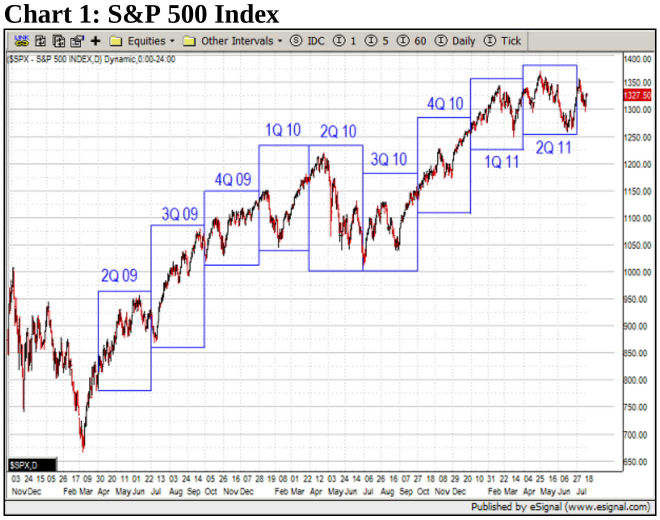
ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — Second Quarter, 2011

After posting strong gains in April, stocks declined during most of May and June as market participants became increasingly concerned about a slowing economy and fears that a Greek default would spread contagion to other weak European Union (EU) members and rattle the global financial system as the interconnected nature of global financial markets render Europe's problems the world's problems. There was, however, a late-quarter rebound in June as it became increasingly likely that the EU and the International Monetary Fund (IMF) would manage to kick Greece's debt can down the road one more time. In fact, for the week ended July 1, stocks notched their biggest weekly jump in two years.

When the dust settled, stocks wound up roughly flat for the quarter. Large-cap U.S. stocks were barely positive while smaller-cap stocks lost around 1.6%. Domestic high-quality, intermediate-term bonds gained 2.3% for the quarter. Looking abroad, developed-market foreign stocks gained 1.6%, while emerging-markets equities fell 1%.

Chart 1: S&P 500 Index



Source: eSignal

This time last year leading economic indicators had rolled over and risk aversion was climbing, largely in response to escalating concerns of a European sovereign debt default. An additional concern at the time was whether the emerging economic recovery could be sustained following the completion of the Fed's quantitative easing program. Sound familiar?

Fast forward one year and we are faced with a similar backdrop as several new shocks have prompted familiar concerns about a deceleration in U.S. growth. The disaster in Japan, steadily tightening monetary policy in China, and renewed weakness in the domestic housing and employment markets have combined to weigh on U.S. growth prospects. Add to that the growing debt crisis in Europe and the uncertainty surrounding the U.S. debt ceiling and it's no wonder that anxiety over the global economic expansion in general and the U.S. recovery in particular is high. Our view is that the contagion in confidence and the fear of a looming crisis is behind the market's inability to generate any real net gains over the last five-or-so months. Ironically, this could actually be good news from a contrary perspective.

> *This isn't the government we are watching, it's junior high school…We're governed by self-absorbed, reckless children…The budget war reflects inanity, incompetence and cowardice that are sadly inexplicable.*
>
> Nicholas Kristoff, *The New York Times*

The debate over the debt ceiling is a study in all that is wrong in American politics. Both parties are doing little to persuade anyone of their entitlement to the leadership positions that they currently hold. First of all, the debate is about nothing since the United States has not a $14 trillion but a $20 trillion deficit if it is properly calculated to include the obligations of Fannie Mae and Freddie Mac (which are held in conservatorship by the U.S. government). Second, any deficit reduction plan is going to raise taxes and cut spending. The key to any plan's ultimate success, however, is raising the right taxes and cutting the right spending.

With that being said, we do not anticipate a default by the U.S. government. However, the fact that Democrats and Republicans are making no progress on their plans to close the budget gap underscores the strong likelihood that any deal will come at the last possible minute. The problem is that even the most ambitious debt reduction plans leave the United States with a $20 trillion debt burden by 2020 (including Fannie Mae and Freddie Mac – the "GSEs" – , which are guaranteed by the government). What is needed to solve the debt problem is higher economic growth coupled with spending discipline. Higher economic growth can only be effected by policy changes that encourage investments in productive areas such as education and energy and the discouragement of unproductive uses of capital such as speculative trading of derivatives and leveraged buyouts.

