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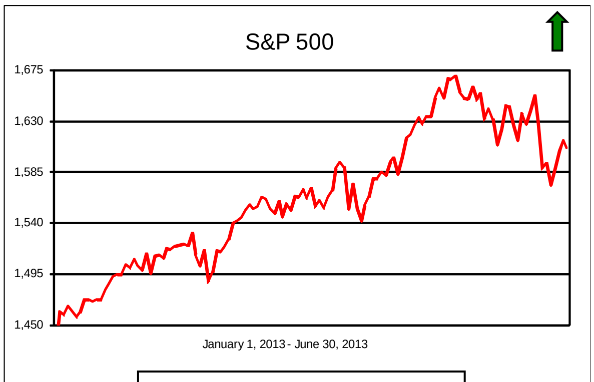
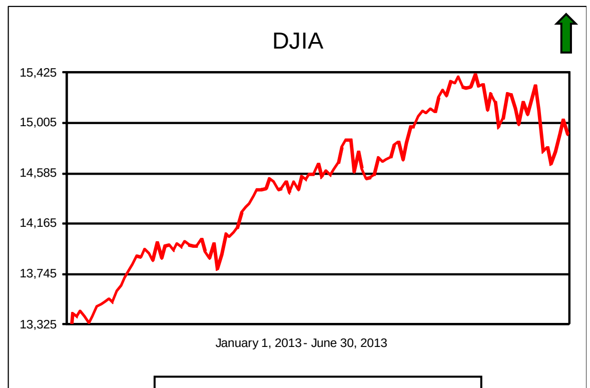
INDEPENDENT INVESTMENT COUNSEL
25 · YEARS · 1988 2013

