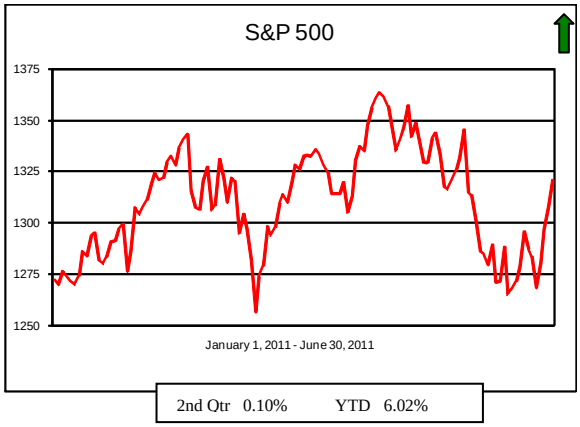
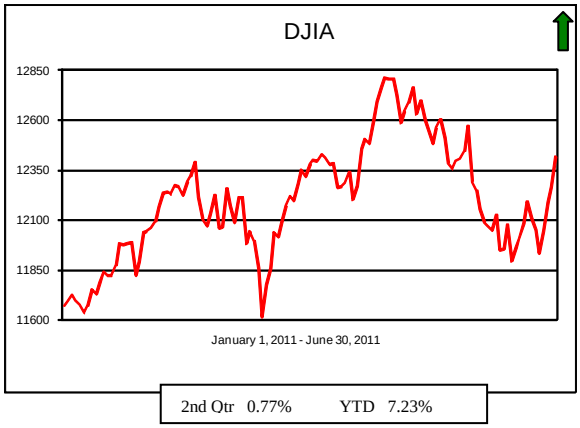
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

CAPITAL MARKETS SCOREBOARD

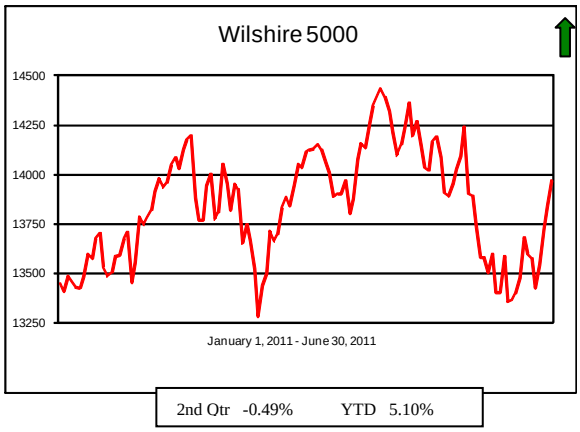
January 1, 2011 – June 30, 2011



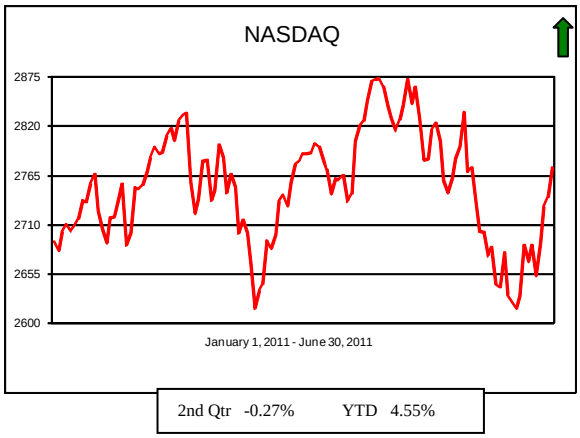
2nd Qtr 0.10% YTD 6.02%



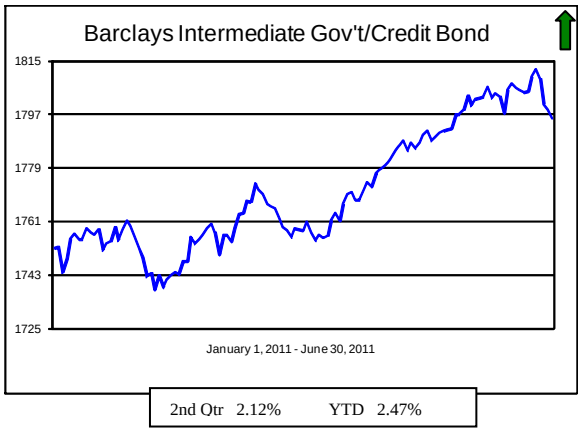
2nd Qtr 0.77% YTD 7.23%



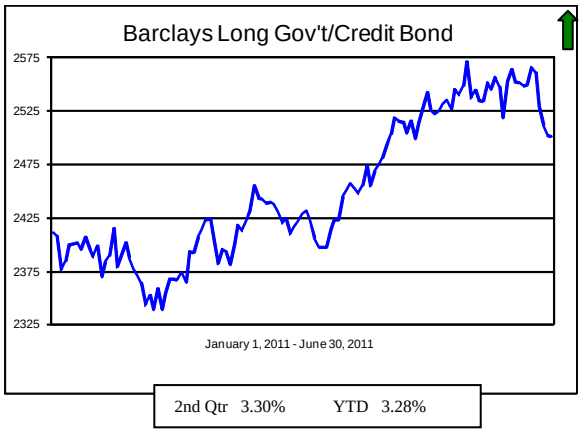
2nd Qtr -0.49% YTD 5.10%



2nd Qtr -0.27% YTD 4.55%



2nd Qtr 2.12% YTD 2.47%



2nd Qtr 3.30% YTD 3.28%

EQUITIES

Equity Market Performance

An axiom of the investment management industry is: "Stocks climb a wall of worry." We certainly had worries to build the wall in the second quarter of 2011, even though it started well enough. Upside momentum from the first quarter carried over into the second quarter and was bolstered by better-than-expected domestic economic data as well as positive earnings surprises. For instance, Intel's exceptionally strong earnings report set a positive tone for the market for two straight sessions. The good times lasted until the first week of May, when energy stocks declined despite higher oil prices and the Institute for Supply Management (ISM) published a worse-than-expected measure of non-manufacturing growth. The cyclical and near-cyclical sectors, such as Materials and Financials, were hit the hardest, while those traditionally considered defensive, like Health Care and Consumer Staples, fared better. The market averages regained some lost ground periodically thereafter, but then Eurozone sovereign debt fears moved to the forefront, causing the major averages to move downward. However, during the last five trading sessions of the quarter, which were lightly attended, the widely followed indices once again rallied as Eurozone fears eased and the string of disappointing U.S. economic data was broken. The market (as represented by the S&P 500) slipped 0.4% without dividends, but eked out a gain of 0.1% for the quarter with dividends.

