

Financial Market Commentary: 3rd Quarter 2012

Exceptional One Year Returns across the Globe Especially in the U.S.

A year ago the U.S debt rating was downgraded, meaning, the stability of the world's reserve currency was called into question. What could be worse than that? The other pillar of the developed world, the European Union, imploded under the weight of a sovereign debt crisis. In response, investors herded into conservative asset classes and out of any risky asset, especially equities. Did these events represent an unmitigated disaster for investors or an opportunity? 3rd Quarter 2011 was the financial market's worst quarter since 2009 and price levels were clearly signaling Armageddon, or a "run for the exits" sentiment as investors obliged. But the fundamentals, the primary driver of markets, ultimately were signaling an enormous buying opportunity.

Investors who had the foresight to buy into a globally diversified portfolio with moderate risk could have accumulated a king's ransom over the following year. Equities were the sweet spot, but even fixed income – not short-duration cash, but real bonds – performed spectacularly. The S&P 500 surged, bonds were up, volatility measured by the VIX plummeted, and the aforementioned moderate risk portfolio was up. This information is astounding compared to the anemic, near-zero cash rates being offered over the last year. The recent performance of the financial markets demonstrates, "Successful investing demands a choice between prudent risk control and outright risk avoidance."

The VIX recently hit a low of 13, a world of difference from the near 50 levels that weighed on markets this time last year. As we start the final quarter of 2012 which has been an extraordinary year so far, it is imperative to assess the current fundamentals, the global risks, and the recent extraordinary global monetary stimulus.

Fundamentals Continue Despite Signs of Weakness

Advancing Corporate Earnings

Earnings are the most important coincidental indicator of a bull market. As the market rally progressed, corporate earnings grew in second quarter 2012 over the year-ago quarter despite many dour Wall Street predictions of negative growth; this marked the 12th consecutive quarter of positive earnings growth. With third quarter earnings season, however, we face the risk that the S&P 500 will suffer the first negative year-over-year quarter since third quarter 2009. This is profoundly meaningful. U.S. corporate earnings have marched through extraordinary global risks to defy negative forecasts before, and they may do so again; however, to borrow a phrase from Apollo 13, "Houston, we have a problem."

Broadening Manufacturing

Global manufacturing indexes have also significantly weakened. The contraction over the last few months is a serious concern. Perhaps the latest round of QE3 is enough to help manufacturing get back on track. But one month of good news is not a trend, and we see that China is already bumping along in a "hard landing" pattern and may further frustrate the potential for future manufacturing expansion.

Consumers Can Be a Game Changer

The consumer once again took retail sales levels to all-time highs during the 3rd Quarter. However, consumers had to dig into their savings to accomplish this causing the savings rate to dial back slightly. However, consumers are gaining confidence as their most important asset – their home – is no longer rapidly declining in value but showing signs of price stabilization if not modest appreciation. Could it be possible that housing has legitimately turned a corner and will provide vital support to consumer balance sheets in time?

Developing Economies

Including but not limited to the Philippines, Indonesia and Vietnam, there is an unstoppable wave of Asian countries queuing up to become the next generation of middle-class consumers. Southeast Asia is a vibrant region of young, educated populations, low debt-to-GDP ratios, stable banks and plenty of room to run, filling the gaps resulting from slowdowns in China, India, Brazil and Russia. The trajectory is not always a straight line, but the potential for growth is staggering.

Risks on the Horizon

Impending Risks That the Market May Assess

- U.S. elections: While the presidential election gets most of the attention, one-third of the Senate and all of the House of Representatives are up for grabs this November.
- Fiscal cliff: Tax increases and spending cuts that, in the absence of other action, will automatically be implemented on January 1, 2013.
- European crisis: Attention will turn from debt containment to growth prospects as peripheral countries and perhaps certain core economies enter recession.
- China's hard landing: An adverse impact on global manufacturing already is evident.
- Iranian under threat: There is a risk that Israel unilaterally launches a military strike against Iran.

