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A Brief Note on Recent Market Action

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Stocks Enter Negative Territory

Recent financial headlines have caused a degree of concern among investors. Since July 22, the S&P 500 has shed about 11% of its value and slipped into negative territory year-to-date. In the past two quarterly market commentaries, Heintzberger | Payne has expressed concern about a "soft patch" in upcoming months. It is now clear that this soft patch has arrived for markets. For over two years the US equity market has provided healthy returns. At the same time the broader economy struggled with high unemployment and a stagnant housing market despite unprecedented stimulative efforts by various levels of government and the Federal Reserve. The recent market pullback reflects broadening views that there is an increased likelihood that a second recession may occur.

What We Have Been Doing

For several quarters, we have continued to favor managers that focus on large, stable companies with stable earnings growth and high dividend yields. Most of these companies were left behind in the rally from the 2009 market lows, and several of our managers were finding compelling valuations in these non-volatile investments. We focused less on smaller companies and reduced portfolio exposure to direct emerging markets. Instead, we favored indirect exposure to emerging markets via investment managers that hold companies such as Coca-Cola.

As the Greek debt crisis evolved, we reviewed the stability of our clients' money market and stable value accounts to both Greek, Italian, Spanish, Portuguese and Irish sovereign debt, and the financial obligations issued by banks in those countries. The money market accounts of Schwab and Fidelity—our primary custodians—have near-zero exposure to any of these nations.

What We Are Watching

Our most recent market commentary also discussed the near-certainty that legislators in Washington would successfully increase the debt ceiling, even if in the final hour. The process was unseemly and somewhat distracting from several larger risks that still remain. We are paying close attention to the following potential headwinds:

- **Peripheral Europe and the European banking system.** Greece, Italy, Spain, Portugal and Ireland are some of the more economically fragile nations in Europe. Yields on Greek government bonds have risen

dramatically, reflecting increasing speculation that this nation may restructure its debt. The Italian economy has also been slowing, and concerns about that nation's solvency are increasing. There are growing concerns that a credit event could cause weakness throughout the European banking system, putting the Euro at risk.

- **Continued level of US government spending**. With continued levels of government spending, and the recent increase of our nation's borrowing capacity, there are concerns that the United States' credit rating may be downgraded. S&P 500 placed the US Government on review, and noted a 50% probability of a downgrade. Several nations have been downgraded from AAA in recent decades (and some had subsequently regained AAA status).
- **Weakening US economic data**. Economic data releases over the past 10 days have been lackluster. These economic realities are being incorporated into market performance. Slow GDP growth, weak manufacturing data and continued slow growth in employment increase the odds of a second recession. As more data is released, we expect market valuations to fluctuate and "price in" improvements or deteriorations.

Final Thoughts

Nothing is certain, and it would be nearly impossible to predict a banking crisis, a recession or a serious credit event for US bonds; but investors can take note of an increased probability that any of these may occur. Understand that some of the worst market corrections have occurred due to unforeseen risks, so the risks outlined above are not all-encompassing. Moreover if the Federal Reserve intervenes with an additional round of stimulus, markets may continue to ignore the underlying economic realities and resume the two-year bull market.

As of Thursday's correction, the markets have erased all of 2011's gains. If economic data continues to argue that we are in fact heading into a second recession, we probably have not yet reached the lows of this correction. Calling market bottoms, however, is almost impossible to do. We believe that maintaining a diversified portfolio will serve investors well over the years to come. We will use the near-term volatility in the markets to put assets with those managers investing in the regions and securities we believe will do best when the markets recover.

An interesting side note: As of the close of today's markets, 22 of the 30 stocks in the Dow Jones Index have a dividend yield higher than the yield on a 10-year U.S. Treasury.

As always, we welcome the opportunity to be of service to you. Should you have any questions or concerns, please do not hesitate to call (503-597-1600).