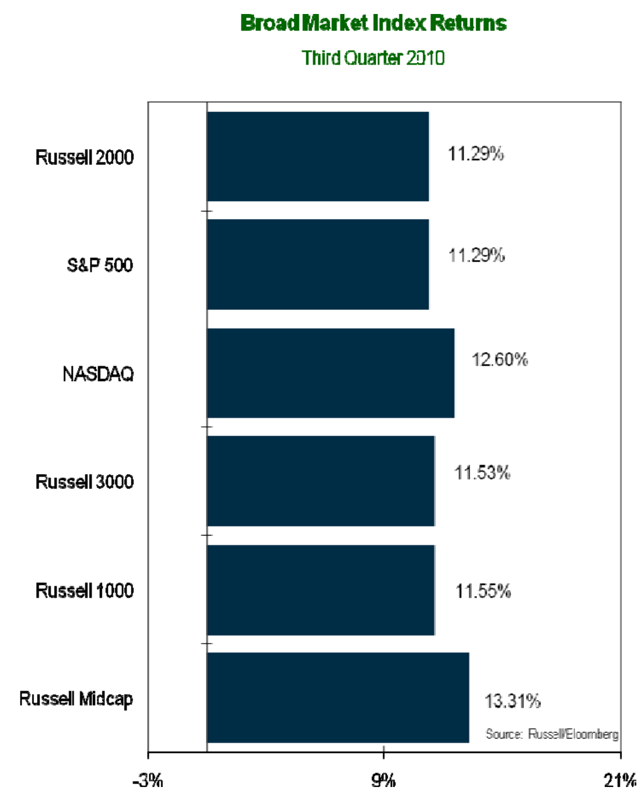
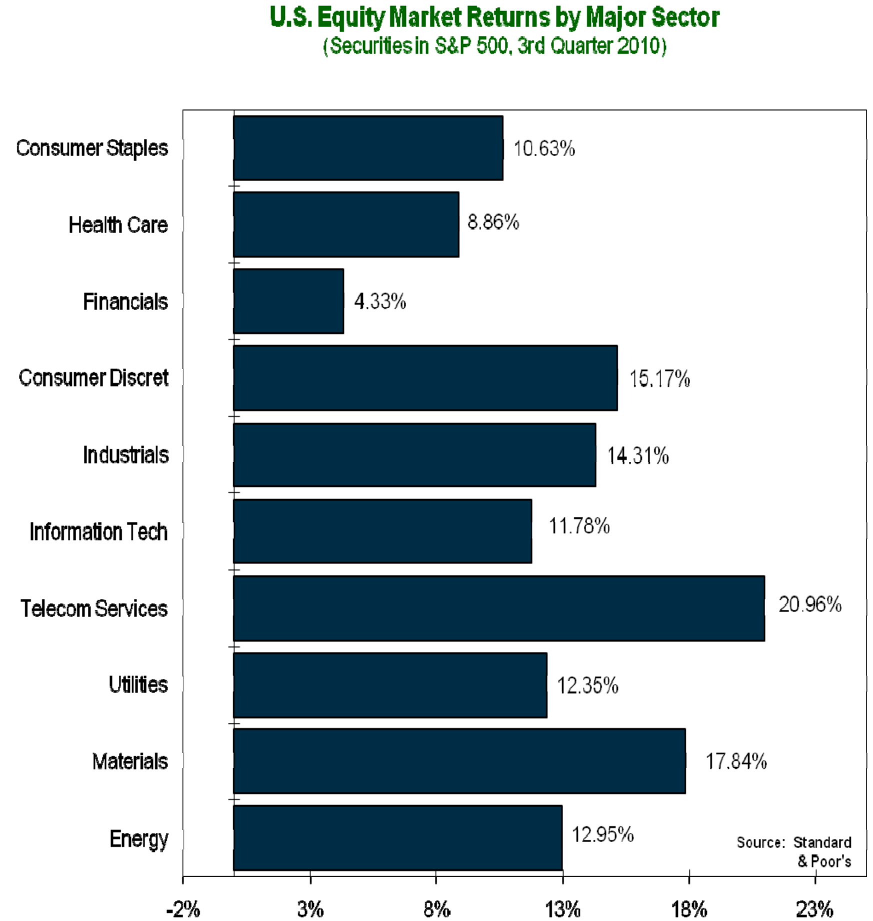
Third Quarter Market Summary

The Economy

The economy continued to moderate in the third quarter, following an appreciable slowing in the second quarter. Even though growth has slackened, and evidence of tangible improvements in many sectors is scarce, the National Bureau of Economic Research (NBER) announced that the economy troughed, and the recession ended, in June 2009. But the drip of lackluster economic data releases during the quarter, and the persistent low yields on Treasury obligations, caused deep concern among market participants and economists, who raised the specter of a double dip recession. The Federal Reserve also expressed concern over the slowing growth, and though many had believed the Fed had previously done all it could to prop up the economy, it demonstrated it still has plenty of ammunition left by announcing that it would undertake a round of "quantitative easing" by purchasing Treasury bonds with the proceeds from bonds that were maturing in its portfolio. As a result, by quarter end, most analysts placed a low probability on a double dip, in fact, occurring.



