Economic & Market Review

~ Year End 2012 Investment Newsletter ~

Steven W. Lieberman, MBA, CFP® Summit Financial Resources, Inc. (973) 285-3637 slieberman@sfr1.com

Executive Summary

The year finished well, but the ride was rough. Indeed, if it were not for fairly strong full-year investment returns, the roller coaster ride of economic gyrations, political maneuvering, policy uncertainty, and investment market volatility would have been enough to make one turn green.

Be that as it may, the year did end well and the outlook has improved. For 2012, stocks were up by mid to high teens and investment grade bonds returned mid single digits. The new year starts out with far less uncertainty than did 2012. For example, European issues are not fully resolved, but the crisis is currently at bay. China appears to have pulled off a soft landing and its pace of growth has started to rise. Global growth is forecast to accelerate modestly this year for the first time since 2010. Finally, the U.S. election cycle has been completed and the most economically onerous aspects of the fiscal cliff were avoided.

Despite the positives, risks and challenges do remain. These will be discussed after a recap of the past year's journey.

First Quarter - Stock market returns were exceptional and credit markets performed admirably. The rally was rooted in the European Central Bank's two-stage infusion of over €1 trillion in funding to European banks, a second round of Greek bailout financing, and a reasonably well orchestrated restructuring of Greek debt. Investment markets were also pushed higher by improved economic fundamentals, most notably in the U.S.

World markets were not devoid of challenges, however. Commodities were hurt after China lowered its growth target for the first time since 2005. Spain's mounting deficit and rising government bond yields resulted in the nation's most stringent budget in 40 years. Greece, eroding under the pressure of austerity, embarked on its fifth year of recession. Lastly, mounting tension with Iran gave rise to fears of oil market supply disruptions and the potential of military action.

Second Quarter - As the quarter began, investors were feeling more comfortable. Europe had stepped back from the brink of collapse and the U.S. economy was showing signs of life. Central banks had been actively supportive in the first quarter and China announced its purchasing managers' index hit its highest level in a year.

The calm was short lived. Greece's initial failure to reach a coalition government caused tremendous global consternation as the nation's future in the euro zone became tenuous. Also in Europe, Spain's economic woes were deepening. Unemployment was rising, manufacturing activity continued to contract, and the government was having a rough time issuing debt. A resulting rout in Spanish bonds weighed heavily on financial markets and revived euro-zone debt worries. It was a brutal quarter for Spain. The country's failure to meet deficit reduction targets resulted in a trifecta of debt downgrades from each of the major rating agencies. Bond yields surged at one point to over 7% and the country requested a €100 billion bailout to recapitalize its banks.

Europe was not the only concern for investors. Growth in the emerging markets, including the BRICs, was slowing. It was also becoming clear that unseasonably warm winter weather had caused an illusion of stronger first quarter U.S. economic activity than was truly the case.

Investors took a step back to let the dust settle. Risky assets, led by emerging markets, declined. A flight to safety drove the U.S. dollar higher and Treasury yields during the period fell to the lowest level in history.

Third Quarter - This was a “risk-on” quarter and capital markets were universally positive. Equities across the globe rallied by mid to high single digits, high yield bonds were close on their tail, and commodities gained nearly 10%.

Attribution for the rally rests squarely on the shoulders of central bankers. Following its July promise to do "whatever it takes," the European Central Bank (ECB) announced in September the willingness to buy an unlimited amount of bonds of struggling euro zone members. One week later, the U.S. Federal Reserve pledged aggressive quantitative easing for an indefinite period of time. Throughout the quarter, investors bought on the rumors of these programs. In September, they bought *again* on the news.

Despite investment gains, economic fortunes actually declined during the quarter. In Europe, recessions were deepening, debt troubles persisted, and unpredictable policy decisions made the region impossible to forecast. Likewise, emerging markets, particularly China, were slowing and tensions were running high in North Africa and the Middle East.

Fourth Quarter - The final quarter for the year was greeted by capital market weakness as the smokescreen of expansionary monetary policy dissipated to reveal fairly weak economic fundamentals. Adding to weakness in China and Europe, Japan’s Tankan business survey grew more pessimistic. Third quarter earnings releases for U.S. corporations were also disappointing and guidance for future periods was weak.

Of course, the second most costly U.S. hurricane since 1900 did not help either. Frankenstorm Sandy resulted in mass evacuations, the shutdown of major transportation systems, power outages for millions, and the first unscheduled financial market shutdown since the attacks of September 2001.

The remainder of the year was all about U.S. politics. After an election that changed very little in terms of government leadership or political dynamics, all attention turned to the fiscal cliff. In typical fashion, lawmakers took until the eleventh-hour (and then some) to reach a resolution. On New Year's day, literally a day late and $3.3 trillion shy of the ever illusive "grand bargain," Congress managed to sidestep the full brunt of what would have been the most significant U.S. fiscal consolidation in a single year since the drawdown after World War II.

Looking forward, there are fewer identifiable potholes and road blocks on the path for 2013 than were evident at the start of recent years. That being said, a seatbelt will still be required.

