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October 2012 Commentary

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The Economy

The U.S.

Though the U.S. economy remains stuck in a slow growth trajectory, there were signs of burgeoning optimism in October. So far 2012 has been characterized by strong returns in the financial markets and weak economic growth for the country. Bad news has so far outweighed good news. For the month of October, economic data were actually more encouraging than expected, though mildly so.

Employment, housing and manufacturing reports point to improving conditions. Much of the disconnect between Wall Street and Main Street has been a result of aggressive monetary policy by the U.S. Fed. Continued record low short term interest rates and quantitative easing have contributed to gains in the financial markets that haven't been felt by the broader economy. October data indicate that the U.S. economy might finally be seeing some improvement from the Fed's actions.

Americans, and the world at large, await political resolution following the U.S. elections on November 6th. Uncertainty has created investment inertia in the U.S. and abroad. Corporations and individuals remain unclear as to the ramifications of the fiscal cliff, ObamaCare and U.S. tax policy. The lack of clarity has discouraged investment and kept cash on the side lines, a detriment to growth.

For greater growth, our country needs fiscal reform and a long-term roadmap to financial sustainability. With a credible plan, we would measurably improve confidence from our private sector, likely resulting in job creation and investment.

In this political season, Democrats and Republicans alike are guilty of placing form over function. Real ideas have given way to hyperbole and slogan. While the realities of American politics will remain, the form of partisan politicking must be joined with the function of creating a substantive plan for our finances. As architect Frank Lloyd Wright once noted: "Form follows function—that has been misunderstood. Form and function should be one, joined in a spiritual union." Congress and the President would do well to follow this advice.

Nonfarm payrolls increased by 171,000 for October, slightly ahead of expectations. The jobs report kept the unemployment rate below 8%. The private sector added 184,000 jobs for the month. In addition, the previous two months of job data were upwardly revised. Though the improvements remain modest, the jobs picture is getting brighter.

Housing and manufacturing surveys were more positive than anticipated. The latest Case-Shiller Home Price Index from August indicated rising prices in nearly all U.S. markets. Previously hard-hit markets like Phoenix and Las Vegas are in positive territory on a year-on-year basis. The latest ISM Manufacturing survey registered a 51.7, the second month of expansion in the sector as new orders and production picked up. Growth remains weak, but still expansionary.

The World

Financial conditions improved in Europe in October, though Europeans are very far from reaching a solution to their fiscal problems. Headlines from Europe's crisis are not going away and still have the ability to move markets on a daily basis.

The crisis in Spain has eased somewhat, as yields on Spanish sovereign debt have come down since the summer. The economic figures out of Spain remain depressed, however. Coupling the country's gloomy economy with badly needed austerity measures, it is only inevitable that they will have to request some form of bailout in the future. The Spanish crisis has taken a brief respite, but will likely return in the upcoming year.

Greece will likely be moving to the forefront of the news in the month of November. The country's ongoing bailout plan will face two potential hurdles in the near future. The Greek government will vote on its 2013 budget in early November, setting the stage for a collapse of the bailout deal should proposed austerity measures be rejected. Eurozone finance ministers meet on November 12th and will evaluate Greece's fiscal progress before signing off on any new funds.

The British economy is finally turning around after a downturn. For the third quarter the United Kingdom GDP grew at a 4.1% annualized rate, the strongest reading in five years. Following painful fiscal austerity measures enacted since the 2008 recession, the British economy has struggled. The latest economic growth number is encouraging and noteworthy.

The recession in Europe has finally caught up with China. As one of the largest customers of Chinese goods, Europe is cutting down on its consumption. China's annual economic growth in 2012 has slowed to 7.7%, a far cry from the 10% rates that the country experienced for years. There may be a silver lining for the Chinese economy. Chinese manufacturing actually expanded in October, indicating that growth may have already troughed and is now increasing again. Many Wall Street economists have now started to raise their estimates for growth in China.

