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MARKET AND ECONOMIC OUTLOOK

STOCK MARKET

Major U.S. stock indices suffered severe declines in the third quarter as the Dow Jones Industrial Average (DJIA) and the Nasdaq Composite dropped more than 12% and the S & P 500, with more exposure to financial companies, tumbled more than 14%. As Congress debated raising U.S. debt limits, stock market investors held their breath. However, after the deal was done to raise the debt ceiling, markets became even more nervous about the unfolding crisis in Europe.

August and September were some of the more volatile months we have seen. During those two months the DJIA increased or decreased by more than 1% on 29 days, with 15 of those days having gyrations of more than 2%. What is responsible for these seemingly irrational movements? It is obvious the fundamentals of investing are not driving these daily changes. Fundamentals will rule in the long run, but in a broad based sell-off or rally, individual stock characteristics do not seem to matter. The removal of the "uptick rule" in 2007, which had been in place since 1938 (although replaced with a more watered down version in 2010) is cited by some as a contributing factor for large swings in stock prices. The uptick rule states that a stock cannot be sold short (meaning the investor who is selling the stock does not own the stock) until there is an uptick in the price. Various media channels with 24/7 coverage of stock markets and any financial news in general can also cause market volatility as investors react suddenly without digesting the news. Twenty four hour cable stations need something to talk about and headline grabbing news attract more viewers. Corporate announcements are dissected many times, not necessarily with rational conclusions.

In general, there were no sectors that had gains for the quarter. Even "defensive" type stocks such as tobacco and household products declined in the quarter, although not to the extent of the greater market indices. However it was the industrial metal related stocks that were some of the worst faring in the quarter. Aluminum, nonferrous metals and iron and steel industry groups were down at least 30% in the third quarter. It is hard to imagine that the economics of the world had changed so swiftly for these stocks to take such a beating, but they are considered deeply cyclical and do very well in good times and extremely poorly in any anticipation of bad times.

Foreign stock markets proved no refuge in the third quarter as the majority of them performed worse than the U. S. market. Greece again led the losers, as the local Greek index declined 38%, even worse when translated into U.S. dollars. What may come as a surprise to some is that the major German market index (DAX 30) declined over 25% last quarter, even though the German economy itself is in better condition than the U.S. economy. The fallout from the Greek debt crisis and its effect on the Euro may place a strain on the German economy. In contrast, Switzerland and the U.K., since they do not use the Euro, only had declines in their respective stock markets of 11% and 14%. Emerging market countries such as Brazil and Russia posted large declines in the quarter, especially when translated into U.S. dollars as their currencies weakened. By the end of the third quarter there was not one major international stock index that did not have double digit percentage declines on a year to date basis.

Bond Market

U.S. Treasuries again were the best performing in the debt category, in particular the

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MARKET AND ECONOMIC OUTLOOK *(CONTINUED)*

longer term bonds had a total return of 29% in the third quarter. Yields on the 30 year bond declined from 4.38% at the end of the second quarter to 2.90% by the end of September, even after Standard & Poors dropped the rating on U.S. government debt from AAA to AA. The 10 year Treasury yield declined from 3.18% to an incredibly low 1.92% after touching as low as 1.72% when the Federal Reserve announced their new policy tool (Operation Twist) to sell $400 billion of shorter term (three years and less) notes and purchase an equal amount of longer dated notes with maturities from six to 30 years. This in turn lowered mortgage rates to levels never before recorded. Yields at such low levels are not compensating for inflation and are negative on a real return basis.

The overall bond market, as measured by the Barclays Aggregate Bond Index generated a positive quarterly return of 3.8%. Barclays Municipal Bond Index also had a return of 3.8% for the third quarter. The municipal yield spread to Treasuries rose last quarter and now stands at 143% versus a ten year average of 95%. A higher yield and tax free status would make these bonds very appealing if not for the very low absolute level of the interest rates. Investment grade corporate bonds continued to show positive returns for the year. In contrast, high yield (junk) bonds which typically act more like equities, posted a decline of 6.1% (including interest payments) in the third quarter. At a current yield spread of 8.9% above comparable Treasuries, high yield spreads are in the highest quartile over the history of the Barclays High Yield Bond Index.

MARKET OUTLOOK

Previously, we forecasted 3% GDP growth for the year which now seems overly optimistic. GDP growth of 1.5% now seems more realistic. Personally, we do not give these government statistics too much weight in our analysis, as these past numbers will continue to be revised multiple times in the future by the government. Our focus is more on corporate profits and revenue. Third quarter earnings per share for S&P 500 companies were up 14% with a Price-to-earnings ratio (P/E) of 13.9. The long-term average for the S&P 500 is about 15. We think there are some very good bargains in the stock market for some solid companies. And although the P/E ratio is not a good predictor of timely stock price direction, it often is a strong predictor of the longer-term upside or downside potential.

The bond market continues to have limited upside, in our opinion, with interest rates near record lows. The Federal Reserve announced that it would keep rates unchanged until 2013 which should mitigate any immediate risk. For longer-term investors, however, we find the attractive valuation and the growth opportunities much more compelling in equities. For instance, those seeking income will find that U.S. ten year treasuries are yielding 2.17% meanwhile the S&P 500's dividend yield is 2.24% (as of 10/11/11). The difference is that over the next ten years interest rates are almost certain to rise, decreasing the value of bonds while stocks are likely near the bottom of the next market cycle. A portfolio of high yielding dividend stocks could offer 3% to 4% in yield annually (also taxed at a lower rate), potentially with lower volatility than the market average, and provide some appreciation potential. This simple strategy has produced market beating performance for decades and can be implemented by Karagosian Financial Services.

Going forward we think volatility will remain high, but moderate somewhat. In general we do not practice market timing and furthermore we do not know of anyone who has been consistently successful at it. However, we do think that the market is closer to the bottom than a top and that barring new negative macroeconomic news, investors will begin to appreciate the better values in the stock market. Recently, Warren Buffet announced that his company, Berkshire Hathaway (NYSE: BRK.A, BRK.B) a conglomerate, would be buying back its own stock. This is the first time that the company has done this, signaling that management believes its shares are undervalued. Although we can not predict when a more sustainable upturn will commence, we think that the record amounts of cash held by companies will make the next bull market more robust and elongated via new investments.