

MARKET UPDATE

SEPTEMBER 28, 2011

SEPTEMBER MARKET VOLATILITY

We last wrote you in August following Standard & Poor's downgrade of the US and the heightened market volatility that followed. Much remains unchanged today. The US economy is showing signs of weakening. Congress is likely to engage in another protracted budget battle with limited progress in reducing the US deficit. Japan is in a recession and there appear to be no resolutions to the European sovereign debt crisis. The result is that market sentiment continues to shift quickly as investors re-assess return outcomes and risk tolerance.

The focus on fiscal policy today, both here and in Europe, has resulted in very high correlations across equity markets, sectors and individual securities. The slightest news causes the markets to move dramatically, with one market following the other across the globe.

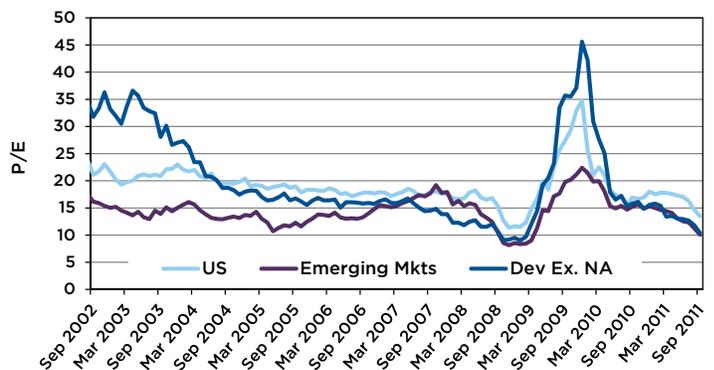
Congress' inability to develop and agree on effective policy measures, as well as the significant use of temporary measures (e.g., temporary payroll and income tax breaks, quantitative easing program) to stimulate the economy will keep uncertainty high in the US, probably until after the election. Europe's inability to effectively deal with over indebted Eurozone members also contributes to market volatility. And, the longer that fiscal policy makers wrangle to come up with real solutions, the greater the likely damage to economies worldwide.

US productivity has returned to year ago (2Q) levels. For profits to remain level, corporations must further cut costs (some have pre-announced layoffs), or sales must increase. With increased European capital tied up in banks or bailout funds, European growth remains vulnerable. Because US production growth is hampered by low demand and high regulation, precursors of a recession have appeared, although a recession is not a certainty. A widespread sustainable market breakout in the near term is not very likely. The market bottomed in 2009 following a surprisingly positive earnings report from Citigroup, which showed that growing profits was possible. However, following several bailouts and

Federal Reserve actions, sustained demand growth has not materialized. Until profits increase as a result of sales growth, the markets will ebb and flow with extraneous news events that capture headlines. The current period of economic stagnation is unlike most downturns, and the only reasonable way to get out of a debt crisis is to pay down debt over time. The alternatives of default or inflation have too many negative implications to be considered reasonable.

The good news is that at today's level, the S&P 500 appears fairly priced trading at 13.5x trailing earnings and 11.4x forward earnings. The EAFE and Emerging Markets indices also appear much more attractively priced today than just one month ago. The European markets appear most cheaply priced, although they are most vulnerable to further decline given current economic and fiscal problems. Emerging markets remain healthy, but amid a global slowdown, earnings growth may decline. Falling earnings or signs of inflation could result in markets trading down further.

Price/Earnings



In uncertain times, we believe it best to focus on fundamentals. We recommend maintaining adequate cash for spending needs and rebalancing back to target levels if allocations move out of line with policy allocations. In light of market volatility, we will monitor allocations more frequently and advise you of any necessary investment changes.