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ECONOMIC AND MARKET OUTLOOK
October -December 2009

"A budget tells us what we can't afford, but it doesn't keep us from buying it."
-William A. Feather-(1889 - 1981), American publisher and author.

The U.S. Economy

Optimism grew during the third quarter as the Dow Industrial Average and the S&P 500 Index each returned 15% and the technology heavy NASDAQ Composite returned 16%. Other non-equity markets followed suit, including the junk bond market, which returned a healthy 15% for the quarter, and investment grade corporate bonds that returned 8.3%.

No doubt, many investors consider the third quarter's solid market rally as an indicator that the economy is moving in the right direction. Stock markets tend to reflect financial hope, and certainly investors are hoping for a recovery.

Still, we have to consider the fundamental economic data. Obviously, the employment situation, falling house prices, tight credit, a sliding U.S. dollar and depressed world trade are cause for deep concern. But as the economy inevitably goes through the cycles of boom and bust, these factors could show rapid changes over the short term, and so we are less inclined to set our long-term investment course by these readings.

More troubling over the long term are two strategic issues; the continued creation of excessive debt and the continued growth of consumer spending as the overwhelming driver of U.S. gross domestic product (GDP). In order for a bull market in stocks to be sustainable, these problems must be dealt with.

The economy continues to deteriorate, though at a slower pace than earlier this year. So we await some strength of leadership on the economic side to outline a plan showing how and when we will emerge from the current mess. Simply selling such a plan could turn consumer and investor confidence around, which is at least half the battle.

Home Prices

Existing *home sales* can be a good barometer of the economy, since most new home buyers tend to spend money on secondary goods and services like landscaping and refrigerators. This indicator has held fairly steady over the last two years, even as mortgage lending and borrowing have been brought to a standstill. Further deterioration in housing could lead to another round of decreased consumer confidence.

Given the dismal fundamentals of the real estate market, it has been projected that home prices would have needed to fall an additional 20% from current levels in order to return to what is referred to as the "Case-Schiller 100-year trend line." But given the massive and continued Federal involvement in every facet of the home buying process, there is nothing at all "fundamental" about home prices today. Absent this intervention, prices would probably continue to fall. And, since the Treasury does have its limits, the outlook for real estate subsidies, and therefore the entire sector, is still negative, despite recent reports (mostly from Realtor Associations) announcing that home prices have stabilized.

We suspect the Fed is desperate to find a way to buy the time they need to convince consumers to translate their existing debts via government-sponsored refinancing schemes into new instruments of longer duration. Imagine 50- or 60-year mortgages that reduce monthly payments for borrowers without reducing the principal for creditors, thus enabling people to start spending and banks to start lending more. Sound farfetched? It's simply "debt consolidation," on a massive scale, with the government's blessing; all in an attempt to get consumers to spend even more.

Unemployment

We are concerned that the growing *unemployment rate* will inevitably cause increased consumer angst as we head into 2010. Of the 7.2 million jobs lost in this downturn (the largest such decline since the 1930s depression), 63.8% of them were lost in the last nine months. In fact, the unemployment rate has climbed from 6.1% on September 30, 2008, to 9.8% on September 30, 2009; a 61% increase over the last 12 months; the sharpest spike since 1958's 90% increase. We don't believe most investors understand how this will affect the economy in coming quarters and are concerned their outlook is too optimistic.

The worse-than-expected job losses suggest the recovery is moving slow and consumers are in little position to help drive private-sector growth. On top of that, the growth rate in average hourly earnings is down to 2.5%; a five-year low, while the average length of the workweek is down to 33 hours, a post-war low.

In our opinion, the employment data was perhaps a wake-up call to those who have considered a strong V-shaped recovery, while giving credence to those who warn of a "double-dip" recession. It might also indicate why policymakers, especially those at the Fed, are in no hurry to remove stimulus.

Tight Credit

Despite reckless federal efforts to boost liquidity, credit remains tight. This reality is the credit market's own discipline is signaling that the fundamentals remain unsound. Meanwhile, the Fed is actually inhibiting liquidity by paying interest on the bank reserves that it holds, for the first time in history. So, banks have little incentive to lend to small businesses, the largest job creators, or to individuals.

Today, monetary policy is about the supply of money, rather than its price (interest rates). In fact, very little thought is given to regular Fed meetings with regard to possible interest rate information, as investors clamor for information regarding the size of the Fed's balance sheet, disbursement of funds under the stimulus package, or the chances for a third stimulus package.