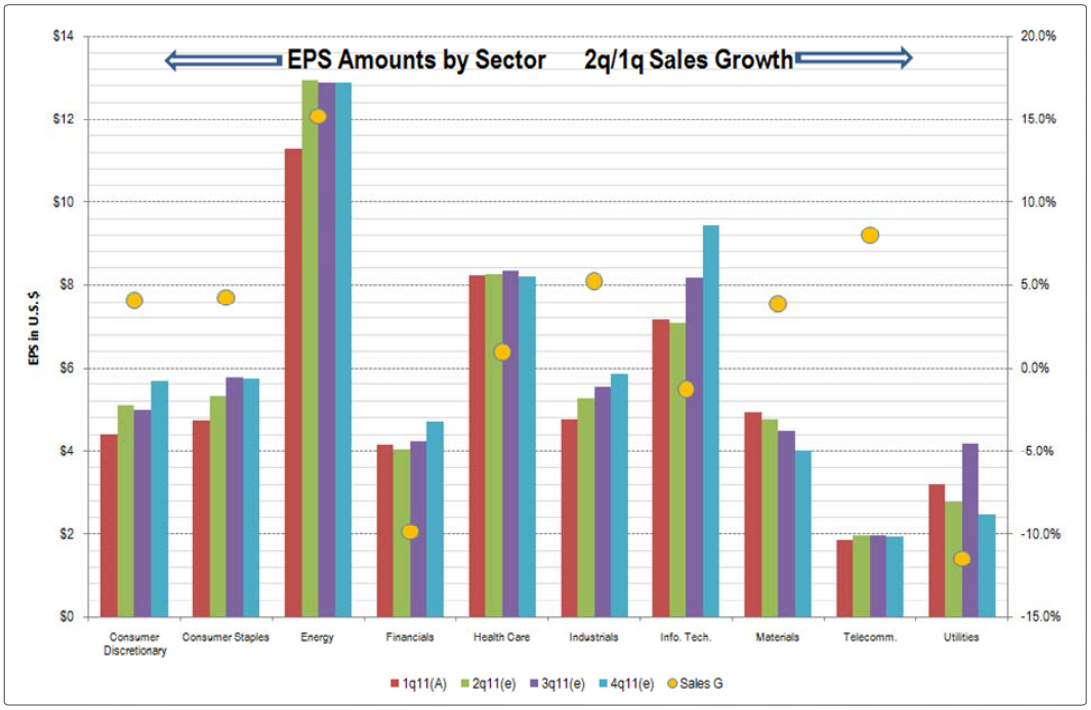
S&P 500 by GICS Sector	Price Return (%)	
	2Q11	**YTD**
Energy	-5.1	10.4
Industrials	-1.2	6.9
Health Care	7.3	12.7
Consumer Discretionary	3.1	7.6
Materials	-1.4	2.6
Telecommunications	0.8	4.4
Information Technology	-1.6	1.6
Financials	-6.3	-3.7
Consumer Staples	4.5	6.3
Utilities	5.0	6.7
S&P 500 Index	**-0.4**	**5.0**

Earnings Growth

During the first quarter of 2011, 340 companies beat analysts' earnings per share (EPS) expectations by an average of 25.3%, 108 delivered earnings misses and the remaining 52 companies had in-line earnings per share. Companies in the Materials sector produced the largest average upside surprise as 25 out of 30 companies earned nearly 52% more than sell-side analysts expected. Financial sector companies significantly outperformed, too, with 53 of 82 companies posting EPS numbers 48% higher, on average, than forecasted. Companies in the Energy and Utilities sector delivered the worst average EPS misses, 122% and 112%, respectively. In the end, the S&P 500 companies earned $24.31 per index share, exceeding estimates by about 6%.

The sell-side and the buy-side seemed out of sync during the second quarter as analysts were raising estimates throughout the quarter, even as the S&P 500 shed 96 points between its intra-quarter peak on April 29th and its subsequent low on June 16th. These estimates provide the basis for earnings headlines in the next few weeks, so it is worth noting what is expected. For instance, six of the ten sectors are expected to post quarter – over – quarter (q/q) EPS gains, with the Energy sector leading the way. On the other hand, the forecast for the Materials sector is to earn less than was earned in the first quarter in spite of an expected revenue increase of about 4%. Once again, though, earnings for the current reporting season may end up mattering less than the companies' *guidance* for the

Actual First Quarter 2011 EPS, Second Quarter 2011 Sales Growth Estimates, EPS Estimates for 2011 by Quarter



