

# INVESTMENT STRATEGY OUTLOOK



## The Economy:

### Third Quarter GDP Up 2.5%

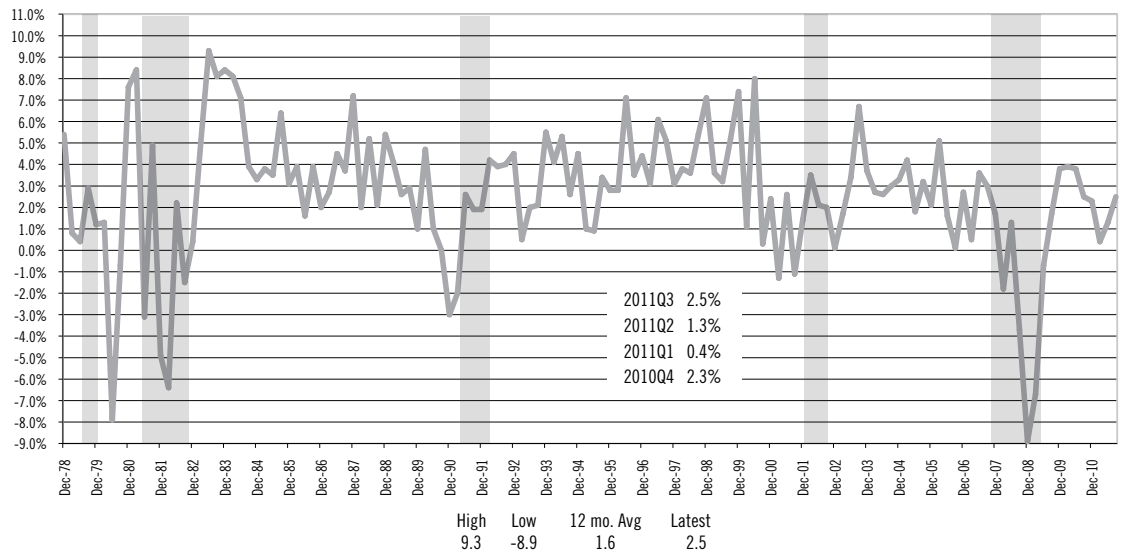
Economic reports turned more positive last month and we saw the incremental improvements we were looking for in capital spending, durable goods orders and consumer spending. Investors' fears that the U.S. economy would slip back into another recession faded, and the stock market's summer plunge and subsequent volatility gave way to a powerful rally. By month's end consumer confidence, which had plunged along with the markets, had ticked back up again.

The first estimate of third quarter GDP (inflation adjusted economic output) growth was 2.5% on an annualized basis, almost double the 1.3% rate in the second quarter. While both of these quarterly growth rates are subject to further revisions and both are below the historical growth rate, the quarter to quarter improvement is good news for investors. Capital spending rose 13.7% in the third quarter. Exports were up 4.0% and consumer spending was up 2.4%. Government spending showed no change, as continuing cuts at the state and local level completely offset increases at the federal level (mostly defense).

The report of September durable goods orders confirmed that capital spending momentum was still in place at the end of the third quarter. Although total orders fell 0.8%, the declines were in the transportation sector, which is very volatile month to month. Non-defense capital goods orders less aircraft, considered the best barometer of private sector investment, was up a substantial 2.4% for the month.

### Change in Real GDP (% Annual)

4th Quarter 1978 - 3rd Quarter 2011



Source: Bloomberg

Despite making significant capital investments this year, businesses have held back on hiring new workers. The good news is that the economy is no longer losing jobs. The bad news is that net job creation has been slow. For the last 12 months 124,000 net new jobs have been created on average each month, enough to keep the unemployment rate from increasing but not enough to push it back down. New unemployment claims appear to have stabilized at about 400,000 a month, but there is no evidence that a downward trend is emerging. The number of job openings, reported by

the Bureau of Labor Statistics, has been in an uptrend for over two years, but at about 3 million, is a much smaller number than the approximately 14 million unemployed. There is probably a significant mismatch between job requirements and job seekers' qualifications. Some people may also be constrained from taking jobs in another location because they are unable to sell their homes.

