ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — Third Quarter, 2012

After a weak second-quarter, risk assets (i.e. investments with a return that is not guaranteed such as stocks, corporate bonds, commodities, etc.) posted solid gains in the third-quarter (Exhibit 1) as central bankers continued adding additional measures aimed at stabilizing economies, increasing growth prospects and bringing down unemployment. First, the European Central Bank (ECB) announced that it would be willing to purchase short-dated, sovereign bonds in the secondary markets to lower borrowing costs for peripheral nations that face difficulty selling their debt [so-called "outright monetary transactions" (OMT)]. Then, the Federal Reserve followed up with a new open-ended, quantitative easing program with no cap, in which it pledged to purchase an additional $40 billion per month of agency mortgage-backed securities until employment improved. It seems as though the old investment mantra: *Don't Fight the Fed* should be changed to: *Don't fight the Fed, European Central Bank, Bank of Japan, Bank of England and Swiss National Bank.*

Exhibit 1

INDEX	3rd Qtr, 2012	Year-To-Date	Last 12 Months	Last 3 years	Last 5 years
US STOCKS					
S&P 500 Index (large-cap stocks)	9.01	16.44	27.99	13.00	1.05
S&P 500 Growth Idx (lrg-cap "growth" stocks)	9.06	17.00	26.49	14.76	3.55
S&P 500 Value Idx (lrg-cap "value" stocks)	8.94	15.78	29.69	11.15	(1.56)
Russell 2000 Index (small-cap stocks)	8.32	14.23	30.34	12.44	2.21
FOREIGN STOCKS					
MSCI EAFE Index (developed foreign markets)	10.80	10.08	12.03	2.19	(5.24)
MSCI EMU Index (European Monetary Union)	17.39	10.51	11.04	(4.49)	(9.35)
MSCI Emerging Markets Index	11.39	11.98	15.55	6.00	(1.28)
MSCI BRIC Index (Brazil, Russia, India, China)	11.42	7.38	9.28	0.47	(4.89)
PRECIOUS METALS					
London Gold PM Fix	13.96	16.00	8.09	21.44	19.04
London Silver Fix Price	29.24	22.96	11.63	29.62	20.48
BONDS					
BarCap US Aggregate Bond (investment-grade bonds)	1.35	3.99	5.47	6.17	6.53
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	(1.75)	4.34	9.47	12.16	11.30
S&P Nat'l AMT-Free Muni Bond Index (municipal bonds)	2.46	6.25	8.43	6.00	5.85
iBoxx Liquid Inv Grade Idx (inv.-grade corp. bonds)	4.61	10.59	13.80	9.88	8.83
iBoxx Liquid High Yield Index (high-yield/"junk" bonds)	4.56	10.52	16.95	11.39	7.50
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	6.59	6.83	2.83	2.16	

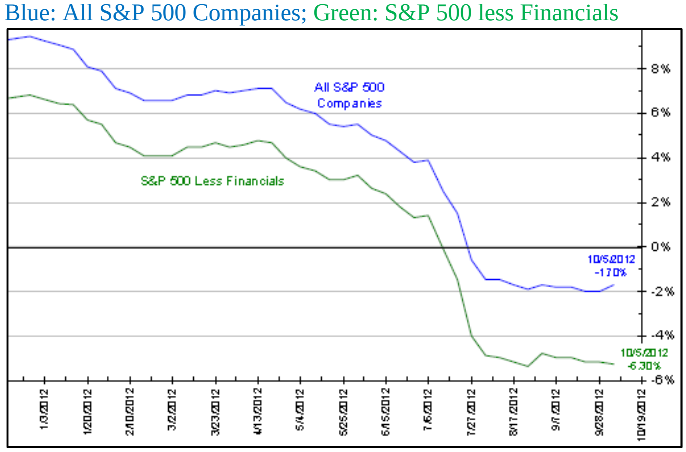
Source: iShares.com

While it has been shown that central banks can provide powerful fuel for stocks and other risk assets to rally, sustained strength eventually requires evidence that the extra liquidity is resulting in strengthening growth and profits. Indeed, growth appeared to be on the upswing during the time of QE1 and QE2. [QE (quantitative easing) has become shorthand for ultra-monetary ease and unlimited lender of last resort on the part of central banks. QE entered a new round in the last few weeks with moves by the European Central Bank (ECB), the Federal Reserve (Fed) and the Bank of Japan (BOJ).] Today, the global economy looks very soft. US growth is approaching stall speed, Europe's recession is deepening, and the outlook for most of the rest of the world is soggy. Also, the near term outlook for corporate earnings and economic growth has grown less optimistic as profits have flattened out and several bellwether firms such as FedEx and Intel have reduced earnings expectations (Exhibits 2 and 3).

