

Equity Market Commentary and Strategy Review

Third Quarter 2011

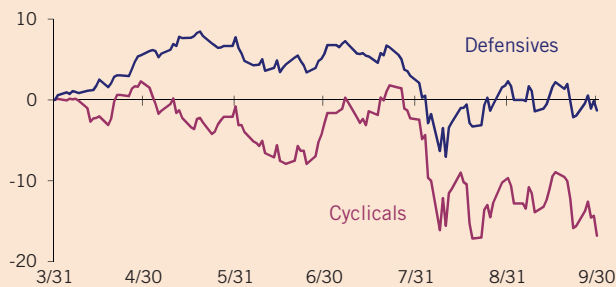


EQUITY MARKET REVIEW

The third quarter of 2011 was a cruel one for stock investors. Global recession fears spiked as the paralyzing effects of the euro zone debt crisis, the S&P downgrade of US long term debt, and weakness in key emerging countries resulted in substantial volatility and a flight to safety [Figure 1]. The evolution of the European debt crisis seemed to have ushered in a self-reinforcing slowdown. Lack of a credible plan to address the problem and recapitalize the banks slowed business activity. This resulted in tempered profit expectations and stock prices and strained credit, which further complicated the plans of the authorities. The US debt ceiling debates highlighted the fragile state of our own legislative efforts and fueled a growing sense that our political system is broken and inept of delivering policy initiatives. Stubborn ideology and political motivations did little to instill confidence and, unfortunately, had a measurable impact on sentiment during the quarter [Figure 2].

FIGURE 1. DEFENSIVES HAVE OUTPERFORMED

March 31, 2011 to September 30, 2011

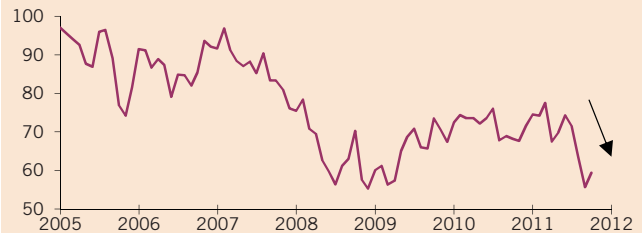


Source: FactSet and Newfleet Asset Management

Last quarter we wrote that the sluggish growth in the first half of 2011 felt temporary as exogenous shocks to the system (Japan earthquake, floods, etc.) would fade and the crescendo of negative news would hit early this quarter. We were hopeful that economic reacceleration would trigger a “growth on” bias, where ongoing mid cycle conditions would favor “growth” with an economically sensitive tilt. Additionally, our view was that the developing world would once again prove to be the engine of growth to offset any slowdown in Europe and the US. Of course, that call has been derailed by the intensification of the European crisis and subsequent economic fallout. Volatility increased substantially, sentiment turned decidedly more negative, and stress within the credit markets was noticeable [Figure 3]. There was little movement on secular challenges [Figure 4] facing the domestic