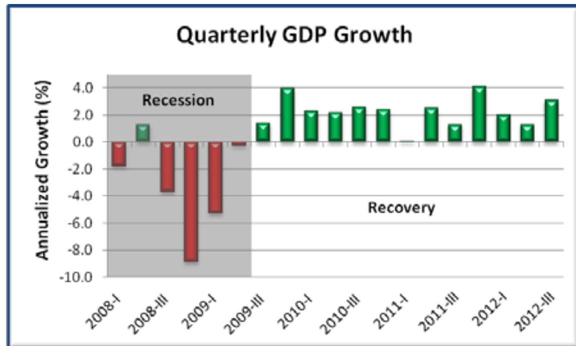
A key near-term challenge will come as a result of issues postponed by last year's fiscal cliff negotiations. Specifically, Democrats managed to increase revenue and taxes, but Republicans made no progress on spending cuts or entitlement reform. Considering the government has also reached its debt ceiling, both sides will be forced back to the table to revisit both new and unfinished business. The timing will be during the first quarter as the government is projected to run out of money in the February/March timeframe. Also tied to these discussions will be the bipartisan desire to modify temporarily delayed sequestration cuts. Republicans are expected to hold out for spending cuts prior to agreeing to raise the debt ceiling or to modifying automatic cuts. Despite Obama's proclamation that he will not debate these issues, a fierce Congressional battle is likely just around the corner.

In addition to fiscal issues, monetary policy is front and center. Central banks have become increasingly aggressive and unpredictable and competitive currency devaluations are being discussed in more open and forceful ways. These issues pose a whole host of risks ranging from asset bubbles and higher inflation rates, to trade wars and other means of protectionism. As for the Fed, minutes from their December meeting portray significant internal debate over the effectiveness of, and potential risks from, nontraditional monetary policy tools. Truncated use of these tools would be a negative to the investment markets.

Economic Review and Outlook

Economic Growth

Driven by an increase in defense spending, continued housing improvement, and a jump in durable goods purchases, U.S gross domestic product (GDP) grew at an annualized rate of 3.1% in the third quarter of 2012. Enhanced by inventory gains as well, the quarter's growth rate was the third fastest among the 13 quarters of the post-crisis recovery. To date, only three quarters following the Great Recession have met or exceeded an annualized growth pace of 3%.

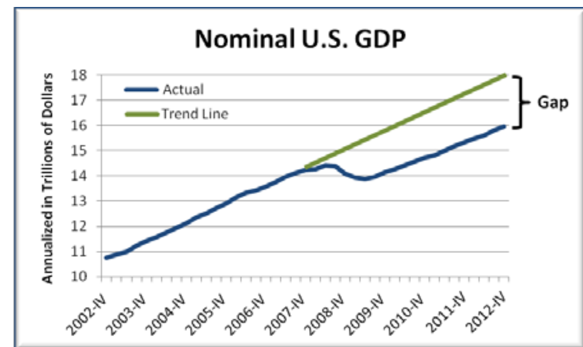


Data Source: U.S. Department of Commerce

Factoring in expected growth of 1.7% for the fourth quarter, U.S. economic output in 2012 rose by 2.3% over that of 2011. Key economic drivers for the full year include:

- Consumer spending growth remained positive, albeit at a fairly tepid pace.
- Business spending tapered off throughout the year to the point of contraction in final periods.
- Residential housing was robust, growing at or near double digit annualized rates since the fourth quarter of 2011.
- Total government spending, following eight straight quarters of contraction, began to expand in the third quarter. The period also marked the first rise in state and local government spending in three years.

U.S. growth will slow to 1% - 2% in 2013 primarily as a result of an estimated 1.5% drag induced by year-end fiscal cliff resolutions. The impact of pro-cyclical fiscal tightening on a weak economy will surely cement the gap in economic output shown in the following graph.



Data Source: U.S. Department of Commerce

Maintaining such a gap is unusual as post recession economies normally accelerate back to trend line output. Clearly, slower growth in 2013 and a permanent output gap are disappointing. That being said, had the economy been hit with the full force of prescribed spending cuts and tax increases, growth in 2013 would have been nearly 4% lower - a definite recession scenario.

Turning to the global landscape, economic growth in advanced economies is in the process of bottoming. The euro area, in recession since the second quarter of last year, is expected to contract through the first half of 2013 before resuming growth later in the year. Japan, also in recession, continued to contract through year-end, but is forecast to begin positive growth this quarter. All told, advanced economies are projected to grow 1.3% in 2013 following the same rate of growth last year.