Exhibit 2: Q3 2012 S&P 500 Earnings Expectations

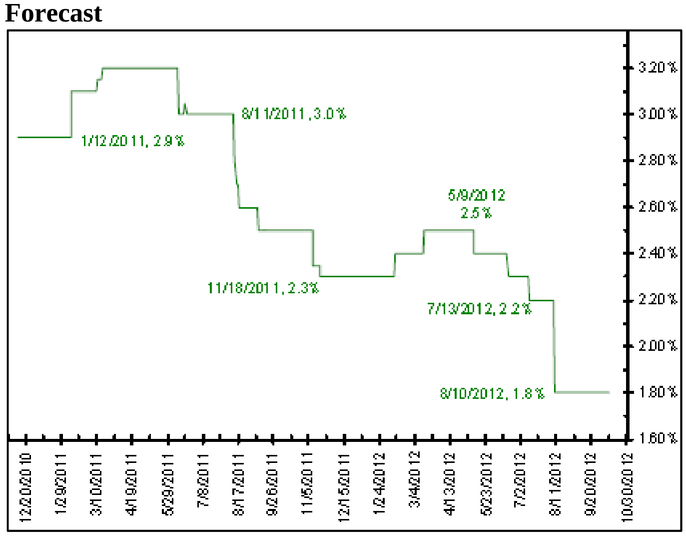
Operating Earnings Estimates Year-Over-Year Change

Blue: All S&P 500 Companies; Green: S&P 500 less Financials



Source: Bianco Research, L.L.C

Exhibit 3: Bloomberg Median Q3 2012 US Real GDP Forecast



Source: Bianco Research, L.L.C

So, while financial assets have responded quite well to central bankers' money printing, the following quote from Dallas Fed president Richard Fischer on September 19, 2012 is worth keeping in mind:

"Nobody really knows what will work to get the economy back on course. And nobody —in fact, no central bank anywhere on the planet —has the experience of successfully

navigating a return home from a place in which we now find ourselves."

So, there is a real tug-of-war between liquidity (monetary stimulus) and economic growth. Another up-leg in risk assets could be achieved if central banks continue adding fuel. However, the clock is ticking – the fiscal cliff is approaching, profits and economic growth indicators are no longer supportive even though risk assets continue their advance. We are probably approaching a time when it's no longer true that: *bad news is good news because it means central banks will step in with even more aggressive intervention, which will further boost asset markets.*

Even though one of the most widespread arguments for a bull market in stock prices is that central banks will keep printing money and the vast liquidity will push share prices higher regardless of fundamentals, we doubt investing is as simple as that. Central banks cannot print their way to prosperity. Policy makers do not create wealth, they bring future demand forward (policy easing) or push current demand into the future (tightening).

Further, while an aggressive Fed provides a strong tailwind for risk assets, additional monetary stimulus can't possibly offset any meaningful fiscal contraction next year. The impact of the approaching fiscal cliff (the simultaneous collision of expiring tax cuts, automated budget and job cuts, and the implementation of 22 new or higher taxes from Obamacare), should it go unchecked, would impose an estimated 4% clip to economic growth, and ultimately corporate earnings, pushing the US into a recession next year.

Some argue that the fiscal cliff will not happen because our brilliant politicians in Washington know the economic fallout will be too great. We agree that the full fiscal contraction implied by current law will most likely be avoided, but some form of fiscal drag remains likely no matter what the outcome of the election. The financial markets are currently pricing in strong economic growth in 2013, as high as 4%, versus the current sluggish 1.25% as of the second-quarter, 2012. It will be great if it pans out that way, but it's hard to reconcile the outlook with the reality of the situation.

The current climate of political polarization and congressional gridlock creates significant additional policy uncertainty, e.g., with regard to when and how the near-term fiscal cliff will be dealt with, let alone the country's longer-term debt problem. Regardless of who is elected, the actual policies that will be implemented in 2013 are still quite uncertain.