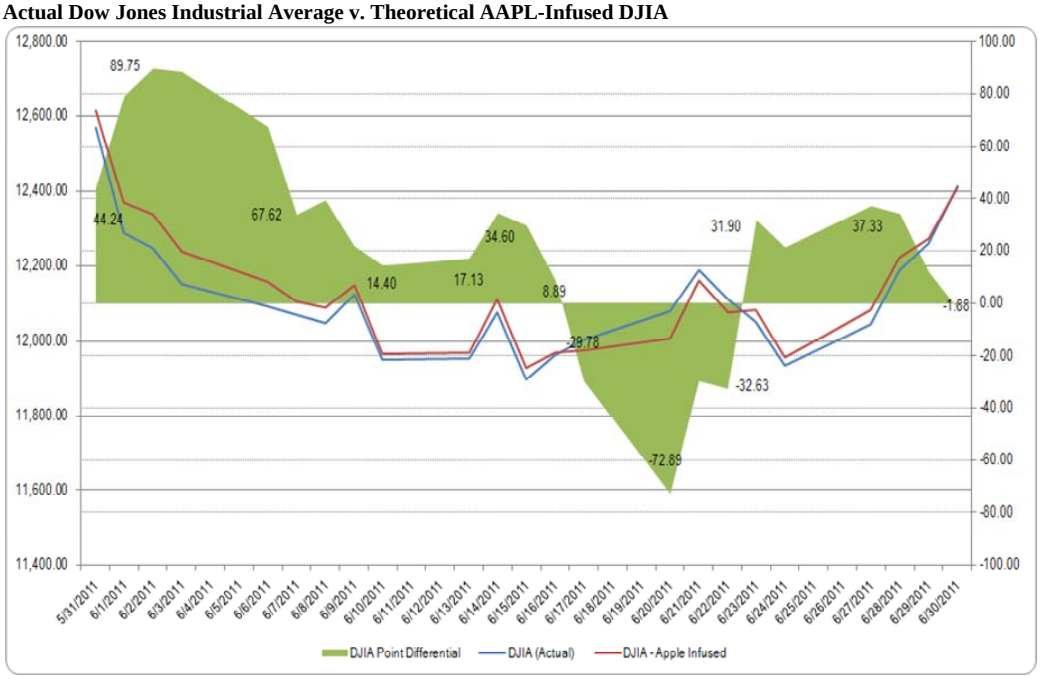
Source: Bloomberg Consensus Estimates, Wallington Asset Management

second half of 2011. Market participants of all stripes have grown especially sensitive to high quality information from (presumably) well-placed sources in light of the conflicting macroeconomic signals (sovereign debt, unexpectedly strong Chicago PMI, lackluster home sales and prices, etc.).

Index Construction

The question, "What is the market doing" is asked almost every day by financial market participants. It does not usually matter whether the response references the S&P 500 Index or the Dow Jones Industrial Average (DJIA) because either one provides a *very general* sense of how the average stock is performing. Many times, though, more precision is needed because it can be helpful to know how an index's construction affects the presentation of the "average" stock. Individual stocks can have a pretty dramatic impact on an index, the magnitude of which is dependent upon the methodology used to construct a particular index. For example, an article in Bloomberg Businessweek recently highlighted this issue when it pointed out that Apple Inc. (AAPL) is not included in the DJIA, even though it is the second largest company in the U.S. when measured by market capitalization. The DJIA's construction methodology coupled with AAPL's high share price may be part of the reason for the shares' conspicuous absence.

Actual Dow Jones Industrial Average v. Theoretical AAPL-Infused DJIA



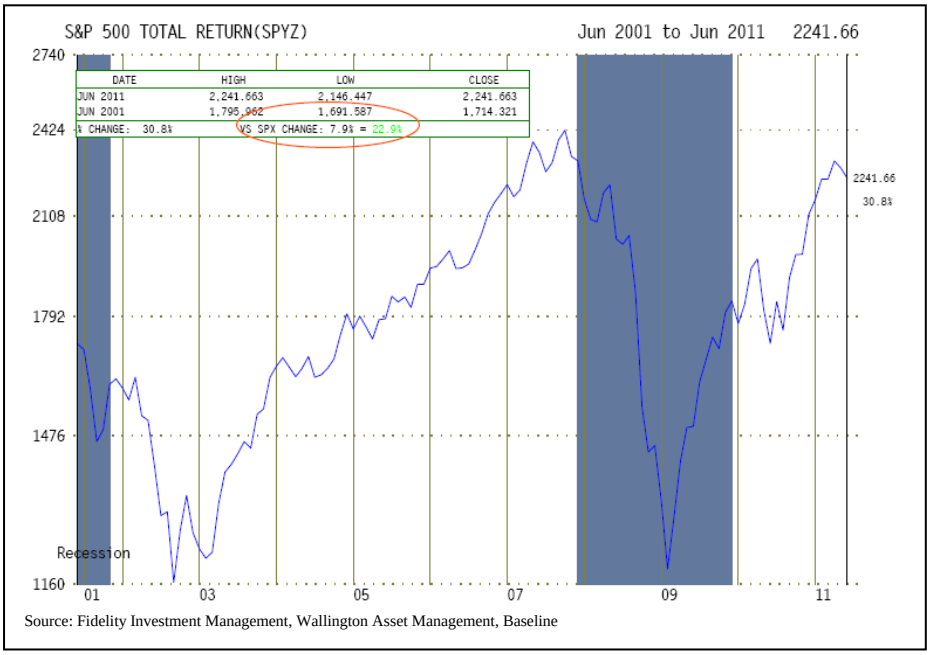
Source: Wallington Asset Management

The DJIA is a price-weighted, scaled average index that gives equal weight to every $1 change in the share price of the index components. Therefore, a $1 price change in Bank of America's stock (BAC) from $11 to $12 has the same effect on the DJIA (about 7.6 index points) as a $1 price change in Caterpillar's stock (CAT) from $104 to $105. Note, though, that $1 represents a 9% price change for BAC, but only a 0.96% price change for CAT. If AAPL, which trades in the $330 context, replaced BAC in the index, a gain or loss of merely 0.30% would negate a 1% move in CAT's share price. Further, Alcoa's shares would need to move about 6% to have the same effect as Apple's minor change. Thus, if the DJIA included AAPL, its outsized influence would make a number of other index constituents superfluous.

Another Tech Bubble?