Global Economic Growth Rates[1]

	Q3 2012	Q4 2012	Q1 2013	2011	2012	2013
Advanced	**1.1**	**1.0**	**0.9**	**1.7**	**1.3**	**1.3**
Euro[2]	-0.2	-0.5	-0.1	1.5	-0.4	-0.2
U.S.[2]	3.1	1.7	1.5	1.8	2.3	2.0
Japan	-3.5	-0.6	0.4	-0.6	2.0	0.2
U.K.[2]	4.0	0.6	1.1	0.9	0.1	1.4
Canada[2]	1.0	2.5	2.5	2.4	1.9	2.2
Emerging	**5.1**	**5.6**	**5.6**	**6.9**	**5.5**	**6.1**
China	7.4	7.8	8.1	9.3	7.7	8.2
India	5.3	5.2	5.7	7.5	5.4	6.5
Russia	2.8	3.2	3.0	4.3	3.7	3.8
Brazil	0.9	2.1	2.3	2.7	1.0	3.5
World	**2.8**	**2.9**	**3.2**	**3.8**	**3.1**	**3.3**

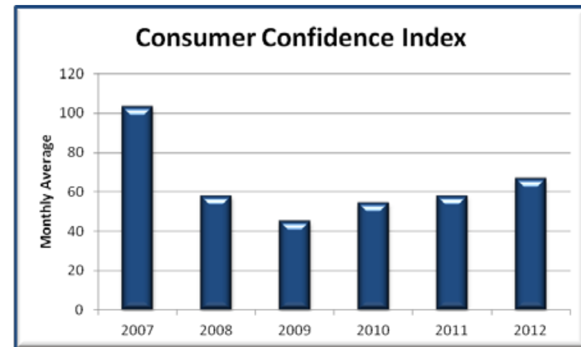
Data Source: Goldman Sachs, Central Intelligence Agency
[1]Q3 2012 and 2011 are actual, all others are forecasts
[2]Quarterly numbers are sequential annualized, others are YOY

Led by China and Brazil, emerging economies bottomed in the third quarter of 2012, and growth has begun to accelerate. Developing nation growth of 5.5% in 2012 is expected to increase to 6.1% in 2013.

Weighing the dynamics of both advanced and emerging nations, the global economy is projected to grow 3.3% next year following 3.1% for the full-year of 2012. If forecasts prove correct, 2013 will be the first year of faster global growth since 2010.

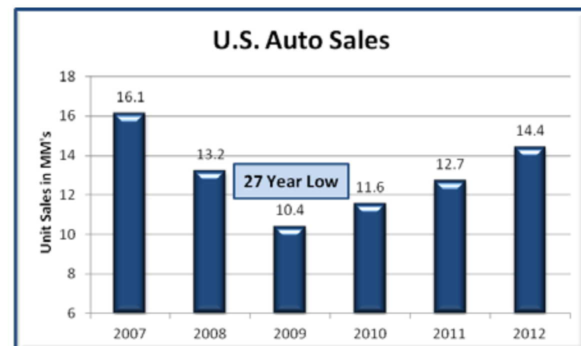
The Consumer

Consumer confidence in 2013 was choppy to say the least. Periods of optimism gave way to bouts of pessimism and no particular trend was discernible. In December, concern over year-end fiscal cliff negotiations resulted in the fifth largest monthly decline in consumer sentiment since the start of the recovery in 2009. Despite seemingly non-directional patterns of consumer confidence over shorter periods of time, there has clearly been a slow, yet steady, upward trend since the dark days of 2009.



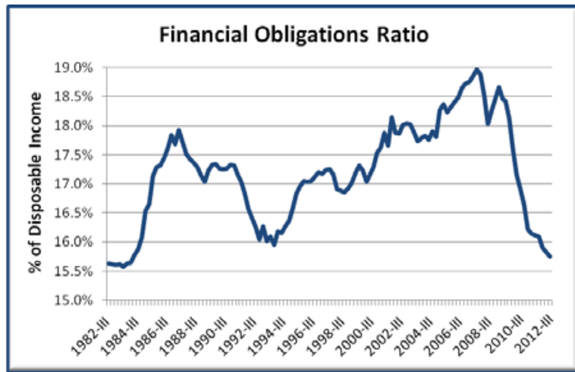
Data Source: The Conference Board

Other metrics support the notion of a healthier and more positive consumer. Retail sales grew in 2012 at about a 5% clip and auto sales, growing at the fastest pace in over a decade, reached 14.4 million units for the year.



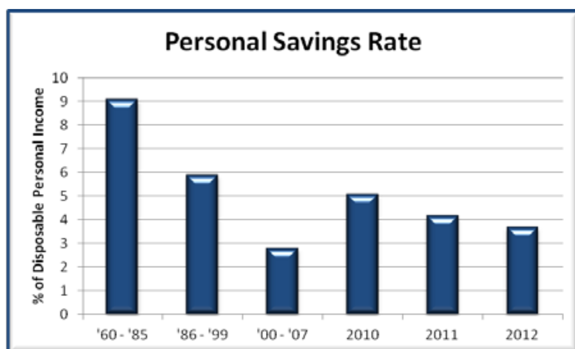
Data Source: Bloomberg

The consumer had cause to celebrate in 2012. Household wealth finally recovered to pre-recession highs, consumer debt relative to GDP reached a 10 year low, and housing is more affordable than it has been in decades. Furthermore, delinquencies on consumer debt are well below pre-crisis levels and the consumer now spends less of their paycheck on fixed expenses than at any time since the early 1980s.