These risks are all serious but there are many forces that can offset or counteract them. For instance, the European Central Bank's OMT pledge to buy unlimited Spanish and Italian bonds. The U.S. Federal Reserve's quantitative easing #3 to purchase \$40 billion per month of Agency mortgage-backed bonds in perpetuity subject to their discretion.

Speaking of the Pending U.S. Elections

As the elections in the U.S. draw near, I've been approached by investors inquiring about my perspective on which political party may best serve the financial markets and ultimately one's portfolio. While I don't have an answer to that question I do possess some opinions worthy of sharing. To start, it is likely and will be welcomed if the next administration and Congress work to forge a compromise on deficit reduction and tax reform. This union may entail significant changes to spending and entitlement programs, as well as higher taxes, but hopefully will be implemented gradually so as to limit damage to the sluggish economic recovery.



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Investors must take heed and not confuse or marry political views with prudent investment strategies. That is, many people allow their political views to tinge their investing decisions. This may be a bad idea for several reasons. First, politics often strike an emotional nerve - feelings of anger, frustration, or inspiration probably aren't going to help you make better investing decisions. Second, it's a pretty lousy way to invest. After all, what you hear in a stump speech or a TV ad is hardly policy. It's just talk, plain and simple political rhetoric. What's more, there's no telling how the market will ultimately greet a political agenda, no matter how investor friendly it might seem.

For example, the administration of President George W. Bush ushered in a free-market, pro-business attitude not seen since the President Regan years. Hearing this agenda for the first time, one might have guessed it would spur the economy and propel financial markets. But as we now know, economic growth was somewhat anemic during President Bush's tenure and two recessionary periods during 2001 and 2008 affected the U.S. stock market causing a substantial downturn in the value of assets while he was in office. On the other hand, the President Obama administration, whose relationship with big business has been unsettled at times, has witnessed one of the strongest stock market rallies in history from 2009 to 2012.

The point isn't that President Bush was a disaster for investors, or that President Obama has been a ringing success. It's that you would have a hard time predicting, in advance, how each candidate's platform would have translated in investing terms. It's unknown. If you have thoughts of realigning your investment plan based on who you think is going to win the presidency or control the U.S. Congress, here is prudent advice – be patient, don't act on emotion, and don't make investment decisions based on stump speeches or TV ads which promote policy changes which are difficult to determine if there will be any actual benefit for investors.

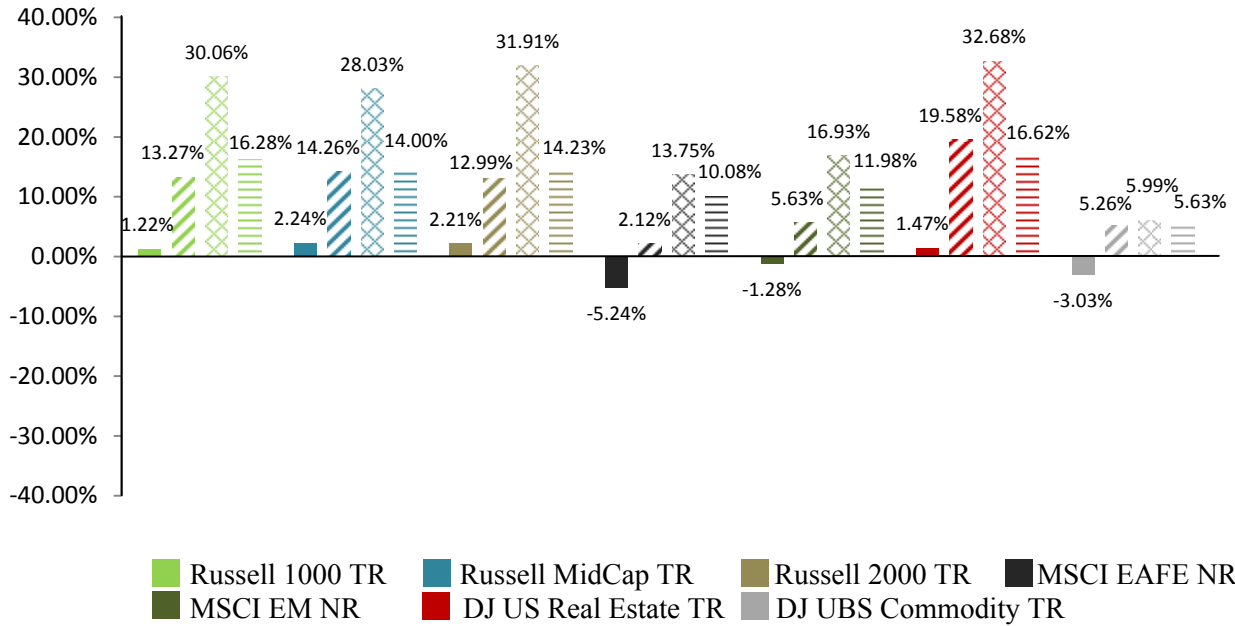
In conclusion, I encourage investors to stay focused on what really matters; invest for the long haul by diversifying among a variety of different assets. Tune out the noise and stick to a well formulated investment plan.