A scenario similar to what occurred domestically also took root in Europe. A general calm emerged after the scare of the initial sovereign debt crisis earlier in the year that involved the so-called "PIIGS" countries (Portugal, Italy, Ireland, Greece and Spain)
once the European Central Bank boldly vowed to avert a currency collapse. However, as developed markets economies continued to struggle, new sovereign debt fears emerged during the third quarter, with Ireland this time the primary country at issue. Policymakers in developed countries are bracing themselves for a long period of slow growth, which is likely to be made worse by measures of fiscal austerity that are being implemented.



Picking up at least some of the slack, and accounting for perhaps whatever growth is occurring globally, are the emerging markets economies, which are growing robustly. Their spending on improving infrastructure and capital goods is helping offset the lower demand of the developed economies. China, in particular, has continued to experience rapid growth, even if not at the pace it had been several quarters ago. China has a growing presence worldwide, establishing itself as a primary trading partner with many Asian, Latin American and industrialized economies. One danger of the rapid growth of the emerging economies, particularly those in Latin America, is the potential for overheating – exceeding their long-term equilibrium growth rate.

The upcoming midterm elections also seemed to have an impact on the economy in the third quarter. Both consumers and businesses preferred to not make significant spending commitments until greater clarity is gained on the outcome of the elections, and specifically on tax policy that might result. The tax cuts instituted by President Bush are due to expire at the end of the year, and President Obama and the Democrat congressional leadership have expressed their desire to extend them only for low and middle income earners. But with a sputtering recovery, many economists

are warning the president not to allow the tax cuts to expire for any earner. The outcome of the midterm elections is likely to have some impact on the confidence of consumers and businesses.

Highlights

GDP

The Bureau of Economic Analysis released the third estimate of second quarter 2010 GDP, an upward-revised 1.7%. The previous estimate had been 1.6%. Although the second quarter figure was a sharp slowdown from the previous three quarters, it marked the fourth consecutive quarter of positive growth. As mentioned previously, the NBER announced that the recession ended in the second quarter of 2009. The economy continues to grow, but at a rate too slow to cause a significant improvement in the unemployment rate. There are a number of reasons for the continued sluggish growth, including the fading effects of the stimulus programs; business reluctance to hire; consumer hesitancy to spend due to the tight labor market and weak housing market; and the growing fiscal austerity of state and local governments. Many analysts believe that growth will remain slow into 2011.

HOUSING

The housing market showed little sign of improvement in the third quarter. Existing home sales plummeted in July by almost 27% before rebounding a bit in August, the latest data available. Potential homebuyers remain reluctant to venture back into the market due to a lack of confidence and a poor outlook for employment. Tight credit also seems to be overwhelming the increased affordability in the market. Many analysts attribute the continued lackluster housing market to the expiration of the home-buyer tax credit and a downgrade in the employment outlook. Housing is likely to remain weak until well into 2011, when the employment picture brightens and mortgage rates are still low.

EMPLOYMENT

The employment situation deteriorated somewhat in the third quarter after experiencing a slight improvement in the second quarter. While the August data was better than expected, with the private sector adding 67,000 jobs, most economists believe that growing employment at less than 100,000 per month is much too weak to improve the unemployment rate, as millions lost jobs during the recession. The unemployment rate declined slightly to 9.6% in August, but is expected to rise back above 10% before meaningful and lasting improvement occurs. Because businesses have cut so deeply and will need to hire in order to grow, more permanent employment gains are likely to come once the economy begins to pick up steam. Even so, analysts believe that it will be 2013 before the labor market returns to its pre-recession level.