FIGURE 2. CONSUMER CONFIDENCE STILL FALLING

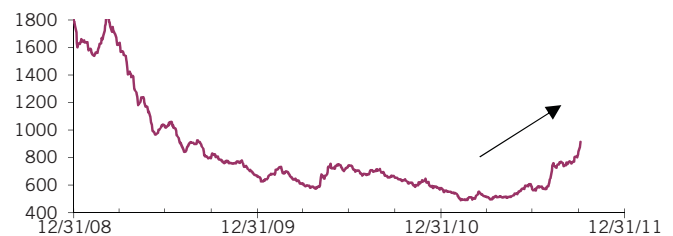
December 31, 2004 to September 30, 2011



Source: FactSet; University Of Michigan Survey Of Consumers

FIGURE 3. SPREADS HAVE WIDENED

December 31, 2008 to September 30, 2011

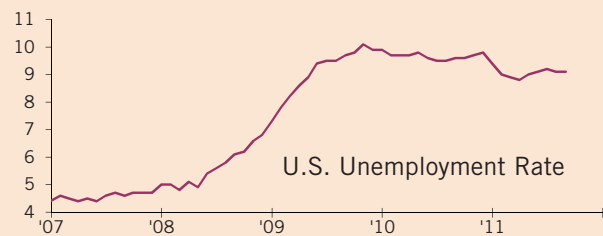


Barclays Capital US Aggregate Credit - Corporate - High Yield - Average Spread

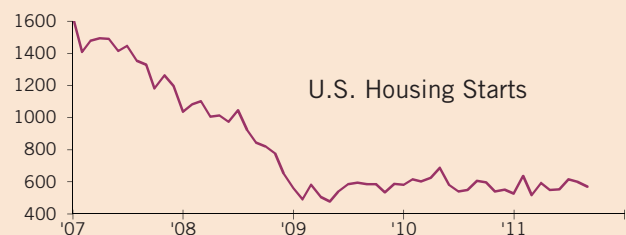
Source: FactSet

FIGURE 4. SECULAR CHALLENGES REMAIN

December 31, 2006 to August 31, 2011



Source: FactSet and Newfleet Asset Management



USA Housing Starts (000's of units)

Source: FactSet and Newfleet Asset Management

EQUITY MARKET REVIEW (CONT.)

economy and these persistent factors are continuing to weigh on the pace of the recovery. However, not *all* the data was bad. Manufacturing reports and durable goods orders remained supportive and retail sales resilient, helping to support a sluggish, yet expansive, growth environment [Figure 5]. Profit revisions have stopped their recent ascent and while we expect estimates to trend lower in the coming months, they should remain at healthy levels [Figure 6].

The trading activity in the marketplace during the quarter was nauseating. Volatility gauges spiked to recent highs and comparisons to the 2008-2009 recession were commonplace. We view these comparisons as decidedly premature, but symptomatic of the “sell first, ask questions later” environment that defined the quarter. Macro overwhelmed the micro, as underlying fundamentals and valuation mattered little when viewed through a recessionary lens. We were active in the quarter, lowering the number of holdings, raising cash levels, and replacing the most “at risk” names with better opportunities. Regardless, we were geared for acceleration in growth and the events of the quarter were clearly not supportive of our positioning in the third quarter.

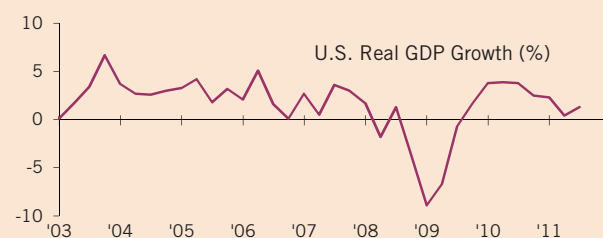
EQUITY MARKET OUTLOOK

Our base case is a continuation of macro uncertainty, but no recession. It is pointless to estimate a “percentage chance” of a recession, but, given the recent developments, it would be disingenuous to say that the odds haven’t increased substantially. The debate is a technical one and irrelevant except for the history books. It is far more important to properly assess the sustainability and impact of the current below trend recovery on corporate profits. It becomes a question of magnitude, and as of this writing the fundamental backdrop is not as bad as the market suggests, in our view [Figure 7]. With increased levels of systemic risk, valuations have rightly corrected but a direct comparison to 2008 is premature given the major differences between the markets (stronger balance sheets, healthier banking system, lean inventories, etc.)

Although we recognize that a climactic disruption in Europe is a distinct possibility, at this point equities have discounted overly bleak economic prospects. Key unknowns related to Europe are the depth and breadth of the contagion. We believe there is a way out of the financial morass, but the authorities will need to move beyond incrementalism. We believe central banks globally will fight hard to avoid a recession

