GODSEY & GIBB
WEALTH MANAGEMENT

INVESTMENT WATCH

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Global Growth Slows as European Debt, U.S. Deficit Crises of Competence Increase Volatility and Recession Risks; Yields Fall To Record Lows, Income Equity Outperforms Amid De-Risking

Growing fears of policy uncertainty surrounding sovereign debt contagion risk in Europe and the debt-ceiling debate in the U.S. drove equity market volatility to record highs in the third quarter, increasing the risk of recession to uncomfortably high levels. The credit crisis has transitioned to a more political phase as European nations debate options for rescuing their neighbors and the U.S. government attempts to get its finances in order. Pessimism about political policy and the economy led to record swings in stock prices, including a 337-point average daily trading range for the Dow Jones Industrial Average in August, the highest since November 2008. In a flight-to-quality bid, investors sent yields for the U.S. Treasury 10-year note to an all-time record low of 1.72 percent on September 22nd. Investors bid up other safe-havens such as gold, which rallied to a record $1,923.70 an ounce and the Swiss franc which touched a high of 1.22 versus the euro, in a wide-scale pullback from risk assets.

The debt-ceiling and deficit crisis policy discussions in July that brought the U.S. to the brink of a default, and led to S&P's subsequent credit rating downgrade, dealt a blow to consumer and business confidence and effectively paralyzed the U.S. economy for a month. Moreover, the agreement announced in early August, which lacked a so-called grand bargain, but did include the naming of yet another bipartisan committee tasked with identifying $1.5 trillion in debt reductions was viewed by most investors as insufficient. While pinpointing specific solutions to the U.S. deficit problems faces significant challenges in Washington, we continue to believe that the issues facing the government can be solved with meaningful long-term proposals, including gradual changes to entitlements and fundamental tax reforms, which focus on spending restraint and economic growth, unlike the more costly, temporary stimulus proposals put forward to date.

Economic forecasts trended lower in the third quarter, including the National Association of Business Economics expectations for 1.7% GDP growth this year, down from 2.7% in May, issued on September 12th. The probability of a recession also edged up to 33.8% in September, from 28.0% in August, according to the Blue Chip Economic Indicators survey of 50 forecasters. Consensus GDP estimates are for growth of 1.9% in the third quarter, up from 1.0% in the second quarter, and for 2.1% in the fourth quarter. While the current environment still feels "recessionary" in many regards, we continue to believe that the U.S. economy will maintain a slow growth trajectory in spite of the harmful U.S. tax, spending and regulatory environment, with an improved pace of growth in the second half of the year. Global growth forecasts also slowed, including the outlook from the International Monetary Fund (IMF), which cut its global GDP expectations for 4.0% for this year and next on September 20, down from 4.3% for 2011 and 4.5% for 2012 in June.

While the risk of an unmanaged default in Greece remains, the real crux of the issue lies in fiscal consolidation across Europe. While trying to handicap the political will of Europeans to, in effect, pay for additional integration is difficult, we continue to believe that the cost of not bailing out the periphery is higher than bailing them out. While we think the possibility of a large scale break-up of the Eurozone remains low for legal, political and economic reasons, market uncertainty over an imminent Greek default needs to be resolved. That can be achieved in a disruptive way through default or via continued disbursements under the rescue program. Additional bond intervention from the European Central Bank (ECB) is also vital. A recapitalization of the problem banks will also be necessary. Meaningful, decisive action by the troika (the European Commission, the ECB and the IMF) involved in policy discussions will also be needed. If the European experiment is to continue in the future in its current form, we believe political will and stricter fiscal enforcement over the next several years will be necessary.

From the market's perspective, the sovereign debt crisis in Europe morphed from saving Greece to saving the region's vulnerable banks. In September, the IMF estimated that European banks conservatively faced $409 billion in potential losses from the euro-zone debt crisis. With bank stock prices declining sharply, rates that banks charge each other for loans rising, and rumors regarding losses swirling, on September 15th, five global central banks including the ECB, the U.S. Federal Reserve, the Bank of England, the Bank of Japan, and the Swiss National Bank announced a coordinated effort to conduct three U.S. dollar liquidity-providing tenders in which banks will be able to bid for unlimited funds, with a maturity of approximately three months. European banks, many of which have lost access to U.S. dollar funding, need the U.S. currency to fund loans and repay past borrowings.

The Federal Reserve announced a widely expected accommodation program on September 21st to buy a larger than expected $400 billion of bonds with maturities of six to 30 years through June, sell an equal amount of debt maturing in three years or less, and reinvest the proceeds from maturing agency debt and mortgage-backed securities into mortgage-related debt. The balance sheet adjustment, previously undertaken in the 1961 – 1965 time period and referred to as "Operation Twist," is an attempt to put downward pressure on long-term interest rates and improve overall financial conditions. In addition to extending the average maturity of its holdings, the Fed downgraded its growth outlook, stating, "There are significant downside risks to the economic outlook including strains in global financial markets", and reduced its inflation expectations. Like all extraordinary policy moves, there are unintended consequences. A flatter Treasury curve will put pressure on banks' net interest margins, and on pensions and insurance companies that buy long-dated securities to match their liabilities.

