



Economic Commentary and Capital Market Update

November 2011

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October's news continues to reflect an economy that is improving modestly but at a pace disappointing to many. Neither recession nor boom; we have entered a period of slow, sustained growth that we have been talking about for many quarters. Now the economy is walking a tightrope between below historical growth rates and another recession. There are no easy economic policies to resolve the slow growth/high unemployment problems that persist in the U.S. So what are we facing? We have slow, subpar growth that should come in at 2.5% for the second half of this year and 2.0-2.5% for 2012.

Anemic growth is anchored by the three major problems of housing, employment, and government deleveraging. Housing has been a strong contributor to growth in earlier recoveries and yet we expect housing starts to improve slowly, averaging 740,000 next year compared to 610,000 this year. Second, job gains remain far below prior recoveries and we expect them to average only 100,000 a month in the year ahead while a typical recovery would average 250,000 mid-cycle. Finally, the restructuring and retrenchment of both the federal and the state-local governments leads us to believe that government purchases will subtract from growth for all of 2012. The outlook is not bleak but it is sure not robust. Moreover, negative events in Europe and the emerging economies could also have an impact.

GDP: U.S. Real GDP rose at a 2.5% pace in the third quarter and is up 1.6% from a year ago. The gains in the third quarter reflected improvement in consumer spending, business investment – equipment and structures, residential investment – and even government spending. *U.S. GDP output has now exceeded the pre-recession peak; it has taken roughly four years to retrace our steps.* The report on GDP follows a recent batch of mixed signals on the U.S. economy. Persistently high unemployment has cast a shadow over the recovery, denting consumer and business confidence and adding to the problems in the housing market. Other data have shown businesses are picking up spending, while once again third-quarter corporate reporting season has brought upbeat profits from a number of sectors, boosting the stock market after a volatile summer.

Consumer Spending: Consumer spending increased by 0.6% in September, up from 0.2% in August. Personal income gained 0.1% while personal spending grew 0.5%. The core PCE deflator – a metric used by the Fed to gauge inflationary pressures – expanded by only 0.03% in September.

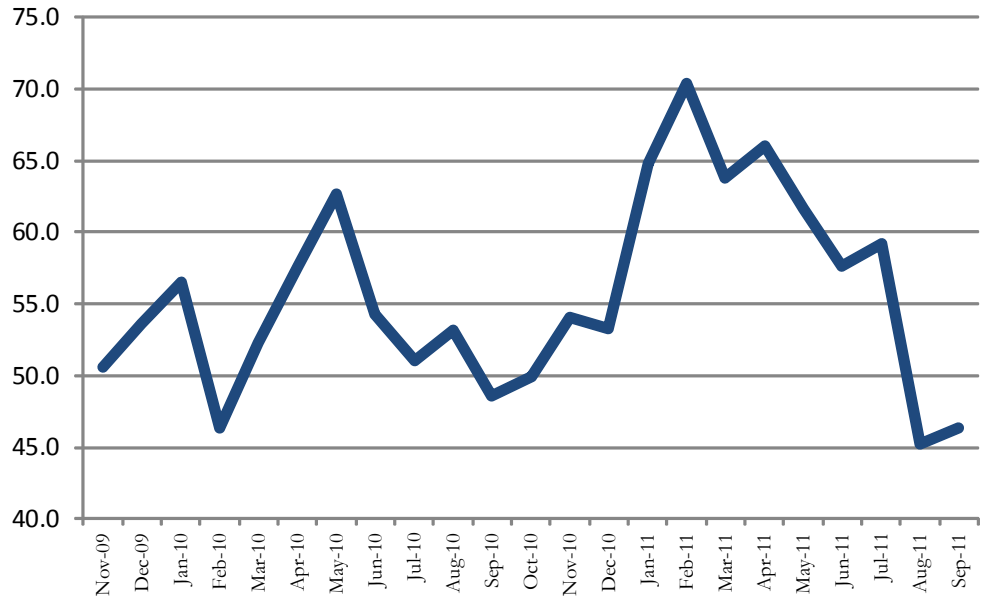
Two factors will likely influence spending in the coming months. First, auto sales should moderate as backlogged demand is fulfilled. That will remove a key support from durable goods spending. Second, incomes are not keeping pace with spending growth. With disposable incomes falling for the third straight month, consumers have used their savings to support a higher level of expenditures; this is probably pent up demand from a more subdued summer. Income growth is necessary for households to maintain spending momentum. Fortunately, inflationary pressures have eased in recent months, which should put a floor under declining real incomes. This new information continues to send the signal that the economy is unlikely to fall into another recession. This should continue to be supportive of the equity markets.