Data Source: U.S. Federal Reserve

Despite the positives, economic imbalances remain and bad habits are on the rise. It seems U.S. consumers have short memories and poor fiscal discipline. For decades, U.S. households regularly saved in excess of 9% of their disposable income. Starting around the mid 1980's consumption took on a life of its own. Greater availability of cheaper and cheaper debt fueled excessive consumption and savings gradually became an antiquated notion. The average savings rate fell by about half from the mid 80's through 1999. By the new millennium, savings had dropped by three quarters and periods when savings went negative became common.



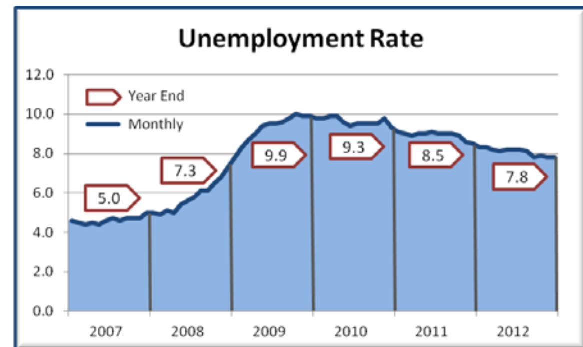
Data Source: U.S. Bureau of Economic Analysis

Following the financial crisis, consumers initially seemed to find fiscal religion. As shown above, savings rates rose nicely. Perhaps the economic catastrophe enlightened the population to the dangers of profligate consumption, excessive leverage, and de minimis savings. Then again, as the subsequent downward trend illustrates, perhaps not.

Other consumer related pressures and imbalances are worthy of monitoring. Employment, discussed in the next section, remains unacceptably weak. Higher tax rates and the expiration of the payroll tax cut will weigh on consumer spending. Finally, inflation adjusted personal income has gone nowhere in five years.

Employment

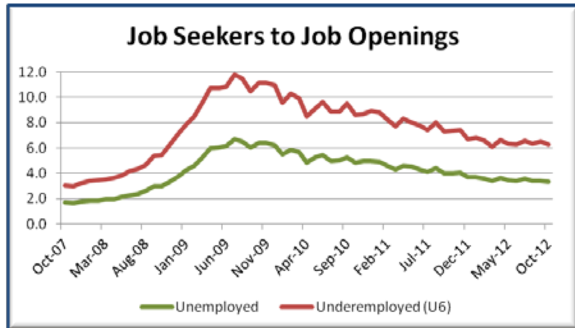
Labor markets improved in 2012 at a similarly modest pace to that of 2011. Average weekly hours ticked higher, the number of unemployed individuals dropped by 843,000, and the unemployment rate fell from 8.5% to 7.8%.



Data Source: U.S. Department of Labor

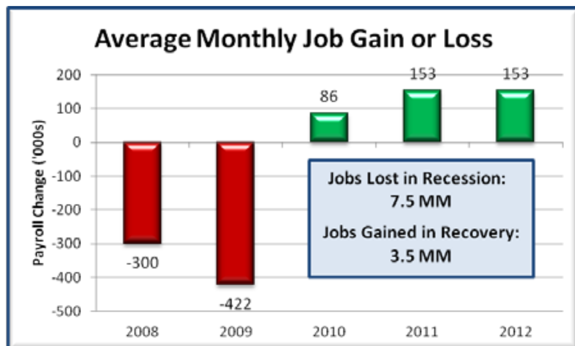
There was no perceptible change in initial weekly jobless claims for the year, but continuing claims fell by about 400,000 to 3.2 million by year-end. A sister metric, individuals characterized as long-term unemployed (those out of work for over six months), also dropped from 5.6 million to 4.8 million people. Likewise, job

opportunities have become more plentiful for those seeking employment.



Data Source: U.S. Department of Labor

A lower unemployment rate, fewer long-term jobless individuals, and more abundant jobs all reflect improvement in the labor market. To some extent, however, these metrics have all been enhanced by individuals giving up and leaving the labor force. In the end, statistical nuances aside, 1.8 million jobs were created during the year, about the same as in 2011.

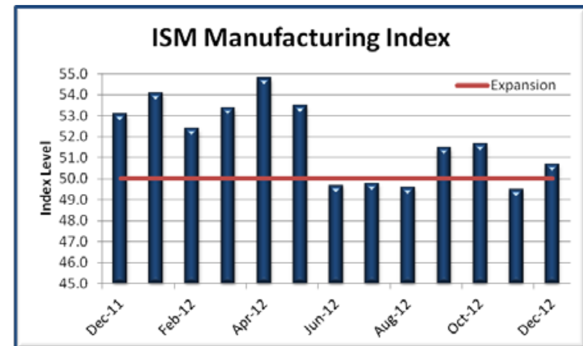


Data Source: U.S. Department of Labor

Looking forward, most economists expect the unemployment rate to continue to fall, but at a slower pace than in the past. The reason is the flipside of a declining labor force participation rate. Just as discouraged workers leaving the workforce artificially enhance many labor market statistics, most notably the rate of unemployment, a gradual return of those workers will likewise falsely depress otherwise positive employment trends. Weighing these factors, forecasts call for the unemployment rate to drop to 7.5% by the end of this year and 7.0% by the end of 2014.