Americans continue to reduce debt and rebuild savings to weather the historically high unemployment rate that has averaged nine percent this year. Payrolls were unchanged in August and the latest Fed data showed households cut debt levels for the 12th consecutive quarter in the second quarter. Consumer confidence in the U.S. dropped in September to the weakest point since the recession officially ended in June 2009 according to Bloomberg's Consumer Comfort Index. However, the Conference Board's Leading Economic Indicators, which increased more than forecast in August, continue to suggest a continuation of modest economic growth. Even so, a period of sustained weakness in confidence could put additional pressure on consumer and business activity. We will be monitoring confidence levels as we believe improvement will be necessary before economic growth can resume at a reasonable pace.

Given the unsettled global economic environment, we expect volatility to continue, as macroeconomic concerns are taking precedence over favorable microeconomic trends. In a low growth environment, we believe that investors will rotate towards companies that can generate sustainable growth given the economic headwinds. With this backdrop, we have positioned portfolios with defensive characteristics including strong balance sheets, attractive yields and relatively low-beta, or market risk.

Utilities, our largest overweight, have led the market year-to-date as safe harbors with large dividends amidst a backdrop of record volatility. Many utility companies maintain dividend yields of four percent or more, which is more than twice that of the 10-year U.S. Treasury note.

Consumer Staples, our next largest overweight, are facing some challenges from higher input costs and substitution effects, but the leading brands maintain strong domestic customer loyalty in personal care, household care and food categories, international growth opportunities, as well as high levels of cash flow generation and attractive dividend yields.

Telecommunications Services, our third largest overweight, continue to offer very appealing and well-covered dividend yields.

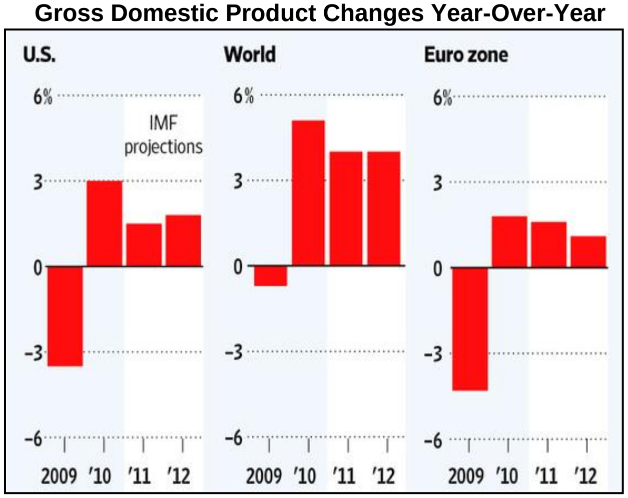
We currently maintain market weight exposure to the **Information Technology, Industrial** and **Healthcare** sectors. Technology and Healthcare have outperformed the S&P 500 Index's total return year-to-date while the Industrial sector has underperformed the benchmark.

Portfolios are positioned with underweight sector exposure to the **Materials**, **Consumer Discretionary**, **Energy** and **Financial Services** industries. The Consumer Discretionary sector has outpaced the broad market year-to-date while the Materials, Energy and Financial Services areas have underperformed the index.

Euro Area Funding and Dollar Liquidity Risks

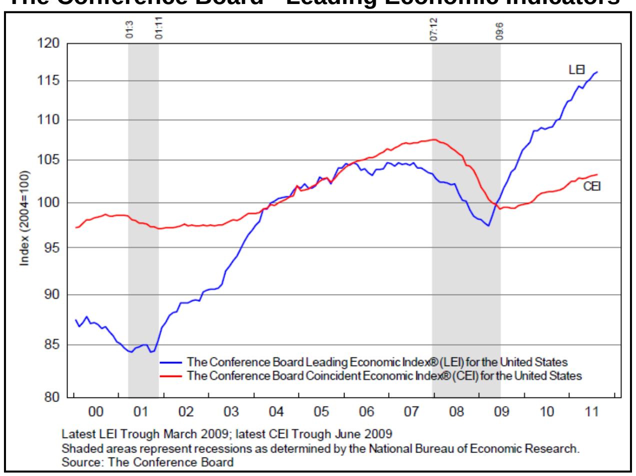
Source: The International Monetary Fund

Gross Domestic Product Changes Year-Over-Year



Sources: The International Monetary Fund and The Wall Street Journal

The Conference Board - Leading Economic Indicators



Source: The Conference Board

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