ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — Third Quarter, 2011

> *"economic growth so far this year has been considerably slower than the committee expected. Indicators suggest a deterioration in the overall labor market conditions in recent months, and the unemployment rate has moved up. Household spending has flattened out…"*
>
> - FOMC Communiqué - August 9, 2011

> *"Financial stability risks have increased substantially over the past few months. Weaker growth prospects adversely affect both public and private balance sheets and heighten the challenge of coping with heavy debt burdens. Public balance sheets in many advanced economies are highly vulnerable to rising financing costs, in part owing to the transfer of private risk to the public sector. Strained public finances force policymakers to exercise particular care in the use of fiscal policy to support economic activity, while monetary policy has only limited room to provide additional stimulus. Against this backdrop, the crisis—now in its fifth year—has moved into a new, more political phase."*
>
> - IMF Global Financial Stability Report - September, 2011

> *"…economic growth remains slow."*
> *"…there are significant downside risks to the economic outlook, including strains in the global financial markets"*
>
> - FOMC Communiqué - September 21, 2011

> *"Eurozone will meltdown in two to three weeks so will the European banking system if eurozone leaders don't address crisis in a credible way.... We are not just talking about a relatively small Belgian bank, we are talking about the largest banks in the world -- the largest banks in Germany, the largest banks in France -- that will spread to the United Kingdom; it will spread everywhere because the global financial system is so interconnected"*
>
> - Dr. Robert Shapiro, IMF Advisor - October, 2011

It was a rough quarter with global risk assets (stocks, non-US government bonds and commodities) suffering steep losses (Exhibit 1) on concerns about Europe's debt woes and negative global economic news.

Exhibit 1

INDEX	3rd Qtr, 2011	Y-T-D	Last 6 Mo.	Last 12 Mo.
US STOCKS				
S&P 500 Index (large-cap stocks)	**(13.87)**	(8.68)	(13.94)	1.14
S&P 500 Growth Idx (lrg-cap "growth" stocks)	**(11.56)**	(5.56)	(10.16)	4.85
S&P 500 Value Idx (lrg-cap "value" stocks)	**(16.30)**	(11.92)	(17.79)	(2.66)
Russell 2000 Index (small-cap stocks)	**(21.87)**	(17.02)	(22.83)	(3.53)
Cohen & Steers Realty Majors (real estate inv. tr.)	**(14.76)**	(4.55)	(10.39)	2.28
FOREIGN STOCKS				
MSCI EAFE Index (developed foreign markets)	**(19.01)**	(14.98)	(17.75)	(9.36)
MSCI EMU Index (European Monetary Union)	**(28.43)**	(19.46)	(26.72)	(17.80)
MSCI Emerging Markets Index	**(22.56)**	(21.88)	(22.70)	(16.15)
MSCI BRIC Index (Brazil, Russia, India, China)	**(25.84)**	(26.08)	(27.61)	(23.29)
PRECIOUS METALS				
London Gold PM Fix	**7.61**	15.26	13.64	23.95
London Silver Fix Price	**(13.05)**	(0.59)	(18.86)	37.97
BONDS				
BarCap US Aggregate Bond Index (investment-grade bonds)	**3.82**	6.65	6.24	5.26
BarCap US 20+ Yr Treas Bond Idx (long-term US treasuries)	**29.21**	31.44	33.88	19.18
S&P Nat-l AMT-Free Muni Bond Index (municipal bonds)	**3.95**	8.93	8.41	3.90
iBoxx Liquid High Yield Index (high-yield/"junk" bonds)	**(6.23)**	(1.88)	(5.48)	1.07
iBoxx Liquid Investment Grade Idx (inv.-grade corp. bonds)	**2.84**	6.41	5.68	3.91
S&P/Citi Intern'l Treas Bond Index Ex-US (foreign bonds)	**(1.77)**	3.02	1.09	0.37
JPMorgan EMBI Global Core Index (emerging mrkt bonds)	**(1.72)**	3.23	2.44	1.00

