Ashdon Investment Management

Q3 2012 ECONOMIC COMMENTARY

November 2012

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- **The economy in the third quarter of 2012 continued with its ongoing recovery.**
- **While we view the Fed's stimulus plan as having a positive effect on the third quarter, its ongoing effects remain to be seen.**
- **We expect a continued slow U.S. recovery and return to trend-like growth in the quarters to come. We see foreign economies remaining weak into the future, particularly in emerging-market countries.**

Third Quarter 2012 Economic Commentary

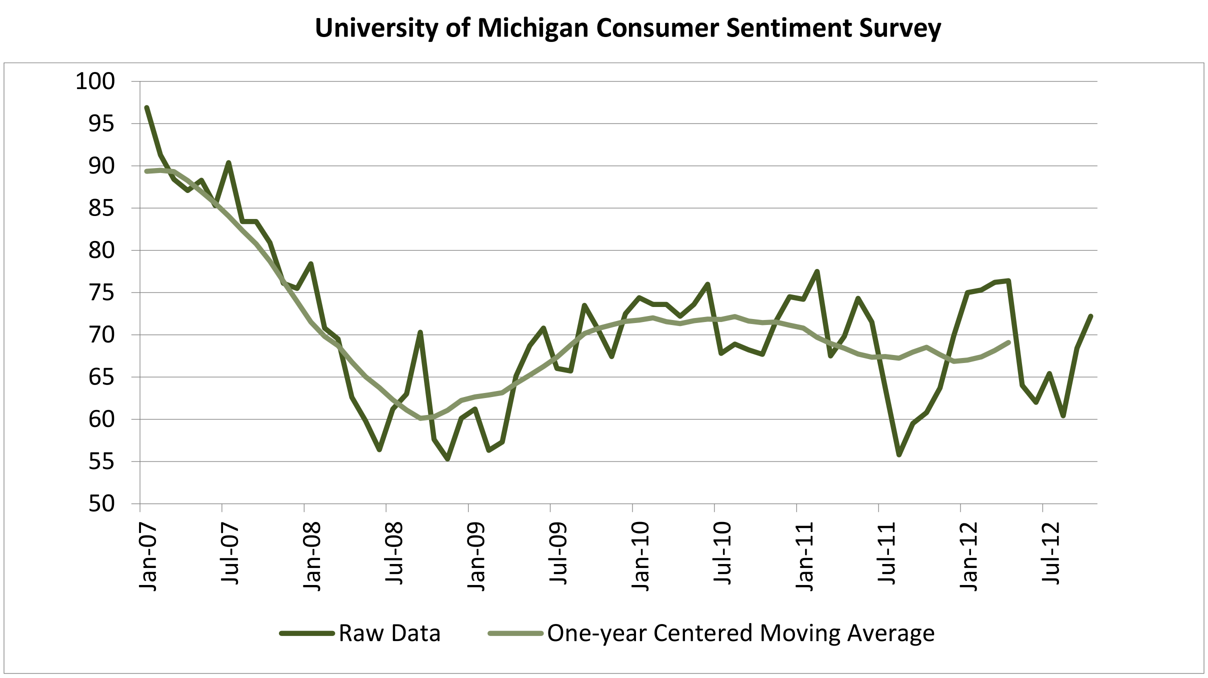
The economy in the third quarter of 2012 continued with its ongoing recovery. The Gross Domestic Product (GDP) showed a 2% growth rate, which while below potential, is a significant improvement over the 1.3% pace of the second quarter. Both housing growth and encouraging corporate profits were positive contributors to the GDP. The Federal Reserve's stimulus efforts had a positive effect during the period on residential housing markets. On the other hand, lean state-level government rankings detracted from GDP growth as state and local governments continue to rationalize their budgets. While this is a detractor to growth in the short term, we view pulled-back governments as favorable with regards to lowering government spending and moving toward a more efficiently run government. U.S. consumption numbers were also robust for the period, as consumer confidence slowly returned. Durable goods expenditures were especially strong after a soft spell and the ongoing trend of growing durable goods expenditures continued unabated.

Improving Housing Starts and Sales

Upward trends in new homes sales and starts support our view of an economic recovery.