CAPITAL MARKETS SCOREBOARD

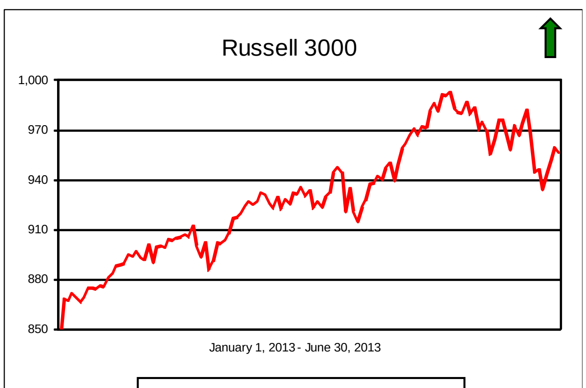
January 1, 2013 – June 30, 2013



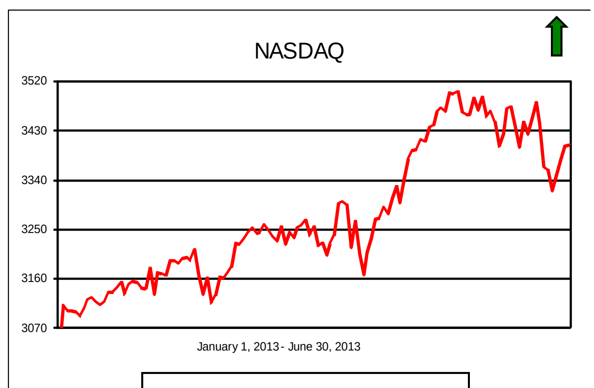
2nd Qtr 2.9% YTD 13.8%



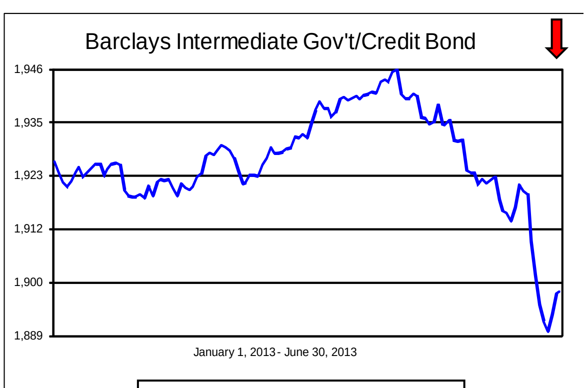
2nd Qtr 2.9% YTD 15.2%



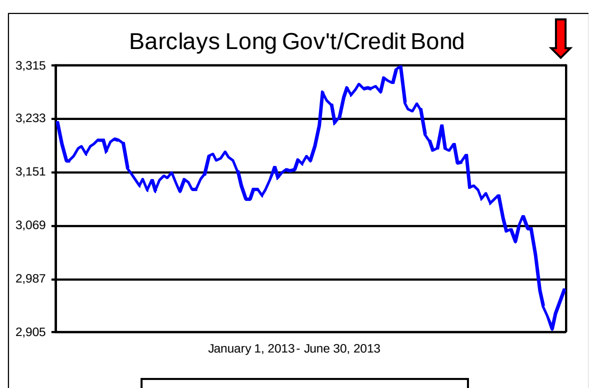
2nd Qtr 2.7% YTD 14.1%



2nd Qtr 4.5% YTD 13.4%



2nd Qtr -1.7% YTD -1.45%



2nd Qtr -6.11% YTD -8.00%

Performance Numbers Reflect Total Returns

8900 Keystone Crossing, Suite 1015 • Indianapolis, IN 46240
www.wallingtonasset.com

EQUITIES

U.S. Equity Market Performance

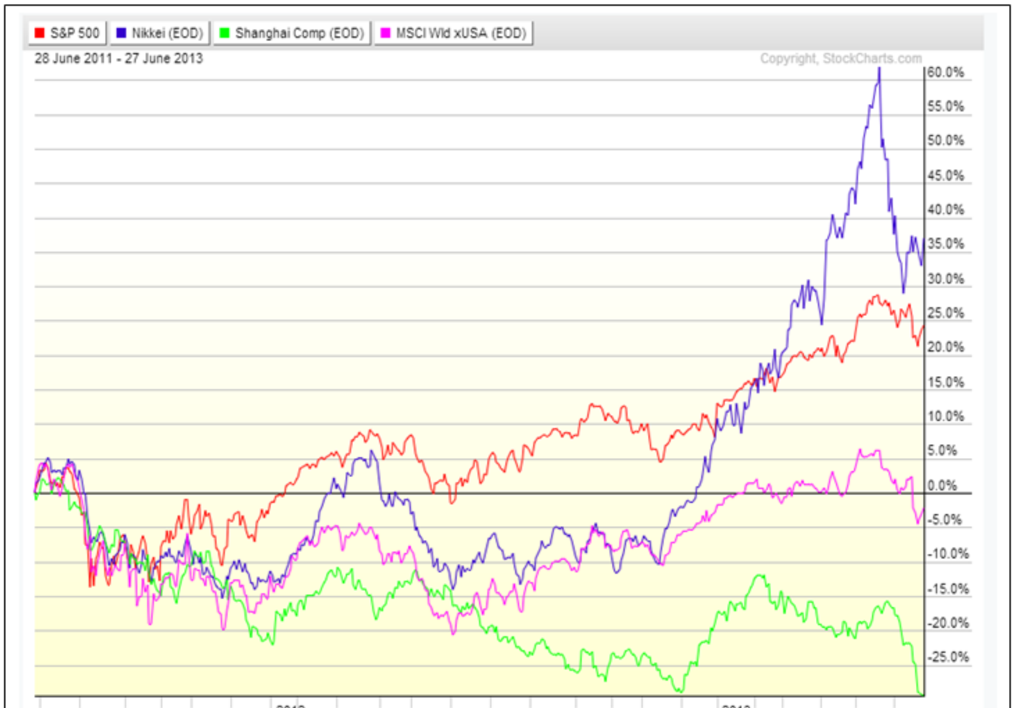
Despite the volatility in June, the Standard & Poor's 500 (S&P 500) index delivered a total return of 2.9% for the quarter. The Financials, Consumer Discretion, and Health Care sectors continued to outpace the market for the second quarter in a row. The three weakest sectors were Energy, Materials, and Utilities, as investors were concerned that the rise in interest rates during the quarter would choke off economic growth.

S&P 500 by GICS Sector	Price Return (%)	
	2Q13	**YTD**
Financials	7.3	19.5
Consumer Discretion	6.8	20.0
Health Care	3.8	20.2
Industrials	2.8	13.8
Technology	1.7	6.4
Telecom	1.0	10.6
Staples	0.5	15.2
Energy	-0.4	9.8
Materials	-1.8	2.9
Utilities	-2.7	10.0
S&P 500 Index	**2.9**	**13.8**

From January through May of 2013, the Dow Jones Industrial Average (DJIA) posted a positive return for 20 Tuesdays in a row. Ryan Detrick, Chief Technical Analyst at Schaeffer's Investment Research, highlighted that this marked the longest winning streak for any day of the week since 1900. According to CNN, this streak perhaps can be explained by the growth of computerized trading strategies. Some have also noted the U.S. Federal Reserve Bank (the Fed) has a tendency to concentrate its purchases of Treasury securities on Tuesdays, which may have resulted in the greater demand for equities.