FED POLICY

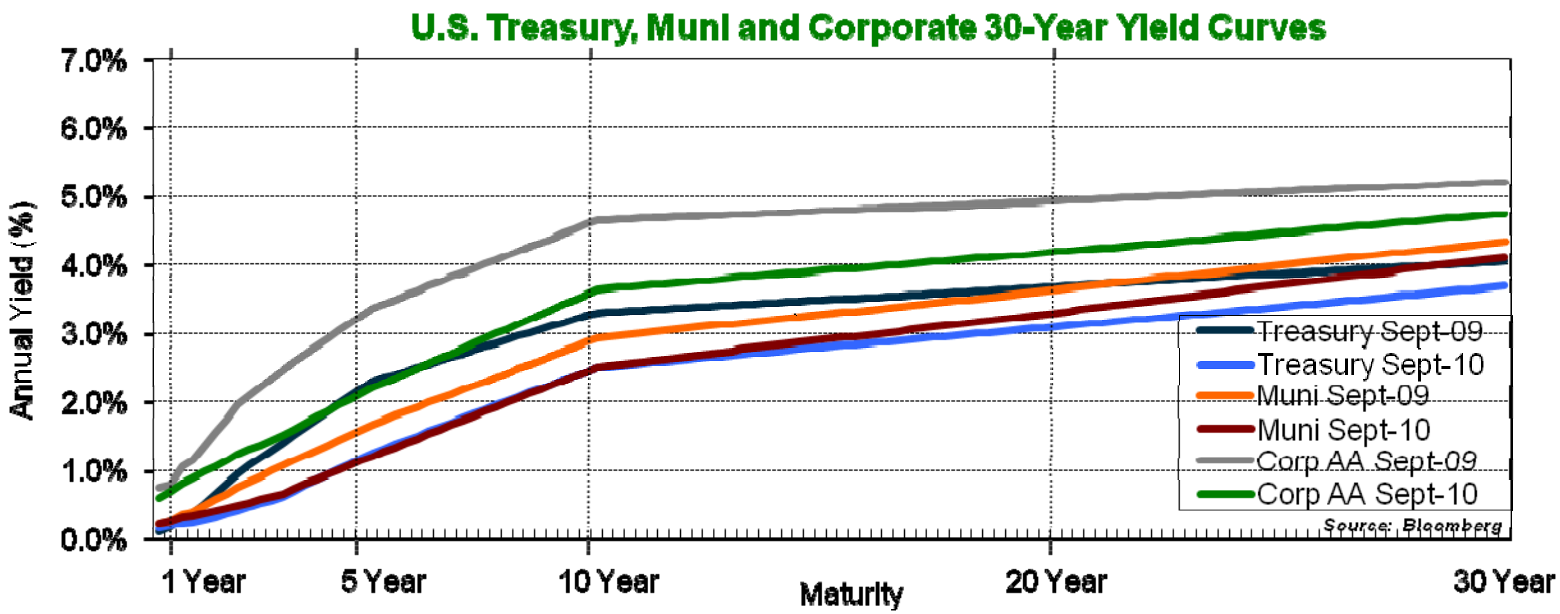
The Federal Open Market Committee (FOMC) left its interest rate policy unchanged after both of its meetings in the third quarter. The FOMC announced that its fed funds target would remain in the 0% to 0.25% range. As after the last several meetings, the FOMC included language in its statement that this extremely low target would remain in effect “for an extended period.” The FOMC did note that inflation is below target, and is likely to remain at that level for some period of time. Analysts believe that because of anemic economic growth, high unemployment and below-target inflation, there is likely to be no change in the Fed’s interest rate policy until late 2011. During the third quarter there was also much discussion as to whether the Fed had any additional policy initiatives it could implement in order to keep the economy from sputtering into a second recession. As mentioned above, the Fed announced that it undertake a program of quantitative easing by purchasing Treasury bonds with the proceeds from maturing bonds held in its portfolio.

Economists and market participants have begun to conjecture what additional measures the Fed may have at its disposal to provide an injection into the economy. In addition to more rounds of quantitative easing, the Fed could also expand its balance sheet once again, this time by purchasing not only more government securities, but also corporate bonds and even equities. An even more serious step would be to begin charging banks interest on excess reserves rather than paying them interest on those funds. Of course, charging interest would create a huge incentive for those banks to lend the funds rather than hold them. While it remains to be seen whether additional steps are necessary, the Fed does indeed have options at its disposal.