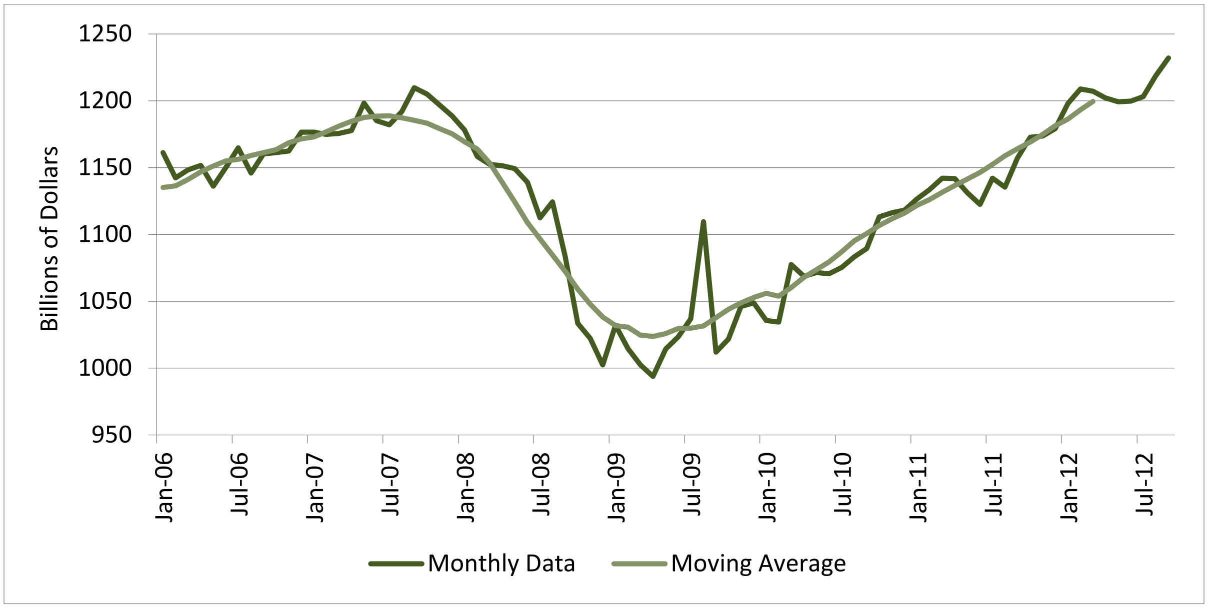
Unemployment numbers improved in the third quarter, following a soft patch during the summer. Respected analysts have noted the late summer decline in employment data appears to be a new characteristic of the data – not the economy. We have seen this factor in other data and believe it to be the result of changed seasonality in the data that is not captured in the government's statistical processing. Viewing the employment data through a wide lens, we see the third quarter data as consistent with the underlying, longer-term trend of an improving employment situation.

Investors' sentiment has been sensitive to incoming data, for example employment, throughout the recovery, with persistent poor sentiment contributing to a below-trend rate of recovery. The widely followed University of Michigan Consumer Sentiment Index has been unable to break away from readings around 70, historically indicative of a weakening economy. News media in the third quarter continued the daily delivery of bad, sentiment-suppressing news. With the then impending presidential election set to decide which party would be setting economic policy in the face of the impending "fiscal cliff," the set of legislative and policy resets, the negatively focused media onslaught accelerated. The continued pervasive investor fear was manifest in the Consumer Sentiment Index through the third quarter. The Consumer Sentiment Index improved, yet its remaining relatively weak was indicative of the many emotionally related factors weighing on our economy's growth. While sentiment improved over the short term late in the quarter, the trend was not changed.



While the Consumer Sentiment Survey was still relatively weak and somewhat up and down, the overall trendline shows marked and steady improvement from 2008 lows.

Personal Consumption Expenditures: Durable Goods



While personal consumption may have fallen in the beginning of the third quarter, the next month showed an overall trend that is positive, again contributing to our belief in continued slow growth over the long term.

The fiscal cliff is widely perceived to have a negative effect on the economy, potentially setting off a new recession. Ashdon provided an analysis of the potential for impact of the fiscal cliff back in the summer and concluded that the expected outcome should not necessarily have a disproportionately negative impact. We view the most likely negative impact to be a reset of tax policy with higher rates for wealthy individuals. For example, while political uncertainty and the presidential election created the illusion of added economic risk, political risk does not anchor itself on elections. Rather, political risk always exists and policy mistakes can be made on any day, in or out of an election cycle. Closely related is the proverbial pending fiscal cliff – looming simultaneous tax hikes and government spending cuts – one of the media's favorite topics during the third quarter. We do however, view the pending fiscal cliff as a problem in that the uncertainty it creates is not necessarily a negative, but rather is important to future growth, albeit slower growth. Putting aside our belief that political uncertainty does not anchor itself on elections, we anticipated seeing higher tax rates regardless of the presidential outcome, and are not more or less discouraged by the results. While the fiscal state of the U.S. has yet to change, we expect to see a higher degree of fiscal conservatism that will likely lead to a more efficiently operated economy.

Overseas, European countries experienced a soft, recessionary period, with a negative GDP. We expect this to continue into the fourth quarter, with some parts of the Eurozone (Germany, France) much stronger than others (Spain, Italy, Greece). While new monetary policies are highly polarized and not yet efficient, new policies have in fact been enacted and their future effectiveness now remains to be seen. In Japan, we continue to see subpar growth, and a country trapped in subpar economic performance with no real end in sight. China and emerging-market countries have seen implicit and explicit tightening, which has translated to slower growth and some markets down by as much as 50%. Their central-bank policies however are beginning to show signs of traction. Again, the pace of growth of emerging countries and China is closely tied to the growth of the Eurozone.

Outlook

While we view the Fed's stimulus plan as having a positive effect on the third quarter, its ongoing effects remain to be seen. The Fed's stimulus plan, as well as coordinated international bond buybacks, has resulted in expanding corporate balance sheets, and simultaneously expanding liabilities. Consider that Fed policies that have been in place since 2008 and have helped the U.S. economy avoid further disaster. In fact, had the Fed put the post-2008 policy actions in place prior to 2008, we might have avoided the financial crisis, or at least have had a few more financial institutions still in existence today. Today we are seeing that the Fed's policy implementation has worked for the housing market, as evidenced by favorable housing and construction data. The question now is whether they have left interest rates too low for too long, and whether this will result in inflation that is too high for too long. We anticipate seeing these effects in the next 48 months, yet not much sooner. In the near term, we expect the Fed's policy to continue to heal the country and contribute to continued U.S. growth moving forward.

All factors considered, we expect a continued slow U.S. recovery and return to trend-like growth in the quarters to come. We see foreign economies remaining weak into the future, particularly in emerging-market countries. While the correction is well underway and we see the beginning of its end, we are cognizant that it will be closely tied to the slow rate of growth of the rest of the international economy.

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