QUARTER IN REVIEW

During the quarter, monetary and fiscal policies around the globe were the key drivers of investors' perceptions of the economic outlook and the pricing of securities. The war in Libya curtailed oil supplies. Social unrest sprung up in various countries. The U.S. Congress engaged in a game of budgeting chicken. There is increasing concern that the Greek debt crisis is spreading.

The Federal Reserve Board (the Fed) culminated three months of pronouncements about weak growth and limited inflation with the late September announcement of "Operation Twist." This is an effort to stimulate the economy and job growth.

In the U.S., unlike the European Union (EU) counterpart the European Central Bank (ECB), the Fed has responsibility for employment as well as price stability. The Fed will sell short-term securities and buy long-term Treasuries and agency mortgages in an effort to lower long-term rates, spur housing stability and job growth. The Federal Funds Rate will be left near zero into 2013.

Table I

	5 Yr. Credit Default Swap Spreads		Interest Rates as of 09/30/2011	
	12/31/2010	9/30/2011	3 Mo.	10 Yr.
Greece	1,074	5,391	6.85%	20.94%
Italy	238	470	1.41%	5.53%
U.K.	72	94	0.44%	2.42%
Germany	59	112	-0.13%	1.88%
U.S.	42	51	0.02%	1.92%

Source: Bloomberg

The ECB kept its focus on the spreading sovereign debt crisis. For 18 months, the ECB has been demanding austerity measures and committing to pump support into the Greek financial system. Each attempt has been greeted with a return to calm, followed by an inability to keep commitments, then renewed concern that has expanded to other southern euro zone nations, as exemplified by the expansion of credit default swap (CDS) spreads and higher interest rates shown in Table I.

Meanwhile, Japan continued to cope with its natural disasters. China has raised interest rates and tightened credit to slow its growth and stave off inflation.

Equity markets churned with the mood swings of the bond markets, as shown in Table II.

Table II

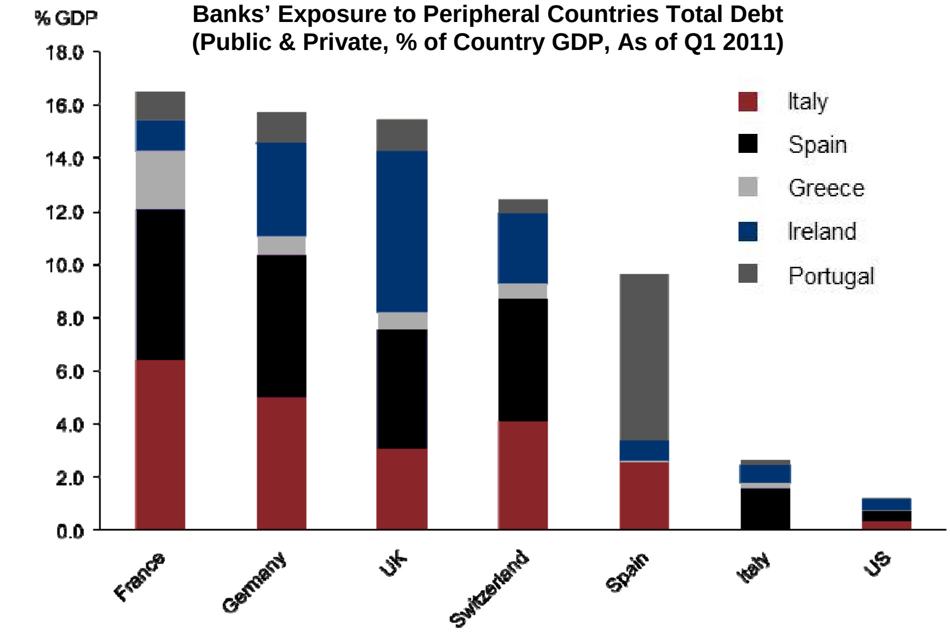
	Interest Rates and Index Levels			
	Year End 2010	2011 Low	2011 Low Date	9/30/2011
3-Month Treasuries	0.12%	-0.01%	08/24/2011	0.02%
5-Year Treasuries	2.01%	0.78%	09/22/2011	0.95%
10-Year Treasuries	3.29%	1.72%	09/22/2011	1.92%
30-Year Mortgages	4.99%	4.01%	09/29/2011	4.07%
S&P 500 Index	1257.64	1119.46	08/08/2011	1131.41
Russell 2000 Index	783.65	643.42	09/22/2011	644.14
MSCI EAFE Index	1658.30	1331.35	09/22/2011	1402.75
MSCI Emerging Markets Index	1151.39	851.51	09/26/2011	894.48

Sources: Bloomberg, Yahoo! Finance, MSCI.com

Global Interconnectedness Matters

Governments, banks and companies lend and borrow from each other, entangling their finances. China is now the largest owner of U.S. Treasury debt, excluding the Fed. Within the EU, the major national banks are more closely tied to their countries and to each other, as you can see from Chart I showing bank ownership of EU/Euro based nations' debt.

Chart I



Sources: IMF, BIS, Goldman Sachs

The U.S. is a federation of 50 states where the whole dominates, has one currency, fiscal and monetary policy. The EU has 27 members of which 17 share the same currency, the euro. The ECB sets monetary policy for euro members. However, each of the 17 member nations sets its own fiscal policy and must approve any substantive change in the balance sheet of the ECB. The EU evolved after WWII; there has been no war on the continent since then.

The euro was introduced in the 1990s and became the sole currency of the 17 nations at the end of 1999. Germany, followed by France, dominates the euro zone. (The United Kingdom declined to adopt the euro.) The biggest issuer of debt is Italy, which is the third largest sovereign debt issuer in the world. After a painful period of austerity during the integration of the two Germanys, Germany is fiscally strongest.

