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ECONOMIC UPDATE -- UNCERTAINTIES ABOUND

Despite concerns over the possible adverse consequences of the European debt crisis, domestic political dysfunction, lingering instability in the oil-rich Middle East and fears over a Chinese economic "hard landing", the recovery in the US economy appears to have actually gained some traction following this summer's slowdown. The most recent sign of an uptick in the pace of business activity emerged with the release of the November jobs report showing an unexpected drop last month in the unemployment rate to 8.6%, its lowest level in two-and-a-half years. The Labor Department's figures also showed that employers added 120,000 jobs in November and that job growth for the prior two months had been better than initially reported.

It is worth noting that as recently as August, many economists were issuing dire warnings of an imminent double dip in the economy with the unemployment rate again rising above 10.0%. Since that point, almost all forward-looking economic data, the Leading Economic Indicators (LEI) and our firm's proprietary Economic Model have signaled improving business conditions despite panic-like concerns about the euro zone and other areas of the global economy.

As resilient as our economy has been since summer, the fate of our still-fragile recovery remains hostage to external -- especially European -- events. Thus far, Europe's problems seem to have been contained to the continent. Many analysts, though, are concerned that a disorderly default by Greece, Italy, or Spain could push Europe into a deep recession and deal a blow to the Chinese economy. If recent history is any guide, even a modest shock wave from Europe could throw our economy off course. Recall that earlier this year, a series of shocks from higher oil and commodity prices, the Japanese earthquake, and the stalemate over the US debt ceiling stalled our recovery for a time, giving rise to talk of a "double dip."

Returning briefly to the employment situation, recent data show help wanted advertising has been rising and that companies have been adding temporary workers, suggesting that more permanent hiring may be in the offing. In addition, weekly Initial Jobless Claims, viewed by analysts as a reliable harbinger of future net job gains, have been falling, declining to 366,000 in the week of December 10 -- well below the four week moving average of about 400,000. Retail and auto sales have risen, commercial and industrial loans at the nation's banks are growing, albeit at a modest pace, and confidence among

small business owners has picked up to the highest level since February. Also encouraging was a recent survey of these same small businesses that found hiring intentions to be at their highest level since September 2008, when Lehman Brothers collapsed.

Still, serious concerns remain about the economy's ability to weather financial and economic turmoil from abroad. The public sector continues to lay off workers at the federal, state, and local level. And, excluding the hundreds of thousands of public employees who have left the labor force, the country still has a backlog of more than 13-million unemployed workers, whose average period of unemployment is at an all-time high of 40.9 weeks. Clearly, the likelihood of continued high unemployment, the most visible sign of just how weak this recovery has been, remains a strong headwind to further economic recovery.

BUSINESS OUTLOOK AND FORECAST

Beyond the slow but improving job growth, recent data on spending, particularly for consumer expenditures and business outlays for capital goods and non-residential construction, have been stronger than expected supporting increases in expectations for real GDP growth for the current quarter. Falling gasoline prices, the drop in unemployment, and the rebound in stock prices may also boost confidence, raising the odds that the recent momentum in household spending will continue into the New Year. On the other hand, gridlock over deficit-reduction measures in Washington, depressed consumer confidence, and concerns that Europe may have entered a recession and that a European nation will default, present roadblocks to additional sentiment gains. Moreover, many of the factors that have been restraining the recovery, such as the large overhang of vacant homes, tight credit conditions, and elevated risk premiums remain in place.

Consequently, we continue to project little further acceleration of real GDP growth in 2012. Fourth quarter 2011 GDP growth is now expected to reach 3.0%, double the average of the past three quarters of less than 1.5%. Growth next year is forecast to remain in a 2.50% to 3.00% range. Meanwhile, S&P 500 profits are likely to reach an all-time high of $97.00 per share this year and advance further in 2012 to $105.00 per share -- an increase of about 8%. Growth in 2012 will be supported by accommodative Fed monetary policy, an extension of the payroll tax holiday and jobless benefits for the year, further improvement in credit conditions, and a pickup in consumer and business sentiment from their current low levels. Since economic growth next year is forecast to be sufficient to only slowly reduce the slack in resource utilization, the unemployment rate is expected to remain elevated at 8.0% by the end of the year. An average of about 150,000 new jobs is expected to be created monthly in 2012. Core inflation is likely to remain well contained -- below the upper end of the Federal Reserve's desired inflation target of 2.0%. Clearly, the upward pressure early this year on consumer inflation from

the rise in commodity and import prices is now behind us. Fed policy will remain focused on accommodation given high unemployment and low inflation.

While our forecast assumes Congress will extend the payroll tax cut and jobless benefits for 2012, a much tougher set of fiscal tightening measures is written into current law for 2013. Failure to defer or offset these measures would place the recovery in serious jeopardy and the resulting uncertainty could weigh on growth next year. And, finally, the threat of the spillovers from a likely euro zone recession amidst the struggle to stabilize the region's sovereign debt and banking sectors should not be ignored. A decline in euro zone GDP while not derailing US expansion, will slow US exports adding another headwind to our recovery.

