



Sound of the Economy

NORRIS, PERNÉ & FRENCH LLP

Investment Counsel

Established 1933



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The profound calm which only apparently precedes and prophesies of the storm, is perhaps more awful than the storm itself; for, indeed, the calm is but the wrapper and envelope of the storm, and contains it in itself, as the seemingly harmless rifle holds the fatal powder, and the ball, and the explosion.

-- Herman Melville

Introduction

The end of the West Michigan summer can deliver some of the finest days of the year with spectacular sunsets and cool, light breezes coming from across the lake. Most vacationers spend these final days of the season relaxing at the cottage, listening to the sounds of summer; families chatting while roasting marshmallows over the fire pit for scrumptious s'mores, the banging of closing wooden screen doors and the lake breeze flapping the main sail of a boat at the dock.

The economic data released during the early summer was forecasting gentle summer breezes for the economic recovery; industrial production rose +0.9% in July (with upward revision to the prior months), the U.S. leading indicator rose +0.5% and the four-week average of initial unemployment claims were trending down. In addition, companies reported generally good earning for the second quarter.

Summer romances end around Labor Day but the summer romance of economic recovery and higher stock prices ended a little early as the gentle summer breeze turned into a gale mid-summer. The storm started during the insane month of August, which was a dramatic month for stocks to say the least. On August 2nd, the day the debt deal was signed, the S&P 500

Index saw its biggest one-day fall in over a year and yields on 10-year Treasury bonds dropped to 2.6%, the lowest (at the time) in nine months as investors sought safety.

The stock market experienced a 5.4% correction during the month of August as investors fretted that the economic "soft-patch" was an illusion, or that it would not be sustained. The decline in the stock market felt much worse than a modest correction to investors. Stock market volatility spiked considerably, driven in part, by concerns over Europe's finances, political wrangling in Washington D.C., S&P's downgrade of the US credit rating and increasing concern about the possibility of a double-dip recession. While volatility is nothing new, the Dow Jones Industrial Average swung an average of 1.9% each day in August, the tenth most volatile month in the past 75 years.

Investor confidence dropped sharply in August. Consumer confidence had been hurt by the political squabbling over lifting the debt ceiling and the Standard & Poor's cut to the U.S. Credit Rating. Consumer confidence dropped in August to its lowest level since April 2009. The Conference Board Index of consumer confidence sank to 44.5 from 59.2 in July.

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Introduction Cont.

The fair summer weather is fading, and the first significant cold snap of the fall season (with a risk of frost) is on its way to western Michigan. Like the Michigan weather, economic conditions may get cooler in the near term. While the hard data (industrial production, leading indicators and initial unemployment claims) were reasonably solid during July, U.S. economic growth is likely to remain sluggish at best, as telegraphed by the decline in key surveys like the one from the Philadelphia Fed.

The Philadelphia Fed Business Outlook plunged -33.9% to -30.7 (lowest level since March 2009) in August. The business outlook survey is a monthly survey of manufacturers in the Third Federal Reserve District (Philadelphia). The Philly Fed index is a diffusion index, taken by subtracting the percentage of respondents who say activity fell from those who say it rose. Participants indicate the direction of change in overall business activity and in various measures of activity at their plants; employment, working hours, new and unfilled orders, shipments, inventories, delivery times, prices paid and prices received. This sample was taken during the time of elevated volatility (August 8-16) in the domestic and international financial markets.

