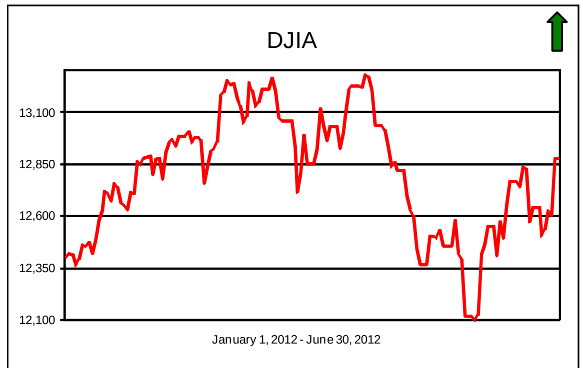
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

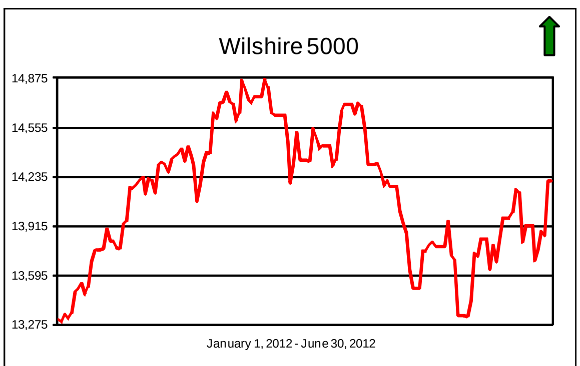
CAPITAL MARKETS SCOREBOARD

January 1, 2012 – June 30, 2012

2nd Qtr -2.7% YTD 9.5%

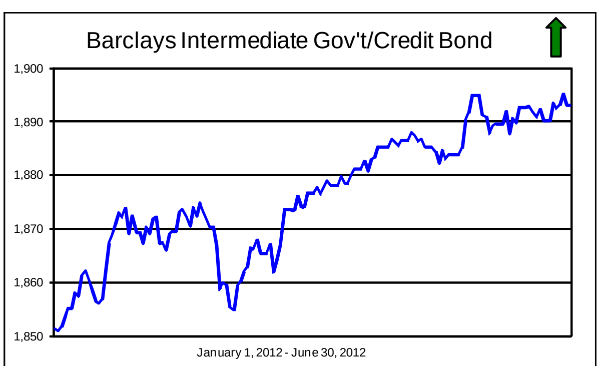


2nd Qtr -2.5% YTD 5.4%

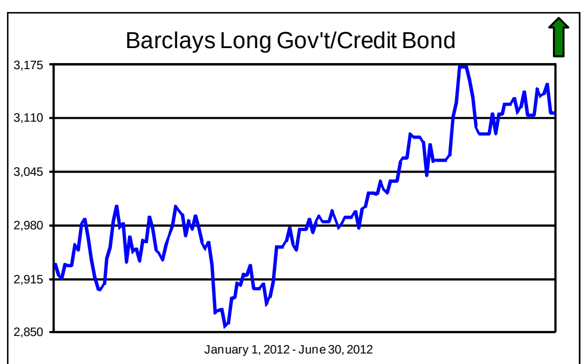


2nd Qtr -3.7% YTD 8.4%

2nd Qtr -5.1% YTD 12.7%



2nd Qtr 1.6% YTD 2.2%



2nd Qtr 9.3% YTD 6.9%

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EQUITIES

Equity Market Performance

The Standard & Poor's 500 (S&P 500) fell 3.3% excluding dividends in the second quarter, retracing about one fourth of its first-quarter gains. The pullback can be attributed largely to concerns about the overseas economies. Most prominent was Europe where the tight austerity programs being implemented have very likely resulted in a recession in Greece, Spain, Italy and the United Kingdom. The MSCI Europe Index lost 7.2% in U.S. dollar terms while the MSCI Emerging Market Index fell by 8.1%. Emerging market economies are extremely sensitive to higher energy prices and the sharp run-up earlier this year has heightened inflation concerns. The strongest sector in the U.S. was the Telecom sector, which returned 12.6% for the quarter. The Information Technology sector and the Financials sector were down approximately 7% in the second quarter on concerns that the economy will weaken further as the year progresses.

S&P 500 by GICS Sector	Price Return (%)	
	2Q12	**YTD**
Energy	-6.5	-3.4
Industrials	-4.2	6.1
Health Care	1.1	9.7
Consumer Discretion	-3.0	12.1
Materials	-4.8	5.3
Telecommunications	12.6	13.3
Information Technology	-7.0	12.7
Financials	-7.3	12.6
Consumer Staples	2.1	7.0
Utilities	5.5	2.6
S&P 500 Index	**-3.3**	**8.3**

Earnings Outlook: A High Hurdle

The vast majority of S&P 500 companies will report second quarter earnings during July, and the results may not be robust. According to Strategas, 65% of companies have had their earnings estimates revised lower by Wall Street analysts. However, the same analysts still forecast 8.8% earnings growth for 2012 and 12.3% growth for 2013. Fulfilling those expectations may be a tall order if final demand falters because it would undermine sales growth, causing companies to support fixed costs with a relatively lower base of revenue. However, as BCA Research noted, "…lower commodity prices and a stabilizing housing market are providing much needed relief to consumers. Homeowner's equity grew at its fastest pace in fifty years in the first quarter, eliminating the previous drag from the negative wealth effect." This consumer relief could provide the wherewithal to support corporate sales goals and, in turn, help support earnings.