In terms of the debt ceiling deadline in early August, we assume that Congress understands that allowing a technical default on Treasury debt could have devastating effects on financial markets, and thus a default will be avoided. Another issue is how the rating agencies will respond. Moody's and S&P (the two largest bond rating agencies) followed through on their threat to place the U.S. on review for possible downgrade. Both rating agencies have indicated that a default would result in a downgrade and that triple-A status would not automatically be reinstated once the default is cured.

The threat of downgrade puts more pressure on our politicians to work out a deal. Failure is not an option because the consequences are too great. One consequence is that, if Treasuries are downgraded, all the debt issued by the GSEs (Fanny Mae, Freddie Mac, etc.) would suffer the same fate. It would be disastrous if the GSEs were to have trouble issuing debt.

Even if a default is avoided this summer, a downgrade would still be possible if there is no agreement on a long-term plan to cut the budget deficit. The common thread running through commentary from the three largest rating agencies is that it is not the level of the debt/GDP ratio that matters *per se*, but rather the resolve of policymakers to enact a plan to stabilize it. So, U.S. politicians are faced not just with the question of the split between tax hikes and spending cuts. They also need to strike a balance between doing enough to avoid a downgrade, but not so much as to derail the recovery. Unfortunately, the recent economic data have not been very encouraging.

Turning to debt woes across the Atlantic, Europe's crisis has entered a new and critical phase. Italy is suddenly under threat of being dragged into the self-reinforcing vicious circle of rising interest rates that undermine a country's ability to service its debt.

Italy is the euro area's third-largest economy and second largest sovereign debt market. Unlike the small economies of Greece, Ireland and Portugal, Italy is simply too large for the EU/IMF/ECB "troika" to finance if the normal credit channels stopped working.

Up to now, the authorities have violated practically every rule in the playbook of dealing with a financial crisis. The indecisiveness, hesitation, inconsistency, and political posturing have been pathetic and have allowed the crisis to snowball, threatening one country after another.

The market has increasingly lost its patience with the authorities and investors cannot see a feasible and decisive plan that will end the euro area debt crisis. All the rescue measures taken so far have been designed to kick the can down the road, but the market knows that the can is getting heavier and each kick is traveling a shorter distance.

On a more fundamental level, the lack of growth in the euro zone is the biggest problem for the debtor countries. Recent history has repeatedly shown that when stuck in a debt trap, economic growth makes all the difference. Unfortunately, Greece, Portugal and Ireland have not really come out of the Great Recession at all. For Italy and Spain, nominal GDP growth rates are low and below their respective debt service cost ratios – an unsustainable situation. Without nominal growth, the debt arithmetic becomes no more that a Ponzi scheme: the government can only rely on issuing new debt to service old debt. A debt crisis erupts when creditors are no longer willing to tolerate the situation.

The bottom line is that the debt crisis will not end until debtors can find a way to grow their economies and generate revenue. Historically, economic growth in a crisis-stricken economy has usually come with a large currency devaluation and dept repudiation. While these adjustments are by no means easy, they are at least viable. The problem is that these adjustments can't take place when the crisis-stricken economies are bound by the euro. Therefore, there are growing odds that both political and economic forces will pull the euro zone apart, not push it together.

Frankly, no one really knows how this crisis will end. The solution that seems to make the most sense (and would encounter the most resistance) would be for the ECB to make an open-ended commitment to buy distressed euro debt at some predetermined level and finance the operation by printing euros. This way, interest rates would collapse toward these predetermined levels and the debt markets would calm. While the consequences of this option could be a sharp fall in the euro and a possible break-out of inflation, these adjustments would be the inevitable cost of keeping the integrity of the euro.

In summary, the euro area debt crisis and U.S. fiscal austerity are the "big-picture" issues creating a high degree of uncertainty over the financial markets. The "macro" landscape of the global economy will be shaped by how these important issues play out in the months ahead and our investment strategy will likely have to adapt as the situations unfold.