Facebook. Twitter. Zynga. LinkedIn. Groupon. These are the Fab Five social media companies – fast-growing, high-profile internet companies with seemingly unlimited potential. *Seemingly* and *potential* are key words, though, because these darlings of the business world appear to have a SMALL profitability problem. That is, they either do not have profits or they have erratic profit levels let alone they may not even have sustainable business models. Groupon's legion of small copycat competitors prompted the company to grow expenses faster than revenues in 2010 – and revenues increased by 15 times. Zynga created the popular *Farmville* and *Cityville* games, but consistently developing chart-topping games is extraordinarily difficult. Creating further risk is that Zynga is unnervingly dependent on Facebook's platform currently because players overwhelmingly access its games through Facebook. Precedent even exists for dethroning Facebook, the most highly regarded company of the group. In 2005, MySpace.com was the premiere social networking website. Its future was so bright that News Corp., controlled by Rupert Murdoch, bought the site's parent company out from underneath Viacom for $580 million that summer. Unfortunately for News Corp.'s shareholders, Facebook eclipsed MySpace, ultimately leading News Corp. to sell its stake for $35 million this quarter. *Caveat emptor*.

No Longer a Lost Decade



Source: Fidelity Investment Management, Wallington Asset Management, Baseline

When the first decade of the new century drew to a close, the financial media wrote a number of "lost decade"-themed articles that pointed out the near-zero return of the stock market the last ten years. The journalists and critics typically cited S&P 500 index returns, with the less-sophisticated authors focusing on the price only return (note the 7.9% ten-year return for the price-only SPX in the graph). When written, the time period under review started near the peak of the tech bubble and ended after the bursting of the credit bubble. As the rolling ten-year time period shifts to begin at or near the trough of the post-Tech Bubble decline while ending after the market rebounded from the credit bubble, the storyline should begin to improve. For instance, if the ten-year period begins in September 2002 and if we assume the total market return is 0% between now and September 2012, then the resulting 92.7% gain represents a compound annual return of 6.8% per year. Alternatively, we could assume the market continues to rise by about 0.63% per month, as it did from September 2002 through June 2011. At that rate, the ten-year annualized compound return would be almost 7.8%, near the low end of annual returns generally used for financial forecasting. Neither value is particularly stellar relative to long-term historical returns generated by equities, but either one should quell any further "lost decade" articles.

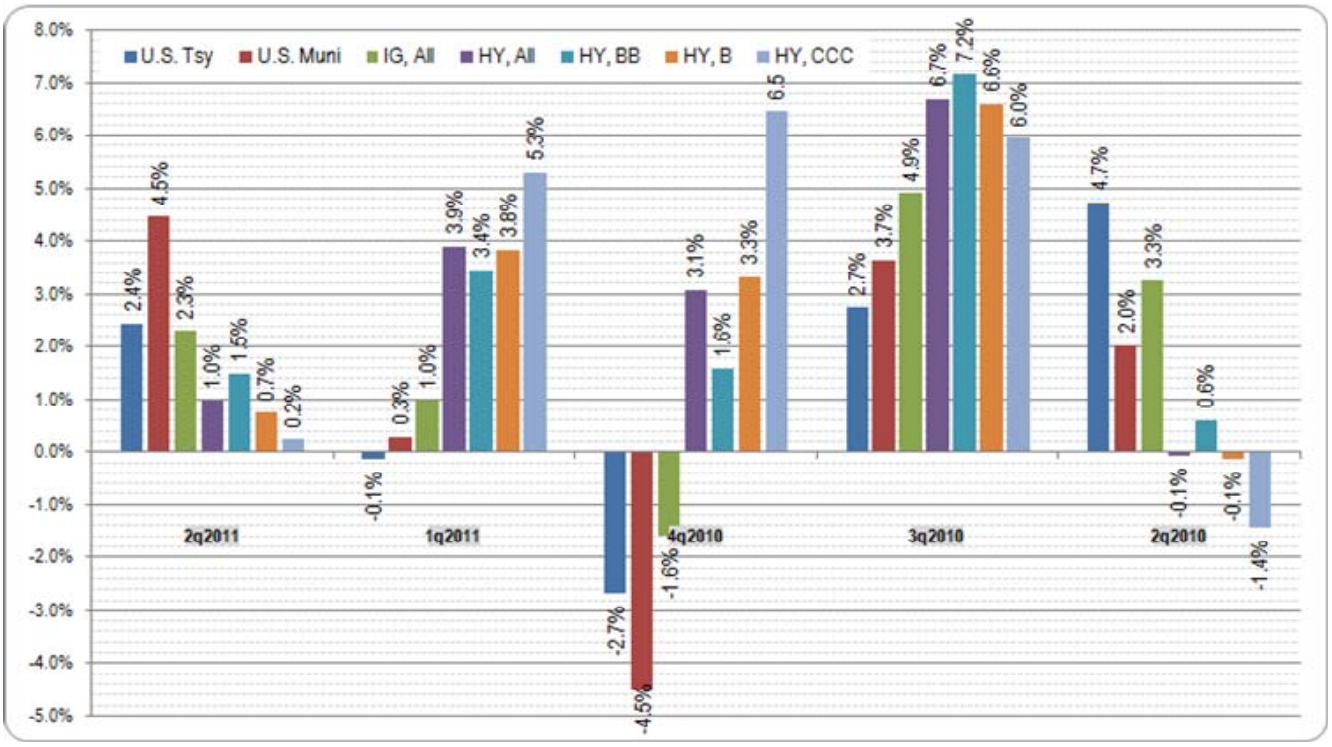
ECONOMICS AND FIXED INCOME

Fixed Income Market Performance

For the first quarter newsletter, we wrote:

> [T]he various classes within the fixed income market showcased the "risk on/risk off" nature of investor sentiment…Treasury bonds, for instance, performed better than corporate bonds each time a major geopolitical event roiled the world (risk off). Once those concerns were placated, though, market participants directed their attention back to securities with better return prospects (risk on).