Global Equity Performance

The U.S. stock market has outperformed most foreign markets over the past two years as many international economies have stumbled. Europe has been in a mild recession after implementing aggressive austerity policies in the U.K., Spain, Greece, Italy, Ireland, and Portugal, while India and China have tightened monetary policy to rein in inflation. The resulting slowdown in the European and Asian economies has impacted the demand for commodities and the economies of commodity-producing countries such as Canada, Brazil and Australia. The one notable outlier on equity performance has been Japan, where the stock market has moved higher since November of 2012. This has been principally because of the aggressive economic policy approach taken by Japanese Prime Minister Shinzo Abe. Many companies in the poorer performing markets have started to respond to shareholder angst by cutting expenses, pursuing new avenues of growth, and adopting more shareholder friendly dividend and stock buyback policies. Also of note, governments in some foreign countries have begun taking steps to rein in government spending and have introduced various programs that encourage companies to expand hiring and capital expenditures. As a result, some forecasters are now predicting global growth will improve modestly in the next 12-18 months, although the International Monetary Fund recently reduced its expectation for global growth. One key challenge for many international economies is the prospect of lower housing construction activity as many governments are worried that housing prices have reached bubble-like proportions.



Source: StockCharts.com

Earnings Review and Outlook

Despite anemic economic growth in the U.S. and around the world in recent years, S&P 500 companies managed to deliver robust earnings growth in 2010 and 2011. This was accomplished in large part by paying down or refinancing high-cost debt, enhancing productivity and/or reducing the number of common stock shares outstanding. In 2012, earnings and revenue growth fell sharply as the impact of weaker overseas economies took its toll on multinational companies. For 2013, Wall Street analysts now expect earnings and revenue growth to accelerate to 5% from the subpar 2% growth level of 2012. Much of the acceleration is expected to occur in the second half of the year when year-over-year earnings growth is expected to reach 7% in the third quarter and 10% in the fourth quarter. This compares to a 3-4% level of earnings growth in the first half of the year and may be a tall order for a few reasons. First, the recent rise in U.S. interest rates will likely negatively impact consumer

%Q Revenues Per Share

%'s Based on Yr to Yr Comparisons

87 ◄ ► 14

	2009	2010	2011	2012	2013	2014
Mar	-13 %	5 %	10 %	1 %	8 %	4 %
Jun	-17 %	7 %	10 %	3 %	3 %	4 %
Sep	-14 %	6 %	12 %	-3 %	9 %	4 %
Dec	1 %	8 %	7 %	6 %	3 %	3 %
Yr.	-11 %	7 %	10 %	2 %	5 %	4 %
Yr. to Yr.		7 %	10 %	2 %	5 %	4 %

Mean Estimates: First Call

F (Quarterly numbers may not add to annuals)

%Q Earnings Per Share

%'s Based on Yr to Yr Comparisons

87 ◄ ► 14

	2008	2009	2010	2011	2012	2013	2014
Mar	-17 %	-31 %	52 %	35 %	-3 %	4 %	8 %
Jun	-21 %	-13 %	29 %	18 %	2 %	3 %	13 %
Sep	-17 %	-5 %	32 %	14 %	2 %	7 %	12 %
Dec	-28 %	47 %	24 %	10 %	7 %	10 %	11 %
Yr.	-20 %	-5 %	33 %	18 %	2 %	5 %	11 %
Yr. to Yr.		-5 %	33 %	18 %	2 %	5 %	11 %

Mean Estimates: First Call House

F (Quarterly numbers may not add to annuals)

Source: Thomson Reuters' Baseline

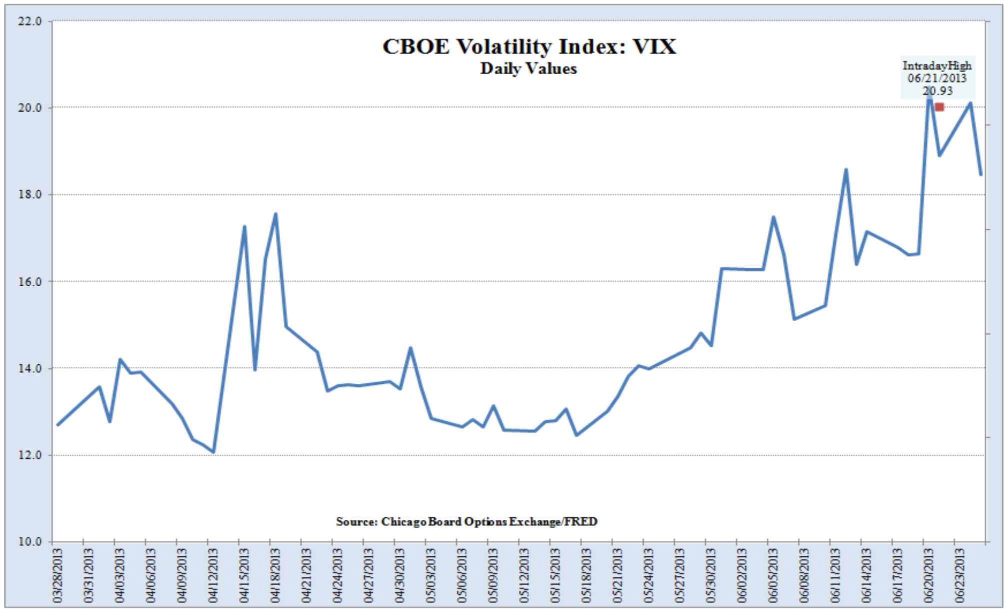
spending for new houses and autos, in addition to refinancing activity. Second, the full effect of the government sequestration cuts will be concentrated in the third quarter, which is also the fiscal year-end for the U.S. government. Lastly, the U.S. dollar has risen by almost 5% this year, which will dampen reported revenue and earnings growth for multinational companies. However on a positive note, some foreign economies may be through the worst of their economic slowdown and thus may begin to contribute more meaningfully to corporate profitability moving forward.