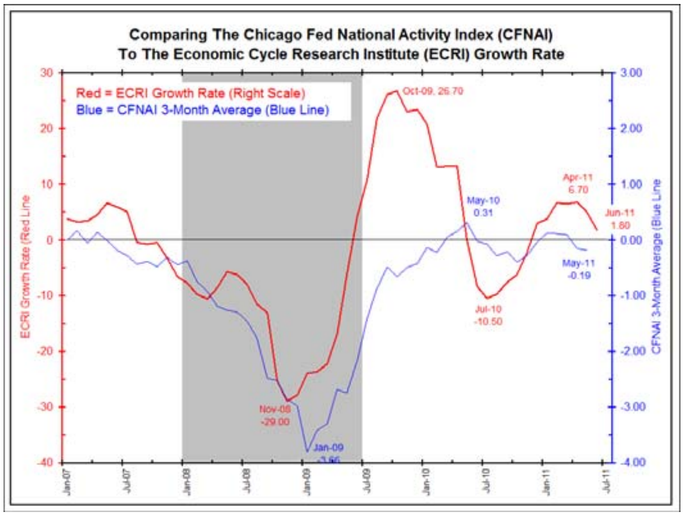
Within the U.S., corporate profits have been stunningly strong since exiting the Great Recession. However, recent economic data raises questions about the sustainability of profit growth. Recent reports imply the third-quarter economy is growing at a fairly low rate and many economists have lowered their third-quarter real GDP estimates to around 2.5% from 3.0% to 3.25%. A major question is whether the U.S. economy is going through a "soft patch", or is sub-3% growth the "new normal".

Chart 2 illustrates how the U.S. economy is struggling to maintain momentum. The red line on the chart below shows the growth rate of the ECRI's leading indicator. It is constructed using seven indicators that are understood to lead the economy. The blue line shows the Chicago Fed National Activity Index, a coincident indicator of 85 economic series. Both of these indicators imply that economic growth is rolling over from levels that were only moderate to begin with.

The good news is that within the U.S., the broad investment environment remains simulative:

- Monetary conditions cannot get any easier with short-rates at 0%.
- Longer-term interest rates are also very low.
- The U.S. dollar is cheap.
- Corporate borrowing costs have collapsed.
- Oil prices are off their recent highs.

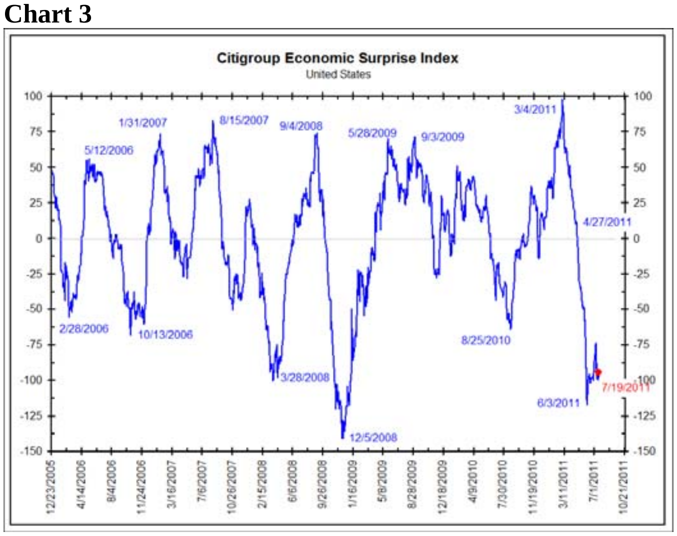
Chart 2



Source: Bianco Research, LLC

Additionally – and as I alluded to earlier – the high levels of pessimism are positive from a contrary perspective.

