Schaper, Benz & Wise
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18 Jewelers Park Dr., Suite 200 | P.O. Box 628
Neenah, WI 54957-0628 | 920.727.1137

Economic and Market Summary
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We cannot recall a time in recent history when our economic roadmap was so dependent on the decisions made by elected officials. Because there is so much divisiveness, uncertainty is high and market volatility has been significant. In Europe, the ongoing sovereign debt crisis has been a primary cause of market stress. Many southern European countries are facing a heavy debt burden combined with an uncompetitive workforce. These problems are normally solved with currency devaluation, but that is not possible under the current structure. Greece, in particular, has been raising taxes and curtailing spending in an attempt to cut its deficit. While austerity is a step in the right direction, we ultimately believe debt restructuring combined with structural reforms are necessary. Debt restructuring has been delayed because the European banking system, in aggregate, is not yet strong enough to absorb the losses. We believe the announcement of a comprehensive, viable plan to recapitalize European banks would improve clarity and allow markets to start moving in the right direction.

The debt saga in Europe may provide a needed wake-up call to politicians in our country. The trajectory of our deficit matters a great deal from an investment perspective. Our deficit cannot continue increasing faster than nominal GDP. Instead of taking bold actions, politicians made negligible progress during the recent deficit debate. Recommendations made by Simpson-Bowles (a/k/a National Commission on Fiscal Responsibility and Reform) were largely ignored, despite being crafted by bipartisan representatives and private business leaders. The stalemate resulted in a downgrade of the U.S. government's credit rating by one of the major credit rating agencies. It also led to a feeling of disillusionment that further lowered the confidence of investors.

The Federal Reserve is doing all it can to prod investors to move out on the risk spectrum in an effort to boost asset prices and ease financial conditions. In August, the Fed announced it would leave its target rate at near 0% for at least the next two years. In September, the Fed announced "Operation Twist" with the objective of lowering longer term interest rates. With the 10 year U.S. treasury yielding less than 2% and the latest consumer inflation reading at 3.8%, investors are receiving a negative real return. Real rates have not been this low in over 25 years.

Fear of a worsening debt crisis caused stocks to sell off sharply since last quarter. While a recession may be taking hold in Europe, recent economic data still point toward modest global growth. The P/E multiple on the S&P 500 index is near a 30 year low while financial metrics such as profitability and cash flow generation have never been stronger. Forward earnings are harder to predict in an uncertain environment, but stock prices are already discounting a more challenging climate. Stock prices can differ from their intrinsic value for extended periods of time, though eventually the valuation gap dissipates. Through our extensive and persistent research process, we acquire an understanding of the secular growth and profitability drivers and we build confidence in management of the companies in our portfolios. This is very important during tumultuous markets when emotional reaction can overcome rational decision-making. Despite gut-wrenching volatility at times, we believe that owning well-managed, consistent growth companies will be rewarding for long-term investors.

Christi Gromer Salm, CFA