In any case, money transactions are slowing. If investors and consumers lack confidence in a long-term outlook, they will hoard cash and other forms of liquidity no matter how much money is injected into the economy.

Collapsing Dollar

The Fed has also demonstrated its willingness to sacrifice the dollar if necessary to keep interest rates low in order to 'save' the American consumer. Because monetary injections are coming from both the Treasury and the Fed, it will be very difficult to rein in these programs as the economy struggles to recover.

Meanwhile, for Americans, the plummeting U.S. dollar is forcing up the price of most commodities, despite decreased demand. This stagflation is a dangerous recipe not only because it hampers the any attempt at policy manipulation (at some point rates will have to come up in order to keep inflation in check), but because it hits the underemployed and unemployed with rising prices for everyday goods.

Conspicuous Consumption

In order to reassert American economic leadership—or at least to guarantee continuity so the world can go about the business of making money, the Fed and Treasury simply have to find a way to get American consumers consuming again—the more extravagantly it seems, the better. China is anxiously biding its time, and pointing fingers at the US and embarking on the greatest infrastructure build-out in its history, apparently in anticipation of a rebound in global demand.

The problem is that the American consumer appears to have exhausted both his credit and his inclination to borrow at the same time his access to credit has been cut off by the very banks his taxes are financially supporting.

The current Administration has shown no appetite for allowing consumers to reign in their spending habits. So, consumption still accounts for some 70% of GDP. Where individuals have tried to reduce spending and increase savings, stimulus programs and quantitative easing have overridden their gains. The massive spending plans for health and educational entitlements will serve to magnify this crucially damaging strategic imbalance.

Over the last 25-years, several administrations, both Democrat and Republican, were involved in a range of policy decisions that have enabled some of the most egregious financial misbehavior in American history, including what proved to be significant impetus for increased sub-prime lending and blocking derivative regulation. But the Obama administration has already demonstrated beyond a shadow of doubt, whatever rescue plans the new administration institutes next rely not only on the continuance but also the expansion of the established interventionist monetary policies that has landed us in this predicament.

Since no one on the planet consumes as recklessly as Americans, emerging markets, especially China, will make a lot of noise but continue to buy US Treasuries to help get Americans back on their feet financially, for there are no other 'consumers of last resort' and China can only stockpile so many commodities in anticipation of a rebound that can only go so far without the participation of the world's largest economies.

Despite the deterioration of the jobs market and continued tight credit, there were signs households were beginning to dish out cash for goods during the third quarter, though much of that was pinned on temporary government schemes such as cash-for-clunkers, and the $8,000 tax credit for first-time homebuyers. But the issue here is one of expectations. Today, we are about $200 billion off the long-term pace of consumer spending and there is no discernible evidence that we can return to our previous pace.

Exploding Debt

Contrary to election promises of "change," there are no signs of controlling government spending and massive debt. Admittedly, the wars fostered by the previous Administration in Iraq and Afghanistan continue to drain resources, both in human and financial terms. This Administration appears set to take the national debt to unprecedented levels.

Due to our failure to restructure, America is finding it harder and harder to compete globally. Instead of taking our lumps, Washington is lashing out with suicidal measures like the Chinese Tire Tariff, which might simply be an ominous prelude to more important and much more damaging tariffs on commodities like steel and raw materials.

Inflation

Aggressive monetary and fiscal stimulus programs by central banks and governments around the world suggest higher inflation is coming. The U.S. is at the forefront, with the federal government creating massive stimulus packages to replace aggregate private demand with public demand. The Federal Reserve and the Treasury are providing trillions of dollars of monetary stimulus to finance these programs, and to keep the global financial system afloat. Furthermore, the Fed has indicated its willingness to purchase assets to keep the federal funds target interest rate at historic lows for an extended period in order to stimulate growth. As a result of these policies, the money supply has already soared to unseen levels.

While the current recession has created near-term deflation, we believe the magnitude of government stimulus could potentially put inflation back in play by in early-2010. Complicating any forecasts is the timing of the Fed's exit strategy and the amount of stimulus withdrawal. Too late and too little, and it won't be able to quell the inflationary forces that have been unleashed. Too early and too much, and the economic recovery could be hindered.