	Sales Growth (%)		Earnings Growth (%)		Implied Margin
S&P Sectors	Level	Relative*	Level	Relative*	Growth
Technology	8.8	3.7	13.3	2.9	4.2
Consumer Discretion	7.9	2.8	15.8	5.4	7.3
Industrials	6.2	1.1	11.6	1.2	5.1
Materials	5.7	0.6	10.7	0.3	4.7
Health Care	5.5	0.4	5.2	-5.2	-0.3
Utilities	5.4	0.3	-2.1	-12.5	-7.1
Consumer Staples	4.5	-0.6	7.6	-2.8	3.0
Financials	4.0	-1.1	17.8	7.4	13.3
Telecom	3.0	-2.1	8.3	-2.2	5.1
Energy	1.1	-4.0	3.4	-7.0	2.3

Source: BCA Research using Thomson Reuters/IBES 12-month forward growth expectations
* Relative to the S&P 500

Facebook: Growing Profits or Just Growing Expenses?

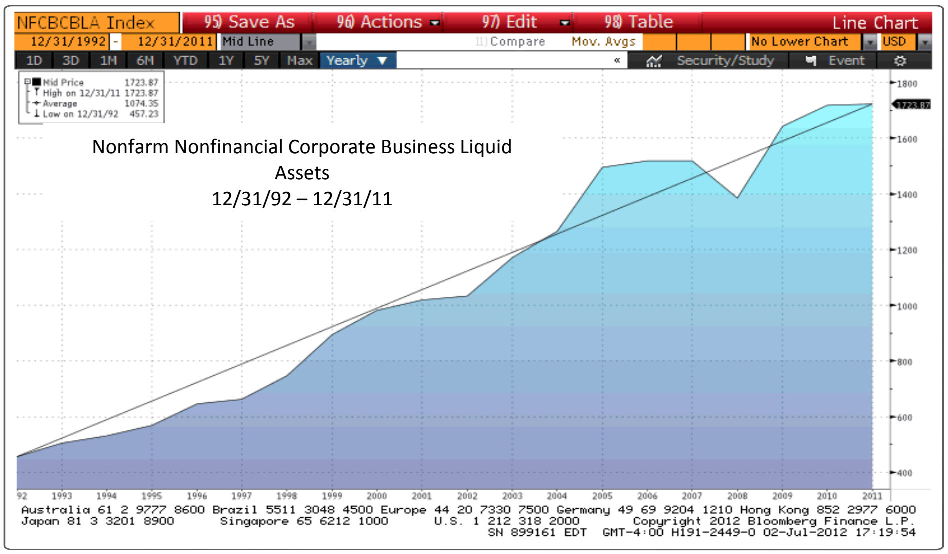
Facebook launched its initial public offering (IPO) in May with much fanfare. According to media reports, Mark Zuckerberg, the 28-year-old CEO, was targeting an IPO price of $45 per share in order to achieve a $100 billion market cap. The IPO was ultimately priced at $38 per share by Morgan Stanley on May 16th. Intraday, the stock briefly jumped to $44 per share and then proceeded to break the IPO price the very next day. Over the next two weeks, investors who bought the IPO suffered a loss of approximately 35% on concerns that earnings growth may have already started to slow at the firm. Wall Street analysts recently initiated research coverage on the stock with an average price target of $37.50, which calls into question the validity of pricing the IPO at $38 per share. There are several

Source: Stockcharts.com

observations from this debacle. First, the sellers of the shares (which include the seed investors and the management) usually have much more information about earnings trends than those on the outside. If these investors are willing to part with their holdings, they will ideally do so at the point where value is maximized. Second, the underwriters of the firm (who are selected by these very same people) receive a commission based upon the total value of the IPO; hence the more money that is raised in the IPO, the bigger the bonus checks will be for the investment bankers. The first social website, Myspace, was acquired by News Corp. for $580 million in July of 2005. One year later, the website became the most visited website in the U.S., only to be overtaken by Facebook two years later. Myspace was ultimately sold for $35 million in 2011 and was recently ranked 161st in terms of website traffic. At a recent market capitalization of $67 billion, Facebook is valued at 100x trailing earnings and ranks among the top 100 companies in the world by market capitalization. While Facebook's traffic is likely to continue to grow, so will their costs. The big unknown is whether their revenues will keep pace with these escalating costs. Recently, General Motors (a large customer) indicated that their advertising spending on Facebook had achieved a lower rate of return than other forms of advertising, which calls into question the growth potential of one of Facebook's prime revenue sources. In a market where investors demand short-term results, Facebook investors may have a long and bumpy road ahead of them.