Manufacturing and Service

Manufacturing led the global economy out of recession in 2009 and had been a relative bright spot until 2012. By the summer, new orders, production, and exports had slowed sufficiently to push manufacturing into contraction.

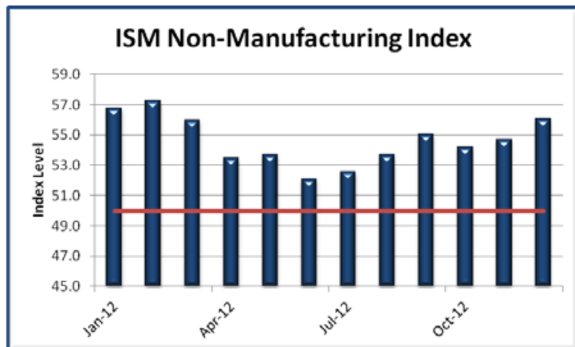


Data Source: Institute for Supply Management

Capacity utilization also peaked at that time and industrial production growth began to slow. A year-end uptick in manufacturing made December only the third expansionary month out of the previous seven. Despite the year-end uptick, uncertainty related to regulation and tax policy appeared to slow orders. Manufacturers also reported limited forward economic visibility and an unpredictable 2013.

The service sector of the economy, far more meaningful in terms of total economic output, also slowed at mid-year. In contrast to manufacturing, however, non-manufacturing never contracted.

Furthermore, the category accelerated from a low in June to a fairly strong level by year-end.



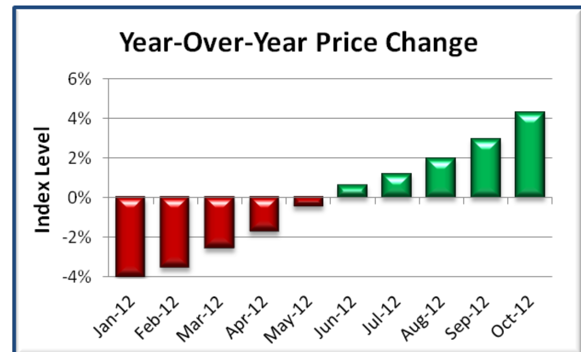
Data Source: Institute for Supply Management

As for subcomponents of the service index, business activity and new orders were generally favorable during the year, and employment growth accelerated impressively into December. Deliveries and backlogs were neutral and trade activity, both exports and imports, trended negatively. By December, businesses were reporting increased consumer optimism, an uptick in business conditions, and healthy year-over-year growth.

In 2013, the net impact of the New Year's Day fiscal cliff resolutions will slow domestic growth and will undoubtedly weigh on the ISM indexes. Upcoming negotiations, presumably in February and March, to raise the debt ceiling and deal with mandated fiscal spending cuts, will also be impactful. Accelerating global growth, primarily driven by emerging economies, will help to counteract some of the fiscally driven domestic challenges.

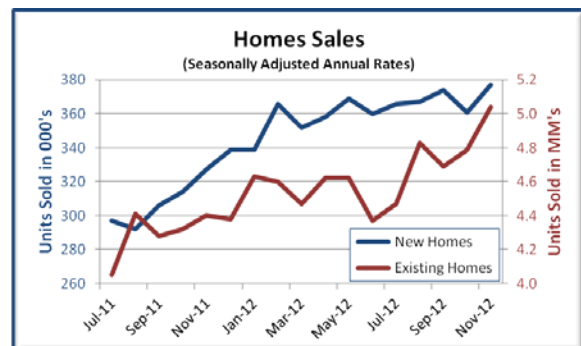
Real Estate

As mentioned earlier, auto sales were a bright spot in 2012. The same goes for the housing market. After peaking in April of 2006, home prices fell 33.9% before bottoming in January of 2012. Prices have risen sequentially in every month since then. Through October, values were up 5.4% from the bottom and sequential monthly gains have averaged 7.5% on an annualized basis. The turn is equally evident in year-over-year price comparisons.



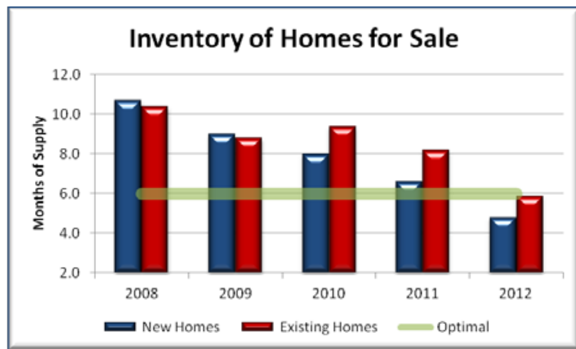
Data Source: S&P/Case-Shiller

Sales volumes have also moved higher. Through November, year-over-year unit sales of new and existing home were up 15.3 and 14.5%, respectively.



Data Source: U.S. Census Bureau, National Association of Realtors

After running for years at very high levels of housing stock, current inventories of homes for sale are actually tighter than ideal conditions. Against a desired target of six months of supply, new and existing home inventories ended November at 4.8 and 4.9 months, respectively. The following graph shows average monthly inventory levels in recent years.