Our view at this time is that we could potentially face a period of higher than normal inflation of 4-6% over the next several years. Moreover, we believe the severity of the global downturn and the trillions of dollars of stimulus at stake may leave the Fed no choice but to let inflation run longer and higher than past recessions to ensure a recovery takes hold.

Conclusion

Our position on the market; sentiment is very much tilted to too many bulls, valuation is not excessive, but is full, the market is overbought, and GDP growth will slow after the 3rd quarter. We could avoid a correction, but the odds are against it.

So why has the market rallied? As mentioned at the onset, stock markets tend to reflect financial hope. The markets were oversold, as paranoia about every company in America going bankrupt ran rampant. Now that total financial collapse seems unlikely, at least in the near term, things have settled down a bit.

Also, consider the extreme technical influences from massive amounts of cash sitting on the sidelines. According to the Investment Company Institute (ICI), there is just over $3.4 trillion in money market funds now, compared to a more typical level of $2 trillion. We believe investors are looking for any excuse to return to the markets.

Seeing *no substantive change in the economy at this time*, though, we believe this situation is much of the cause of the market's current rally. Eventually, investors will realize this to be the case, and prices will settle and then drift downward.

We expect market volatility to remain high, if not increase, through the end of the year. Our investment strategy for WFA Asset Management clients has changed little in the third quarter. We remain focused on liquidity, and preservation of capital, holding some 25 to 35% of our individual portfolios in money market funds, and have recently added to short- and intermediate-term treasury bonds, given our view that short-term rates will remain stable at 0 - 25 basis points for the next several months.

Since numerous structural and fundamental problems remain, it is likely that the current market rally does not represent the early stages of a long-term bull market. When investment decisions are driven partly by the fear of being left behind, they may not appear to be prudent or based on common sense. Corrections tend not to occur in the early stages of a new bull market because there is so much cash looking for an opportunity to enter.

Common sense and prudence say stocks must experience a significant correction soon. Admittedly, waiting for a correction to participate in the current stock rally has proved frustrating, but we remain cautious.

U.S. Market Index Results
As of 9/30/09

INDEX	**Y-T-D Return**
S&P 500 Index	17.0%
Dow Jones Industrial Average	10.7%
NASDAQ Composite	34.6%
Russell 2000	21.0%
Barclay's U.S. Aggregate Bond Index	5.7%

Additional Notes

In addition to the fundamental and strategic risks discussed above, there are of course geopolitical risks to the global recovery, as well. Below is an informative commentary from Gary Thayer, a Senior Economist with Wachovia Securities in St. Louis.

Macro Comment (Economy)

September 30, 2009

Geopolitical Risks

The U.S. economy continues to move down the road to recovery. Things are looking better but it is too early to flash a green light. The economic news is improving but there are many lingering problems, and geopolitical risks are high. Therefore, a yellow caution light is probably still warranted.

On the economic front, more reports are indicating improving economic conditions than are showing deteriorating conditions. This is what usually happens as the economy begins to heal and a recovery starts. At this point in the economic cycle, the greatest risk to continued economic gains would be any unexpected event that dampens confidence and spending again. That is why it is important for investors to keep an eye on geopolitical news.

On the geopolitical front, global political news has been relatively benign for the financial markets. However, geopolitical risks remain high, especially regarding the Middle East and Iran. When many global leaders are preoccupied with domestic economic problems, some foreign leaders appear to be pushing the envelope in order to see if they can boost their power and influence in the global arena.

The tensions with Iran over its nuclear program heated up in September when the Iranians revealed to the United Nations' International Atomic Energy Agency (IAEA) that they had constructed a secret nuclear enrichment facility. This revelation came just days before Iran was scheduled to begin talks about its nuclear program with the five permanent members of the UN Security Council, plus Germany. Iran contends that its nuclear program is strictly for peaceful purposes. Yet a few days after revealing its secret facility, Iran flexed its muscles by testing missiles that could strike Israel and Europe. The United States wanted Iran to begin negotiations

before the September G-20 meeting in Pittsburgh. But Iran managed to push that date back to October 1. This posturing ahead of the meeting could be designed to make Iran look strong despite domestic political problems following its contested election and protests this summer.

Up to this point, Russia and China have been reluctant to impose more sanctions on Iran. Instead these countries seem to be allowing Iran to progress with its nuclear program in order to extract more concessions from the United States. This policy may have worked for Russia, as the Obama Administration agreed to cancel a program to put radar and missile interceptors in the Czech Republic and Poland.