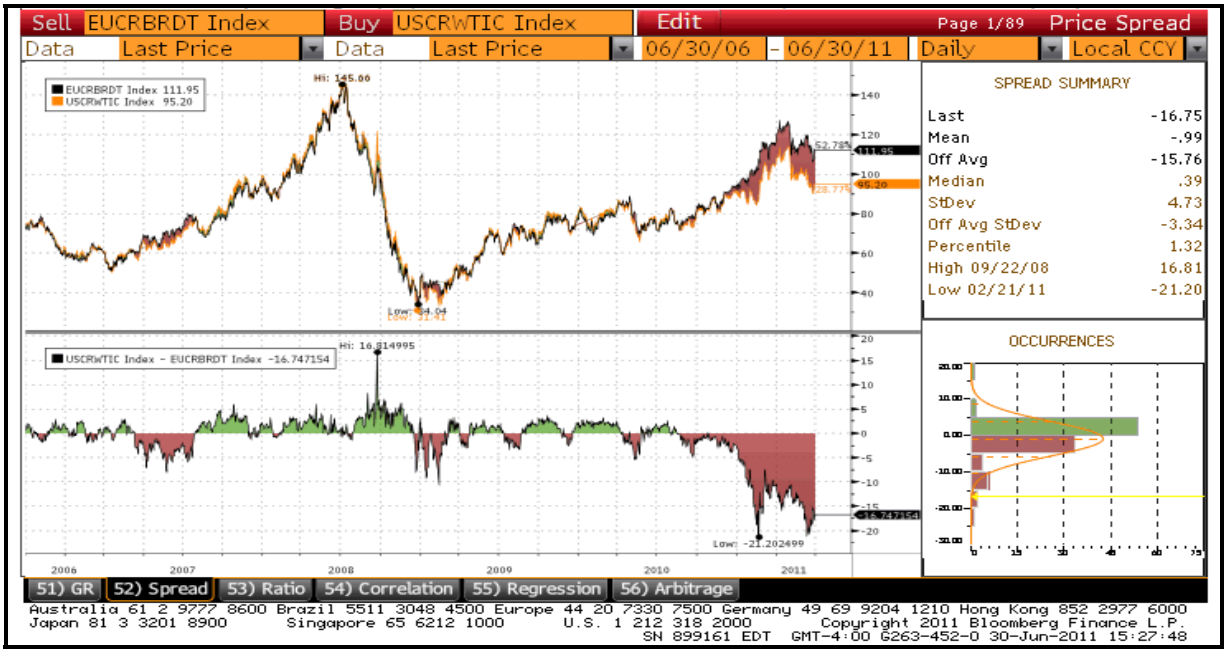
The risk-on/risk-off dynamic remained in force throughout the second quarter, although risk-off predominated. The cautious tone can be seen in the chart on the following page, as returns declined in-line with credit ratings, i.e., AAA U.S. Treasurys gained 2.4%, investment grade corporate bonds increased 2.3% and high yield bonds were up just 1% (note that higher quality BB-rated high yield bonds outperformed lower rated B and CCC bonds). Municipal bonds were the obvious standout sector of fixed income for the quarter. Muni bonds' gains likely occurred because 1) Treasury rates continued to decline and 2) states began reporting *increasing* tax receipts versus lower expense bases due to prior budget cuts. While there are still many fiscal issues to address at the state and local government level, the improving income picture lessens the possibility that there will be defaults en masse in the municipal bond sector and has led to some strategists recently to change their tone to a degree regarding such defaults.



Source: BOA-ML Indices, Wallington Asset Management

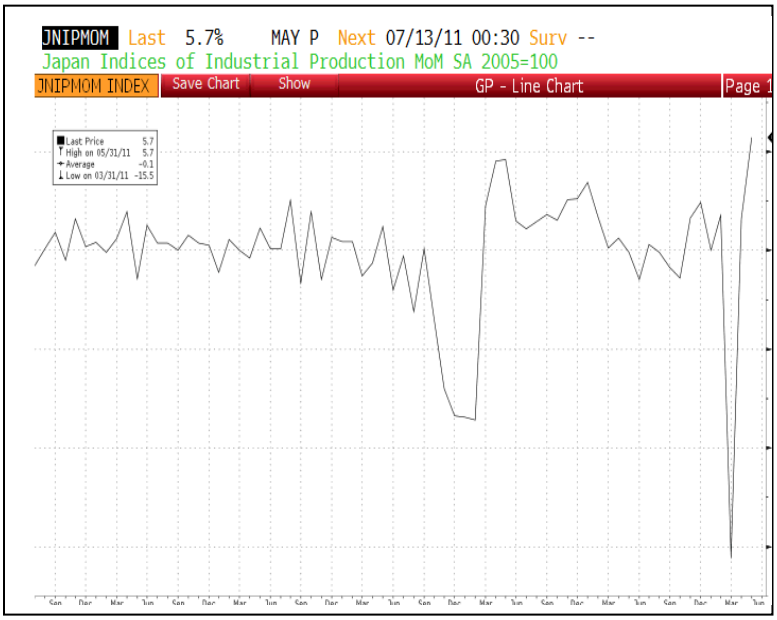
Index Construction - Redux

As stated earlier, sometimes the referenced index does matter, and this applies even in non-equity markets. For instance, consider the price of oil. In the U.S., the financial and general press overwhelmingly report the New York Mercantile Exchange's quote for a barrel of West Texas Intermediate (WTI) at the Cushing, Oklahoma oil supply hub. Oil is traded worldwide, though, so crude is priced at a variety of other hubs, including the Euro-area Brent Sea hub. WTI and Brent Sea crude prices are highly correlated, of course, but they do not move in lockstep. The bottom panel in the five-year chart below clearly illustrates that 1) WTI sometimes sells at a discount to Brent crude and sometimes at a premium, and 2) the discount or premium can vary widely over time. The large red section in 2011 represents a historically large discount of WTI crude versus Brent Sea crude, which is especially strange since WTI is a higher quality crude and Cushing is a well-known supply-chain bottleneck in North America. Nevertheless, the discount exists and raises the question of which index is the correct index. For U.S. refiners, WTI is the most likely candidate because that is the basis for their costs. For U.S. automobile fuel consumers, though, Brent Sea prices probably better reflect the experience at the pump.