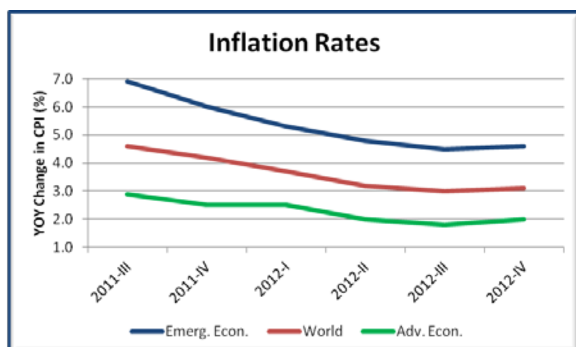


Data Source: U.S. Census Bureau, National Association of Realtors

Lastly, in terms of contribution to economic growth, residential housing accounted for an average of 15.4% of quarterly U.S. GDP growth for the first three quarters of 2012.

Inflation

Whereas inflation concerns were a prevalent theme in 2011, disinflation (a lower rate of inflation) and outright deflation were more common issues in 2012. Indeed, with the exception of India, every major economy experienced disinflation in 2012. On a worldwide basis, inflation has come down meaningfully over the past five quarters.



Data Source: Goldman Sachs

In the U.S., consumer price inflation is down from as much as 3.9% in 2011 to a current level of about 2%. Additionally, based on pricing of Treasury inflation protected securities, long-term inflation expectations are stable in the range of 2.0% to 2.5%.

Monetary Policy

Low inflation and contained inflation expectations provide cover for expansionary monetary policy. Considering this, along with high rates of unemployment and below trend economic growth rates across the globe, central banks pursued aggressive monetary policies throughout the year.

Monetary easing was so widespread, it would be a challenge to chronicle the moves. Among others, Japan, the U.K., China, Brazil, Denmark, South Africa, South Korea and Taiwan cut rates, implemented or expanded quantitative easing programs, and/or cut bank reserve requirements. In several cases, individual nations deployed more than one policy tool and even took multiple actions in the same month.

If monetary support was a contest, however, the ECB and Federal Reserve took the game to a whole new level. The ECB completed issuance of over €1 trillion in low interest rate loans in February, cut interest rates at mid-year, and promised to do "whatever it takes to preserve the euro" in July. In September, they announced the intention to acquire an unlimited amount of sovereign debt in support of struggling euro zone nations.

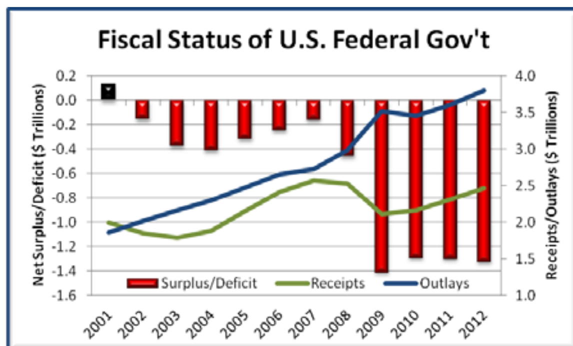
The Fed extended Operation Twist through year-end and launched a third round of quantitative easing in September. QE3 targets the monthly purchase of $40 billion of agency mortgages and will continue for an indefinite period of time. Additionally, at the central bank's December meeting, the board eliminated a specific end-date for their low policy rate in favor of an unemployment target of 6.5% or less.

Furthermore, upon the year-end completion of Operation Twist, the Fed began outright purchases of $45 billion in Treasury securities on a monthly basis.

Fiscal Policy and Legislative Activity

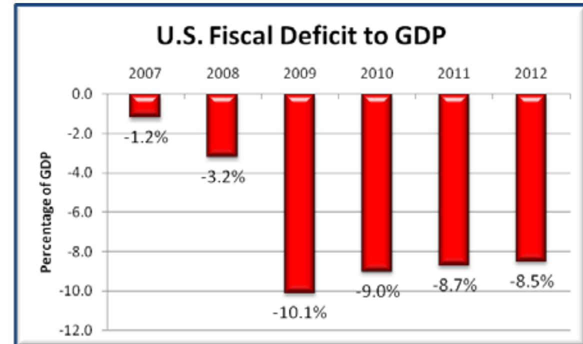
The most significant legislative action for the year was the American Taxpayer Relief Act of 2012. The eleventh-hour deal effectively avoided the full force of scheduled year-end tax increases and spending cuts totaling $668 billion. The so-called fiscal cliff would have driven the U.S. economy into immediate recession by subtracting approximately 4% from the nation's economic output. The New Year's Day agreement will subtract a more manageable, yet not inconsequential, 1.5% from economic growth in 2013.

Considering subdued domestic and global growth, the timing of dramatic U.S. fiscal retrenchment was clearly not ideal. That being said, longer term plans must be developed to achieve a healthy fiscal balance. To put this into perspective, the Act passed by Congress is expected to reduce this year's deficit by only $157 billion compared to a massive $1.3 trillion deficit in 2012.