Source: iShares.com

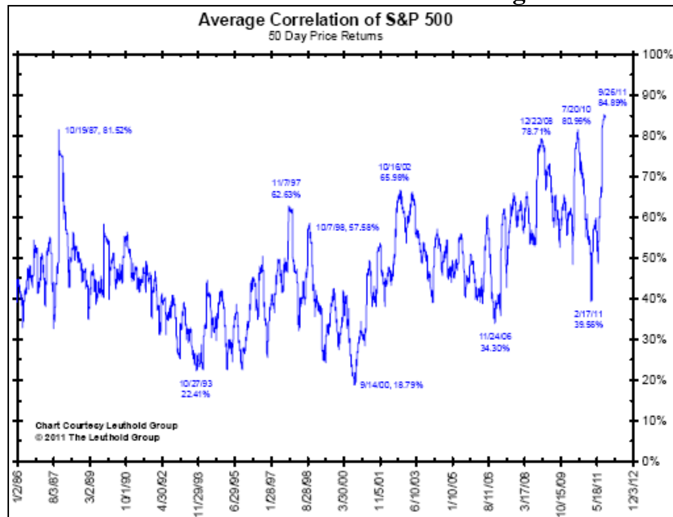
While already underweight stocks to some degree, we further reduced equity exposure in our clients' portfolios during the quarter; first during the debt ceiling debate, and later as incoming data continued to weaken. While this positioning lead to positive returns relative to our overall investment policy benchmarks, being underweight high-grade intermediate- and longer-term bonds offset the positive impact of our equity underweight to some degree.

As we head into the final three-months of 2011, the world remains gripped by fears of a meltdown in the euro zone and the increasing likelihood of renewed global recession. Europe is on the precipice of economic contraction and a growing number of forward-looking indicators of US growth have weakened further over the last three-months.

For the most part, we are in a "macro" driven investment environment with the primary driver (for now) being the evolution of the European debt crisis. During the quarter, much of the ebb and flow in the financial markets was driven by "developments" in euro land. The media has been running *'stocks rally on optimism of European debt crisis solution'* headlines and stories for the past several months, but there has been no solution to the European sovereign debt/banking crisis…just like we are no closer to a solution to the US budget/debt crisis. Time and again we have learned that the authorities are in denial and simply incapable of making the necessary moves.

As a result of this and other factors, correlations among stocks are at an all-time high and volatility has been extreme (Exhibits 2 and 3).

Exhibit 2: Stock Correlations at All Time Highs



Source: Bianco Research, LLC

Exhibit 3: Volatility and "90%" Days*

Source: Lowry Research Corp. and eSignal
**A measure of extreme buying/selling pressure*

To a degree, the high correlations imply an inefficient allocation of capital in the equity markets because there should be more differentiation based on each issue's underlying fundamentals. However, today's fundamentals amount to: will Greece default or not? Will there be a banking crisis in Europe or not? Will there be a recession in the US or not? Will the Fed respond with another round of quantitative easing or not?

Throughout time, the government has come to the rescue whenever there has been stress in the system. Recently, however, the government has been there to act to a degree not even conceivable before the 2008-2009 financial crisis. To Illustrate, Exhibit 4 shows total government stimulus during the last 13 recessions. "Monetary stimulus" is the amount by which the Fed expanded its balance sheet. "Fiscal stimulus" refers to the size of the budget deficit.

Exhibit 4

Last 13 Recessions

Peak	Trough	Length	GDP Change	Monetary	Fiscal	Combined
Aug-29	Mar-33	44	-27.0%	3.4%	4.9%	8.3%
May-37	Jun-38	13	-3.4%	0.0%	2.2%	2.2%
Nov-48	Oct-49	11	-1.7%	-2.2%	5.5%	3.3%
Jul-53	May-54	10	-2.7%	0.0%	-1.4%	-1.4%
Aug-57	Apr-58	8	-3.2%	0.0%	3.2%	3.2%
Apr-60	Feb-61	10	-1.0%	0.7%	1.0%	1.7%
Dec-69	Nov-70	11	-0.2%	0.3%	2.4%	2.7%
Nov-73	Mar-75	16	-3.1%	0.9%	3.1%	4.0%
Jan-80	Jul-80	6	-2.2%	0.4%	1.1%	1.5%
Jul-81	Nov-82	16	-2.6%	0.3%	3.5%	3.8%
Jul-90	Mar-91	8	-1.3%	1.0%	1.8%	2.8%
Mar-01	Nov-01	8	-0.2%	1.3%	5.9%	7.2%
Sum/Average		**14**	**n.a.**	**6.1%**	**33.2%**	**39.3%**
Dec-07	**Jun-09**	**18**	**-3.3%**	**18.0%**	**11.9%**	**29.9%**

Fiscal Balance: Federal Budget Deficit As a % of GDP
Monetary: Cumulative Change In The Fed's Balance Sheet

Source: Bianco Research, LLC and Grants Interest Rate Observer

During the Great Depression, the Fed's balance sheet was expanded by about 3.4% and the budget deficit was 4.9% at its largest, for a combined government response to the Great Depression of 8.3%. This was the largest government response to any recession until you get to the bottom line – December '07 to June '09, the 18-months commonly referred to as the Great Recession.