Interest Rate Sensitivity and Dividend Paying Equities

"Yield chasing", the "dividend play" and the "new sovereigns" are all phrases which have been used to describe financial market participants' recent preference for owning a stake in dividend-paying companies rather than government bonds at ultra-low rates. That preference came into question when Fed Chairman Ben Bernanke raised the possibility of the Fed making its policies modestly less accommodative sooner than expected. Similar to bonds, dividend paying stocks show sensitivity to interest rates. Ned Davis Research recently provided a chart which shows dividend paying stocks produce far better returns than non-dividend paying stocks when the Fed's monetary policy is "neutral" or "easing." One might assume then that non-dividend paying stocks outperform when the Fed is "tightening." However, broad aggregations miss salient details, namely the business prospects of a dividend paying company. Additional data provided by Ned Davis Research compares the theoretical total returns of three baskets of equity shares – shares of companies that increased dividend payments, shares of companies that did not raise dividend payments and shares of companies that did not pay a dividend. The data shows that dividend paying shares actually outperformed non-dividend paying shares in a rising interest rate environment, while shares from companies that increased their dividend payments outperformed both of the other groups.

Increasing Volatility with the VIX Rising Above 20 – Temporarily

The VIX index is the Chicago Board Options Exchange's measure of expected volatility for the S&P 500 over the next 30 days. Generally, a reading below 20 indicates investors believe prices will not move significantly in one direction or another over the 30-day time period. Thus, market participants were complacent for 61 (or 62 excluding intra-day levels) out of the 64 trading days in the second quarter of 2013. Volatility moved above 20 on June 20th, 21st and 24th, after Chairman Bernanke indicated for a second time that the Fed may begin its efforts at some point in the not too distant future to withdraw extraordinary monetary support in a measured manner. Equity market participants quickly translated his plan to "taper" Fed support into a 56 point S&P 500 index price decline. However, after the third trading session of June 24th, the VIX failed to breach 20 again for the rest of the quarter.



Source: Chicago Board Options Exchange / FRED

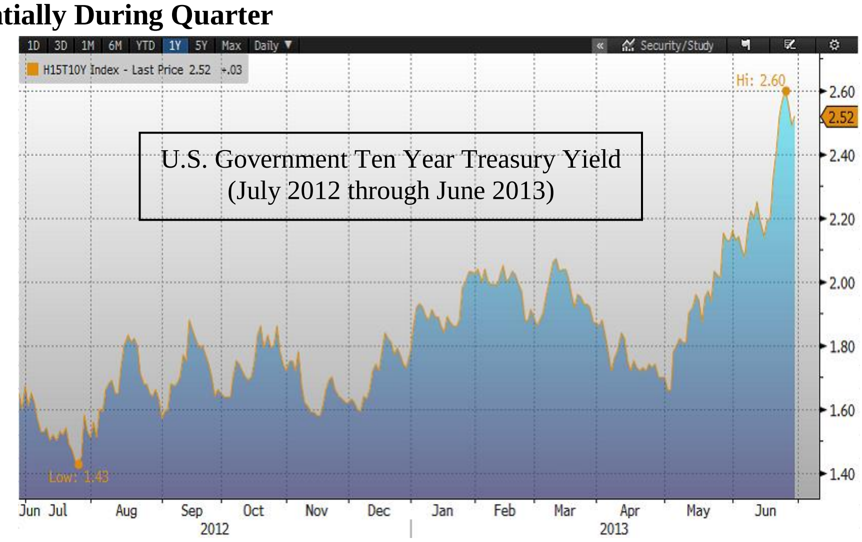
ECONOMICS AND FIXED INCOME

Fixed Income Market Performance

The BofA Merrill Lynch US Corporate Index, which tracks the performance of U.S. investment grade debt, tumbled 3.4% for the quarter. Corporate bonds underperformed U.S. Treasury (UST) bonds, which declined 2.2%. The municipal bond index that is part of the Bank of America/Merrill Lynch suite of fixed income indices fell 3.3%. Debt issued by companies rated below investment grade, known as high-yield debt with ratings from BB+ through CCC-, again posted better returns than the previously mentioned groups, but still posted a decline of 1.4%. Within the investment grade space, bond returns from financial companies bested the returns from non-financial companies by 1.1% (-2.6% versus -3.7%). The downward pressure on bond prices was primarily due to interest rates moving upward on the expectations of a tapering in monetary support by the Fed.