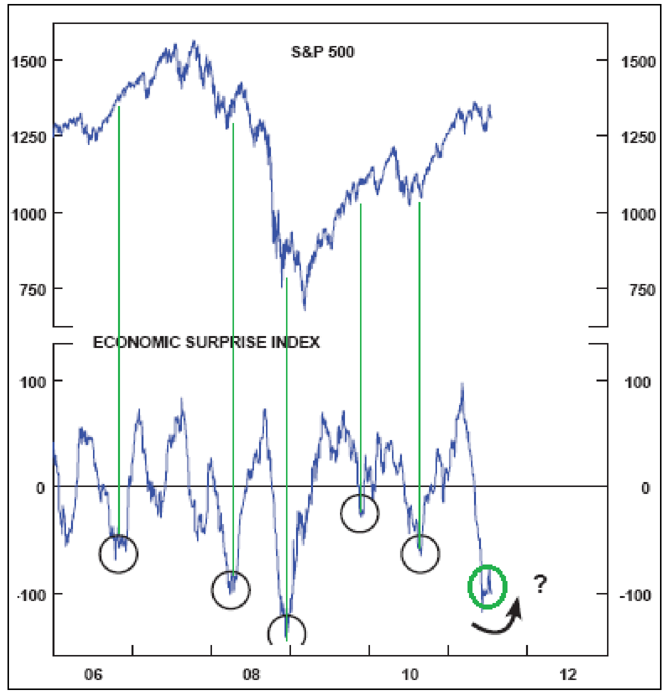
Chart 3



Source: Bianco Research, LLC

Chart 3 above shows that the Citigroup Economic Surprise Index (CESI) has stabilized. This index measures the difference between expectations and the real economic data. A rising line means real economic statistics are outperforming estimates. A falling line means they are disappointing. Between March and June this index collapsed, reflecting the continual disappointment of the economy relative to expectations. In the last six weeks, the index has stabilized. This could either mean economists have finally downgraded their forecasts inline with the weakening economy or that sentiment is washed out and future surprises are likely to be to the up-side. Either way, the implication is that future data is unlikely to surprise markets to the down-side which is positive. Historically speaking, lows in the CESI have been associated with positive turns in the U.S. Stock Market (Chart 4)

Chart 4



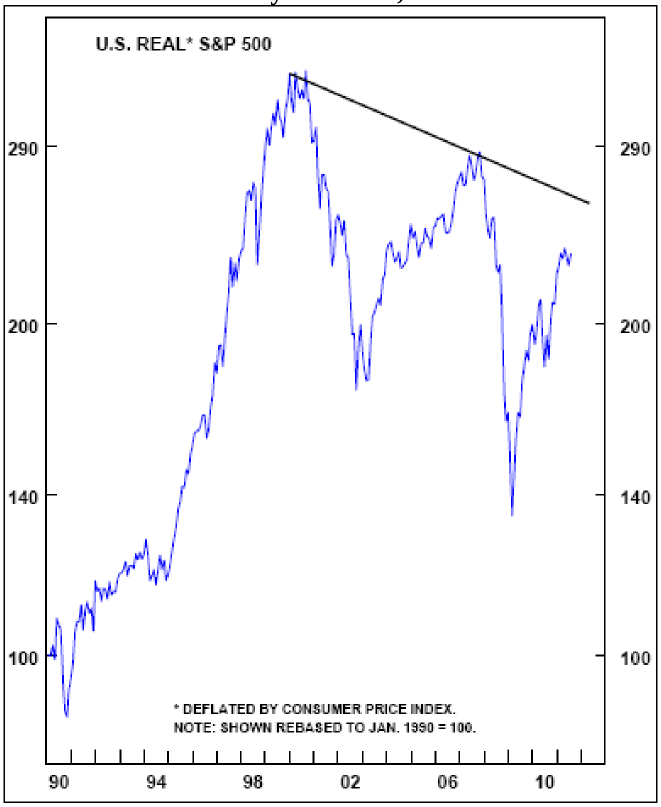
Source: BCA Research

From a long-term perspective, the U.S. stock market has been in a secular bear market since 2000 (Chart 5). Nevertheless, there have been large cyclical upswings within this secular decline (2002 to 2007 and since March, 2009). We don’t believe the bull market in stocks that started in March, 2009 is over. However, the rate of price appreciation is slowing and will continue to slow – with more frequent corrections, reflecting a slowdown in underlying earnings growth.

As long as the broad environment stays hyper-simulative and borrowing costs are below economic growth, corporate profits will be subsidized and the inherent tendency for the economy will be to maintain growth. In the end, it is economic growth and corporate profits that matter most for stock prices.

It is interesting to note that stock valuations have not changed much since March 2009 when share prices started to recover. Assuming modest earnings growth over the next 12-months, the S&P 500 is trading at around 13-times its 12-month projected earnings. All of this is to say that broad stock market valuations should not be a roadblock to further share price gains. Nevertheless, it’s easy to see the picture darkening into the second-half of 2012 as the financial, economic and political situation could all change.