Consumer Confidence: The Consumer Confidence Index dropped to its lowest level since March 2009 (the month the stock market began its historic rally), down to 39.8 in October from an upwardly revised 46.4 in September. October's drop in consumer confidence is perplexing because all the signs point to an economy that continues to improve. Interestingly, deterioration in consumer confidence continues in the vein of other survey-

based data that have diverged markedly from actual measures of economic production in recent months.

Consumer confidence has been falling since early 2011 and this sustained drop is worrisome because it suggests pessimism is becoming engrained in the consumer psyche. The more consumers and businesses lose confidence and turn inward, the longer will it take for the economy to recover its full strength.

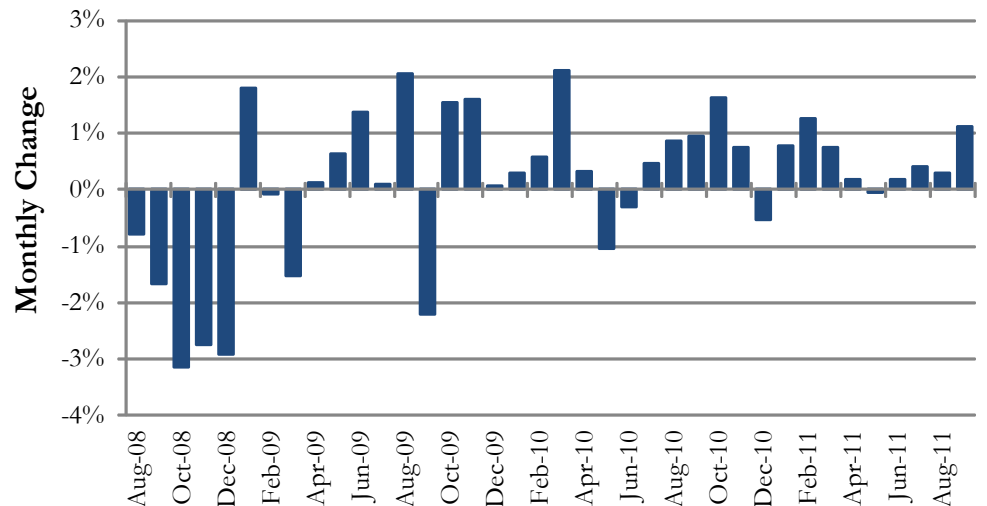
Consumer Confidence



Retail Sales: One noticeable divergence in news over the past couple of months is the separation between consumer confidence and actual consumer behavior. Strong retail sales in September combined with a 0.6 percent jump in personal spending suggested that, while consumers are not confident, they are at least still buying. Retail sales rose 1.1% in September. Excluding autos and gas, core retail sales were up 0.5%. Retail sales have managed to register gains at a time when confidence in the economy has dropped and financial market volatility has become the new normal.

The retail picture seems to be brightening gradually as we move into the key holiday season. Core sales grew at an average annualized rate of 4.6% over the last three months, still below levels from earlier in the year, but higher than the late summer lows. With job growth inching upward and other areas of the economy holding firm, retail sales should remain firm over the next few quarters. Consumer behavior is key to capital market sentiment since it represents 70% of economic activity.

Retail Sales



Industrial Production: Despite building positive domestic momentum, the rebound in U.S. manufacturing sector activity continues to be constrained by a combination of heightened uncertainty surrounding the ongoing European debt crisis and weakening global demand. Industrial production (IP) increased 0.2% in September. Manufacturing, which makes up two-thirds of the headline index, accelerated to 0.4% from 0.3% in August. The gain was driven by growth in motor vehicles and parts and computer and electronic parts production. Capacity utilization expanded to 77.4%, a 1.7 percentage point increase from its level a year earlier but 3.0 percentage points below its long-run average from 1972 to 2010.

Surging auto production has done much to boost IP since July, but this is unlikely to be sustained as much of the growth in auto production was to make up for the slowdown in production last spring that followed the supply chain disruption caused by the earthquake in Japan. With inventories now rebuilt, we expect auto production to return to a more moderate pace of expansion in the coming months.