Economic Pulse – Signs of Strength and Signs of Weakness

As the major macroeconomic data points disappointed time and again in the second quarter, sentiment turned negative, economic forecasts were rapidly reduced and headlines with the phrase "soft patch" or "slow patch" abounded. Professionals and enthusiasts alike debated whether the worse-than-expected data were caused by temporary factors like the tragedies in Japan or were signs of a looming recession related to long-term structural problems. Some of the economic data reported late in the quarter support the "temporary factors" argument.



Perhaps the most definitive sign came from Japan itself on June 29th when Japan's Trade and Economics Ministry reported that the May industrial production increase of 5.7% month-over-month (m/m) exceeded any other m/m gain since March 1953. This rise in factory output follows a 1.6% increase in April and a debilitating 15.5% decline in March when the undersea earthquake caused a tsunami and ultimately wrecked a nuclear power plant.

Additional encouraging signs:

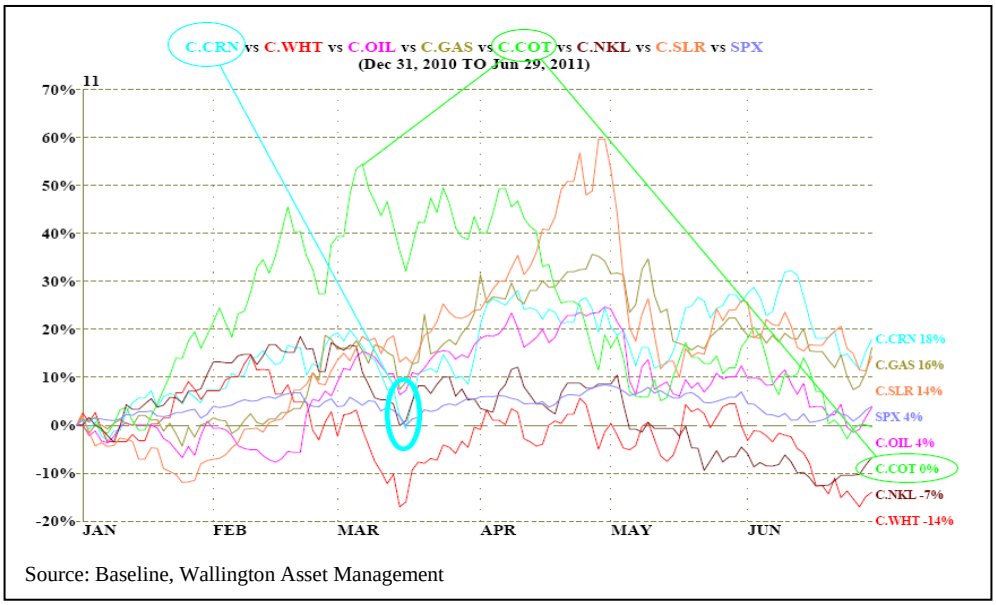
1. The Thomson Reuters/PayNet Small Business Lending Index for May gained 26% year-over-year (y/y), reaching its highest level since July 2008. Businesses typically use the loans tracked by the index to buy or update plant and equipment.
2. The latest durable goods report, released by the Department of Commerce, indicated a material pickup in new orders for U.S. manufactured goods. Orders rose 1.9% in May and April's decline was revised upwards to 2.7%. Furthermore, non-defense, ex-aircraft orders improved to +1.6% versus the prior reading of -0.8%.
3. On June 1, the ISM Purchasing Managers Index, derived from its monthly manufacturing survey, showed that all five components (new orders, production, employment, supplier deliveries and inventories) improved from the previous month.

Unfortunately, the Bureau of Labor Statistics' Nonfarm Payroll (NFP) report for June indicated that just 18,000 jobs were added in the country versus expectations of 100,000 to 125,000 (depending on the estimate source) and versus May's downwardly revised 25,000 value. ADP's better-than-expected reading from its jobs report earlier in the same week had raised expectations, so it heightened the pain of the disappointing NFP number. The net effect of the conflicting data was that pricing whipsaws occurred as each new piece of macroeconomic data prompted buying or selling of "risk assets".

The Rise and Fall of Commodity Prices…All in One Quarter

Although commodities were once only considered appropriate for those hedging input costs (Hershey's, Dow Chemical, etc.) and speculators, it is now an acceptable asset class under the rubric "alternative investments". The plethora of commodity-related exchange traded products (ETPs such as exchange traded funds and exchange traded notes) exemplify commodities' move to the mainstream. Reasons for commodities' growing popularity include:

1. Long-term Secular Demand Growth – In the energy space of the market, the familiar example of depleting oil reserves leading to higher prices appears reasonable to many. In the agricultural space, the growing wealth of China and India and the concomitant demand growth for various grains as people in those countries can afford to eat more protein appeals to a large number of participants, too.
2. Monetary Hedging – Precious metal commodity prices have greatly benefited from demand as a hedge against high inflation, hyperinflation, deflationary monetary spirals and/or end-of-the-world scenarios. Gold has been the primary investment vehicle, but some turned to silver during the first half of 2011.
3. Familiarity and Ease of Use – Prior to today's ETPs, participating in any commodities market often required a separate options account, learning an entirely new argot and the inherent use of leverage. ETPs opened commodities trading to a wider base because they are accessible to those familiar with trading ordinary equities.