Chart 5: U.S. Stocks: Cyclical Bull, Secular Bear



Source: BCA Research

As we've discussed in the past, there seems to be a pattern of four-year cycles in stock prices. While no one can foresee whether this cycle will be repeated, if earnings grow moderately, the S&P 500 could easily trade at a level near its 2007 highs. This would be a cyclical top if we are still in the secular bear market illustrated above.

By that time, economic and political uncertainties could be as high – or higher – than they are today. First of all, Fed monetary policy could become a major stress point. If the Fed keeps rates at zero longer than what is needed, it will overdose the system with stimulus forcing the Fed to roll back aggressively. On the other hand, if the economy is too weak, the financial markets could become frightened by the Fed's lack of options to stimulate.

In the meantime, fiscal policy could become an even more contentious issue. By then, we will have a better idea as to whether the authorities have implemented too much or too little fiscal austerity. In other words, the risk of policy errors will escalate.

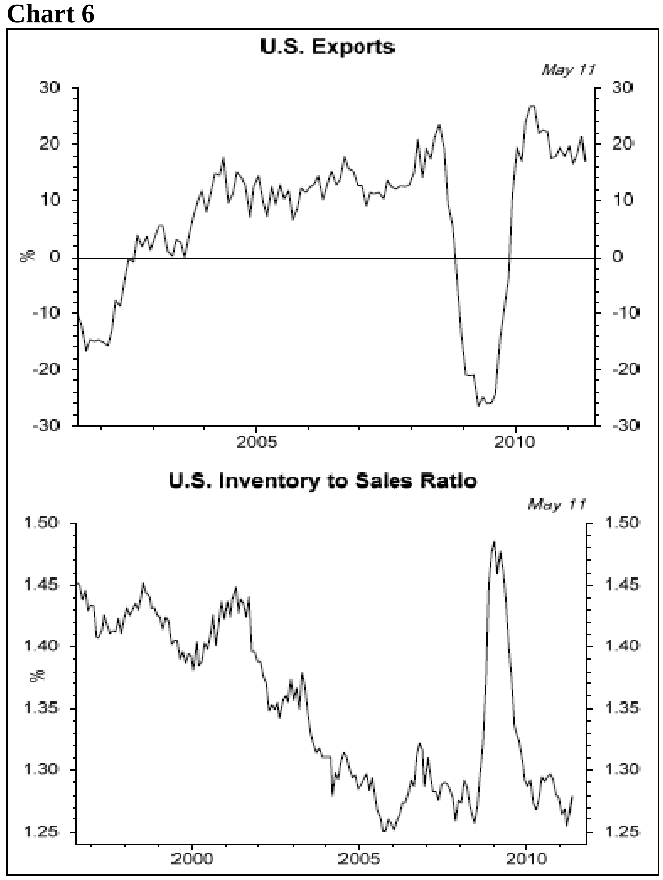
By the end of 2012, we will also know who will be living in the White House. If President Obama is reelected, it is likely that he will refocus on pushing many left-wing agendas – and higher taxes will follow. However, if a hardcore Republican assumes power, the severity of the fiscal austerity could be more than the markets are able to bear.

In short, there will be plenty of reasons to be cautious as we get into 2012. In the meantime, however, we believe there is more upside to the current cyclical bull market – albeit at a more volatile and slower rate than over the last two-plus years.

Within the global stock market, the U.S. should produce better results than most of the other G-7 markets for the following reasons:

- Despite the current soft data, the U.S. economy has and will likely continue to outperform most other developed markets (Japan, Germany, France, and Italy).
- Fed policy will likely remain the most simulative.
- Europe is plagued by the ongoing debt crisis which continues to threaten the European banking sector. The U.S. financial system has been re-capitalized and is much more transparent.
- The relative monetary and fiscal policy environment favors a declining dollar. In a world where growth is weak in general, stock markets with weaker currencies tend to outperform those with stronger currencies.
- Exports have recovered sharply and inventories are low (Chart 6).

