

Fears of a potential recession and European contagion led to a significant sell-off in late July and early August. Since then the markets have been highly volatile while trading in a wide range. In a classic flight to quality, investors from around the world moved into the U.S. Dollar and U.S. Treasury securities. Yields on Treasury securities continued to decline, with the yield on five year U.S. Treasury bonds dropping below 1.0%.

The situation in Europe continues to slowly evolve, with lots of rhetoric but few concrete actions to address the underlying debt problems in Greece and other countries. Italy has now emerged as the biggest concern given its size relative to the rest of the Euro zone. European banks have significant exposure to the debt of these troubled countries and the health of the financial sector across Europe is a growing concern for policymakers and investors.

In an attempt to provide support to the U.S. markets and the domestic economy, the Fed announced intentions to manipulate the shape of the yield curve by selling short-term bond holdings and buying bonds with maturities as long as 30 years. The goal is to lower intermediate and long-term interest rates. "Operation Twist" has only been tried once before and it is far from clear that it will have a meaningful impact. In addition, the Fed announced a new program to purchase mortgage backed securities in the open market to try to reduce mortgage rates.

Unemployment remains stubbornly high and economic data show little improvement in the housing market. There has been minimal progress on fiscal policy in Washington, with both sides appearing more concerned with scoring points ahead of next year's elections than with actually addressing unemployment or the federal deficit. The U.S. budget crisis will be back in the news soon as the bipartisan "super committee" starts deliberations with a November 23 deadline.

The U.S. economy has continued to grow, although there are signs that the pace of growth is moderating. Corporations continue to be very cautious and are holding record levels of cash on their balance sheets. Business confidence is low as corporations face increasing regulation and uncertainty over future tax rates, the direction of the economy, and upcoming elections. Profit margins are at record highs, but could be coming down as productivity gains appear to be starting to tail off. The global economy has also started to moderate, with Europe remaining sluggish and China and other emerging markets showing signs of slowing.

Looking forward, we expect the markets to remain highly volatile as investors react to developments at home and abroad. In this environment we will continue to favor high quality assets and exercise caution with overall asset allocation strategies. Stocks of well established companies with strong balance sheets and attractive dividend yields remain an important part of our investment strategy.

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