During this period, monetary stimulus was <u>18%</u> and the budget deficit (fiscal stimulus) was <u>12%</u>. Adding it up, we had total stimulus of 30% of GDP as a government response to the last crisis versus the prior record of 8.3% during the Great Depression (top line of table).

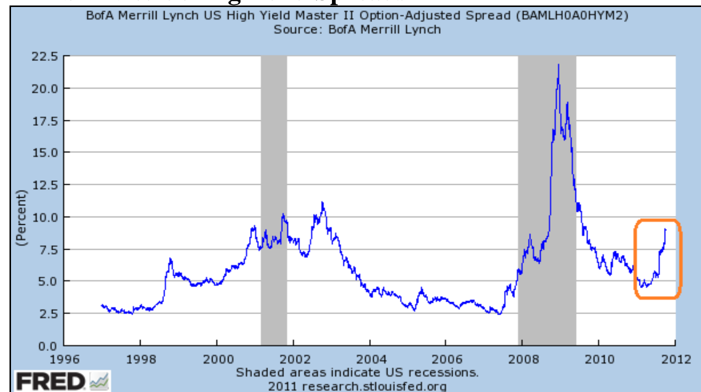
The size of the response to the crisis was inconceivable prior to its implementation and was a game-changer. It reinforces the market's increasing dependence on government involvement in the markets and its manipulation of unpleasant outcomes.

In addition to macro events, daily volatility is being compounded by high-frequency and algorithmic trading, basket trading, ETF arbitrage and intraday reweighting of leveraged investment products as the "machines" bang up against one another ("in a co-location agreement somewhere in New Jersey, close to the exchange server so that they can get the fastest access to data possible" – Jim Bianco) in an arena where positions commonly last between a few seconds and a few minutes. This type of activity constitutes around 75% of stock trading. We believe these strategies are eroding confidence in the marketplace and likely causing a *reflexive* and negative impact on the real economy.

The bond market, on the other hand, has not (yet?) evolved to this point. Here, human beings still make decisions about the allocation of capital based on their interpretation of available information. Credit markets, therefore, have become even more important as a leading indicator.

Exhibit 5 illustrates that corporate yield spreads (the amount by which corporate bond yields exceed treasury bond yields) have widened recently. This is generally associated with deteriorating fundamentals and increasing risk aversion.

Exhibit 5: Widening Bond Spreads



Source Federal Reserve Bank of St. Louis

While many in the media seem surprised by weakening economic data, history tells us that "the aftermath of a systemic banking crises involves a protracted and pronounced contraction in economic activity that puts significant strains on government resources" (*This Time Is Different: Eight Centuries of Financial Folly,* Carmen Reinhart & Kenneth Rogoff). Therefore, the environment we find ourselves in is exactly what should be expected as a result of the balance sheet recession (vs. a run-of-the-mill business cycle slowdown) we're emerging from.

It is disappointing that politicians and central bankers (both in the US and in euro land) still do not comprehend the scale of the crisis and are therefore placing too much hope on simple solutions. At some point, they will have to acknowledge that balance sheet recessions are very different than "normal" recessions and act accordingly. The longer the authorities wait, the more the situation deteriorates and the fewer their options become. Unfortunately, reaching consensus on taking truly meaningful action is very unlikely in this political environment.

In such a world, the threat of another crisis will continue to haunt the financial markets. This will not only keep volatility elevated, but will also reduce the odds that the lows of this cycle have been seen.