Corporate Cash

Near the end of June, Bloomberg News reported that the non-financial company members of the S&P 500, in the first quarter of 2012, reduced their collective cash balances for the first time since mid-2008. Bloomberg based its story on data disseminated by Howard Silverblatt, a senior index analyst for S&P, as well as capital expenditure data compiled from its own Bloomberg Professional service. Mr. Silverblatt reported that non-financial company cash declined 1.4% to $1.01 trillion, while Bloomberg data showed that capital expenditures increased 3.3% during the same period. On the other hand, the Wall Street Journal (WSJ) published a story on June 11th citing the Federal Reserve's (the Fed) latest Flow of Funds report, which showed cash balances at non-financial companies increased $12.6 billion to $1.74 trillion from $1.73 trillion in the first quarter of 2012. The WSJ report also noted that the $1.73 trillion value had previously been reported as $2.23 trillion, or $500 billion higher. This discrepancy is the result of measuring different data sets, utilizing different measurement methods and the Fed's use of preliminary or estimated data that is subject to revisions. Based on this information, it seems fair to conclude that companies have stopped accumulating cash at the same pace they did just after the most worrisome days of the Credit Crisis, while acknowledging that the largest corporations may have actually started spending again.



Source: The Bloomberg

Risk-on/Risk-off Trades

"Risk-on" and "risk-off" are increasingly popular terms in the financial media today that refer to the rapid flow of capital between risk-free and risky assets. Risk-free assets are generally financial instruments that offer a very high probability of receiving one's original capital back along with a predictable (even if very low) and consistent cash flow, irrespective of the economy. These instruments are typically thought to be less volatile in price. U.S. Treasury bills, U.S. Treasury notes and certificates of deposit are good examples of risk-free assets. Risky assets offer the opportunity to earn higher average returns but with more price volatility, greater competitive concerns and more sensitivity to the economy. Companies that manufacture automobiles, operate in emerging markets or lend to consumers with low credit scores are all good examples of riskier investments. The recent uncertainty in Europe has resulted in a "risk-off" trade: i.e., a sell-off of overseas assets and high-yield bonds and a mad dash to buy the U.S. dollar, U.S. Treasury bonds and "safe" dividend paying stocks. Even so, the slightest good news out of Europe or about the U.S. economy could result in a "risk-on" trade: i.e., extreme inflows into "risky" assets and out of "risk-free" assets.