U.S. Treasury Bond Yields Rise Substantially During Quarter

On May 2nd, a hypothetical owner of a portfolio of 10-year U.S. Treasury bonds (UST10s) was almost wealthier than at the beginning of the second quarter since yields had declined from 1.87% to 1.66%. By quarter-end, though, yields rose 86 basis points (or 0.86%). That rise amounted to a nearly 50% increase due to the low level of interest rates, and left the owner of UST10s with a high single digit loss for the second quarter. UST10s closed the quarter yielding 2.52%. The rate on the 30-year U.S. Treasury bond began the second quarter at 3.10% and rose to 3.52% when the quarter closed.



Source: Bloomberg Professional Service

U.S. Economic Health - Part One: Automobile and Light Truck Demand

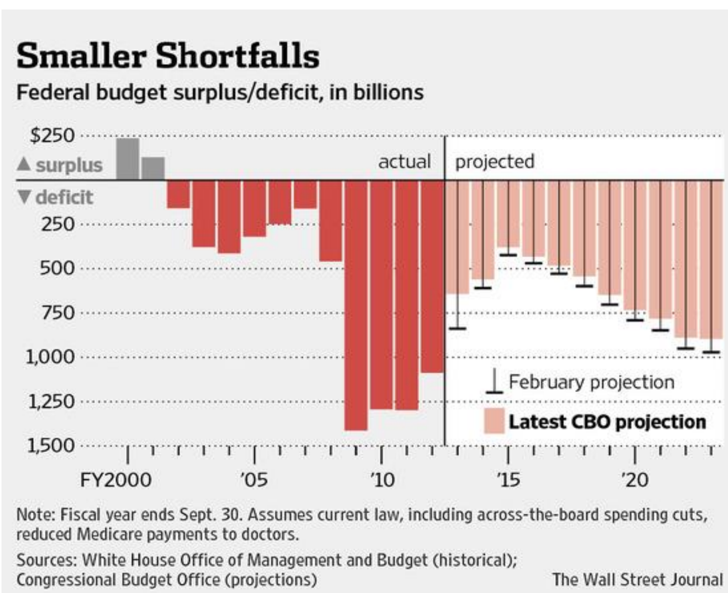
The health of the economy can be measured using a myriad of data. For example, Gross Domestic Product (GDP) is the broadest measure of aggregate economic activity and encompasses every sector of the economy. Recently, the Bureau of Economic Analysis revised down its estimate of first quarter 2013 GDP growth from 2.4% to 1.8%. Even with this recent revision, GDP growth in the first quarter was significantly higher than the 0.4% level in the fourth quarter of 2012. Bolstering GDP was the American consumer's appetite for automobiles. Since bottoming out in 2009 when "just" 10.4 million new cars and light trucks were purchased, sales have steadily increased to 11.6 million units in 2010, 12.8 million in 2011, 14.5 million last year, and are now on pace to exceed 15 million units this year. Some economists are now questioning if this level will be met due to the recent increase in interest rates.

U.S. Economic Health - Part Two: Housing

Vehicle sales have not been the only source of strength. Sales of previously owned homes rose 4.2% in May to a seasonally adjusted annual rate of 5.2 million, the highest level since November 2009, but still behind the 7.3 million peak set in September 2005. According to the National Association of Realtors, median prices rose 15.4% from a year earlier, to $208,000, the highest level since July 2008. New construction of single-family homes was up 16.3% in May from a year earlier, and at an annual pace of 599,000 homes. It also appears that homes being listed for sale are decreasingly the result of foreclosure or "homeowners under pressure." In fact, according to the *Wall Street Journal*, the percentage of sales from distressed properties was at 18%, the lowest level since October 2008 when the National Association of Realtors began tracking the data. This led Jim O'Sullivan, Chief U.S. Economist at High Frequency Economics, to recently state "…housing is now the strongest part of the economy in growth terms." As with vehicle demand, though, it remains to be seen how much of an impact higher interest rates will have on this sector of the economy.