Chart 6



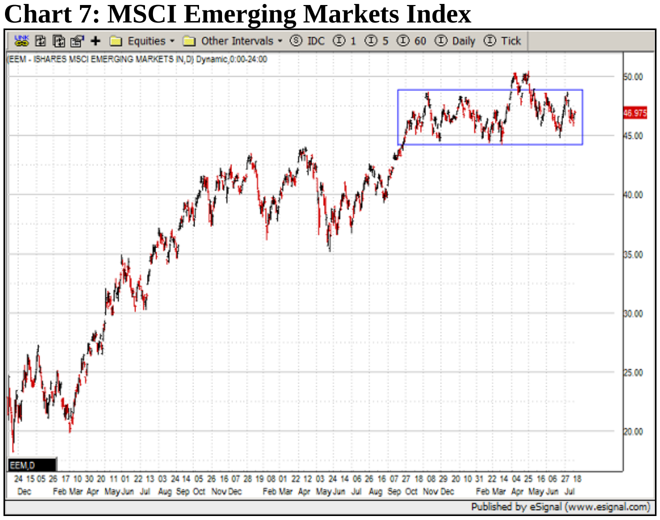
Source: Thomson Reuters Datastream

In short, it appears that the U.S. economy is not in too bad shape, given the healing necessary from the private debt drama and housing collapse of 2008-2009. However, even though the recovery is still intact, there is no way that the U.S. can grow at the supercharged, debt-driven rates of previous cycles.

While the G-7 markets are in a cyclical bull within a secular bear market, the emerging markets remain in a secular bull market. However, they have been flat over the last nine-months and in cyclical retreat over the last few (Chart 7). Nevertheless, we see increasing probability of rotation back into emerging markets:

- One of the key reasons behind the interruption in emerging markets outperformance has been monetary tightening in many key countries. With food and energy prices either stabilizing or rolling over, we anticipate a pause in policy tightening.
- The Price/Earnings (P/E) ratio for emerging markets has been flat for the last 10 years, suggesting equity market outperformance has come from faster profit growth. We believe emerging markets will continue to outperform on this front.
- Structurally, it could be argued that emerging market stocks are undervalued relative to G-7 markets. Chart 8 shows that emerging markets still sell at a discount to the G-7 on a P/E basis. This is despite the fact that the macro risks are skewed toward the latter. With interest rates at or near zero in the developed world, liquid savings will be compelled into markets where investors can find both growth and yield.

Chart 7: MSCI Emerging Markets Index

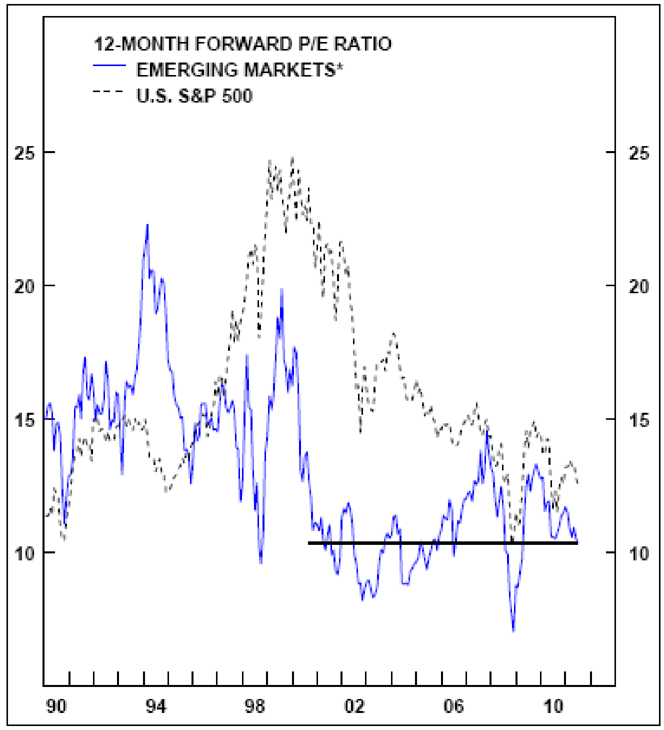


Source: eSignal

The bottom line is that emerging market *relative* performance may have already bottomed and the chances of outperforming the global average are improving.

In the weeks and months ahead, our bias will be toward U.S. large-cap and emerging market for the reasons outlined above. In most cases, our equity exposure is below "normal" due to the well known macro worries (decent valuations offer little defense during a shock to the financial markets). However, with sentiment relatively depressed and the fact that the situation in the euro area and the U.S. debt ceiling stalemate are both well known (i.e. unlikely to surprise investors), we anticipate using market weakness to bring our clients' portfolios up to benchmark equity weightings.

Chart 8



Source: BCA Research and Thomson Reuters / IBES

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