cash for clunkers"). This is not being lost on the American consumer.

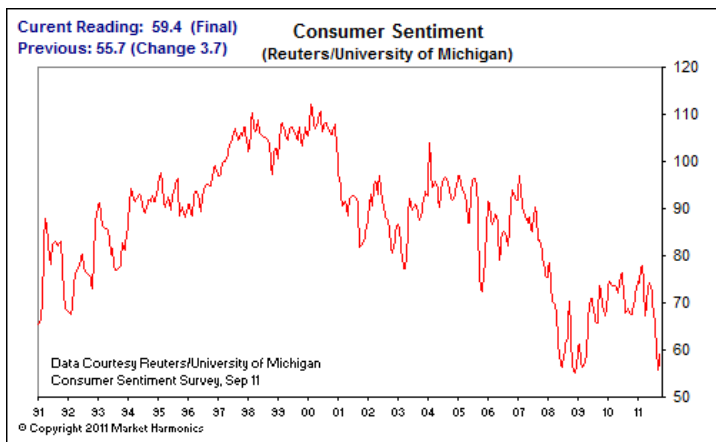
Economic Recovery: The economic recovery that began in 2009 has been tepid and recent indicators show continued growth but at a less than desired rate. While growth probably is very sustainable, the American consumer is wary and concerned with job stability which tempers financial decisions. In some respects this is a self-fulfilling prophecy. The Real GDP growth chart over the last 15 years shown below illustrates the point:

REAL GDP



Source: Bureau of Economic Analysis

Consumer Sentiment: Currently (September 2011) at as low a point as it was at the height of the recession and the bottom of the equity markets in 2009, as measured by the Reuters/University of Michigan Consumer Sentiment Index shown below:



This should come as no surprise given the unemployment rate, the housing picture, the current political environment, and what many consumers believe is a tenuous recovery. In addition, while the Federal Reserve has been taking steps to fight this lack of confidence in its efforts, it appears to be actually having the opposite effect. “QE1” and “QE2” were never understood by the general public and produced no tangible results. Now we have the latest effort, “Operation Twist.”

Conclusions: We believe that the positives outweigh the negatives. The main problem facing the economy is a total crisis of confidence and not a structural shortcoming of the system. The economy appears fundamentally sound, corporate America is healthy and robust, and the financial system has been revitalized. The consumer balance sheet is improving, and stock valuations are compelling.

We believe the EU is close to a resolution to its debt crisis and as that recedes into the background, the world markets will stabilize.

The US fiscal crisis is real and needs to be addressed now in a bipartisan fashion. Any meaningful progress on this front will go a long way in defusing the crisis of confidence and should substantially improve world equity markets.

We have our clients well-positioned in high-quality equities, exchange traded funds, and fixed income securities in a very well-diversified manner. We believe these investment vehicles will provide above-average returns over the foreseeable future.

David J. Szatkowski, CFA
 October 2011