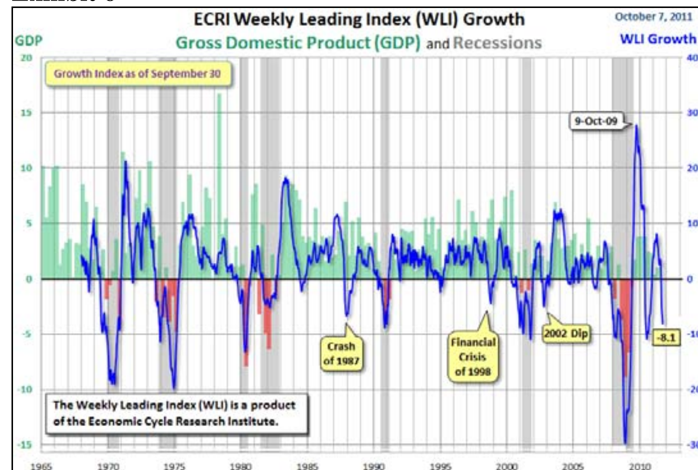
US OUTLOOK

Wall Street has been lowering its growth estimates for months now. However, only a minority of analysts are projecting a relapse into recession in the US. Based on published forecasts, the consensus outlook seems to be that there is at least a 50% chance that the euro area will fall into recession by early 2012, but the US economy – while flirting with negative growth – will avoid one.

If this indeed turns out to be the case, the decline in stock prices during the third-quarter probably won't get much worse. While everyone hopes the consensus is correct, we think it is too optimistic. Our interpretation of the various data and indicators we follow favors at least a mild relapse into recession. This implies additional downside in asset prices. Additionally, even if the US doesn't "officially" enter a recession, plodding along at less than 2% growth is nothing to feel good about – it's not enough to get unemployment down, and it's not enough to see any kind of real expansion in the economy. It may not be negative, but it's not far from it.

Below (Exhibit 6) is a graph of the Economic Cycle Research Institute (ERCI) Weekly Leading Index (WLI). While ECRI keeps the exact construction of its index proprietary, it is widely viewed as a very good leading indicator of future economic activity.

Exhibit 6



Source: Advisor Perspectives, Inc.

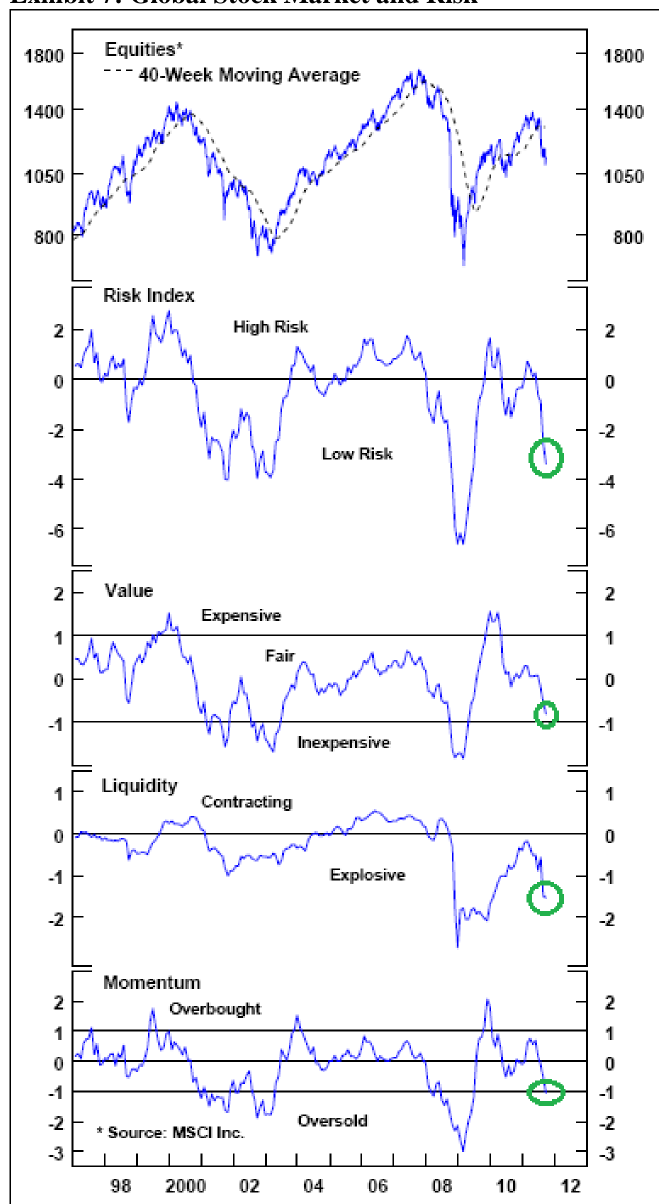
A significant decline in the WLI has been a leading indicator for six of the seven recessions since the 1960s. It lagged one recession (1981-1982) by nine weeks. The WLI did turn negative 17 times when no recession followed, but 14 of those declines were only slightly negative (-0.1 to -2.4) and most of them reversed after relatively brief periods. During the last significant dip in mid-2010, ERCI's Chief Operations Officer, Lakshman Achuthan, correctly predicted that we would avoid a double dip. This time, however, during a Bloomberg interview on September 30, Achuthan said the U.S. is "going into a new recession".