EURO ZONE CRISIS

The two-year-long euro zone crisis finally reached a fever pitch last week as negotiators from European Union members agreed to create a more integrated, fiscally-disciplined core of nations. Exactly twenty years after European leaders signed the treaty that led to the creation of the EU and the euro currency, every current member of the union except Britain signed on to a new agreement calling for tighter regional oversight of government spending and near-automatic sanctions among the 17 members with others joining if they wish. The accord would allow the European Justice Court to strike down a member's laws if they violate fiscal discipline. Rules to support this new regime will be written over the next several months.

In our view, the summit agreement is unlikely to calm fears that Europe is unwilling to raise the financial resources necessary to defend the sovereign debts of large member states, including Italy and Spain, that have little or no economic growth and have major debt obligations coming due soon. At the summit, member governments agreed to raise only $266 billion that could be used by the International Monetary Fund (IMF) to stabilize Europe's bond markets. About a fourth of the funds would come from non-euro zone countries. But they put off until March a decision on raising the 500 billion euro cap on resources of the permanent euro zone bailout funds which Germany continues to oppose. Investors have argued that a much larger fund will be needed to ensure the euro's survival.

Greece still remains on the brink of default. Yields on Italian and Spanish debt, while down from their peaks of last week, are near unsustainable levels. Prolonging the crisis raises the risk of a severe recession throughout the region and could lead to the breakup of the euro zone. Market action in the past few days shows the summit failed to revive investor confidence in peripheral bonds to bring their yields down. Many investors are still looking for the European Central Bank (ECB) to make large-scale purchases of bonds of peripheral European nations which would prop up bond prices more broadly. So far, the ECB has resisted, choosing instead to make smaller purchases.

As the dust has settled on the summit, it has become clear that implementing the accord is not going to be easy. The EU agreement to advance up to $266-billion to the IMF to bolster its resources has become the subject of dispute in Germany and Ireland and it will probably require parliamentary approval in Sweden, Hungary, the Czech Republic, and possibly Denmark. How long these approvals will take is anyone's guess. Rating firms have reacted skeptically with strongly worded criticisms of the summit and the perceived slow pace of reforms. And, taking a gradualistic approach imposes additional economic and financial costs compared with an immediate comprehensive solution obviously favored by the financial markets and the US Treasury Secretary. It probably means the crisis will persist at varying levels of intensity throughout 2012 and beyond.

With the summit having fallen short of expectations, investors are likely to remain on the sidelines. While the aggressive selling that took bond prices sharply lower this summer has faded, absent confidence in official steps to combat the crisis, buyers will remain scarce.

CHINA

Newly released economic indicators for November have shown a further moderate slowdown in economic activity. Industrial production continues to decelerate but at a slower-than-expected pace while year-to-date growth in fixed-asset investments declined. Retail sales growth maintained its stable trend. With eased consumer inflation at 4.2% last month and producer price inflation at 2.7% -- the lowest level in 40 years -- the Central Economic Working Conference announced this week a shift in economic policy toward "stabilizing growth." In addition, the Political Bureau of the Communist Party of China (CPC) Central Committee made known last weekend that China will "fine tune" its monetary and fiscal policies next year as conditions change. Slower growth, less inflationary pressure and more accommodative fiscal and monetary policies on the horizon should dispel investors' concerns over a Chinese "hard landing."

EQUITY STRATEGY

Poor investor sentiment, supportive US credit conditions, attractive valuations, and depressed earnings expectations should underpin the US equity market despite investor's anxieties. Absent a severe exogenous shock, US equities remain inexpensive at 12.5 times this year's S&P 500 earnings per share and 11.5 times expected earnings next year. Other measures of stock market valuation we monitor confirm the statistical attractiveness of equities. Equity portfolios under our supervision remain fully invested with *growth* shares favored over *value* stocks given the likelihood of a protracted slow growth environment. Portfolio concentrations in industrials, technology, and energy are significant. The non-US domiciled portion of equity portfolios is now tilted toward

emerging markets, following a reduction in European expsosure, in view of the more rapid growth expected from these regions when compared with *developed markets*.

FIXED INCOME STRATEGY

We continue to view bonds as relatively overvalued when compared with the dividend yields and inflation protection of equities. We have, therefore, avoided purchasing bonds with maturities beyond three years. Despite their safety, we view US Treasury obligations as particularly unattractive preferring investment grade corporate bonds which we continue to ladder within a three-year maturity range. Portfolio durations remain below those of the benchmark.

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In closing, we extend Season's greetings and warmest best wishes for a happy and healthy New Year to our many clients, friends, and associates whose valued friendship and support over the past seventeen years has played an important role in our firm's success.

This year, in particular, has been a difficult one for many families. To help those in need, we have again made a contribution to the Chicago Food Depository in lieu of sending holiday greeting cards.

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