Fiscal Policy Tightening - Federal Budget Deficit Shrinking in 2013

In May, the Congressional Budget Office (CBO) said the federal budget deficit is expected to shrink to $642 billion for the fiscal year ending September 30, 2013. This forecast was lower than the agency's $845 billion estimate three months earlier and significantly lower than last year's $1.087 trillion shortfall. The substantial positive shift was attributed primarily to larger-than-forecasted income tax receipts from individuals and corporate taxpayers, and large dividend payments of $95 billion expected from Fannie Mae (FNMA) and Freddie Mac (FMCC) later this year. The increased tax revenue was driven by higher tax rates on income and capital gains enacted in the American Taxpayers Relief Act of 2012 (ATRA2012). Additionally, many taxpayers decided to realize capital gains in 2012 to avoid the expected rate increase in 2013, providing an unexpected one-time recognition of revenue. A smaller contributor to 2013's shrinking deficit was lower spending projections for Medicare, Medicaid, and Social Security.



After four consecutive years of $1 trillion deficits, the 2013 forecast comes as a welcome surprise. However, these developments have nearly eliminated the incentive for deficit-reduction negotiations among politicians who have vastly different ideologies on budgeting. The new forecast has now moved the expected date of reaching the federal borrowing limit from August to either October or November. The White House and Republicans have been engaged in a budget fight since 2011, which has led to several individual deals to reduce the deficit by raising taxes, such as the ATRA2012, and smaller expense reductions, e.g. the sequestration cuts. The White House continues to lobby for more tax revenue as opposed to Republicans who have argued for structural changes to the enormous federal health care programs of Medicare and Medicaid, while refusing to support any further tax hikes until already enacted revenue increases have been matched by spending cuts.

The 2013 deficit is projected to be 4.0% of GDP, which is higher than historical averages but down from 7.0% in 2012 and 10.1% in 2009. The CBO said the improving deficits would continue until 2016 when it expects spending to increase substantially due to Medicare and Social Security. By 2023, Social Security and government health care programs are projected to reach $3 trillion, a staggering 50% of the federal budget. As seen in the above graph, the CBO projects annual deficits to increase to nearly $1 trillion by 2022 or 2023. "Such high and rising debt later in the coming decade would have serious consequences," the CBO said.

Monetary Policy Tightening - Chairman Bernanke and Tapering by the Fed

Within the framework of a tightening in fiscal policy, Chairman Bernanke mentioned more than once during the second quarter that the Fed's intention is to tighten monetary policy at some point. The unwinding of the Fed's balance sheet, which increased dramatically the past few years, has been a major concern among almost anyone who has paid attention to Fed actions in dealing with the financial crisis of 2008-2009. In essence, the expansion of the Fed balance sheet has amounted to a large scale, real-time experiment. Chairman Bernanke mentioned the tapering in purchases of Treasury debt from current levels *may* begin in September 2013. Although both the fiscal policy tightening mentioned above and the monetary policy tightening may be appropriate on their own merit, some economists are concerned pursuing both concurrently could prove to be difficult for the economy to sustain its current anemic recovery. (See Commentary for further discussion on Fed tapering).

Abenomics

The term "Abenomics" refers to the aggressive economic policies of Japanese Prime Minister Shinzo Abe, who is attempting to "shock" the Japanese economy out of 22 years of deflation. At the heart of this policy is an aggressive quantitative easing program which will expand the size of the Bank of Japan's balance sheet from 30% of GDP to 60%. (To put this into perspective, the U.S. Federal Reserve's balance sheet is expected to peak at 20% of the U.S. economy). The other key aspect of the policy is the expansion of Japan's federal deficit from 9.5% of GDP to 11.5% of GDP by increasing government spending on infrastructure projects. While the stock market has reacted positively to "Abenomics", the Japanese Yen has lost 20% of its value since November and interest rates on the 10-year Japanese government bond spiked from 0.4% to 1% during the month of May. The stock market peaked shortly thereafter as investors became concerned about the government's ability to support a total debt load that exceeds 200% of GDP. Despite the volatility in the Japanese stock and bond markets, there are increased signs that "Abenomics" is indeed working, as consumer confidence has increased and the inflation rate has stopped falling. Investors are now awaiting policies from Prime Minister Abe that will incentivize companies to hire more workers.