Interest Rates

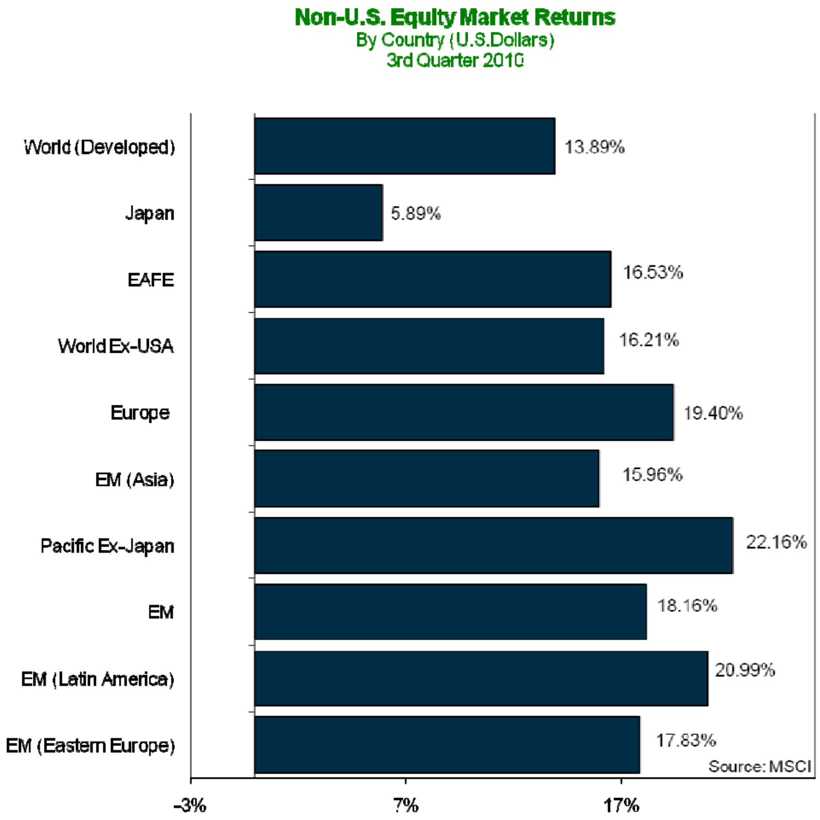
As with the second quarter, without much clarity over the direction of the economy, and an uncertain outlook for employment, interest rates generally declined in the third quarter. Corporate issues generally outperformed government bonds, and longer dated maturities fared better than short-term bonds. Whereas in the first and second quarter one of the primary drivers of the declining interest rates was the sovereign debt crisis occurring in Europe, the third quarter saw a decline in interest rates due to concerns about the possibility of a double dip recession. It prompted the Fed to announce a round of quantitative easing, which drove long-term bond prices higher and yields lower.

The yield curve continued to flatten in the quarter on the announcement of the quantitative easing. The yield on the Barclays Capital (BarCap) 1-3 Year Treasury Index declined 20 basis points, from 0.63% on June 30th to 0.43% on September 30th. At the same time, the yield on the BarCap 7-10 Year Treasury Index declined by 46 basis points during the same period, from 2.77% to 2.31%. Longer term bonds also experienced a decline in yields with the Fed's program to buy long-dated government obligations. At the same time, it appears that the market is digesting the new issuance of government paper.



Unlike the second quarter, the credit segment of the fixed income market actually fared better than government securities, as the drop in yields was not precipitated by a flight to quality. The yield on the BarCap 1-3 Year Credit Index fell by a whopping 63 basis points during the quarter, from 2.08% to 1.45%. The intermediate section of the credit yield curve also witnessed a dramatic decline in yields, as the yield on the BarCap 7-10 Year Credit Index fell by 68 basis points, from 4.66% to 3.98% during the quarter. High yield securities also performed extremely well during the quarter, as the yield on the BarCap U.S. Corporate High Yield Index sank from 9.28% on June 30th to 8.18% on September 30th.

Municipal bonds also got in on the act during the third quarter, with the BarCap Municipal Bond Index gaining 3.40%. During the quarter, the yield on the index dropped from 3.41% to 3.01%. State and local governments are still feeling the pinch of the recession, but there are signs that at least certain states are beginning to tighten their belts through fiscal austerity programs.



Equities

Thanks in large part to a significant September rally, stocks fared very well in the third quarter. The Russell 1000 Index of large capitalization stocks advanced +11.55% during the quarter, after gaining +9.19% in the month of September alone. For the year, the Russell 1000 Index is up +4.41%. Small capitalization stocks generated similar performance, with the Russell 2000 Index gaining +11.29% in the quarter on the back of a September advance of +12.46%. Across all market capitalizations, growth stocks outperformed value stocks, as growth companies are generally perceived to be able to sustain cash flow in uncertain economic times.

International stocks bested their domestic counterparts during the quarter, perhaps as investors sensed the worst of the sovereign debt crisis had passed. The MSCI EAFE Index of developed markets stocks gained +16.53% for the quarter, after a +9.49% advance in September. The MSCI EAFE Index is up +1.46% year-to-date. Emerging markets stocks did very well, as the MSCI Emerging Markets Index posted a return of +18.16% for the quarter. Year-to-date, the index is up +11.02%. Emerging markets economies have been the primary growth drivers on a global basis for the past several quarters, and are likely to continue providing leadership for the foreseeable future.