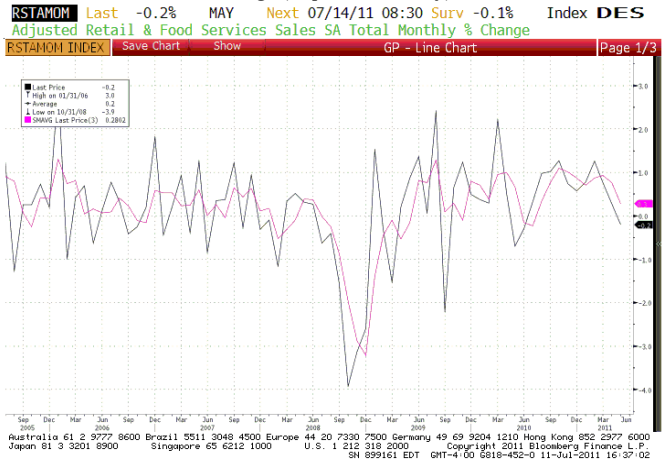
Source: Baseline, Wallington Asset Management

Price performance for the most-recent decade compared to large-cap stocks, especially right before and right after the Great Recession, also likely accounts for some portion of commodities' popularity. However, price changes over discreet time frames masks the inherent volatility of commodity prices, a volatility that can obliterate *actual* returns as prices rocket skywards and plunge precipitously. In the graph above, for instance, corn's price (C.CRN) increased 18% year-to-date through June 29th but only after giving back its entire 20% year-to-date gain in the first half of March, rebounding 26% in the following three weeks, losing 13% by mid-May, regaining 18% over the next month and finally sliding 25% by the end of the second quarter. Cotton's flat (0%) first half of 2011 return (C.COT) features even more dramatic gains and losses. Silver's rapid descent (C.SLR) should also be noted. In short, common equity volatility pales in comparison to commodity volatility.

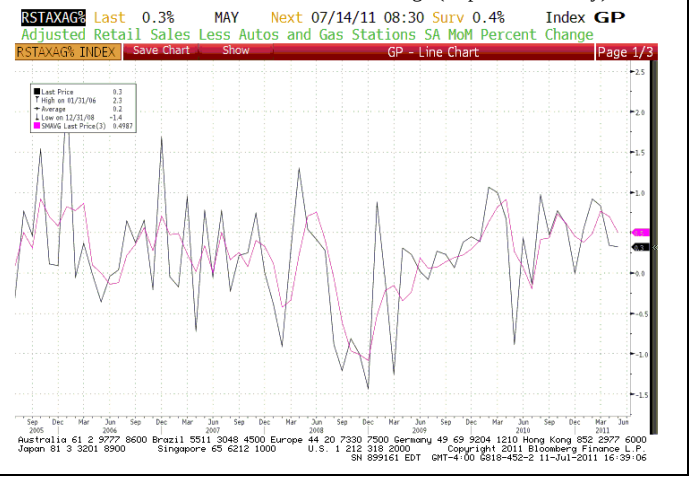
The Census Bureau's Retail Trade Surveys

Although three different sources report retail sales, including weekly indices from ISCS/Goldman Sachs and from Johnson Redbook, the Census Bureau sets the benchmark with its retail trade surveys.[1] Since its reports reflect 1/3 of consumer spending, which represents just over 2/3 of U.S. economic activity, market participants pay close attention to each revision the Census Bureau publishes. Some people fret about the m/m changes in total seasonally adjusted retail sales, as depicted in the graph on the left below. Others, however, find it useful to consider retail sales excluding automobile purchases and gasoline due to the latter two items' volatility. Very few market commentators seem inclined to spend much time discussing a smoothed average of the m/m changes, which seems wholly appropriate given both series' volatility (even after seasonal adjustments).

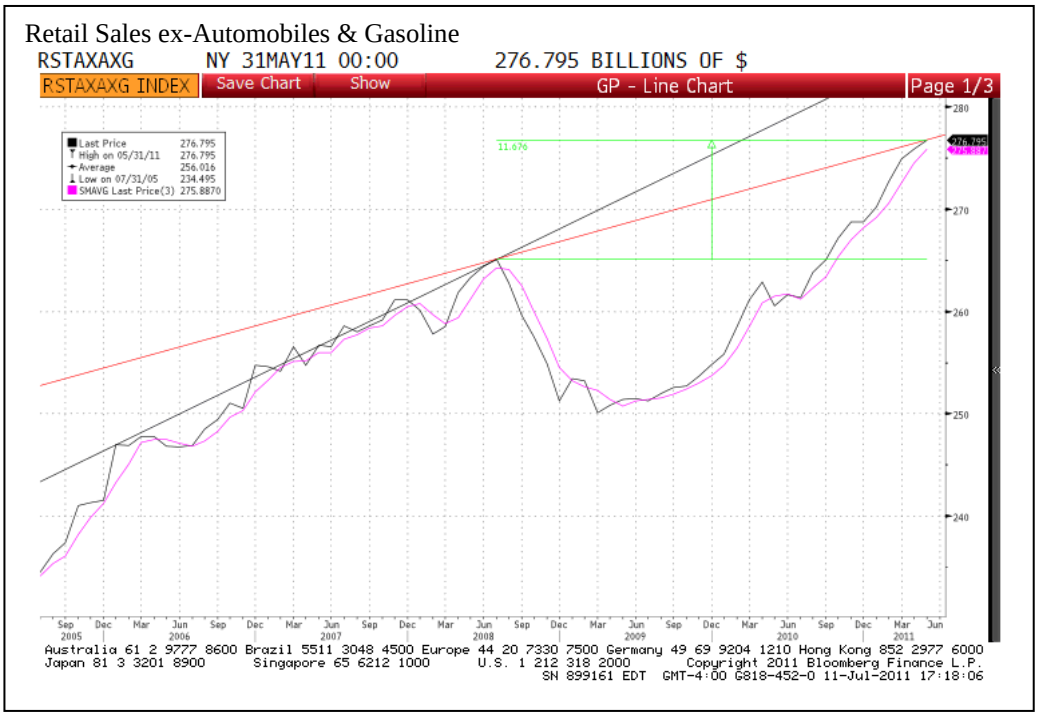
Total Retail Sales; M/M Change (Reported Monthly)



Total Retail Sales ex- Autos & Gas; M/M Change (Reported Monthly)



[1] The Census Bureau surveys approximately 5,000 retailers immediately after the end of every month in order to produce the *Advance Monthly Retail Trade and Food Services Survey* report – commonly known as the Advance Retail Sales report. It subsequently surveys another 7,500 retailers to create the preliminary and revised (final) *Monthly Retail Trade Survey* reports. In practice, data from each estimate are graphed as one series.



