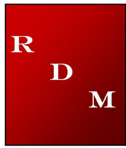

RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

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THIRD QUARTER MARKET COMMENTARY

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EXECUTIVE SUMMARY

With little fundamental U.S. economic improvement in the Third Quarter, the equities markets were a classic trader's market – driven by anticipation of stimulus by the Federal Reserve and concerns over Europe's debt crisis. Meanwhile the domestic economy is stagnating with 8.1% unemployment (16% if you factor in under-employed) and mediocre economic growth. Further, business managers and many weary investors continue to leave their capital on the sidelines awaiting resolution of the great political, tax and regulatory uncertainty labeled the "Fiscal Cliff".

Nevertheless, the equity markets have risen significantly this year and have rebounded from the minor correction we anticipated in the Second Quarter amid progress in the European debt crisis and anticipation of additional Fed stimulus. We believe that the equities markets will likely trade near their current levels in the near term, but have the potential for 5-10% of upside after the presidential election.

While the markets will continue to fluctuate with developments in Europe, the November presidential and senatorial elections and the resolution of the Fiscal Cliff will have the greatest impact on the performance of the equity markets in the Fourth Quarter and future growth in the economy. We remain optimistic that Europe will continue to muddle through its debt crisis and the U.S. economy will not go over the Fiscal Cliff. Long term, we favor investments in equities over low-yielding Treasuries and corporate bonds, and we continue to prefer companies in the financial, energy and industrial sectors for long-term capital gains and high-dividend paying stocks in the pharmaceutical and utility sectors for current income.

2012 YTD Performance
as of 9/30/12

RDM Capital:	13.71%
Dow Jones:	9.98%
S&P 500:	14.56%
Russell 1000 Value:	13.55%

The U.S. Economy Remains Sluggish Despite Multiple Rounds of Fed Stimulus

This election year, the most highly publicized economic statistic has been the persistence of the unemployment rate over 8%. The persistently high unemployment rate is a product of both structural changes to the labor market after the recession and too little production growth in the economy. Businesses streamlined their labor costs during the recession and are not currently expanding fast enough to absorb the influx of new workers in the labor force or re-hire those unemployed workers looking for work after the recession. Rather, many discouraged workers are simply dropping out of the labor force entirely and in reality, most of the minor gains in the unemployment rate in recent months are attributable to a participation rate that has declined 1% over the past 2 years. With GDP estimated to remain near 1.5 – 2% this year, a historically anemic growth rate, there is little hope that the economic status quo will cause enough growth to create jobs for the new entrants into the labor force and significantly lower the unemployment rate closer to a healthy 5 – 6% rate.

Up to now, the government and Federal Reserve have attempted to stimulate the economy primarily by increasing liquidity in the hope that flooding the financial system with additional dollars will lead to increased lending, spending and investment in the economy. While originally coming in the form of bailouts and increased deficit spending, these liquidity injections have recently come in the form of several rounds of "quantitative easing", which is the Federal Reserve's open market purchases of treasury and mortgage-backed securities. Quantitative easing is essentially our government borrowing money from itself – the Treasury issues debt obligations of the U.S. government and the Federal Reserve buys them with newly printed dollars that then make their way into the capital markets. What all of this monetary smoke and mirrors accomplishes is (i) lower yields on safe harbor fixed income investments, (ii) lower long-term interest rates for borrowing to stimulate business investment, (iii) lower mortgage rates to stimulate the housing sector, and (iv) stock and commodity inflation via a weaker dollar and higher relative yield compared to fixed income.

Diminishing Returns of Quantitative Easing

Post QE 1 *(Nov. 2008)*	S&P 500	GDP (Annual Rate)	Unemployment Rate
1st Quarter 2009	-12.12%	-5.30%	8.7%
2nd Quarter 2009	+16.03%	-0.30%	9.5%
3rd Quarter 2009	+14.56%	1.40%	9.8%
4th Quarter 2009	+5.84%	4.00%	9.9%
4 Quarter Average	***+6.07%***	***-0.05%***	***9.47%***

Post QE 2 *(Nov. 2010)*	S&P 500	GDP (Annual Rate)	Unemployment Rate
1st Quarter 2011	+5.71%	0.10%	8.9%
2nd Quarter 2011	-0.66%	2.50%	9.1%
3rd Quarter 2011	-14.34%	1.30%	9.0%
4th Quarter 2011	+11.28%	4.10%	8.5%
4 Quarter Average	***+0.49%***	***2.00%***	***8.87%***

Despite causing lower interest rates and higher stock market and commodity valuations, quantitative easing has not led to significant growth in the economy. The charts to the left illustrate the performance of the S&P 500, GDP and the unemployment rate in the four quarters after the announcement of the Fed's quantitative easing programs in November of 2008 and 2010, respectively. While the S&P 500 received a short-term bounce (although to a lesser extent in 2011), GDP averaged between 0 and 2% and the unemployment rate remained elevated at 8 to 10% in the four quarters following each announcement. GDP and unemployment have settled near these averages over the past 4 years and the S&P 500 has retreated somewhat in between announcements of each round of stimulus.