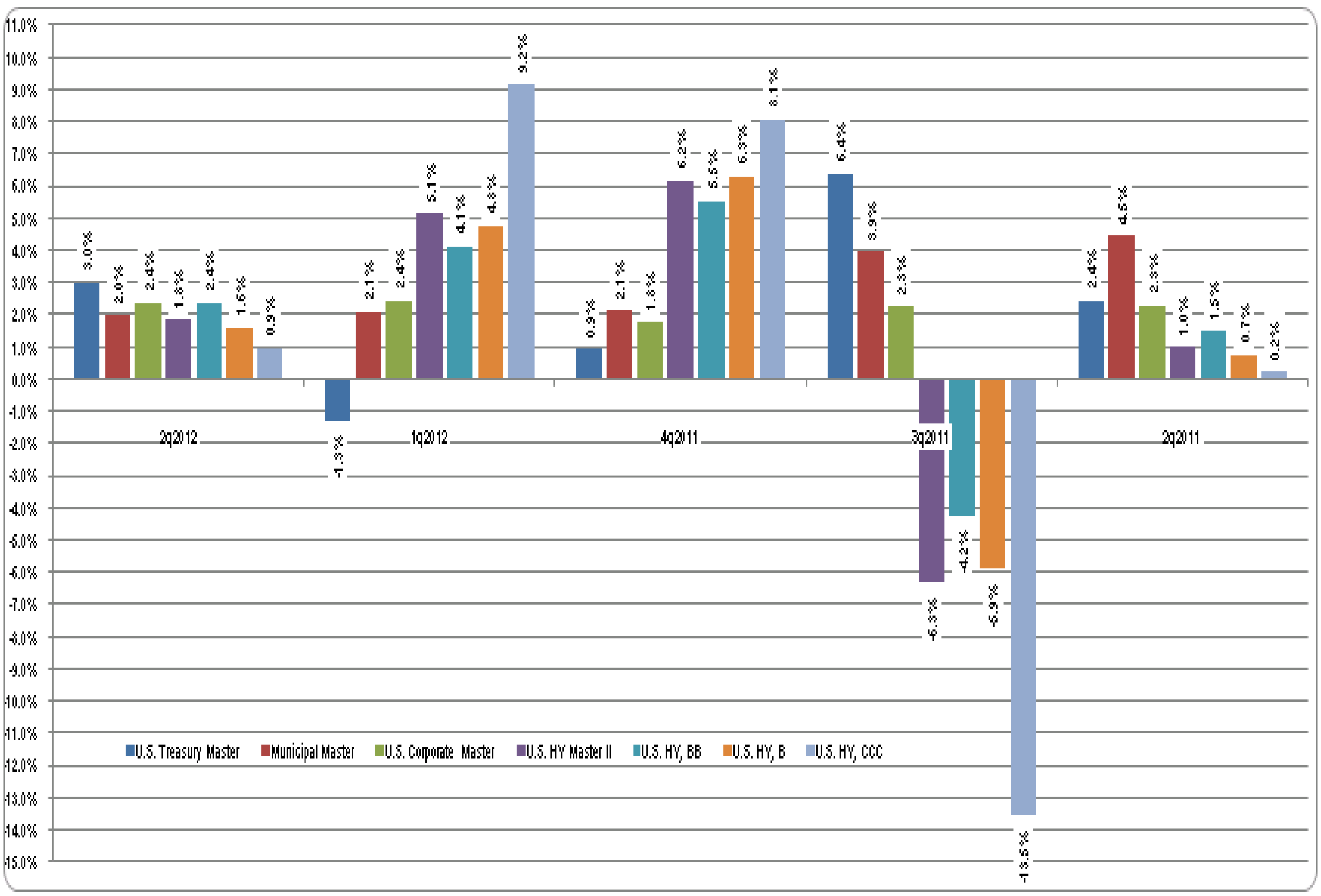
JPMorgan's Risk Management Fails

JPMorgan announced a potential loss of up to $2 billion dollars as a result of a poor hedging strategy executed by its London operations. Because of the massive flow into bank deposits and away from money markets, banks have been flooded with more cash than they could (or would be willing to) lend. Some of this cash has been invested in more exotic fixed income strategies that fluctuate day-to-day with the markets. JPMorgan's actual loss has the potential to grow larger since many of the positions that the company is attempting to unwind are illiquid. Regulators and politicians around the world continue to debate whether the largest banks have become too large to manage.

ECONOMICS AND FIXED INCOME

Fixed Income Market Performance[1]

The broad fixed income categories featured quite a bit less performance disparity in the second quarter of 2012 (2q2012) compared to any of the previous four quarters. Obligations of the U.S. topped the fixed income space in the quarter by returning 3% versus 2% for municipal bonds and 2.4% for both investment grade (IG) and high yield (HY) corporate bonds. The relatively homogeneous returns this quarter likely reflect a heightened degree of uncertainty, as some investors sought safety at all costs (a benefit to Treasury prices) or yield (a benefit to lower-rated corporate bonds).



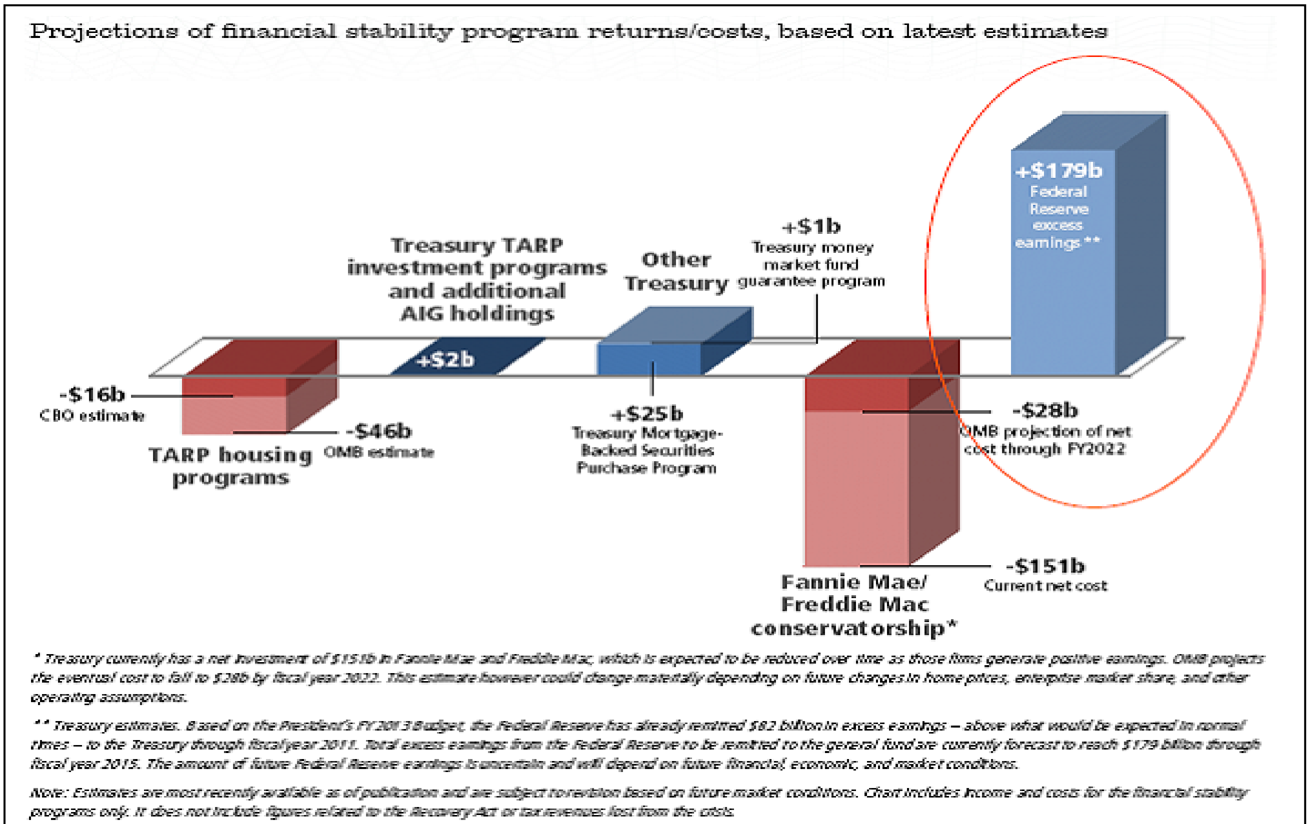
Sources: Bank of America-Merrill Lynch, The Bloomberg