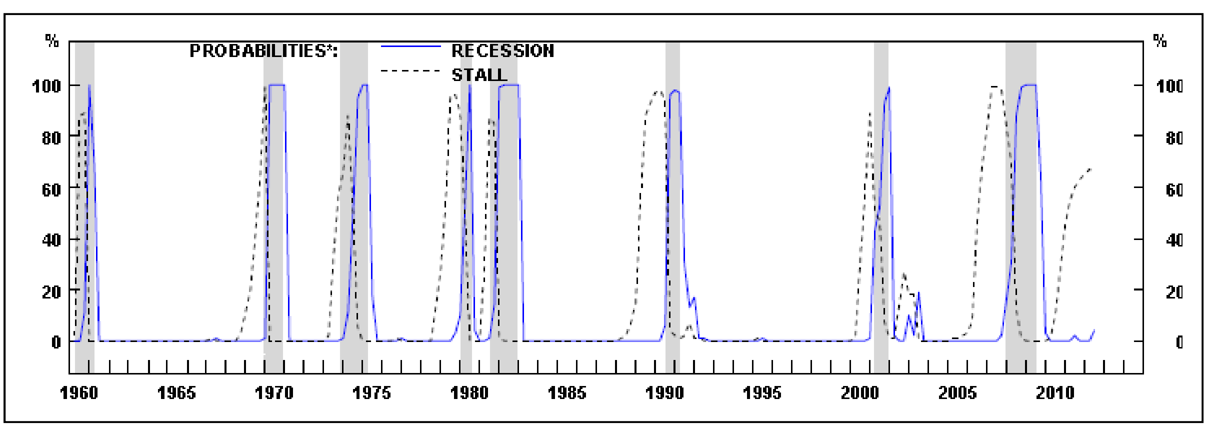
"One of the most important lessons learned during the economic recovery is that there is a limit to what monetary policy alone can achieve. The responsibility for stimulating economic growth must be shared with fiscal policy. <u>Ironically, and sadly, Congress is doing nothing to incent job creators to use the copious liquidity the Federal Reserve has provided. Indeed, it is doing everything to discourage job creation."</u>

- Dallas Fed president Richard Fischer

We find it interesting that while the fiscal cliff has received considerable coverage, asset prices have not made much (if any) allowance for the potential disruption that the coming debate among policymakers may cause. We believe the most likely scenario is that Congress agrees – at the last minute – to temporarily extend the Bush-era tax cuts and delay the sequestering to provide more time for debate. Therefore, the final showdown is likely sometime in February – April, 2013, when the debt ceiling again becomes binding and a compromise can no longer be delayed. At some point in the process, a replay of the 2011 debt ceiling debacle seems likely. Recall that stocks and other risk assets registered a strong selloff in August 2011 under similar conditions.

To be clear, we believe a compromise will ultimately be reached and the majority of the fiscal contraction will be avoided. Nevertheless, evidence is building that the economic damage is underway as businesses postpone hiring and capital spending. Growth is already near stall speed and an additional drag of 1-2% threatens recession. According to one model, there is already a 66% chance that the economy was in stall speed state as of the second quarter, 2012 (see chart below).

Historically, stocks have lost roughly 30% of their value on average during a "normal" economic recession. With such a wide disparity between current stock prices and the underlying economic and fundamental realities, the potential for a recession should not be dismissed. We wonder how the Fed would react then. It already seems like the Fed has



doubled down on an approach aimed at recreating the madness of an asset- and credit-dependent consumption model – the same strategy that pushed the US economy toward a deep hole between 2003 and 2007.

Even if a recession is avoided, the side effects/unintended consequences of massive amounts of quantitative easing could wind up being significant. While many worry about an upsurge in inflation, given the outsized slack in the global economy – and the likelihood that it will persist for some time – it seems unlikely over the near-term. Paradoxically though, once markets sense inflation is rising and higher short-term rates are at hand, demand for credit will accelerate preemptively. That will lead to an increase in money supply and an acceleration of inflation.

As the global economy has gone from crisis to crisis in recent years, the cure has become part of the disease. In an era of zero interest rates, quantitative easing, and no fiscal discipline, overall macroeconomic policy has become unhinged from reality.

Investment Strategy

With the Fed working overtime and growing ever more committed to supporting the markets and the economy, asset values are likely to continue diverging from underlying fundamentals. While financial assets have been the most direct beneficiaries of Fed policy, we are concerned that the groundwork is being laid for the next crisis.