This ineffectiveness of monetary stimulus to have a lasting impact in the real economy is an indication that liquidity, while a major problem during the throes of the financial crisis, is no longer the problem inhibiting economic growth. In reality, corporate balance sheets have been flush with record levels of cash since the recession and many investors have parked their investable assets in cash. The true culprits, as we have argued in the past, are the unnecessarily high degree of uncertainty caused by foreign and domestic sovereign debt mismanagement, the threat of tax increases in 2013, and lack of capital investments due to regulatory cost uncertainty. Due to this uncertainty, according to a recent Bank of America study, less than half of the 250 finance executives polled anticipated additional hiring or higher profit margins for their businesses going forward in 2012

Europe Muddles Through its Debt Crisis

Throughout the European debt crisis, we have reiterated our belief that European leaders will continue to accomplish just enough to avoid a disorderly default by Greece and unraveling of the Euro. It appears that Europe continues to merely "muddle through" as it struggles to find common ground in the EU among the competing sovereign interests for a plan to balance the need for austerity for its bankrupt members, with the simultaneous need to stimulate economic growth to avoid a prolonged recession. Recent data shows the Euro-zone falling into a recession, while the debt crisis begins to have a more significant economic impact on even the stronger EU nations, like Germany.

While Greece remains in the headlines, investor attention has primarily shifted to Spain during the Third Quarter, where the political leadership is waffling over a request for a bailout of its own. The markets are hoping for a bailout, as there is little support for significant austerity domestically in Spain (judging by the mass violent protests recently) and the Spanish banking sector is still struggling with its bad mortgage exposure. The situation is causing Spanish sovereign yields to flirt with the 7% rate that is widely considered to be fiscally unsustainable over time.

European leaders are taking steps towards fiscal integration among the EU nations that have adopted the Euro.

Despite this seemingly dire situation, there are some silver linings on the European storm clouds. The first, and most important in our opinion, is that European leaders are taking steps towards fiscal integration among the EU nations that have adopted the Euro. We believe this development is imperative to avoid the possibility that the fiscal mismanagement by one Euro-zone nation, e.g. Greece or Spain, could cause a cascading collapse of the financial system throughout the entire Euro-zone. To avoid this scenario, there must be greater supervision and controls over the fiscal health, in general, and more specifically the debt-to-GDP, of each Euro-zone nation. This can only be accomplished through a fiscal integration in the form of a Euro-zone budget, including a supervisory body to act as fiscal overseer to ensure compliance with such a budget and administer penalties for non-compliance. As we have seen in recent years, the collapse in confidence in the strength of one Euro nation due to a floundering economy and unmanageable debt can be an existential threat to the entire Euro currency. The second silver lining is that the European Central Bank has committed itself to its own form of "quantitative easing" to keep sovereign debt yields at manageable levels for Euro nations such as Spain and Greece that are suffering from a lack of market confidence. As we discussed above in relation to the Fed, we believe that quantitative easing will produce diminishing returns over successive rounds of stimulus, however we are not opposed to an initial shot in the arm to provide a backstop for investor confidence in the marketplace.

The November Elections Will Determine the Fate of the U.S. Economy

While we are professionally agnostic regarding the outcome of the upcoming presidential and congressional elections, we believe that the elections will have a significant short and long-term impact on the performance of the economy and the markets. Current polling suggests that President Obama is leading former Governor Romney in several battleground states that may end up deciding the election, including Ohio, Virginia and Florida. If the current polling is correct, the election will result in the continuation of the status quo in Washington, with Democrats controlling the presidency and the Senate and Republicans controlling the House. This may bode well for the market: the greatest market performance historically has come from a split presidency and congress, with a Democratic President/Republican Congress providing the greatest average return of 21.3% on the S&P 500. The markets also typically perform better when the incumbent party wins. Between the two political parties however, the Dow has risen on average 10.3% after a Republican victory, with a 3.9% rise after a Democratic victory.

Presidential Election Year Returns

Time Period	DJIA Return
Presidential Election Years Overall	+7.6%
Incumbent Party Wins	+15.1%
Incumbent Party Loses	-4.4%
If Democrat Wins	+3.9%
If Republican Wins	+10.3%

Source: Forbes

To summarize the key differences between each candidate, as they may impact the stock market:

President Obama

The most significant short-term market impact if President Obama is reelected may be higher taxes on investment income earned by investors and businesses. Currently, the Bush tax cuts are scheduled to expire at the end of the year, meaning that the currently preferential tax rate of 15% on capital gains would increase to 20% and the preferential rate on dividends would increase to the taxpayer's ordinary income tax rate (as much as 40% for some wealthier taxpayers and small businesses organized as S-Corporations, LLCs or partnerships), respectively. Obamacare also imposes a 3.8% tax on passive income from dividends, interest and capital gains. Further, President Obama favors eliminating the "carried interest" investment income treatment that many private equity professionals currently enjoy and treating such income as ordinary income, as well as reverting the estate and gift tax exclusions to $1 million. The likely effect of these tax hikes is to reduce some economic incentive for individuals and business to invest in publicly traded and private equity, and particularly in high dividend stocks that have served as a fixed income alternative for many retired

investors in the current low interest rate environment. However, we believe the negative impact on dividend stocks will be short-lived as the market corrects in the months immediately following the tax hike and muted by the fact that the higher rate will apply only to those investors earning more than $200,000 in taxable income.