Credit Crisis Bailout Costs

The U.S. Treasury recently reiterated its stance that 2008's Troubled Asset Relief Program (TARP) would likely cost taxpayers nothing in dollar terms and possibly even generate a profit. This claim is somewhat startling since early loss estimates for TARP ranged from about $350 billion to $24 trillion. In light of the funds repaid and earnings on funds disbursed, the Treasury might be right. Consider: the largest U.S. banks (Bank of America, Citigroup, JPMorgan Chase and Wells Fargo) have repaid the funds lent to them during the crisis and AIG, once considered a financial black hole, is on track to completely repay the $67.8 billion lent to it by the Treasury (which excludes the $110 billion loan it repaid to the Federal Reserve). Although a large number of small financial institutions may collectively cost the Treasury less than $5 billion, the undeniable

[1] As measured by Bank of America-Merrill Lynch's fixed income indices.

loss-makers are GM and Chrysler, both of which filed bankruptcy. Chrysler, now part of Fiat, repaid $11.1 billion of the $12.4 billion lent to it; the Treasury does not expect to ever receive the other $1.3 billion. GM, in contrast, needed nearly $50 billion to



Source: U.S. Department of the Treasury, *The Financial Crisis Response In Charts;* April 2012

ensure its continued existence. The Treasury ended up holding 912.4 million common shares as well as preferred shares of the "New" GM that emerged from bankruptcy. It subsequently sold 412.3 million common shares as well as its preferred shares, bringing in $13.5 billion and $10.5 billion to the Treasury, respectively. The Treasury's bailout of Fannie Mae and Freddie Mac remains active, with current cost estimates exceeding $100 billion. Note that the Fannie and Freddie bailouts are conducted under a program completely separate from TARP, though.

The Volcker Rule

"At the heart of the Volcker rule is a simple notion: Banks cannot trade with their own funds. Such transactions are known as proprietary trading." -- Bloomberg News, 06/27/2012

"The [Volcker] rule proposal [drafted by financial regulators] said drawing the line between prohibited and permitted trading 'often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice.'" -- Reuters, 10/11/2011

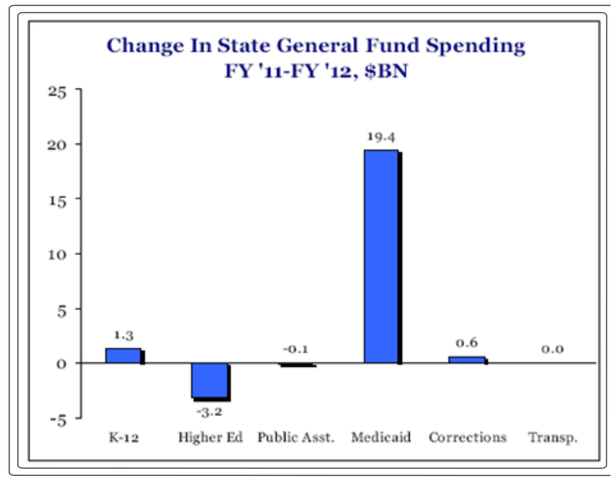
In the aftermath of the Credit Crisis, former U.S. Federal Reserve Chairman Paul Volcker proposed that Congress severely restrict U.S. banks' ability to enter into speculative trades using the banks' own money. Curtailing this proprietary trading by financial institutions that can access the Federal Reserve's liquidity support facilities seems like a good decision given recent events, yet the Senate never voted to include the so-called Volcker rule in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Instead, the Volcker rule became part of Federal law when it was inserted into Dodd-Frank during the House-Senate conference committee meeting.