While many analysts have expressed their belief that the sell-off in stocks during the third-quarter already reflects this outlook, according to David Rosenberg (Chief Economist and Strategist at Gluskin Sheff & Assoc, Inc.), the stock market has never before discounted a recession before it began. So if we are again entering a recession, another leg down in share prices is the likely outcome.

Having said all of the above, it is true that it's always darkest before the dawn. Not all indicators are negative and a rally in

stocks and other risk assets is possible in the near term. The sell-off since mid-July, combined with favorable liquidity conditions and reasonable valuations (especially relative to other asset classes), combine to put an objective measure of overall stock market risk in the "low risk" zone (Exhibit 7). Additionally, market sentiment has turned very negative, which from a contrarian viewpoint is a positive. Also, the Citigroup Economic Surprise Index (Exhibit 8) has reached very negative readings which often times means stock prices have already absorbed a lot of negative news. (This index measures the difference between expectations and real economic data. A rising line means real economic statistics are outperforming estimates. A falling line means they are disappointing.) We are also now are entering a period (i.e., the month of October) that is associated with important lows.

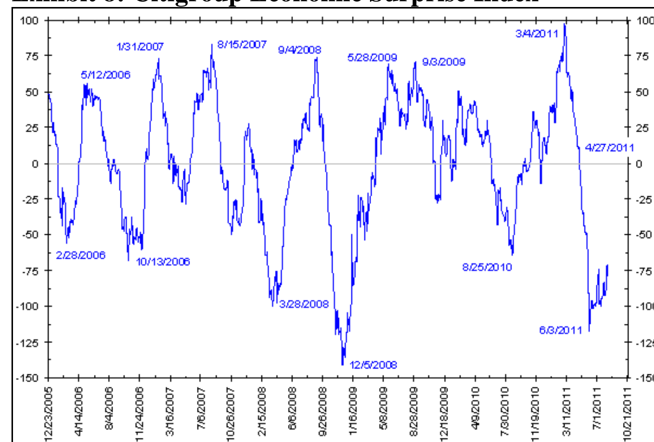
Exhibit 7: Global Stock Market and Risk



Source: BCA Research

However, the ultimate durability of a rally (assuming one does materialize) will be dependent on a credible solution to the euro zone debt crisis and a meaningful improvement in the performance of the global economy – neither of which seem imminent at this point. Unfortunately, the requisite purging and restructuring will be painful and politicians will do anything and everything. So, the market will have to institute the necessary purging and pain at some point.

Exhibit 8: Citigroup Economic Surprise Index



Source: Bianco Research, LLC

Putting It All Together

For now, there are a number of disasters or potential blowups that could inflict additional economic damage and result in further market declines. Ultimately, policymakers will have to "get it right", but probably not without additional chaos within the marketplace. Therefore, we are probably not out of the woods yet. It does seem – little-by-little – that there is an increasing sense of urgency for action among the developed world's leadership.

While we're likely to stay below benchmark with regard to our risk levels as long as our leading global and US indicators continue to deteriorate, we're also looking for reasons to start adding "risk" during sell-offs now that the market's overall risk profile has improved (Exhibit 7).

-Brant Kairies
952-885-2732

Securities offered through FSC SECURITIES CORP, member FINRA/SIPC and a registered investment adviser. Investment advisory services offered through Access Financial Services, Inc., a registered investment adviser not affiliated with FSC Securities Corp.

The views expressed are those of Access Financial Services, Inc. and not necessarily the opinion of FSC Securities Corporation, and should not be construed directly or indirectly, as an offer to buy or sell any securities mentioned herein. Due to volatility within the markets mentioned, opinions are subject to change without notice. Information is based on sources believed to be reliable; however, its accuracy or completeness cannot be guaranteed. Investing is subject to risks including loss of principal invested. Past performance does not guarantee future results.

Please see additional disclosures enclosed with the accompanying reports.