Giving up the missile defense system in Eastern Europe may be a way the United States could get more cooperation from Russian on sanctions. But Russia probably wants more than just the cancelation of the U.S. missile program. It also wants to extend its influence and power in its former Soviet states which had been seeking membership in NATO. That is probably why Russia invaded the Republic of Georgia a year ago. Russia wanted to show the Eastern European governments that the United States was not willing to go to war with Russia in order to defend the former Soviet republics. Russia is also a major oil exporter. Therefore, any geopolitical event that boosts oil prices increases Russian oil revenue.

Iran does not appear to be willing to give up its nuclear ambitions. After all, it probably feels threatened by the United States' military presence in Iraq to its west and Afghanistan to its east. More importantly, Iranian leaders may not feel that it needs to give up its quest for nuclear power because the United States can hardly afford to get engaged in another war. Moreover, efforts by the United States to adopt a cooperative policy with Middle East countries may make the United States look weaker. Canceling the missile deployment program only adds to that perception.

Unfortunately, time is running out. If Iran continues with its nuclear program, it will probably be able to build a nuclear bomb within a couple of years. Therefore, Iran is likely to drag its feet in negotiations. If the United States cannot get cooperation on sanctions, then other actions may be taken. Israel may decide to attack Iran in order to destroy its ability to build a bomb. This could lead Iran to retaliate by mining the Strait of Hormuz, potentially causing oil prices to skyrocket until strategic oil reserves can be sold.

The biggest risk from any of these and other scenarios is the chance for a wider conflict because of miscalculation. Israel and the United States may be trying to get Russia to refrain from siding with Iran in return for more concessions by Western governments. But a weakened Iran would add to Western power in the Middle East at the expense of Russia. Therefore, it may not be in Russia's interest to acquiesce to an attack on Iran.

If the United States cannot get support for increased sanctions from Russia and China, then U.S. policymakers may have few remaining options. The big question is whether the Obama Administration is willing to draw a line in the sand and demand Iran give up its nuclear program or face a military attack. Iran could stall by appearing to cooperate with IAEA inspectors. This could slow things down but the United States may not be able to stop Israel if it decides that it cannot afford to wait.

At this point, the course of geopolitical events is unpredictable. If Russia and China cooperate with Western governments and impose sanctions on Iran, then a diplomatic solution is possible. If the Obama Administration's openness to cooperation rather than confrontation leads to broader support for U.S. policies, then a political solution is possible. If Iranian dissidents force a change in Iranian policies, then a political solution is possible. Unfortunately, if a political solution cannot be achieved, then military action becomes more likely, and this could lead to many unfavorable outcomes.

Given these uncertainties, investors need to be careful and not take more risk than is appropriate for achieving their goals. No one knows the future. When times are good and geopolitical risks are low, investors may be rewarded for assuming more than normal market risk. But when times are bad and geopolitical risks are high as they are now, then risk-adverse investors need to be more cautious.

Efforts to thwart Iran's nuclear program are likely to be front-page news during the next few months. This could lead to increased stock market volatility. Investors wanting to gauge the willingness of other investors to take risk may want to monitor the value of the dollar. Recent foreign exchange movements suggest that the value of the dollar has been moving up and down with changing investor risk preference. For example, when the global equity markets declined late last year, investors became more risk adverse and the dollar strengthened. When the global equity markets began to recover this year, the dollar weakened again because investors sought higher returns in overseas investments, selling dollars and buying into foreign markets. If the dollar begins to strengthen again, it could be a sign that investors are increasingly worried about economic or geopolitical risks.

WFA Notes

As you know, WFA sold the Franklin Drive building that we currently occupy back in 2005, and signed a lease with the new owner that terminates on December 31, 2009. From an investment point of view, the timing of our sale was fortunate.

Over the last year or so, we have casually been searching for a new home for WFA. Our intent is to own our own building in the near future, and hopefully situate ourselves in a more centrally located part of the Milwaukee area. We have been planning for this eventuality, and we are financially prepared to make such an investment when the right property presents itself.

We promised ourselves that the search would be low key, and not distract us from our day-to-day operations, and the management of your assets. Well, time flies when you're busy, that's for sure. In fairness to the current building owner, and since we haven't come across a building that suits are needs, we are extending our current lease for another two years.

We have included language in or lease that allows for an early exist under certain conditions, but it's a safe bet we will remain at our current location for at least the next 18-months. We will, of course, update you in plenty of time if anything changes.