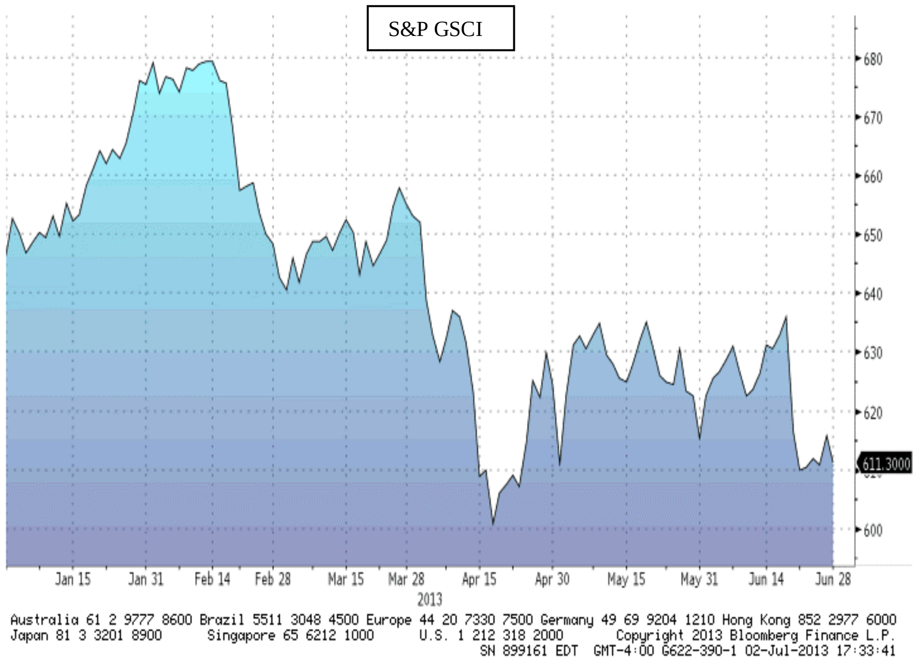
Source: StockCharts.com

Monetary Policy Tightening in China

China has been tightening monetary policy in order to rein in credit and its shadow banking system. Shadow banking allows for highly leveraged investments which utilize unregulated high interest loans. This has fueled what many think is a new housing bubble as new home prices in China jumped 6.9% in May. The government has recently stepped up efforts to contain the real estate market and rebalance growth by imposing new property taxes, instituting purchase restrictions, and raising down-payment and mortgage requirements. In doing so, the government is seeking to attain a more sustainable economic growth rate of around 7%.

China's Impact on Commodity Price Decline

Commodity prices tumbled in the second quarter as the largest global user of raw materials, China, continued to grow at a slower pace due in part to higher interest rates and tighter credit. China's economy grew at 7.7% in the first quarter, missing analyst estimates of 7.9%. As a result, many analysts and the International Monetary Fund (IMF) cut their growth outlooks for the country. According to Deutsche Bank, China alone accounts for a quarter of global commodity demand. The S&P GSCI, formerly known as the Goldman Sachs Commodity Index, tracks 24 different commodities. In the second quarter, the index fell 6.7%, the S&P GSCI All Metals index fell 14.8%, and gold futures dropped 23%. Many analysts have surmised that this represents the end of a commodity supercycle, or a longer-than-average period of rising prices. Decreased demand for commodities has a rippling impact on many emerging market countries which rely heavily on commodity exports. With emerging market countries and China responsible for a significant portion of recent global economic growth, it is not surprising the IMF lowered its forecast recently for global growth in 2014.



COMMENTARY: Fed Monetary Policy - The Perils of Tampering and Tapering

Since Fed Chairman Ben Bernanke testified before the Joint Economic Committee of Congress on May 22nd, volatility in most markets (stocks, bonds, and currencies) has increased, not only in the U.S. and Europe, but also in Asia and especially in emerging markets. In his answer to a question about slowing the Fed's monetary stimulus, Chairman Bernanke replied, "If we see continued [economic] improvement and we have confidence that it is going to be sustained, then we could – in the next few meetings – take a step down in our pace of [bond] purchases." Taking a step down in the pace of bond purchases (i.e. tapering) has its risks, as Chairman Bernanke also warned that "premature tightening would carry a substantial risk of slowing or ending the economic recovery."

The above response was in reference to the Fed's most recent quantitative easing (QE) program called QE3 or QE Infinity. The two prior QE programs had definite purchase amount targets and schedules. QE1 involved the purchase of $1 trillion of mortgage-backed and U.S. Treasury bonds in 2008 and 2009. QE2 involved another $600 billion of bond purchases from November 2010 to June 2011. QE3 is more open-ended in that the Fed announced in August 2012 that it would purchase $85 billion of bonds each month. It did not give any clear signals at that time as to when the purchases would taper or end, unlike short-term interest rates which the Fed indicated will remain close to zero until the unemployment rate falls below 6.5%. When considering the size of the U.S. economy, $85 billion may not sound like much, but it comes to more than $1 trillion annually. The QE programs (i.e. tampering) have bloated the Fed balance sheet from $800 billion before the financial crisis of 2008-2009 to $3.3 trillion today – four times larger in five years.