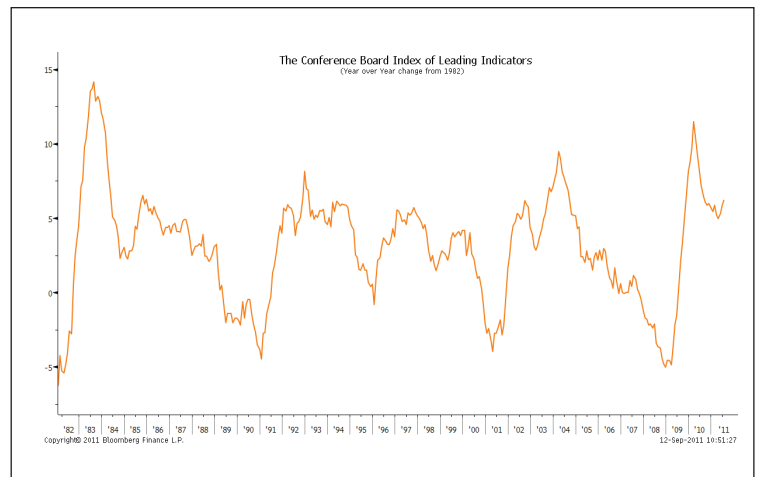
The wild gyrations in the stock market indexes during the month produced alternating signs of weakness and strength that have tormented many investors. These concerns are very similar to fears fanned by the media at about this point in two previous economic recoveries in the fall of 1992 and 2003. Similar to then, we are in the midst of a moderately-paced economic recovery that will likely be sustained.

The gale winds from the shock of the August Philly Fed report began to calm in early September, on a report showing that U.S. manufacturing, although weak, continues to expand. The Institute for Supply Management (ISM) for August came in at 50.6, which was down from the 50.9 that was posted in July, but better than the 48.5 that was expected from economists. ISM figures greater than 50 signal expansion. Falling commodity prices and a recovery from setbacks related to Japan's earthquake have helped keep U.S. manufacturing from shrinking amid a global slowdown that is curbing overseas demand.

Finally in mid-September, there was some promising news from the Philly Fed. Its index of current activity was -17.5 in September, an improvement from the -30.7 reading in August. There were some promising signs in the September report. Despite the apparent signs of a slowdown in recent months, respondents to the survey were optimistic that conditions will improve six months from now. The broadest indicator for future activity showed a notable improvement, increasing 20 points, from 1.4 to 21.4, nearly reversing a 22 point decline in August.

In the past several issues of the *Sound of the Economy*, we have forecasted that the economy would continue to expand at a sluggish pace and would be subject to periodic doubts about its viability. We still believe this to be the case despite recent headlines and bouts of panic selling. The global economy is sputtering but a "soft-patch", rather than a recession, is the most likely outcome.

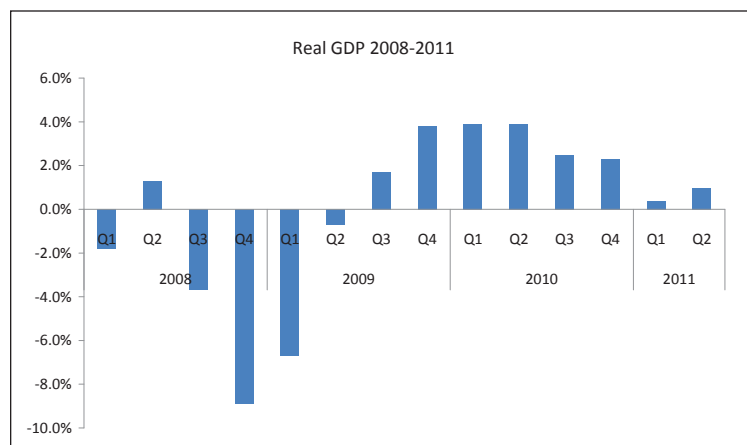
This outlook is confirmed by several promising economic indicators including the continued rise in the Index of Leading Economic indicators which are not near recessionary levels. The Index of Leading Indicators, while moderating some, is still increasing at more than a 6% annual rate. In addition, while recent market turbulence will weigh on U.S. growth, an easing of commodity inflation should provide much needed relief to households. Bank lending is growing at the fastest pace in a year (implying we have yet to feel the full effects of QE2) and initial jobless claims have not signaled imminent recession. Although corporate earnings guidance may be trending down, they are not signaling a major reversal and are still growing. Finally, the largest monthly increase in motor vehicle and parts orders in 8 years suggest that the impact of the Japan earthquake disaster may be beginning to dissipate.