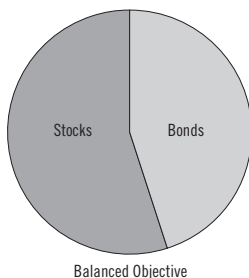
We expect economic growth to continue in the U.S.,

but the rate may slow again. The third quarter's growth in spending is probably not sustainable without some improvement in employment. The consumer was helped by the easing in energy prices in the third quarter, but the price of oil rose in October. Also, personal income growth has not kept up with spending increases in recent months, and the savings rate has been coming down. We expect no growth in government spending, with fiscal austerity in place at all levels, whether by necessity or by policy. The economy is also at risk from financial market turmoil if the European Union does not continue to make progress on a credible plan to contain the Greek debt crisis and build a framework for fiscal integration and economic growth. The spotlight will inevitably return to U.S. policy makers as they face deadlines to reduce the budget and projected borrowing. As investors weigh the implications of likely action (or inaction) in Washington, the outlook for economic growth might look worse.

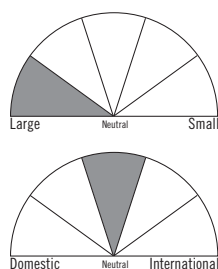
Recession watch is over for now in the U.S. although many policy challenges remain in order to get the economy on the right track for the long term. In Europe it appears that recession may further complicate regional efforts to implement solutions to the fiscal and financial problems.▲

### Asset Allocation Strategy Unchanged

#### Asset Allocation



#### Tactical Tilts



Source: Internal

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## Stocks:

### A Reversal of Fortune

With returns of 9.7%, this past month went down as one of the best Octobers in the history of the Dow Jones Industrial Average. The other major market averages performed even better, with returns ranging from 10.6% for the S&P 500 Growth index to 15.1% for the Russell 2000. Potential progress in Europe, strong earnings reports (with albeit mixed guidance) and positive growth in the GDP inspired investors to get off the sidelines to take advantage of the attractive valuations within domestic stocks. Histori-

Index	October Total Return	1 Year Total Return	3 Year Total Return*	5 Year Total Return*
S&P 500	10.93	8.09	11.41	0.25
S&P 500 Citigroup Value	11.31	5.65	7.93	-2.43
S&P 500 Citigroup Growth	10.59	10.48	14.76	2.85
Russell 2000	15.13	6.71	12.87	0.68
Russell 1000 Value	11.45	6.16	8.78	-2.05
Russell 1000 Growth	10.97	9.92	15.62	3.04
Russell 1000	11.21	8.05	12.24	0.56
NASDAQ Composite	11.20	8.14	17.17	3.52
Dow Jones Industrials	9.72	10.39	11.83	2.55
International-EAFE	9.63	-3.58	10.51	-1.86

\*Annualized

Source: Bloomberg

## Bonds:

### Respite from the European Crisis

During October, there were significant developments in the financial markets that removed some of the uncertainty facing investors and led to an overall lowering of risk levels. The most important event for the market was Europe's agreement on a blue print for addressing the immediate problem of a Greek default and reducing the risk to the banking system posed by the sovereign debt of other weaker governments in the European Union. While some uncertainties exist about the plan and execution risk still remains, it has lowered the risk of a near term default and the fear of the chaos it would bring. Should the plan be implemented as proposed, it should give those governments time to address the fiscal problems caused by large deficits and high debt to GDP levels and afford Europe's banks the time needed to raise additional capital. Investors will continue to watch closely for any weakening of Europe's resolve to move ahead with the plan, but the plan is both credible and sufficiently robust to address any near term problems.

Another equally important development for the markets has been the improvement in the domestic economic data. The slowdown in economic growth in the first half of the year led to fears of the economy slipping into a recession again. This moved some investors to the sidelines and lowered the appetite for risk. These fears reached a peak with the release of the employment data for August which reported a decline in new jobs. The employment data reversed strongly in the report for September with upward revisions for the previous months. Overall, the domestic economic data for the month show growth to be continuing at a slow pace. With more confidence in the outlook for growth, investors have begun to reverse the flight to quality that was so evident in the second quarter.