As useful as rate-of-change graphs can be, they sometimes hide surprising information that can be seen by simply graphing the original data. The accompanying chart of retail sales excluding automobiles and gasoline, for instance, clearly illustrates the continued upward trend for retail sales. In fact, the rate of increase in the index appears to be at least as fast as it was in 2010, which included the bounce from 2009's panic levels. In addition, and somewhat surprisingly, the index is $11.676 billion *higher* than its pre-Great Recession peak.

COMMENTARY: The End of the Ride on QE2

We have written in the past about Quantitative Easing (QE), a monetary tool used by the U.S. Federal Reserve (Fed) to stimulate a lethargic economy. The Fed's normal monetary tool is short-term interest rates, which it started to reduce in September 2007. From that point, the Fed lowered short-term rates until they approached zero by December 2008. It was a very aggressive move by the Fed but unfortunately it was not enough to stimulate the economy in rebounding from the very difficult financial crisis. The main reason was that the Fed was caught in what is known as a "liquidity trap", whereby plenty of liquidity existed in the system, but that liquidity was not spent by consumers, invested by corporations or lent by banks. The problem – a lack of confidence.

QE2 was announced by Fed Chairman Ben Bernanke in August 2010 whereby the Fed would purchase $600 billion of U.S. Treasury securities from November 2010 to June 2011. It was called QE2 because the Fed had already purchased more than $1 trillion worth of mortgage and Treasury bonds during the financial crisis in 2008 and 2009 to stabilize the system under QE1. Those purchases, which added liquidity to the system, unfortunately did not stimulate economic growth or employment sufficiently to reduce the unemployment rate, a key issue for the economy to prosper.

The goal of QE2 was to stimulate the economy through the wealth effect. By lowering long-term interest rates, all rates were supposed to come down, including mortgage rates and corporate bond rates. This was supposed to create wealth by increasing housing prices, stock prices and bond prices, which would create confidence so consumers and corporations would start spending again. Another objective of QE2 was to increase inflationary expectations in order to stimulate consumption; consumers would spend rather than wait to spend out of concern that prices would be higher later. Finally, an ancillary objective of QE2 in many people's opinions was to devalue the U.S. dollar. A devalued dollar makes exports more competitive, thus stimulating the economy, and imports more expensive, thus creating inflation.

QE2 did not come without risks. The biggest was that inflation could have reared its ugly head and exceeded the Fed's inflation target of 2%. Higher than expected inflation would certainly have raised interest rates and likely hindered economic growth, perhaps even to the point of creating another economic recession. Another risk of QE2 was that it could have created speculative bubbles in other markets such as commodities and gold. A third risk of QE2 was that the balance sheet of the Fed greatly expanded from a little over $800 billion in 2007 to $2.5 trillion today. If QE2 increased inflation and interest rates too much, the Fed could very well have been forced to sell bonds at a loss. Finally, since QE2 indirectly devalued the dollar relative to other currencies, it could have motivated currency wars and protectionist moves in international trade.

There has been much debate recently on how QE2 worked since it was announced in August 2010. The verdict is mixed, although we would contend that the results have been more positive than negative. Consumer confidence increased as the economy grew and stock prices increased leading to greater wealth as hoped for at the inception of the program. Long-term interest rates initially went up due to an improving economy and increased inflationary expectations. However, they came back down in 2011 as the U.S. economy slowed and unemployment remained high. Housing prices have continued to decline, but at a lower rate recently. QE2 caused the dollar to weaken for the most part and thus made exports more competitive to the benefit of U.S. multinational corporations. Coupled with a weak labor market, which is a significant input cost for corporations, and extremely low borrowing costs, the balance sheets of many multinational corporations were positively impacted as a result of QE2.

The U.S. Fed has not been alone in pursuing a QE strategy and it just may find that starting it ultimately proves to be a lot easier than ending it. The exit strategy has been unclear, even with the increased transparency under Fed Chairman Bernanke, and has created a lot of uncertainty about the direction of long-term interest rates and inflation. Since QE2 started, the Fed purchased 70% of all U.S. Treasury securities issued while foreign investors purchased the other 30%. What happens now that the Fed's buying power has been pulled? Who will fill the void if the Fed is no longer the major buyer? Bill Gross of PIMCO, one of the most successful bond managers in the U.S., sold all of the U.S. Treasury securities in his portfolio earlier this year, convinced that interest rates would rise with the end of QE2. That could prove to be difficult for the economy in the second half of 2011 and into 2012 and it certainly would be difficult for a continued troubling housing market, assuming mortgage rates are not artificially held lower in some manner.

If the markets efficiently process information, stock and bond prices should have reflected the end of QE2 well in advance of the end of the program. The early prognosis as seen during the second quarter was that the ending of QE2 would not be too dramatic. Further, even if interest rates rise now that the program has ended, it may not necessarily slow economic growth as long as interest rates stay under the long-term norm. A rise in interest rates could lead to a belief that the economy is improving and ultimately prove to be stimulative as long as they do not rise too far. However, if long-term rates increase dramatically because of inflation concerns, the Fed may have to tighten monetary policy by raising interest rates and selling securities purchased under QE1 and QE2. That scenario is not likely at this point but it is certainly one that has to be considered. The more likely scenario is one in which the Fed continues to hold securities purchased in QE1 and QE2 until solid economic growth is sustainable. Given the slowdown in economic growth that occurred as the second quarter progressed, it may be that the Fed not only holds the securities purchased under both QE programs so far, but that it finds the need to pursue QE3. That would certainly prove challenging for Chairman Bernanke, who has faced political ire for QE1 and QE2. It would also be a challenge for politicians, who have another issue of importance in front of them that needs to be addressed – the debt ceiling. The bond vigilantes will definitely be watching closely, just as they did with certain European sovereign debt.

"There are risks and costs to action. But they are far less than the long range risks of comfortable inaction."
*– **John F. Kennedy***

*"An ounce of action is worth a ton of theory." – **Ralph Waldo Emerson***

July, 2011