There have been explanations of the many headwinds that have adversely affected the economy. Any good sailor knows one will get nowhere with "three sheets to the wind". When sailing directly upwind, one must tack (for non-sailors tack is the alignment of a sailing vessel with respect to the wind when moving upwind; that is, when the vessel's bow is pointed within 90 degrees of the wind) to make progress in a head wind. As experienced portfolio managers that have weathered similar dire market conditions, we are trimming our sails, tacking and navigating portfolios through the current treacherous waters on to calmer waters ahead.

Second Quarter Real GDP

The U.S. economy continues to recover from the 2008-2009 recession. However, economic growth has slowed. The U.S. economy grew at a slower pace in the second quarter than previously estimated. Real GDP increased at an annual rate of 1.0% in the second quarter of 2011, (that is, from the first quarter to the second quarter), according to the “second” estimate released by the Bureau of Economic Analysis. This revised number was below the 1.3% that the Bureau estimated at the end of July. New data showing weaker exports and a smaller buildup of inventories during the quarter led to the lower number. In the first quarter, real GDP increased 0.4%. For the first half of 2011 the U.S. economy expanded at a 0.7% pace.



Another measure of broad economic activity suggests better economic performance in the first half of the year than the GDP figures suggest. Gross domestic income (GDI), income received by households and businesses, rose 2.4% in the first quarter and 1.5% in the second. GDI indicates the economy grew steadily at about 2.0%.

Some good news, corporate profits remained strong in the second quarter despite higher costs and slower growth facing most firms. Corporate profits rose 3% in the quarter up from a 1% increase in the first quarter. The trouble is that companies aren't putting these profits to productive use. Corporate cash levels continue to rise while hiring remains anemic and corporate investment is showing signs of slowing.

High gas and food prices forced consumers to sharply pull back on spending. Consumer spending was almost flat in the second quarter, increasing only 0.1%. Spending on durable goods (long-lasting manufactured goods, such as autos and appliances) fell 5.1%, the biggest drop since the fourth quarter of 2008. Spending on durable goods was adversely affected by the shortage of vehicles on dealer lots caused by the auto supply disruption of the March 11 earthquake in Japan. The supply disruption appears to be temporary as a rebound in auto production is underway.

Government spending fell for the third straight quarter. State and local governments cut spending for the seventh quarter in eight since the recession ended. Federal government spending was up slightly in the second quarter, but was offset by falling state and local spending. Private investment and consumption could make up the gap, but consumer confidence has been badly shaken by the debt-ceiling battle and financial market havoc.

Like most financial crises, the U.S. meltdown was triggered by the dramatic expansion of credit and financial leverage. Unwinding leverage is typically a long and painful process, which leaves the economy fragile and vulnerable to shocks, as we have experienced this summer.

Employment

U.S. payrolls were flat in August as employers added no net jobs and the unemployment rate was unchanged at 9.1%. It's the first time since February 1945 that the government has reported a net job change of zero. Job gains in June and July were revised lower, to show 57,000 fewer jobs added. The downward revisions were all in government jobs. Average hourly earnings declined -0.1% month-over-month and average weekly hours declined to 34.2

Initial claims for state unemployment benefits dropped 12,000 to a seasonally adjusted 409,000. While the figure still points to a struggling job market it remains well short of a recession signal. The four-week moving average of claims rose 1,750 to 410,250.

Nonfarm productivity was revised down to a -0.7% annual rate in the second quarter (the biggest decline since the fourth quarter of 2008) from the previous estimate of a -0.3% decline. A slowdown in productivity usually suggests that businesses have to add new workers to meet production, but against the backdrop of an economy growing at a near stall-speed, companies may have to cut costs to protect profits.

Unit labor cost grew much stronger than previously estimated in the second quarter, increasing 3.3% rather than 2%. However, the revised pace is still lower than the 6.2% rate in the first quarter. Wage pressures remain too well contained to stroke a broader rise in inflation.

Housing

The housing data continues to be weak. The National Association of Home Builders (NAHB) market index was flat in August, the four-week average mortgage application for purchase was flat (increasing only 0.5% week/week), housing starts fell -1.5% month/month in July and existing home sales declined -3.5%. The flat mortgage applications for purchase number suggests weak sales in September and October.