At this point, central bank policy – both here and abroad – is the most influential factor on financial markets. We will not complain about the impact monetary policy has had on financial assets, but we continue to be cautious with our clients' portfolios because we don't believe central bank policy – alone – is enough to engineer strong and sustainable growth.

Investment strategy is made even more difficult by the fact that historical experience provides no real guide to the outcome of extensive quantitative easing. This is an experiment. The longer it persists, the higher the risk that the benefits will be offset by collateral damage and unintended consequences if the transition to self-sustaining growth continues to allude us.

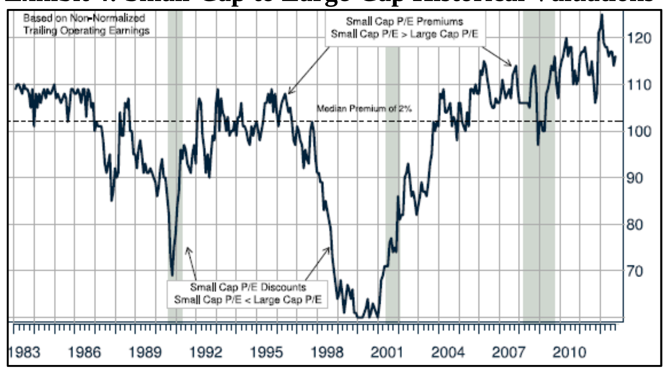
It is impossible to know whether or when policy will no longer be sufficient to drive risk assets higher without improvement in the underlying fundamentals, and no one will know when the next big turn in the markets is upon us. We do know that if the economy was improving in a material way, the Fed would be taking its foot off the gas pedal instead of applying additional pressure.

Even though our clients' portfolios have been positioned more conservatively than "normal", returns for the quarter generally outpaced the various benchmarks we use when comparing and evaluating results.

We are proceeding with caution as we enter the final quarter of 2012. We continue to have very little exposure to small-cap stocks (0% to 50% of "normal"), about half of our normal exposure to foreign stocks, around 5% in gold and gold stocks (in most cases), and a significant allocation to fixed-income sectors outside the of the government sector.

Within the US stock market, our emphasis is on large companies with solid balance sheets and strong cash flow (i.e. "high quality" companies). Small-cap stocks, as a group, are selling at a 16% valuation premium relative to large-caps (using non-normalized trailing operating earnings). This ranks in the 96th percentile of the 1983 to date history of this measurement (Exhibit 4). Using estimated 2012 operating earnings, small-caps are selling at an even higher valuation premium of 18%.

Exhibit 4: Small-Cap to Large-Cap Historical Valuations



Source: The Leuthold Group

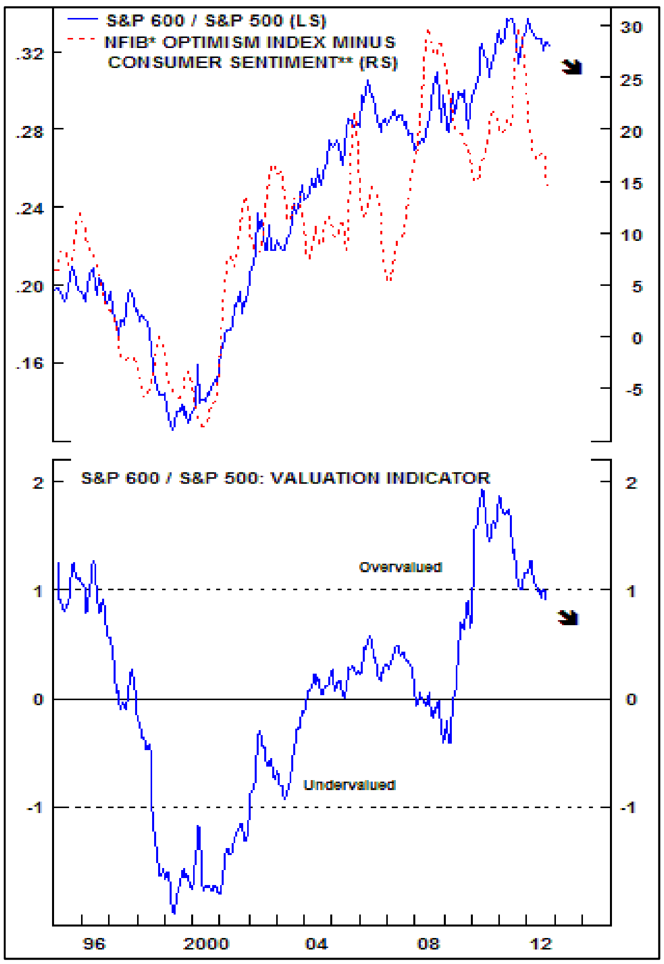
Another argument against small companies relative to large ones is the latest data from the National Federation of Independent Businesses (NFIB). Their survey of the small business sector continues to send warning signals and the NFIB overall optimism index remains in recessionary territory.