Finally, the government announced enhancements to its Home Affordable Refinance Program (HARP). HARP will enable home owners who are current on their mortgage loans but whose mortgage exceeds the current market value of their home to more easily refinance. This should significantly increase prepayment rates on higher coupon mortgages issued before 2009. While this will provide a boon to the home owners in the form of lower mortgage payments, it will be negative for investors who hold those mortgages, especially those issued from 2005-2009.

The reversal in the flight to quality trade was evident in U. S. Treasuries. With the

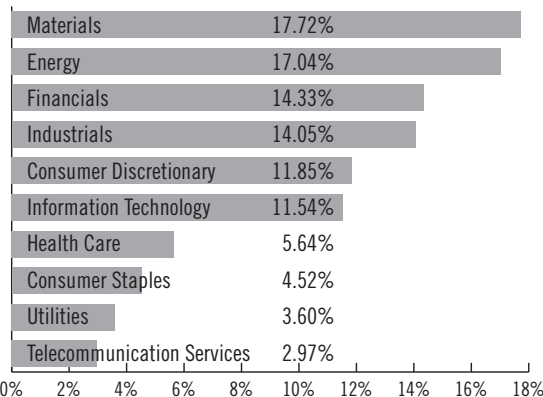
usually, the period of the year from Halloween until May is a strong one, so if that proves to be the case this year, the markets already have a good head start. Market sentiment has dramatically improved in a very short time so earnings and economic reports need to maintain their positive momentum to support further stock strength.

Materials and Energy were by far the best performing areas of the market in October, followed by the Financials sector. The price of oil has risen to \$93 so that has driven the Energy sector. While the earnings quality is not ideal at the Financial companies, earnings are coming in better than expected.

On a relative basis, the defensive sectors of the market were the laggards in October, but their returns were still very respectable on an absolute basis. Year to date, the Health Care and Utilities sectors are still at the top of the market, and that speaks volumes about investor attitudes towards risk in 2011. ▲

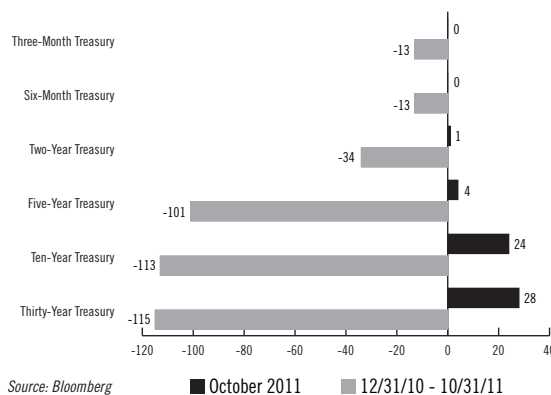
### S&P 500 Performance by Sector

Economic Sector Total Return — October 2011



Source: Factset Research Systems, Inc.

### Basis Point Change in Yield



Source: Bloomberg

Federal Reserve on hold for an extended period, two-year Treasury yields rose only slightly from 0.25% at the end of September to close the month at 0.26%; however, the ten-year Treasury yields increased from 1.93% at the end of September to 2.17% in October. The slope of the yield curve increased from 168 basis points to 191 basis points at the end of October, totally reversing the tightening in September.

The corporate sector remains the most attractive for fixed income investors. Corporate spreads tightened during October as investor fears eased. Company earnings reported for the third quarter remained positive and balance sheets are strong. These fundamentals continue to provide this sector with the potential for further outperformance.

With the enhancements to the HARP program and the Federal Reserve's continued purchases of mortgage securities, forecasts for prepayment speeds, an important component of yields, have been made particularly difficult. Spreads on higher coupon mortgage backed securities widened while those on lower coupons narrowed. The upside in this sector continues to be limited by the potential spike in prepayment speeds and uncertainty over the housing recovery. We therefore remain underweight to agency-quality mortgages anticipating eventual widening of their spread to Treasuries.

The performance of the municipal bond market has been solid this year. After-tax yields remain attractive and state budgets are improving as revenues continue to rise and governments reduce excess expenditures. ▲