The purpose of the QE programs has been multi-dimensional. One primary objective is to reduce long-term interest rates and increase asset (stocks, bonds, and housing) prices. By reducing interest rates and increasing asset prices, which has happened, the Fed is counting on the wealth effect and lower interest rates to increase confidence and stimulate consumer spending and corporate investment. Through QE, the Fed also is hoping to repair bank balance sheets and thereby increase the health of the financial institutions in this country. That has also happened in spite of huge regulatory burdens. Finally, the Fed is concerned about deflation, and through its expansive monetary policy is hoping to derail deflation by targeting 2% as the desirable inflation rate.

Chairman Bernanke's May response was certainly measured and cautious, and some have referred to it as "splitting hairs," but it created turmoil in the financial markets. Since his remarks, financial market participants have taken on the perspective that bad news is good and good news is bad. When the economic news has been too good, long-term interest rates have risen and bond and stock prices have fallen. When the economic news has been not so good, the opposite effect has usually occurred. Investors prefer a Goldilocks economy, news that is not too good, not too bad, but just right.

As mentioned, the QE programs have been successful in keeping long-term interest rates low. The result has been higher bond prices, until this past quarter when less Fed accommodation became a concern. Despite the recent decline, bond prices are still up from when QE began. Lower mortgage rates have helped increase house prices by 15.4% (May median price increase from May 2012) after a drop of more than 30% on average from peak prices in 2006. Lower interest rates have also been behind the significant rise in the S&P 500 from its low in March 2009.

When viewing the overall effect of QE on the U.S. economy, the results become much more opaque. June 2013 marked the fourth anniversary of the present economic recovery. Economic growth has averaged around 2% during this four-year recovery period, one of the slowest economic recoveries in the post-WWII era. The 16 quarters of growth have been very uneven, from the highs of 4% in the fourth quarters of 2009 and 2011 to the lows of less than 0.5% percent in the first quarter of 2011 and the fourth quarter of 2012. There have been many occasions of hope but also many occasions of disappointment for U.S. economic growth.

Employment and job creation has been one of the biggest problems in this recovery. There are still nearly 2.2 million fewer people employed today than when the recession began, and the unemployment rate remains high at 7.6%. Year-to-date, there have been only 130,000 full-time jobs added to the economy. All remaining job additions (slightly more than 550,000) have been part-time. The percentage of people working in a job for which they are overqualified, or working part-time when wanting full-time employment (referred to as the underemployment rate) increased recently to 14.3%. McKinsey & Co. also recently reported that 45% of college graduates currently have jobs that don't require college degrees. For many, it has been a jobless recovery. The private sector of the economy has been creating jobs recently, albeit at a slower than normal recovery pace, while the public (government) sector has caused employment headwinds, shedding more than one million jobs at the federal, state and local levels.

While the impact of QE on the overall economy certainly has not been as dramatic as the Fed had hoped, who knows how the U.S. economy would have fared without the QE programs? A non-accommodative Fed in the 1930s cost the economy greatly, as Chairman Bernanke well knows. In all fairness to the Fed, fiscal policy and the regulatory burden coming out of Washington have to carry much of the responsibility for the slower recovery. Still, the key operative word in the financial markets is tapering - when will the Fed begin to gradually reduce its $85 billion monthly purchases of bonds, and when will it stop completely? After the recent June meeting, Chairman Bernanke tried to explain how the Fed will figure out when the time is right to pull back on the monthly bond purchases, but the market reactions were negative. At the news conference, he essentially stated that if the economy continued to improve, it would be appropriate to moderate the monthly pace of purchases later this year and end the program by mid-2014 (tapering). This scenario would play out only if the economic recovery continues. If not, the Fed would reassess, likely adjust its purchases, and continue with QE3 (tampering). Thus, there is no deterministic or fixed plan, which means continued uncertainty for investors. With QE being deemed by some economists as a large scale, real-time experiment, it is understandable that the Fed is reluctant to be too dogmatic in its approach.

No matter when the Fed actually starts tapering or eventually ends QE3, it cannot keep purchasing $1 trillion of bonds each year. While inflation and inflationary expectations do not appear to be a problem in the short term or even out to five years, continued monetary stimulus could ultimately result in inflation longer term – especially given the fiscal and monetary stimulus undertaken recently by Japan and the Bank of Japan as well as the Eurozone and the European Central Bank. It has been six long years since the Fed became so entangled in the economy, which has caused distortion in the financial markets. Less Fed entanglement (tapering) in itself would create uncertainty and risk in the short term, but is probably much better than tampering at this point. If the Fed was to signal its exit plan with clarity and transparency, some uncertainty would at least be removed for investors. Financial markets typically favor clear signals and abhor uncertainty. Whether the Fed tapers or tampers, investors will continue to be faced with high levels, maybe even unprecedented levels, of uncertainty. Such an environment makes a fundamental and disciplined approach to investing all the more crucial.

July, 2013

"Thirty to 40 years ago, most financial decisions were fairly simple." – **Scott Cook**, Founder of Intuit Software