FIGURE 5. REAL GDP GROWTH

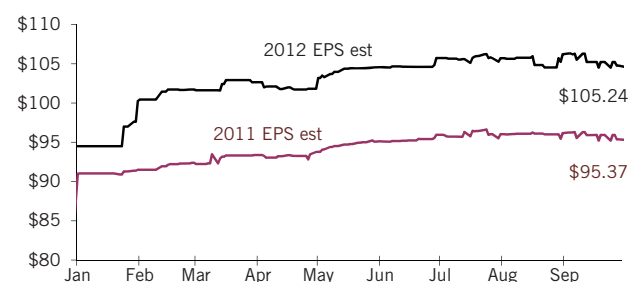
December 31, 1991 to June 30, 2011



Source: FactSet, Newfleet Asset Management

FIGURE 6. S&P 500 ESTIMATES

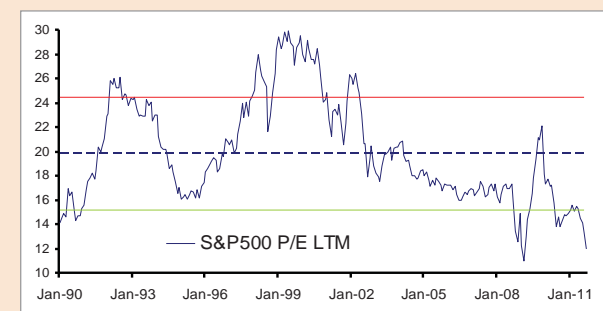
January 3, 2011 to September 30, 2011



Source: FactSet, Morgan Stanley Research, Newfleet Asset Management

FIGURE 7. S&P 500 TRAILING P/E IS 1 STANDARD DEVIATION BELOW ITS 20+ YEAR AVERAGE

December 31, 1989 to September 30, 2011



Source: Weeden & Co., Bloomberg, CapIQ, Newfleet Asset Management

and we wouldn’t be surprised to see additional easing of monetary policy beyond the “operational twist” announced recently. While monetary and fiscal policy won’t have the same influence as before (because they have fewer options), we believe it won’t need to. One reason we don’t forecast a severe slowdown is that we aren’t primed for one. Normal cyclical indicators (vehicle sales, capital equipment, etc.) are already at low or even maintenance levels, leaving less room for

EQUITY MARKET OUTLOOK (CONT.)

a pull back. Households and businesses (including most banks) have higher levels of liquid assets and lower levels of risk. There are far fewer imbalances in the real economy (like housing) compared to 2008 when we were coming off several years of growth. This recovery so far has been tepid.

We expect China to avoid a hard landing. Policy tightening and a downturn in export demand will weigh on growth in the near term. We expect inflation to begin to cool later this year along with their credit restraint and ultimately forestall any significant slowdown. Given our own portfolio positioning and the importance of China to global growth [Figure 8], we will monitor developments closely.

We expect profit forecasts will need to come down, but to levels more benign than the market is pricing.

Assuming our base case is correct, it is too late to sell many of our growth cyclicals. In most cases the multiples already reflect the most pessimistic assumptions. Our portfolio positioning still has a growth bias to it [Figure 9]. There is little question in our minds that some of our hardest hit holdings are worth more than they are trading for in the public market. However the markets perception of the global economy is that the worst is yet to come. Here again, it comes down to magnitude. We have pruned many holdings from the portfolio where we felt valuations were not taking into account future estimate cuts. There will surely be more. However, as the focus turns from imminent crisis, opportunity will take hold and we will look to be more active, possibly adding to those names that hurt us the most this quarter. The flight to safety has been swift. “Low beta” stocks are now more expensive than “high beta;” relative valuation is near a record high for defensives and near multi year lows for sectors such as Technology, Energy, and Materials [Figure 10]. You can expect fewer holdings, larger market caps, and higher weights in the months to come. Thematically, we continue to focus on opportunities that we feel have secular growth tailwinds and provide a more stable profit stream should the economic climate soften even further [Figure 11].

FIGURE 8. CONTRIBUTION TO WORLD GDP GROWTH as of September 30, 2011

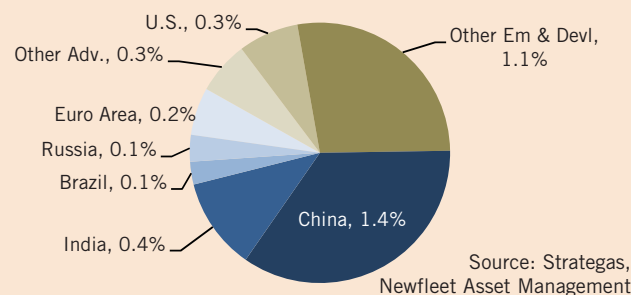


FIGURE 9. PORTFOLIO OVERWEIGHTS / UNDERWEIGHTS as of September 30, 2011

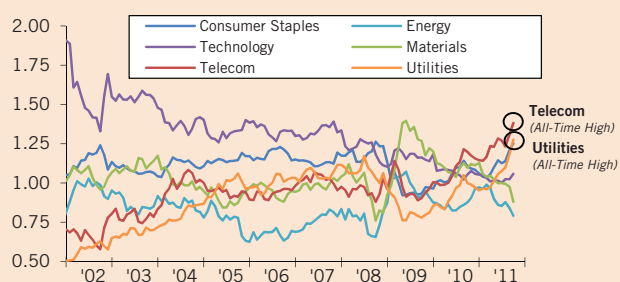
Overweight Sectors	Earnings Growth	Sales Growth
	2011E	2011E
Technology	14%	13%
Energy	40%	25%
Materials	40%	14%