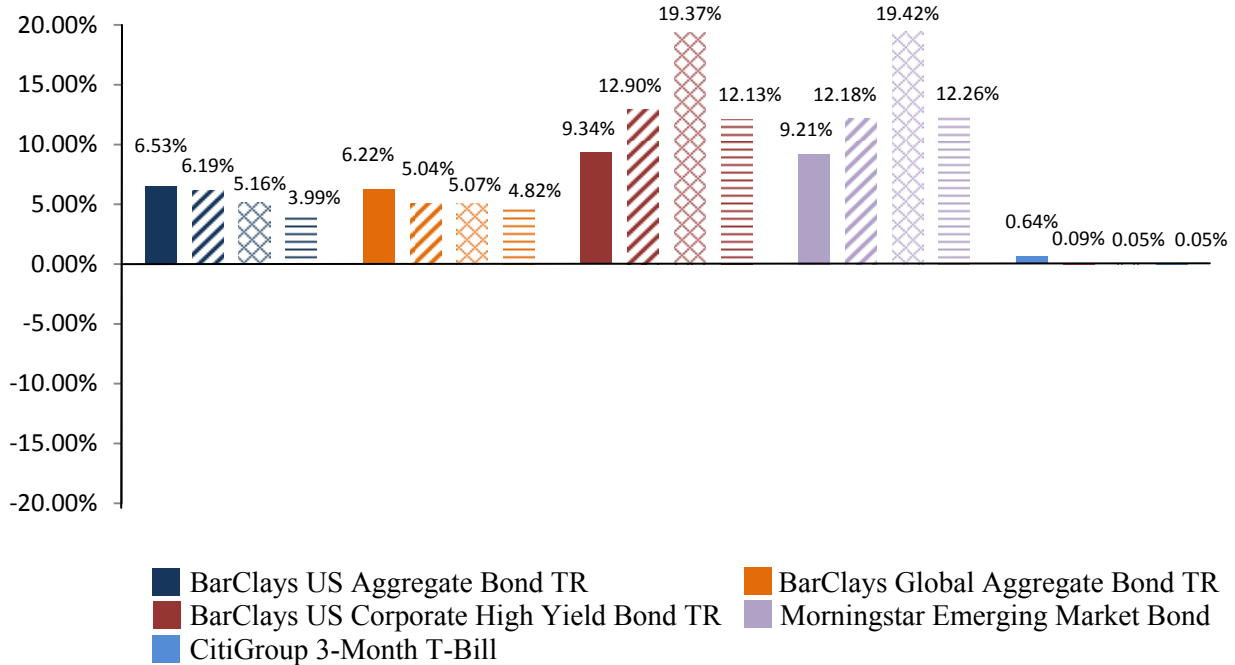
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Solid Bar	5 Year Average Return as of 9/30/2012
Diagonal Bar	3 Year Average Return as of 9/30/2012
Diamond Bar	1 Year Average Return as of 9/30/2012
Horizontal Bar	YTD Return as of 9/30/2012

Equity Performance



Fixed Income Performance



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