When compared to the broad economy, the news is even bleaker. A simple relative confidence gauge, small business optimism minus the University of Michigan consumer sentiment survey (top panel Exhibit 5), is sinking quickly, suggesting that the small business sector is underperforming the broad economy. This relative confidence gauge has been positively correlated with the small-cap stock/large-cap stock share price ratio for the past decade. The current message is to expect a decline in small-cap relative performance relative to that of large-caps, especially since relative valuations do not offer any cushion should small-cap earnings underwhelm the market.

Within the US stock market, we continue to overweight energy and health care companies. We are also starting to build a position in financial stocks.

The Fed's latest open-ended QE program should boost bank profits because the Fed is directly targeting the housing market by purchasing mortgage-backed securities, and indirectly subsidizing bank earnings. Banks are able to originate long-term fixed mortgages at roughly 3.4% and then offload them in the secondary market, resulting in a nice profit. The second panel of Exhibit 6 shows that this spread (the value of primary mortgages versus those traded in the secondary markets) is at the highest level in over ten-years. Assuming the housing recovery gains steam (top panel Exhibit 6), mortgage origination volumes should also rebound, providing both an interest rate spread and volume growth lift to profits. Banks are also benefiting from post-crisis capacity cutbacks. The third panel of Exhibit 6 shows that banks have regained significant pricing power, helping to offset the costs from a more onerous regulatory backdrop. All of this at a time when valuations are far below their long-term average (bottom panel Exhibit 6).

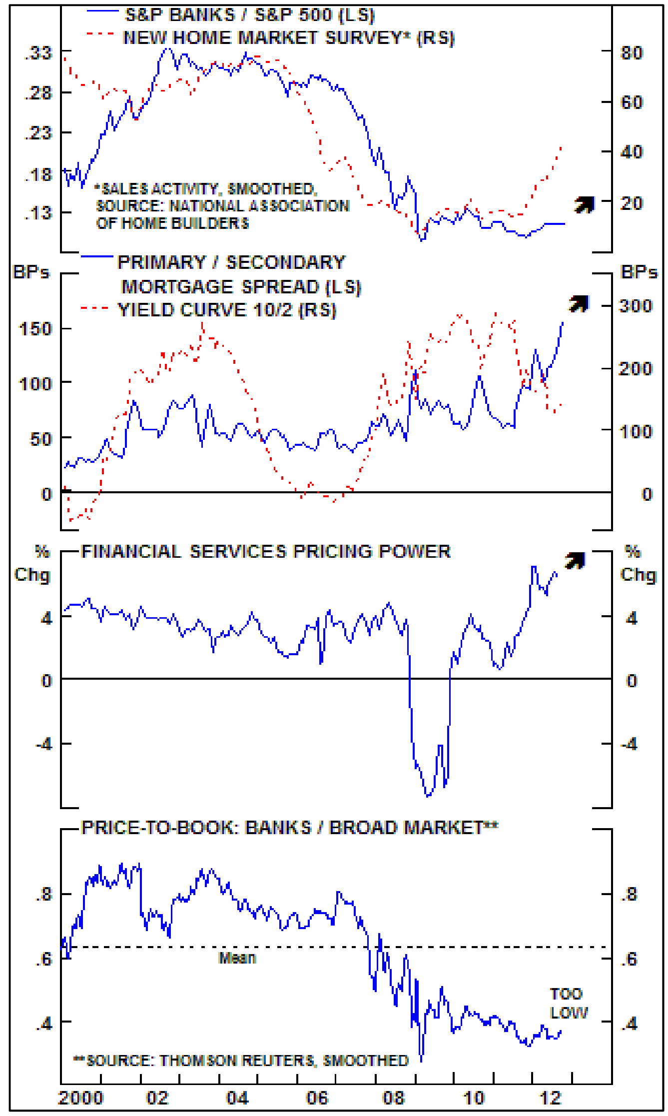
Exhibit 5



Source: BCA Research
**National Federation of Independent Business*
***University of Michigan Survey*