Housing Cont.

On a positive note, The S&P/Case-Shiller Home Price Index showed that the U.S. National Home Price Index increased by 3.6% in the second quarter of 2011 (that is, from the first quarter to the second quarter), after falling -4.1% in the first quarter. The index still posted an annual decline of -5.9% versus the second quarter of 2010. Nationally, homes prices are back to their early 2003 levels.

Even with interest rates at all time lows and 30-year mortgage rates down to 4.17%, the four-week average Refinance Index is down -3.9%. An indication that homeowners are unable to take advantage of record low interest rates to refinance because of unfavorable loan-to-value ratios.

Optimists would like to believe with current data and after four years of brutal declines in home prices, that the worst of the housing crisis is over. The view through the rose color glasses sees a housing market improvement as early as this fall. On the other hand, some pessimistic predictions from analysts of asset bubbles are very different. They call for the housing market to follow a similar pattern of prices after the busting of other asset bubbles, including the Dow Jones Industrial Average following the crash of 1929 and Japan's Nikkei after its 1989 peak. It starts with a steep decline lasting three or four years, followed by a brief rally that ends in years of stagnation. The Dow took 35 years to return to pre-crash levels. The Nikkei trades at less than a third of where it peaked 22 years ago.

We are not Pollyannaish in our outlook for the housing market nor are we as pessimistic as the Eschatology camp. We see the housing market currently going through a bottoming process, but don't see any improvement in the near future. It may not be until after the next business cycle that the housing market bounces back.

Inflation

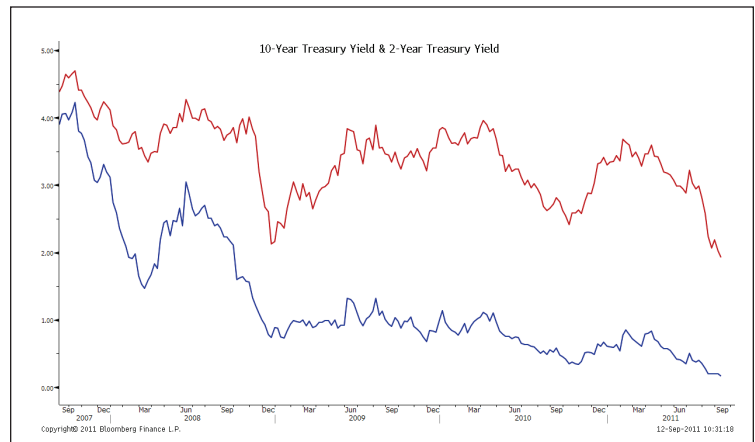
The highest inflation rate in three years was reported in the August numbers released in mid September, with the core CPI up +0.2% month/month. Core prices have risen for eight straight months. Headline inflation increased +0.4%. Core CPI is now up 2.0% year/year, while the headline CPI rose to 3.8%. Upward pressure stemmed from higher energy and food prices.

While we continue to be cognizant of the risk for increasing inflation expectations, we have grown less concerned about rising inflation in the near term. This is due to the recent contraction in commodities which alleviates some of the cost pressure that drives prices higher. With emerging economies cooling after several years of rapid expansion, demand for raw materials is likely to abate and help subdue commodity inflation. Lastly, with the labor market struggling, there is virtually zero inflation in wages.

Fixed Income

Bonds have performed better than many investors anticipated during the past few months as the economy has cooled and commodity prices have fallen. Investors have turned more cautious causing the bond market to rally and the stock market to consolidate. Through the end of August, the Barclay's 5-year Municipal Bond Index has returned 5.6% year-to-date and the Barclay's Intermediate Government/Credit Bond Index has returned 5.0% year-to-date.