The Markets: A Slight Pause

In the wake of a very strong third quarter, the U.S. equity markets declined in October. For the month, the S&P 500 lost 1.85%, bringing the year-to-date return to a still notable 14.29%. A breather for U.S. stocks was at some point almost inevitable following such strong gains in the summer and early fall.

Foreign equities experienced mixed results in October. Mild optimism over improving credit conditions in Europe provided a base for European markets. For the month, the MSCI EAFE Index rose .83%.

Emerging market equities told a slightly different story, declining 0.61% in October. Tepid global growth continues to dampen optimism in the developing world.

Bonds were mostly up in October. The Barclays U.S. Aggregate Index rose 0.20% for the month. Yields on U.S. Treasury bonds remain very low. Given the low growth environment and below-capacity utilization rates in the U.S., inflation is still not a concern. The Barclays U.S. IG Corporate Bond Index rose 1.29%. The Barclays Global Aggregate Index declined 0.14%, mostly due to a weaker US Dollar for the month.

The Dow Jones UBS Commodity Index declined by 3.87% in October. The IMF recently cut its global growth forecast, while China reported its seventh straight quarter of slowing growth. The increase in pessimism about the global economy weighed on demand for commodities.

Equities Index	Return Date	1 Month	Year to Date	1 Year	3 Years	5 Years
S&P 500	10/31/2012	-1.85	14.29	15.21	13.21	0.36
S&P MidCap 400	10/31/2012	-0.79	12.87	12.11	15.81	3.12
S&P SmallCap 600	10/31/2012	-2.03	11.49	13.60	16.61	2.49
MSCI EAFE	10/31/2012	0.83	11.00	4.61	2.83	-5.81
MSCI EM	10/31/2012	-0.61	11.30	2.63	5.38	-3.47
Fixed Income Index						
Barclays US Agg Bond	10/31/2012	0.20	4.20	5.25	6.08	6.38
Barclays Global Aggregate	10/31/2012	-0.14	4.67	3.54	4.82	5.85
Barclays Municipal 1-10Y Blend	10/31/2012	0.16	3.41	5.78	5.12	5.39
Barclays US Corporate High Yield	10/31/2012	0.88	13.11	13.61	12.56	9.40
Other Index						
DJ UBS Commodity	10/31/2012	-3.87	1.54	-4.44	2.77	-4.43
Wilshire US REIT	10/31/2012	-0.90	13.70	14.40	22.22	1.32
S&P Developed Property	10/31/2012	1.09	22.96	17.39	14.25	-2.23
LPX 50	10/31/2012	2.23	24.07	13.59	11.46	-9.97
BofAML US Treasury Bill 3 Mon	10/31/2012	0.01	0.08	0.08	0.11	0.66

Closing Thoughts

Clarity in the world, both economically and politically, is low. Political ambiguity is rife both in the U.S. and Europe. Confidence in our system and its infrastructure are perquisites for a strong economic recovery. Heretofore in 2012, this confidence has been lacking.

If there is a silver lining to all of the uncertainty, it is that financial markets have still performed very well in spite of the turmoil of our headlines. Through October, the S&P 500 is still up over 14% this year. The Barclays US Aggregate Bond Index is up over 4% through October. Assuming a positive resolution to our fiscal cliff at home, or German bailout acquiescence abroad, a relief rally could be in order for the financial markets.

As long term investors we view the investment cycle in years, not months. In uncertain times like today, it is difficult to ignore the short term: the fiscal cliff and Greece are top of mind. Yet we are not in a sprint. Famed U.S. long distance runner Steve Prefontaine often talked about winning the long distance race—and ignoring the pain.

> *A lot of people run a race to see who is fastest. I run to see who has the most guts, who can punish himself into exhausting pace, and then at the end, punish himself even more. Nobody is going to win a 5,000 meter race after running an easy two miles. Not with me. If I lose forcing the pace all the way, well, at least I can live with myself.*

Steve Prefontaine could ignore short term distractions for long term gain. As a result, he held the record for nearly every single long distance track event in U.S. history in the 1970s. While we are not suggesting that there will be impending short term pain, the long term approach to investing is always a better approach. We will try to take the same philosophy for winning at investing as Pre took for running.