Implementing what appeared to be a straightforward idea has proven quite complicated. For example, the 298 page proposal required by §619 of Dodd-Frank features 215 pages for the preamble, nearly 400 footnotes, needed approval from five different regulators and prompted 393 questions from the regulators to interested parties in order to clarify certain issues. The proposal devotes just three sections to defining proprietary trading, despite (or perhaps due to) also acknowledging the difficulty of discerning a proprietary trade from allowable trading activity. The allowed activities, "trading on behalf of customers", "risk-mitigating hedging activity" and "underwriting and market-making activities", are exceptions to the proprietary trading ban in order to facilitate the smooth functioning of financial markets. The allowed activities *are not* *allowed* if they involve a "…material conflict of interest…or if they threaten the safety and soundness of banking institutions or U.S. financial stability." Essentially, only intent separates an allowed trade from prohibited trade.

Although the conformance period begins July 21, 2012, the final rule has not yet been issued by financial regulators because of the problems involved in the rule-making process. As a consequence, the Fed issued a statement in April indicating that regulated institutions can continue making proprietary trades until the "full-out ban" becomes effective on July 21, 2014, as long as the companies "engage in good-faith planning efforts" to comply with the Volcker rule in a timely manner. Even the deadline for compliance is confusing.

State Budgets and the Supreme Court of the United States' ACA Decision

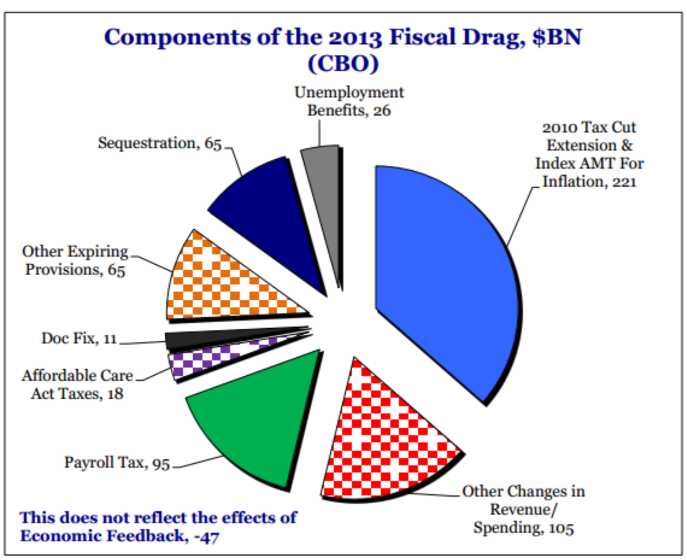
The Supreme Court of the U.S. upheld the Constitutionality of the Patient Protection and Affordable Care Act's "individual mandate" provision. The law, a.k.a. the ACA, also included a provision tying funds from Federal tax dollars to expanding Medicaid to anyone earning up to 133% of the income level that defines the poverty line. The Court did not allow the ACA's Medicaid provision to stand though, indicating that forcing expansion was beyond Congress' ability to regulate interstate commerce. States are free, then, to either opt in to the new system or continue operating under the previous program. Although expansion under the ACA is heavily subsidized, some state governments may choose to forego the Federal government's largesse due to budget constraints. For example, state tax revenues that had been rising rather rapidly have begun to rise less quickly. In addition, states have been passing relatively restrained budgets since the Credit Crisis. As the event slowly fades into the past, pressure to implement broad-based spending increases has increased. The source of state government spending fund increases in fiscal year 2012 (FY2012) may be an especially important factor. As the graph shows, state governments, in aggregate, increased spending in just one major budget area in FY2012 – Medicaid, which jumped $19.4 billion.