Data Source: U.S. White House Office of Mgmt and Budget

Fortunately, nominal growth in GDP helps to reduce the deficit relative to total economic output as it has over the past three years.



Data Source: U.S. White House Office of Mgmt and Budget

Despite the improvement, however, the deficit for 2012 was the fourth largest in the past 68 years. Furthermore, total Federal Government debt reached the debt ceiling of $16.4 trillion by the end of December.

Congress plans to deal with the debt ceiling as well as unfinished fiscal cliff business over the next two months. In the meantime, the U.S. Treasury must take extraordinary measures to keep paying the government's bills. Cash will ultimately run out sometime in February or March.

Capital Markets Review and Outlook

Overview

It was a good year in the investment markets. Globally, stocks, high yield bonds, and real estate delivered mid teens returns or better. Lower risk assets, such as investment grade corporate and municipal bonds, were up mid single digits. Commodities fell slightly.

Capital Market Returns

	4rd Qtr 2012	Full Year
U.S. Treasury Bills	0.0%	0.1%
Barclays Aggregate Bond	0.2%	4.2%
Barclays Municipal Bond	0.7%	6.8%
S & P 500	-0.4%	16.0%
Wilshire 5000	0.2%	16.3%
MSCI ACWI ex. U.S.	5.7%	17.0%
MSCI EAFE (Int'l	6.6%	17.3%
MSCI EM (Emerg. Mkts)	5.6%	18.2%
DJ UBS Commodity Index	-6.3%	-1.1%

Data Source: Morningstar

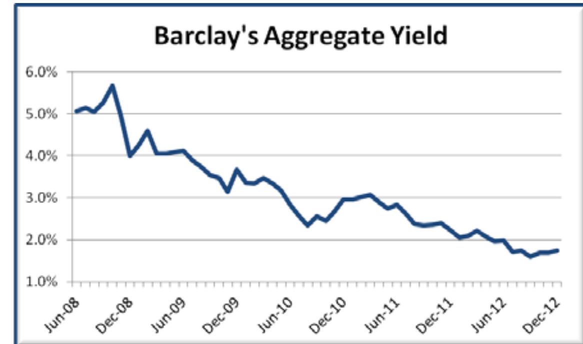
Key factors behind the year's results were:

- Highly supportive central banks aggressively pursuing expansionary monetary policies
- Bottoming of global economic growth and anticipation of acceleration into 2013
- A shift to higher risk assets by investors searching for return in a low-yield world
- Post-election clarity of U.S. political leadership and averting the full impact of the fiscal cliff
- Avoidance of catastrophic failure in Europe and relative calm, at the present time

Fixed Income Markets

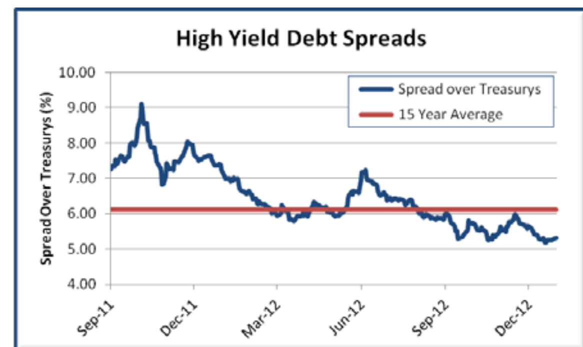
Slight contraction in Treasury yields, significant credit spread compression, and a limited number of credit events provided a positive mix for fixed income in 2012. Quantitative easing by central banks and strong investment flows into fixed income were also highly supportive of the category.

The 10-year U.S. Treasury yield fell 11bps to end the year at 1.78% and the yield on the Barclay's Aggregate index fell 50bps to end the year at a paltry 1.74%.



Data Source: Bloomberg

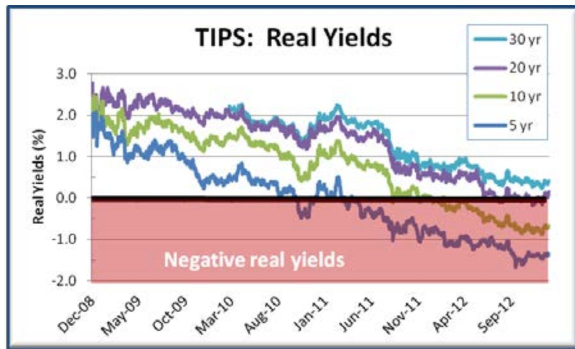
High yield credit spreads compressed even more substantially, from 7.23%, well above the 15 year average, to 5.31%, well below.



Data Source: Bank of America Merrill Lynch

Junk bond yields recently fell to less than 6% for the first time in history, and issuance of these speculative securities hit a record of $350 billion in 2012. Forty percent of new issues in the fourth quarter had fewer than normal protections, the highest ratio since the crisis.

In terms of inflation protected securities, an investor now needs to go beyond a 20 year maturity to capture a positive real return.