Bond yields moved lower during the summer, with the ten-year Treasury yields falling to a record low in September. Interest rates fell as Treasury bonds were bid up due to the slowing economy and Greek debt crisis. During July, the 10-year Treasury yield began moving lower but remained in a trading range between 3.2% and 2.5%. In early August, 10-year yields began to drop quickly as economic numbers disappointed. In mid-August, investors concerned about European debt issues and the FOMC statement to keep short-terms rates low for two years pushed the 10-year yield down to 2%. The 10-year Treasury yield began September at record lows and is currently 1.9%.



We expect short term maturity bond yields to remain at extremely low levels, anchored by Federal Reserve policy which has pegged short-term rates at virtually zero for at least two years. A two year period of low short-term rates does not change our long-term expectations for higher rates, but it does delay an eventual rise in rates. In addition, the Fed is likely to consider something like "operation twist" (last used in the 1960's) which would involve relocating but not necessarily expanding the Fed's balance sheet in an attempt to lower long-term interest rates.

In such a low yield environment, it remains difficult to find attractive bonds without sacrificing credit quality or extending the maturity range beyond 20 years, neither of which we are willing to do. We have maintained our focus on finding high quality corporate bonds which offer some additional yield above government bonds, backed by companies with strong cash flow, and stable to improving balance sheets. Our buying has generally been focused on the five to seven year maturity range, with occasional purchases out to ten years. We have also added to municipal bonds in portfolios where appropriate. As always, our focus begins and ends with credit quality.

U.S. Treasury Security Downgrade

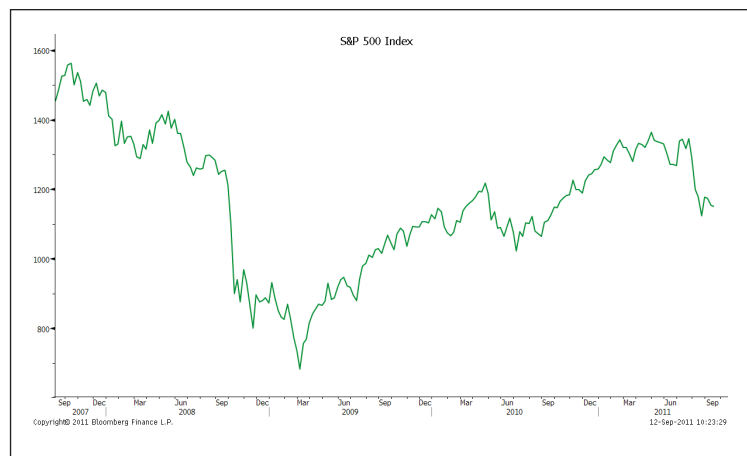
On August 5th, Standard & Poor's Ratings Service downgraded the long-term debt of the United States by one notch from the top AAA rating of extremely strong to AA+ rating of very strong. Two other rating agencies, Moody's and Fitch, reaffirmed the U.S.'s AAA rating. The downgrade of U.S. Treasury securities has little immediate investment significance, but it is a reminder that we have a very serious long-term problem of unfunded future pension and medical care promises.

The downgrade has not cost anything with respect to interest rates, at least in the near term. The level of the federal debt, economic activity and inflation expectations have and will be the more influential drivers of interest rates. The ability of the U.S. to pay its debt is not in question because the U.S. is currently the world's reserve currency and can print dollars to pay its debts.

The downgrade was driven by a lack of confidence that Congress will be willing to address any key spending issues in the foreseeable future. The debt deal implies only modest new spending cuts in the short-term and fails to address any of the real sources of the fiscal problems, such as entitlement spending.

Stocks

The summer has not been kind to the stock market. During July, the continuing sovereign debt crisis and signs of slowing economic growth weighed on equity markets. The S&P 500 stock index declined -2% during the month. In August, volatility spiked considerably driven by concerns over Europe's finances, S&P's downgrade of the US credit rating and increasing concern about the possibility of a double-dip recession. For the month of August the S&P 500 stock index was down -5.4% bringing the year-to-date decline to -1.8%. Investors, battered and bruised by August's volatility are experiencing continued volatility in September. At mid-month, the S&P is down another -2.4% bringing the year-to-date decline to -4.1%.