September's IP figures complement the recently released and somewhat improved employment and retail sales reports and is consistent with our view that the economy is slowly inching forward. This is further evidence that a double dip recession is more unlikely in our immediate future. Looking ahead, with the economic recovery appearing to be regaining traction, we expect overall manufacturing sector activity to rebound and the ISM index to move decisively back into expansionary territory.

Durable goods: New orders for durable goods dropped 0.8% in September due to a sharp decline in the volatile transportation equipment component. Orders for durable goods, excluding transportation equipment, were up 1.7% in September. This signals a solid performance of fixed investments in machinery and equipment during the third quarter. This should reduce fears that the U.S. economy is likely to slip back into recession, at least over the next several quarters.

Inflation: Consumer prices (CPI) rose by 0.3% in September while core CPI came in at 0.2% in the month. On a year-over-year basis, overall consumer price inflation rose to 3.9% (up from 3.8%), while core (excluding food and energy) remained steady at 2.0%. Gasoline prices led the way in terms of price increases in September while food price growth decelerated slightly.

Despite a decrease in oil prices, gasoline prices have continued to contribute strongly to overall inflation. This discrepancy should not last, and we expect gas prices to move down over the next several months, taking some of the steam out of headline inflation. The deceleration in core price inflation was largely due to the alleviation of temporary factors that had been pushing up price growth in previous months. Moving forward, we continue to believe that inflation will be a non-issue in the coming months.

Housing: Housing starts rose to a 658,000-unit pace in September following an upwardly revised 572,000-unit pace in August. The gain was driven primarily by increases in multifamily starts. Strength in housing starts was broad-based across the regions. Not only did activity come in much stronger than markets had expected, it did so at a time when sentiment over the economy has taken a turn for the worse.

For developers, rental properties have become an attractive prospect. A weak labor market and tightened lending standards is forcing many would-be homebuyers into the rental market, which is swelling the demand for units,

and driving up prices. We continue to expect new home construction to gradually improve but at an uneven pace. Given today's consumer preference for the rental market, the improvement for the remainder of this year will likely continue to be reflected in multifamily building.

Separately, new home sales in September increased. While the increase is encouraging, the level of new home sales has remained relatively flat over the past year. Builders still have very little incentive to increase construction activity in a meaningful way when existing homes are selling at a discount. The 20-city Case-Shiller Home Price Index fell 0.05% in August, following a downwardly revised 0.15% decline in July. Home prices are now 3.8% lower than a year ago. Given weak summer home sales and a large inventory of foreclosures still in the pipeline, there continues to be a risk that home prices could fall further and pose a further impediment to a sustained economic recovery.

Labor: While economic growth continues, the improvement in employment remains muted. Last month's employment report showed modest job gains and unemployment stubbornly above 9%, reinforcing the message that structural unemployment has taken on a greater share of the jobs issue today. For many workers, the skills and location issues are significant barriers to an easy transition to a new position.

After grinding to a halt in August, the U.S. labor market recovery appears to be slowly regaining traction. This positive momentum is expected to be sustained in October with the economy set to add a respectable 130,000 private sector jobs. This pace of employment growth is largely consistent with the improving tone of recent jobless claims, which has held relatively steady at about the 400,000 mark. Employment growth in the education sector, professional services and retail sales should be the main driver for labor market activity, accounting for almost all of the gains in service sector employment. Public sector employment should continue to decline. With the modest improvement in employment, we expect the unemployment rate to dip marginally to 9.0% as the increase in employment is likely to only partially offset the increase in the size of the labor force. In the coming months, with the economic recovery continuing to gain traction, the pace of job growth should accelerate, though the unemployment rate is expected to remain elevated and could rise appreciably as previously displaced workers move back into the labor force in search of new jobs.

Federal Reserve: To repeat a theme we have held all year, we believe that modest economic growth and a sub-2% core deflator dictate that the Fed will not change the federal funds rate at all in the next year. While short-term interest rates are anchored by the fed funds rate, long-term benchmark Treasury rates have fallen sharply in response to the turmoil in Europe as well as the significant downshift in economic growth expectations.