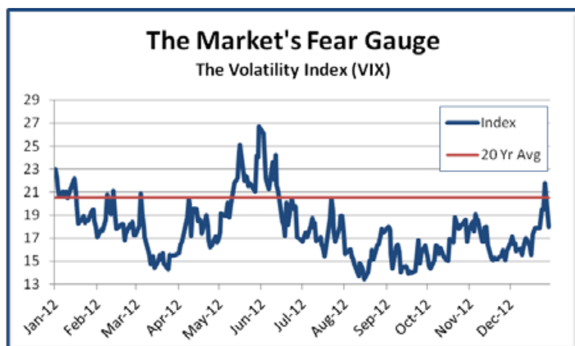
Data Source: U.S. Treasury

Considering the best expectation for return on a fixed income portfolio is the current yield, the bond component of diversified portfolios should be expected to deliver very little in terms of total return.

Equity Markets

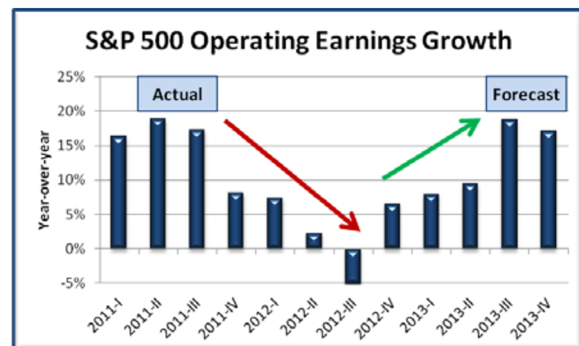
On a global basis, equity markets did well in 2012. As per the Wilshire 5000 index, the U.S. stock market was up 16.3%. International developed and emerging stocks did about 1% and 2% better than that, respectively. Based on Russell indexes, value outperformed growth for the year and no particular capitalization range was favored.

Aside from weakness in the second quarter, stock markets were reasonably well-behaved, and volatility remained well below the 20 year average for much of the year.



Data Source: Yahoo! Finance

As for the outlook on stocks, consideration must be given to competing asset classes. As discussed in the previous section, the outlook for the bond market is not particularly strong. Expected returns are low, and in the case of most fixed income segments, are negative from a real return perspective. Under these circumstances, it is reasonable to expect capital to flow out of bonds and into stocks. Likewise, modestly accelerating global growth in 2013 should be supportive of equities. Lastly, and much in-line with expectations for the global economy, year-over-year earnings growth of the S&P 500 is forecast to accelerate into double digits in the second half of 2013.



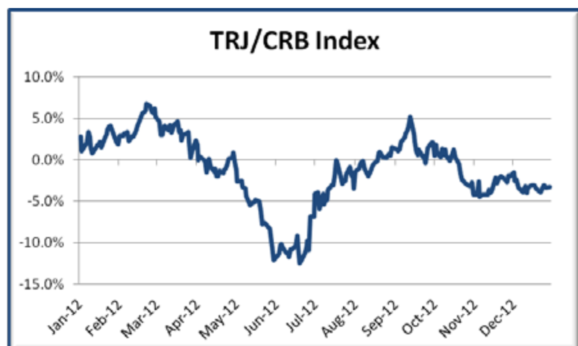
Data Source: Standard & Poor's

While these factors are all supportive of the equity markets in 2013, crises tend to crop up quickly and when you least expect them. Additionally, compared to historical valuations, stocks are not particularly cheap.

Hedge Funds and Alternatives

Hedge Funds - The HFRI Fund of Funds Composite index gained 5.3% in 2012. Fixed income, distressed, and relative value managers did particularly well. In contrast, short biased, macro, and systematic traders did poorly. As with 2011, short-lived market swings driven by unpredictable macro events made for a challenging environment for managed futures (CTA) managers.

Commodities - In light of macroeconomic headwinds, commodities fared poorly in 2012. For the year, the DJ-UBS Commodity index was down 1.1%, while the Thomson Reuters/Jefferies CRB Index lost 3.3%.



Data Source: Thomson Reuters / Jefferies

Stronger growth this year, particularly in China, would be supportive of commodities.

Real Estate - After falling by mid-single digits in 2011, the best performing asset class in 2012 was publicly traded real estate. For the year, domestic and international publicly traded REITs gained 18.9% and 28.7%, respectively.

Energy - *Petroleum:* Average crude oil prices in 2012 were at historically high levels for the second year in a row. Brent crude oil averaged $111.67 per barrel, slightly above the 2011 average, and West Texas Intermediate oil averaged $94.05 per barrel in 2012, down slightly from 2011. U.S. crude oil production rose by an estimated 780,000 barrels per day (bbl/d) in 2012, the largest yearly increase to date.

Gasoline: High crude oil prices were reflected in motor fuel prices paid by consumers at the pump during 2012. The national average pump price for gasoline set a record of $3.62 per gallon. Last year also marked the second year in a row that the average price for gasoline remained above $3 per gallon during every week.

Natural Gas: Average wholesale prices for natural gas fell significantly in the U.S. in 2012. The average price at Henry Hub, a key benchmark location for pricing, fell from $4.02 per MMBtu in 2011 to $2.77 in 2012. This was the lowest average annual price at Henry Hub since 1999.

Disclaimers

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