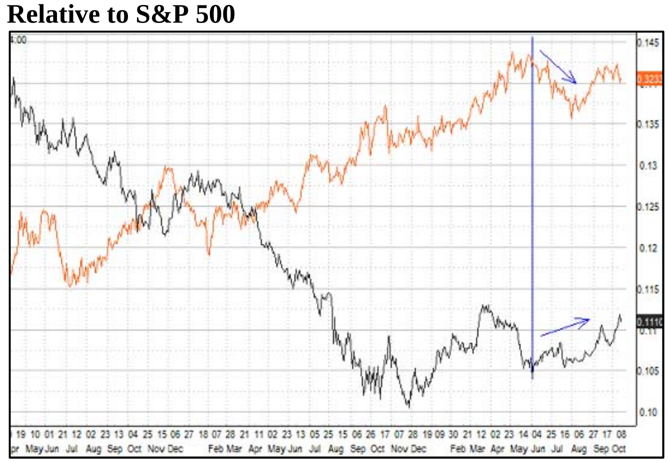
We are also looking for leadership to continue moving from the consumer discretionary sector to the financial sector as market participants continue to rotate from higher-momentum sectors that are more richly valued to sectors offering better value (Exhibit 7). This also holds for the technology sector versus the energy sector (Exhibit 8).

Exhibit 6



Source: BCA Research

Exhibit 7: Financials and Consumer Discretionary Relative to S&P 500



Source: eSignal

Exhibit 8: Energy and Technology Relative to S&P 500

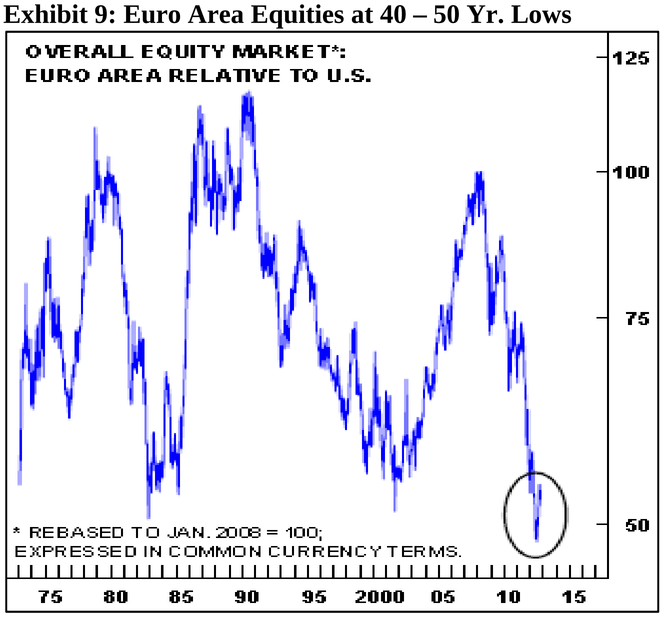
Source: eSignal

Within our allocation to foreign stocks, we are adding exposure (slowly) to European stocks.

One of the greatest imbalances in the global equity markets is the underperformance of euro area equities versus other major stock markets. The underperformance versus the US market still stands at a 40- to 50-year extreme (Exhibit 9). As the euro area's economic distortions adjust (as they eventually must), this performance imbalance should also correct in the euro area's favor.

While the imbalances in the euro area would correct very quickly and violently if the monetary union disintegrated (which would almost certainly plunge the euro area – and other parts of the world – into a Depression), the alternative of keeping the union's architecture largely in place and proceeding through a long "L" shaped adjustment that corrects the imbalances gradually is still overwhelmingly favored by European policymakers.

Exhibit 9: Euro Area Equities at 40 – 50 Yr. Lows



Source: BCA Research

As we move forward, we will continue to challenge the assumptions that underlie our views, consider new information as it becomes available, and stay focused on making well-reasoned investment decisions for our clients. We appreciate your continued confidence and trust.

-Brant Kairies
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