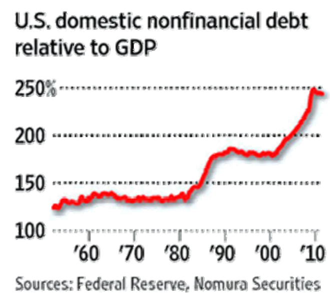
The Greek sovereign debt issue is a solvency issue; Greece does not have the resources to repay its debts. Countries with liquidity problems include Italy and Spain. In the third quarter, the ECB established a European Financial Stability Facility (EFSF) to buy Greek debt and the debt of other euro members under siege by bond investors. How the EFSF will operate is under discussion. European banks have made substantial use of wholesale funding, paying for large deposits from sources such as money market funds. As sovereign debt concerns broadened, U.S. money funds have cut their exposure to European banks whose balance sheets include substantial sovereign debt holdings (see Chart I above). As noted in the last issue of *Perspectives*, we did our evaluation of money market, bond and equity funds' and managers' exposure to euro zone banks in June. We continuously update our assessment.

Stop gap measures continue to be developed and haggled over and wind their way through each euro zone member's government approval process. So far, none appear to be a long-term solution. There are several long-term routes: 1) increased government sector assumption of debt and possible "mutualization" of euro sovereign debt through issuance of ECB backed bonds that replace members' debt with some, such as Greek debt, bought at sizable discounts; 2) increased private sector leadership through privatizations, as well as reduced government regulation, coupled with something like "Brady Bonds," which were used to resolve the Latin American debt crisis more than 20 years ago, with a "Trichet Bond," as suggested by Dominic Rossi, Global CIO Equities, Fidelity Worldwide Investments in the *Financial Times* on 9/23/11; or, 3) break-up of the euro zone. None will be easy or fast. Each has its own implications for global finance.

Signs of a U.S. slowdown in growth are visible in Chinese exports to the U.S. China's purchasing managers' index (released the third week of September) declined for the third consecutive month.

So long as the developed world is working down its financial leverage, which was built up over almost 30 years, economic growth will be meager. Even though U.S. consumer debt has dropped from a peak of 76% of GDP in early 2009, at 66% it remains far above the 37% average of the last 60 years. Total U.S. domestic nonfinancial debt relative to GDP remains near its peak since government debt has soared, as shown in Graph I.

Graph I



Haggling over the long-term U.S. budget will extend past the 2012 elections, though some short-term compromise should come out of the current negotiations due to be completed in November. The rest of the world will be watching and will make judgments on the price (interest rate) demanded to invest in U.S. Treasuries based upon the outcome of these decisions. Lack of fundamental long-term progress to reduce the federal budget deficit will increase the U.S. cost of borrowing, as has been the case for other countries with sizable and growing deficits.

Japan presents an exception because, despite their 220% debt to GDP ratio, they are able to self-fund their government debt due to the extremely high personal savings rate, historically double that of the U.S.

Implications of Low Interest Rates

Monetary policies that attempt to stimulate growth (when deleveraging is widespread) appear to stimulate financial markets, rather than job creation or much inflation. The inflation we are experiencing appears to be driven by basic supply/demand factors. Emerging markets are consuming more commodities to build infrastructure, drive cars and eat more protein. The disruption of oil from Libya caused Brent crude, the European price, to rise substantially more than West Texas Intermediate crude. U.S. health care and education costs are being driven by expanding demand.

Interest rates on short-term investments hover near zero in the U.S. The ECB and Bank of England raised rates in response to inflation worries, but are now expected to lower rates because of recession worries. Japanese rates remain near zero. China has raised its key rate and tightened lending standards to slow the pace of economic growth and inflation.

With the introduction of "Operation Twist," longer-term interest rates are near historic lows. The low level of rates is having two effects:

1) hurting savers, retirees, funding of pensions and insurance; and,

2) driving investors into riskier assets, whether longer maturities or equities. The pension funding gap of Standard & Poor's (S&P) 500 companies has dropped from 130% in 1999 when long-term rates were near 6% to under 80% currently. Money has flowed from money funds into bond funds. Although highly volatile, equities have advanced when viewed over a multi-year period and across the market capitalization and geographic spectrum.

Equity Valuation

Our challenge is how to value equities when interest rates are so heavily influenced by government policies. Inflation is about 3.5%, measured by the Consumer Price Index (CPI). Current projected 10-year inflation priced in the bond market is about 2%.

Historically, the return on short-term investments has generally covered the cost of inflation. On average, bond investors desire a real return of about 2%. Assuming 3% inflation, then short-term interest rates would be about 3%, 10-year Treasuries about 5%, and corporate bonds might yield about 6% to7%, depending on credit risk. Assuming corporate profits grow at their long-term average, of 6%, plus dividends of about 2.5%, then equities would return 8.5%, near their long-term average.

Looked at another way, if the companies in the S&P 500 earned about $95, a conservative estimate for this year, at 1200, the S&P 500's earnings yield is about 8%. (The earnings yield is the reciprocal of the P/E.) If the S&P sold at its long-term average of 15 times, the S&P would be at 1425, about 19% higher than its current level. European equities are cheaper than their historical averages, reflecting the uncertainties that surround the EU. In spite of the decline in prices this year, emerging market stocks are trading above their long-term norms, reflecting their improved finances and better growth prospects. Since these do not appear to be average times, perhaps lower P/Es are justifiable.

However one chooses to evaluate the long-term outlook, when looking back in five years, we believe equity investors have a high probability of earning more than bond investors. But, equity investors will endure more volatility. Equity returns will be enhanced when buying at times of heightened fear and reduced by doing so when calm, not to mention greed, reigns.

So discipline remains a key to long-term success.

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