Underweight Sectors	Earnings Growth	Sales Growth
	2011E	2011E
Consumer Disc.	12%	7%
Health Care	5%	5%
Consumer Staples	6%	7%

Source: FactSet, Morgan Stanley Research, Newfleet Asset Management

FIGURE 10. RELATIVE SECTOR MULTIPLES

January 1, 2002 to September 30, 2011



Source: FactSet

FIGURE 11. PORTFOLIO INVESTMENT THEMES

THE AGRICULTURAL ECONOMY	Higher commodity prices, lean inventories, and fertilizer demand present a positive backdrop for many ag-exposed equities.
NEXT GENERATION TECHNOLOGIES	Enterprise productivity enhancement needs provide a tailwind for many next generation technologies, particularly in the telecom infrastructure and enterprise software and storage areas.
HOME IMPROVEMENT/ NESTING	Continued weak housing market encourages consumers to stay in existing homes, catch up with deferred maintenance and feather the nest rather than upgrade to new, larger homes.

EQUITY MARKET OUTLOOK (CONT.)

Emotion is at extremes [Figure 12]. We sense indecisiveness in the markets and this will lead to further volatility. It is always challenging when the market's fortunes rest largely on policy and the margin for error is slim. This is one reason why correlations amongst stocks have spiked to record levels [Figure 13]. While we oscillate between fear and hope, the business cycle, and our perception of it, will adjust accordingly [Figure 14].

We are optimistic, but grounded, as the secular challenges are paired against what we see as cyclical opportunities.

In summary, we have reset our economic expectations. We expect profit forecasts will need to come down, but to levels more benign than the market is pricing. We are optimistic, but grounded, as the secular challenges are paired against what we see as cyclical opportunities. We are more than happy to share our thoughts with you in greater detail and welcome any questions and comments you may have. Thank you for your continued support.



Doug S. Couden, CFA
 Director of Equity & Senior Equity Portfolio Manager

FIGURE 12. VOLATILITY INDEX (CBOE VIX)

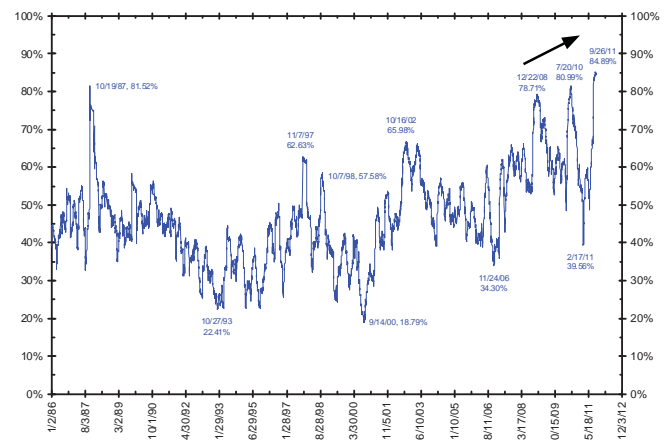
December 31, 2005 to September 30, 2011



Source: FactSet

FIGURE 13. AVERAGE STOCK CORRELATION

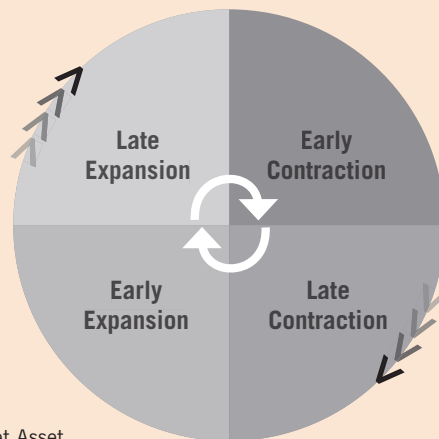
January 2, 1986 to September 30, 2011



50 Day Price Returns

Source: Bianco Research, L.L.C., Newfleet Asset Management

FIGURE 14. EXPECT COMPRESSING BUSINESS CYCLES



Source:
 Newfleet Asset
 Management