While volatility has risen this year, the outlook for many stocks appears more constructive than the economic picture would lead you to believe. This conviction is grounded in our having first hand knowledge of our core stocks. The positive earnings outlook expressed by many of the companies we own stand in sharp contrast to the barrage of negative news reported daily by the media and provides the foundation to our more constructive outlook for the stock market.

During the August stock market melt down, insider buying (company executives buying stock of their company) reached its highest rate since March 2009. More executives are buying their stock than any time since the depths of the credit crisis after stock valuations declined 25% below their five-decade average. Nobody knows a company better than the executive running the company. It's a positive sign that company executives are committing their personal capital in their companies.

One other positive note is that corporations have spent the last few years getting their financial house in order, raising cash, refinancing high cost debt with cheaper debt, and trimming expenses. We are looking beyond economic weakness and seeing the potential for earnings growth to come. In fact, earnings among the S&P 500 companies are expected to rise about 15.8% this year versus 2010 levels.

While these estimates for earnings growth may be revised lower if the economy continues to slow, we still expect positive earnings growth versus last year. As companies have cut costs, they have expanded profit margins to record levels in recent quarters. Stocks also do not appear expensive based on historical valuation measures, assuming current earnings estimates are achievable. With that said, one thing we have not seen is any indication by corporations to dramatically ramp up employment. Instead, the preference continues to be spending on capital expenditures, technology and other productivity related items.

As we have commented before, NPF believes buying high-quality businesses and holding them for the long term is the best path to long-term capital appreciation. Markets do matter and we monitor them closely. We do not, however, allow them to divert our attention from our core responsibility of identifying, selecting and managing a portfolio of businesses for our clients.

Outlook

Going forward we expect more volatility and anxious moments. Deteriorating global indicators and the spillover effect from European debt concerns will likely contribute to continued volatility in the financial markets. Nevertheless, underlying strength in several areas (including corporate profits, capital expenditures and

Outlook Cont.

manufacturing) suggest that the expansion is ongoing, albeit at a sluggish pace.

Stocks of growth companies (generally defined as those that produce earnings growth more rapidly than the overall economy) will have an edge. During this post-recession period with lower than normal GDP growth, we expect investors to pay a premium for growth, since any kind of growth is a scarce commodity. Even if the markets get spooked in the short-term, we want to ride out the storm tacking with solid growth companies with good cash positions, that continue to grow earnings.

We will continue to be alerted to the possibility that prevailing winds may change. However, as we monitor our core stocks, we would expect to add to our positions whenever short-term fears lead to bargain pricing for good businesses. Given this muted, but on balance positive outlook, we will continue to buy good growth businesses when they are available at attractive prices and sell them as prices approach full value.

Conclusion

To make sense of the current market, we believe we have to focus more on the emotional cycle than the economic cycle. The economy is not unimportant. Much ink is spilled interpreting the economic data, most of which confirms that overall the economic picture is not bad. Something else is troubling investors. The shock has been

the revelation of a serious breach of both corporate and political standards. Investors are losing trust and losing confidence, more so in the past few months than in the first year of the recession. While 24/7 cable news rehash the ideology from both ends of the political spectrum, the realization that the system is flawed has affected investors. Our sense is that the mood has deteriorated somewhat since the summer. We continue to believe the shadow cast by the last financial crisis is a long one.

Certainly investors have reason to feel let down by what has transpired in recent years, some of which is only coming to light recently. The refusal to compromise, rapidly becoming a badge of honor for both parties, is wreaking damage in the governing process. Compromise is not a bad word. Politicians are elected to run the government not to stand on a soap box and preach their ideology.

The fate of the global financial system rests, to a large extent, on the decisions of a small number of policymakers, some democratically elected and some not. Trust is an essential ingredient in the functioning of our economic system and our financial markets. Skepticism is healthy while mistrust is corrosive. Investor confidence plays an important role in business and consumer investment decisions. Deterioration in confidence could easily counter the positive effects of any economic stimulus package.

The U.S. economy will most likely avoid recession and slowly begin to pull out of this mire, a testimony to America's underlying strengths.

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