Source: Strategas Research Partners

The Fiscal Cliff: The Can May Be Too Big to Kick

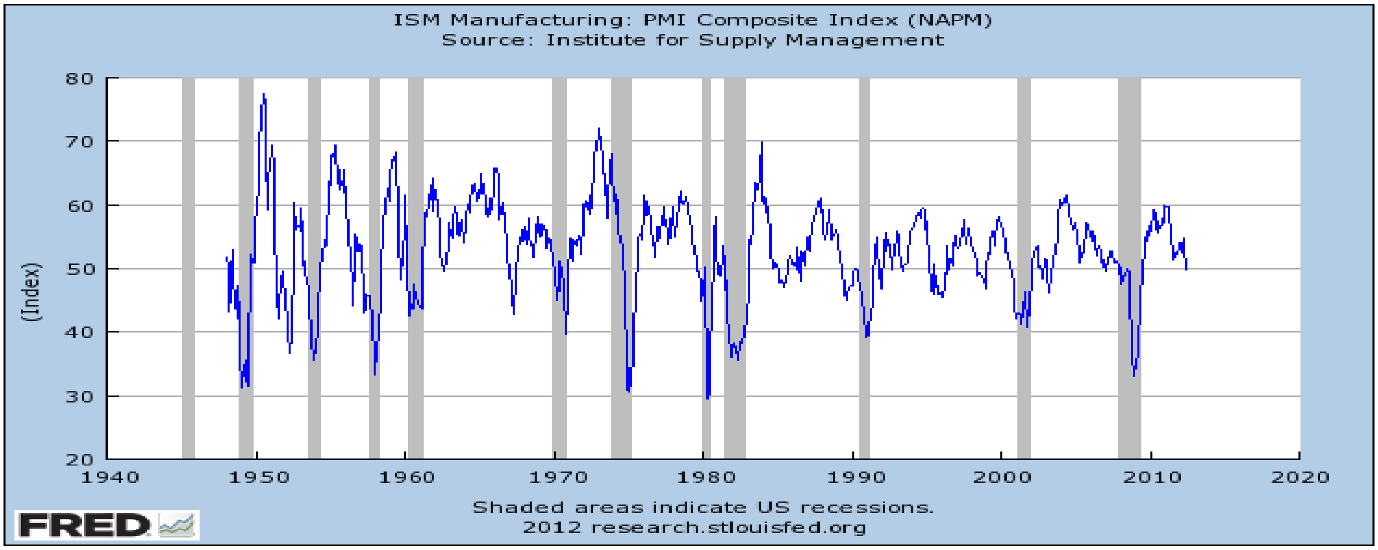
The "Fiscal Cliff" refers to the simultaneous expiration of major fiscal policies designed to boost the economy over the last 10 years. Many of these stimulus packages are set to expire on January 1, 2013, at which point consumers and businesses will pay an additional $335 billion in taxes, the unemployed will lose $26 billion of benefits and businesses will lose $239 billion of revenues from government contracts. The combined headwind in 2013 is projected to be 3.5% of Gross Domestic Product. Considering that the economy is growing at 2% per year, a 3.5% hit to the economy risks throwing the U.S. back into a recession. As a result of this future uncertainty, many companies, such as those that depend on defense spending, have already started to defer hiring and capital expenditures. Both S&P and Moody's have indicated they will monitor the political situation closely and would view a less-than-bipartisan approach to solving the U.S.' fiscal issues as a reason to downgrade the credit rating of the U.S. government. The good news is if Congress does nothing by the end of the year, the deficit may start to shrink on its own. The bad news is if a recession ensues, politicians may demand even more government stimulus and even higher deficits.



Source: Strategas Research Partners

The ISM Index

The Institute for Supply Management (ISM) Manufacturing Index for the month of June dipped to 49.7, the lowest level in 3 years. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. Economists start to worry about a recession when this important leading indicator slips under 50. The Economic Cycle Research Institute recently reconfirmed their expectation that a recession may have started in the second quarter of 2012. While these concerns are not to be discounted, the chart below indicates that the ISM Index has dipped below 50 on 12 occasions in the last 60 years without immediately leading to a recession. Indeed, a slowdown after a recovery phase is to be expected and may be an indicator that the economy is shifting gears towards an economic expansion. Recessions are usually identified 2 quarters after they begin, so the data over the balance of the year and revisions to the reported data will be closely watched by the Federal Reserve, in particular. An indication of a material deceleration in the economy may prompt additional accommodative policy from the Federal Reserve in the coming months.



COMMENTARY: Slow Growth Trumps No Growth

June 2012 marked the third anniversary of the end of the Great Recession, the most severe of the 11 U.S. recessions since WWII – although the 1981-82 recession was comparable. Conventional wisdom is that the strength of an economic recovery is related to the depth of the recession; deeper recessions lead to stronger recoveries. That wisdom has certainly not proven prophetic three years into the current U.S. economic recovery as growth in real (inflation adjusted) Gross Domestic Product (GDP) has been 2.4% since July, 2009, the start of the recovery. This is about one-half of what real GDP growth would normally be three years into an economic recovery and lags the longer-term (1997-2007) U.S. GDP growth rate of 3.4%.

Growth in employment, albeit slow, appears to be faring better than GDP growth as the unemployment rate has dropped from a peak of 10.1% to 8.2% today. However, those statistics are misleading. During the Great Recession, 8.8 million jobs were lost while only 4.5 million jobs have been created so far during the recovery. Thus, there are fewer jobs in the U.S. today than in December 2007 when the recession started. In spite of fewer jobs, the unemployment rate dropped because of the decline in the civilian labor participation rate. This rate measures the number of people (16 years of age and older) who are working or looking for work versus the number of people in the total population. While the potential number of workers has increased during the recovery, the number of workers leaving the workforce has increased even more. As a result, the labor participation rate dropped from a peak of 67.3% in 2000, to 65.7% when the recession ended, to the current rate of 63.8%, the lowest level since 1981-82. A continued decline is unusual in an economic recovery because more people, not less, usually seek employment as the economy improves. So where have all the workers gone? Some of the baby boomers (those born between 1946 and 1964) may be retiring early, marginal workers (those who worked less than 6 months the previous year) may not have entered the workforce because of slow job growth and stagnant wages, and more potential workers are opting for government subsidies. Medicaid spending, disability payments and food stamp usage have all risen sharply in recent years. The reality is that no one truly has a good grasp of the numbers and exactly why people are leaving the workforce.

