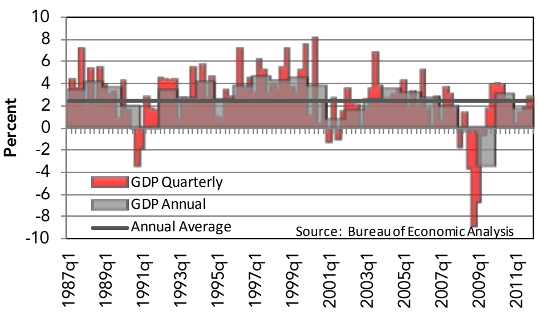
January 2012

Economic Review

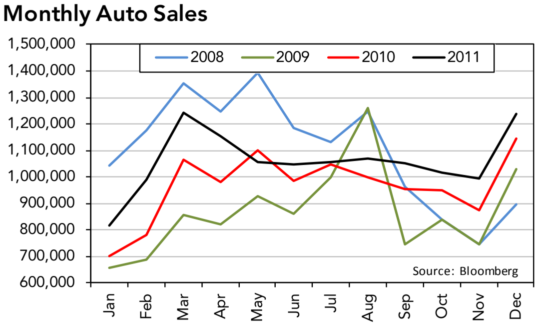
European economic issues remained in the forefront during January. Standard and Poor's downgraded France, Austria, Portugal, Italy, Spain, and others, while Fitch downgraded Belgium, Spain, and Italy. Fears of a European recession, along with a flight to quality, sent German 6-month bond yields below zero. German factory orders fell, reflecting negative sentiment across the continent. Chinese airlines refused to pay European Union charges on emissions, which started on January 1. The charges added to the already high cost of flights that enter European airspace. As tensions escalated in the Persian Gulf, European nations agreed to join an Iranian oil embargo, starting in July. To bypass the international sanctions on the Iranian central bank, India contracted to buy oil from Iran using gold as payment. Adherence to the oil embargo would have negative implications for the Indian economy. French President Sarkozy announced a 1.6% increase in the country's VAT, bringing the rate to 21.2%. An offsetting cut to corporate pension contributions was touted as a way to improve economic growth and employment. However, consumer tax increases rarely lead to marked economic improvements. The Keystone XL pipeline was delayed until January 2013, at the earliest. Indiana was poised to become the 23rd right-to-work state, as it looked to increase its competitive advantage against high-cost neighboring states.

GDP



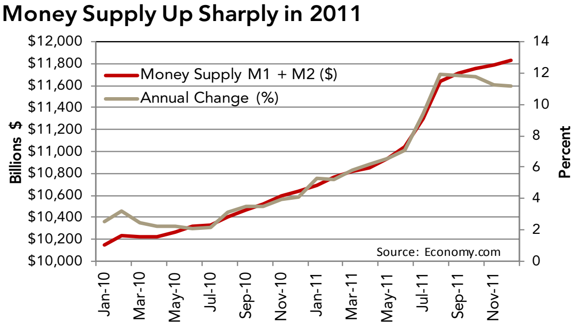
GDP advanced at a 2.8% rate in the fourth quarter. With only a 0.4% difference between nominal and real GDP, the GDP deflator (price inflation component) was the third lowest reading since 1970. Positive contributors to GDP were motor vehicle sales, residential construction, and inventories. Motor vehicle sales reflected the start of a long expected cycle of replacement, due to an aging fleet and steadying employment outlook. The average US car age rose to a record 11.1 years, and light trucks rose to 10.4 years. The increases attest to real quality gains from American and Korean car companies, as they neared Japanese makes in longevity. As new car sales rise, the pressure on used car prices is expected to ease. Home construction posted a surprisingly strong gain, compared to past quarters. Homebuilders expressed guarded optimism that the trend may be sustainable. Inventories rose strongly, reflecting increased optimism for industrial production. The largest detractors from GDP were utilities and defense spending. Utilities spending was a seasonal aberration, as an unusually warm winter and falling natural gas prices helped lower bills. Defense spending is poised to be an ongoing drag on GDP, as budget agreements heavily targeted defense for cuts. The drawdown of forces in Iraq also will lower future defense spending.

Monthly Auto Sales



The Federal Reserve forecast for low inflation prompted Ben Bernanke to expect interest rates to stay at record lows through 2014. Bernanke pushed the Fed to give additional weight to improving employment, while also setting an explicit 2% target for inflation. As inflation expectations decreased, market speculation that the Fed would purchase additional MBS debt (agency and non-agency) rose. The program is seen as a boon for the distressed mortgage security market. The Fed views purchase programs as pro-growth, causing investors to sell low-risk assets and invest in higher-risk assets, in theory promoting the wealth effect as asset prices rise in general. In reality, the Fed's programs have stoked past inflation, especially on food and energy, as investors are pushed from low-yielding Treasuries and MBS to invest in commodities and higher yielding investments.

Money Supply Up Sharply in 2011



As part of the Dodd-Frank financial reform, starting in 2013, banks will not be allowed to count trust preferred securities toward their tier-one capital requirements. As a result, banks are expected to call a large amount of existing preferred securities back from investors. The change will force banks to find a significant amount of replacement capital. The likely alternatives are Treasury securities or the banks could issue non-cumulative preferred stock. Many banks may institute follow-on common stock issuances to raise capital, which would dilute current stock holders. European banks also are searching for additional capital to shore up balance sheets heavy on sovereign debt.

Market Returns

As of January 31, 2012

	January	3 Months	One Year
S&P 500	4.5%	5.3%	4.2%
Russell 1000 Value	3.8%	5.3%	1.9%
Russell 1000 Growth	6.0%	5.6%	6.1%
Russell 2000	7.1%	7.4%	2.9%
MSCI EAFE	5.3%	-0.7%	-9.6%
Emerging Markets	11.4%	2.7%	-6.4%
Barclays Agg	0.9%	1.9%	8.7%
3-Month T-Bills	0.0%	0.0%	0.1%

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