The upbeat Q3 GDP report should provide some important context for the discussions on the conduct of monetary policy at the November FOMC meeting. The renewed positive growth momentum in the U.S. economy will almost certainly result in a slightly more optimistic tone on the Fed's economic assessment, relative to the previous state-ment. However, with the risks to the outlook continuing to be tilted to the downside, the Fed will remain guarded on overplaying this sentiment. The Fed appears to be considering additional ways (such as large-scale MBS purchases) to shore-up the ailing housing market and boost economic activity. However, we don't expect any action at the November meeting.

Trade Deficit: Exports have declined in three of the past four months while imports have dropped or have been

unchanged in five of the last seven months. The weak monthly changes are clear evidence that the Japan disaster, the U.S. debt ceiling negotiations, the U.S. credit downgrade, the European debt crisis and signs of a China slowdown have all factored into a pullback in demand for goods globally. While the effects of the Japan disasters have largely faded, the other factors are still in play, suggesting that further deterioration in these headwinds may prevent trade from being a major contributor to global economic growth in the coming months.

Europe: After weeks of negotiation, European heads of states announced a broad agreement on measures to stem the debt crisis. Those measures covered four areas: i) a voluntary write-down of 50% on Greek debt held by the private sector; ii) an agreement to boost the lending capacity of the European Financial Stability Facility (EFSF) to around 1 trillion euros; iii) an increase in the European banks' core capital ratio to 9% of weighted risk assets; and iv) a commitment to further fiscal consolidation by Euro zone members. Global markets reacted positively to the news.

Without downplaying the significance of these policy announcements, we don't expect this to have a prolonged positive impact on the markets. The initial positive reaction should give way to a more cautious market assessment.

The European leaders have delivered a skeleton of policy measures that are very thin on critical details. Setting aside the short-run rally in equity shares, the sovereign bonds' market reaction was much more subdued – Irish, Italian and Spanish yields had been trading only a few basis points below the levels observed earlier. Our analysis of how the plan might be implemented raises the possibility that the new proposals may not be adequate to fully address the fiscal and financial challenges facing Europe. Governance and growth challenges for the European Union remain after this deal. We believe the transition to an economic union on par with the monetary union is critical. Going forward, we expect the European sovereign debt crisis and its related uncertainty to continue to rattle the global markets.

Outlook: Looking ahead, we expect this environment of sluggish and grinding growth to persist as the U.S. economy continues to heal from the credit crisis. Economic growth will remain modest through 2012, suggesting that unemployment is likely to be stuck at an unfortunately high level, inflationary pressures should remain modest, and we expect no change in the Federal Reserve policy on the federal funds rate. For the next six months we anticipate growth will reflect modest gains in consumer spending, equipment & software spending and modest improvement in commercial and residential construction (mostly apartments).

There were a number of factors which have changed in recent months which should improve economic prospects in the coming year for 2013 and beyond. First, the national average mortgage interest rate has declined by more than 1% since early this year. Long-term interest rates have declined by similar amounts on Treasury securities and on corporate and municipal bond yields. As a result, long-term credit costs for many economic sectors have been significantly reduced allowing for refinancing credit at lower interest rates for the long term.

Second, since the summer, the annualized growth in the U.S. money supply has increased from about 5% in June to more than 15% in October. While some of this money supply increase may be due to fallout from worries over the European crisis, it nonetheless has massively improved economic liquidity conditions, and similar to last year, should help improve the pace of economic growth in future quarters.

Third, despite a recent surge in the value of the U.S. dollar, the trade-weighted dollar index is still more than 15% below its highs in mid-2010 and about 8% lower than it was at the beginning of 2011. A weak dollar has typically been a good indicator of future improvements in U.S. net exports which have added to real GDP growth in each of the last two quarters. U.S. dollar weakness during the last few months implies net exports should regularly add to real GDP growth in 2012.

Fourth, energy prices have fallen since late spring. Pump prices are down nationally by about 15% allowing these dollars to be redirected for other discretionary household purchases

Fifth, U.S. corporate profits posted yet another solid quarter of growth in the third quarter probably rising at an annualized rate of about 20%. This record-setting profit recovery cycle coupled with an improvement in business confidence may increase business spending and improve job creation during 2012. Even if it does not in the short run, corporate America is well positioned to add workers as demand becomes more visible and productivity gains can longer keep up with increased demand.

Finally, as the Japanese economy bounces back from its early-year tsunami, U.S. manufacturing supply chain problems are rapidly diminishing. The unexpected slowdown in manufacturing following the disaster appears to be behind us now.