There are multiple reasons why the U.S. economic recovery continues at a below average pace. First, the Great Recession was caused by the severe financial crisis of 2007-2008. Households have been forced to pay down debt (deleverage), and banks have had to increase their capital base by extending less credit. Evidence shows that recoveries from financial-caused recessions are slower than from other recessions because of the deleveraging that has to occur. This deleveraging process will take more time to work its way through the system, so expectations are that slow economic growth in the U.S. will likely be the norm at least for the next few years.

As the experience of Japan has demonstrated, asset bubbles such as in housing can impede an economic recovery. U.S. home prices have fallen about one-third from their 2006 peak because of the speculative bubble in housing prices and the over-supply of houses. Usually construction, housing and commercial, leads an economy out of a recession, but that is not occurring this time. Construction jobs in the U.S. are still nearly 30% below their peak. Until housing prices stabilize and the excess capacity is worked down, this important segment will continue to be a drag on the economy.

The U.S. corporate sector is sitting on nearly $1.7 trillion in cash and cash equivalents and they are investing less in plant and equipment than normal in an economic recovery. This reluctance to invest has been due to problems in the Eurozone, a slowdown in China, regulatory reform, healthcare costs (including the Patient Protection and Affordable Care Act), the so-called fiscal cliff facing the U.S. in 2013 when the Bush tax cuts expire and mandatory spending cuts to the U.S. budget take place, and escalating public-sector debt. Corporations' hesitancy to invest coupled with gains in productivity are the primary reasons why the number of manufacturing jobs in the U.S. is still more than 15% below its 2007 peak.

What can be done to stimulate the U.S. economy to a faster pace of growth is an important issue facing policymakers and investors today. Monetary policy has essentially played out with historically low interest rates, several rounds of quantitative easing, excessive bank reserves, and massive amounts of liquidity. There also continue to be strong political headwinds against further stimulation as the effectiveness of Chairman Bernanke's aggressive stance toward monetary policy in response to the Great Recession has been called into question many times. Fiscal policy is constrained as the U.S. has already borrowed more than $5 trillion to cover fiscal deficits since the start of the Great Recession. Some may argue that there has not been enough stimulus, but $5 trillion has resulted in GDP growth of less than $1 trillion. The bond markets are closely monitoring public-sector debt and will quickly raise bond yields if government debt and deficits appear unreasonable. What the U.S. economy may need more than anything is confidence. Confidence that government can control spending and deficits, that consumers can spend and in the process not take on too much debt, that banks can provide credit again but also manage risk, and that regulatory reform is reasonable and not anti-business. Otherwise, it is difficult to see what will get the U.S. economy back to a normal growth rate and off its present path. With such tepid growth, the economy is more susceptible than otherwise to falling into another recession and not making it to a fourth anniversary. Time will tell, but it would certainly help for the leaders of this country to put their partisanship aside to come up with creative solutions to bring confidence back into the economy. In so doing, the U.S. would once again prove its resiliency as it has done so many times in our history and allow our country to have one of the highest standards of living in the world. Also, we all need to keep the slow growth recovery in perspective. While there are countries such as China and India which are growing faster, the U.S. economy does not appear all that bad when considering many economies across the globe. No doubt this is one of the major reasons behind the outperformance of the U.S. stock market recently compared to most international markets. This is in spite of many U.S. investors leaving equities altogether the past couple of years after two severe bear markets since early 2000. However, as BCA Research recently alluded to in their research report entitled "Nearing The End of The Secular Bear Market in Equities?", many of the characteristics of the financial markets today suggest we are much closer to the end of the secular bear market in equities than the beginning just as we are much closer to the end of a secular bull market in bonds than the beginning. This is not to suggest that the investing climate will get any easier in the near term as secular transition periods can be volatile and take time to pass. They often serve to seriously test the fortitude of investors. Just as with the economy, an increased dose of confidence would certainly help investors maintain the discipline necessary to be successful, long-term, in the financial markets; particularly if volatility increases as BCA Research suggests; particularly if equity prices grow at a pace that does not match their recovery from the bear market of 2007-2009 or, for those who have a longer memory, the pace of the roaring decade of the 1990s.

"There are no great limits to growth because there are no limits of human intelligence, imagination, and wonder."
– Ronald Reagan

July, 2012