The effect of [President Obama's] tax hikes is to reduce some economic incentive for investment by individuals and businesses in equities.

President Obama plans to use the additional tax revenue generated by these higher taxes to help finance Obamacare and the stimulus investments that the government has promoted in the past, such as alternative energy, road and infrastructure investments. President Obama will likely also pursue some form of tax or debt relief targeted at the middle and lower classes, such as student debt reform. In our opinion, however, even these tax increases cannot pay for all of the additional spending projected under a second Obama term and we are likely to see a tremendous growth in our country's debt through additional deficit spending. We believe that if President Obama wins the election and the Democrats maintain control over the Senate, but not the House, as current polling seems to suggest, the trend of extreme deficit spending and higher taxes will continue relatively unabated during his second term. The tax hike on dividend and capital gains income may provide a headwind for the stock market, particularly high dividend stocks, offset somewhat in the short term by the increased government spending.

The reelection of President Obama also may have an effect on homebuilder and healthcare/ pharmaceutical stocks. Specifically, homebuilder stocks will benefit if new legislation is passed to aid underwater homeowners, as the amount of available foreclosed homes will decrease leading to a demand for new homes. Such legislation is more likely under an Obama administration. Obamacare also may lead to an increase in the demand for healthcare and pharmaceuticals because of the increase in patients with insurance coverage. This ultimately may benefit healthcare and pharmaceutical stocks.

<u>Mitt Romney</u>

Governor Romney's biggest impact on the markets will come through tax and regulatory reform. Governor Romney advocates a tax cut across the board for all Americans, along with the elimination of some tax deductions and loopholes that are often abused to avoid taxes. He would pursue a strategy to stimulate the economy by creating greater incentives for individual Americans and businesses to invest, mainly by lowering taxes on businesses and a 20% across-the-board tax cut on all tax brackets. Governor Romney would also seek to relax certain regulations on the banking industry introduced by the Dodd-Frank law and repeal and replace Obamacare in order to create greater healthcare cost certainty for businesses. This would allow for business managers to more assuredly plan for future business development as the future cost structure would not be clouded by newly drafted and undeveloped regulatory schemes.

[Governor Romney] would pursue a strategy to stimulate the economy . . . by lowering taxes on businesses and the upper income brackets that tend to provide the majority of investment dollars in the economy.

Should Governor Romney win the election and the Republicans maintain control of the House, regardless of the outcome in the Senate, the Republicans will have the power to enact many of the changes that Gov. Romney advocates on the campaign trail. While decreased government spending may have a short-term negative impact on the economy, similar to (albeit on a much smaller scale) the austerity measures that have hamstrung some European economies in recent years, the long-term economic and market outlook would be much improved with a more favorable climate for business and investor spending due to lower taxes and less regulatory intervention in markets. Further, a Romney election would have a short-term, positive effect on several sectors. Romney's position on taxing dividends would benefit companies that pay high dividends – such as those in the utilities, telecommunications and consumer staples sectors. A Romney election also could have a positive effect on the energy sector, as Romney favors increasing domestic production of oil and natural gas through, among other things, relaxing federal impediments to "fracking" and drilling on federal lands and green lighting the Keystone XL pipeline. Easing restrictions imposed by the Dodd-Frank law and other financial regulations also may be a short-term positive for financial stocks.

Conclusion

To summarize, we believe that the markets continue to drift upwards tentatively as investors await the resolution of several key issues impacting the U.S. economy: most importantly, the U.S. presidential election, the U.S. Fiscal Cliff and the European debt crisis. The Fourth Quarter will likely see progress on each of these matters and the uncertainty over the presidential election will subside within the coming weeks.

At the beginning of 2012, we forecasted the S&P 500 to finish the year at 1,425 and the Dow Jones Industrial Average to reach 14,025, based on analysts' expected 2012 S&P 500 corporate earnings of $105 per share. The S&P 500 has recently surpassed our projection while the Dow lags approximately 4% behind the S&P 500. We believe there is a moderate upside to the markets after the election if the markets begin to more clearly foresee the resolution of the Fiscal Cliff, regardless of the winner.

We believe that, due to the ongoing Federal Reserve low interest rate policy and quantitative easing, many "safe" investments, such as Treasury securities that currently yield a negative interest rate, are to be avoided in the foreseeable future for our client accounts, as they have become overly inflated. It now seems that the Fed is doing everything in its power to turn the tide of investment dollars back towards equities. We continue to favor equities that are likely to out-perform in an expanding economy, particularly those that benefit from a weaker dollar, such as those companies in the energy, pharmaceutical, industrial and financial sectors.

As usual, all comments are welcome.

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