(See next page for Index Performance Chart)

Index Performance as of October 31, 2011	1 Month	QTD	YTD	1 Year	5 Year
Russell					
3000 Growth Index	11.35	11.35	2.55	9.92	3.01
3000 Index	11.51	11.51	0.47	7.90	0.55
3000 Value Index	11.68	11.68	-1.55	5.94	-2.01
1000 Growth Index	10.97	10.97	2.98	9.92	3.04
1000 Index	11.21	11.21	0.92	8.01	0.54
1000 Value Index	11.45	11.45	-1.08	6.16	-2.05
Mid-Cap Growth Index	13.48	13.48	0.33	10.08	3.46
Mid-Cap Index	13.01	13.01	-0.93	7.85	2.26
Mid-Cap Value Index	12.55	12.55	-2.09	5.83	0.73
2000 Growth Index	15.86	15.86	-2.17	9.84	2.68
2000 Index	15.14	15.14	-4.46	6.71	0.68
2000 Value Index	14.41	14.41	-6.77	3.54	-1.42
S&P 500					
	10.93	10.93	1.30	8.09	0.25
Consumer Discretionary	11.89	11.89	5.47	12.74	2.61
Consumer Staples	4.51	4.51	8.04	11.29	6.78
Energy	17.05	17.05	3.71	19.24	5.77
Financials	14.33	14.33	-14.43	-5.89	-15.64
Health Care	5.75	5.75	8.42	10.02	2.19
Industrials	14.00	14.00	-2.74	5.95	0.76
Information Technology	11.54	11.54	5.06	8.77	4.76
Materials	17.73	17.73	-7.92	2.76	3.21
Telecommunication Services	2.97	2.97	1.41	7.75	1.30
Utilities	3.60	3.60	14.73	14.69	3.52
Other U.S. Equity					
Dow Jones Industrial Avg	9.72	9.72	5.45	10.39	2.55
MSCI USA	10.99	10.99	1.31	8.21	0.46
Wilshire 5000 (Full Cap)	11.53	11.53	0.21	7.58	0.94
International Equity - Broad Market					
MSCI EAFE	9.65	9.65	-6.38	-3.64	-1.95
MSCI Emerging Markets	13.26	13.26	-11.27	-7.44	6.83
MSCI Frontier Markets	2.21	2.21	-14.95	-11.72	NA
MSCI AC World	10.74	10.74	-3.88	0.94	0.23
MSCI AC World ex USA	10.54	10.54	-7.67	-4.25	0.08
MSCI AC Asia ex Japan	12.01	12.01	-10.08	-6.50	7.00
International Equity - Country Region					
MSCI Brazil	19.41	19.41	-14.05	-12.28	13.76
MSCI BRIC	15.99	15.99	-14.11	-13.27	6.66
MSCI China	15.16	15.16	-12.91	-15.58	9.06
MSCI Europe	12.11	12.11	-4.85	-4.65	-2.15
MSCI India	8.56	8.56	-20.45	-19.99	5.43
MSCI Japan	-0.25	-0.25	-10.97	-2.17	-5.14
MSCI EM Latin America	17.52	17.52	-12.67	-10.27	11.23
MSCI Russia	19.14	19.14	-9.46	0.52	-3.73
Fixed Income					
BC Aggregate Bond	0.11	0.11	6.76	5.00	6.41
Merrill Lynch 3-month T-Bill	0.00	0.00	0.10	0.13	1.66
BC Government	-0.71	-0.71	7.34	4.89	6.30
BC Credit Bond	1.46	1.46	8.10	5.95	6.86
BC High Yield Corporate Bond	5.99	5.99	4.52	5.17	8.04
BC Muni Bond	-0.37	-0.37	8.00	3.82	4.80
BC TIPS	1.86	1.86	12.65	9.03	7.54
BofA ML Global Broad Market Ex USD	2.01	2.01	7.02	3.49	7.29
BofA ML Global Broad Market	1.17	1.17	6.88	4.12	6.91
BofA ML Emerging Market Credit	6.60	6.60	5.65	5.82	9.01
Alternative Investments					
NAREIT Equity REIT Index	14.28	14.28	7.36	10.16	-1.01
DJ-UBS US Commodity Index	6.62	6.62	-7.90	1.58	-0.75
			-3.34		