

ECONOMIC AND MARKET OUTLOOK FOURTH QUARTER 2010

The economic recovery is ongoing and likely to sustain itself into 2011. However, the lack of a strong uptick in some critical areas, notably housing and employment, casts a cloud over the strength of the advance. Discernable improvement in these areas is necessary for economic growth to accelerate and to restrain additional government actions. The next several months will determine if the encouraging trends in capital spending, exports, and retail spending, provide sufficient heft to accelerate new employment and provide stability and recovery to the depressed state of residential housing.

Despite angst about current economic trends whole swaths of our economy have shown ongoing improvement in recent months and quarters. Capital spending and exports have been important primary contributors of the domestic recovery. The strength in both areas is partly the result of the unprecedented decline that occurred during the recession. At the nadir capital spending declined 20% in the first quarter of 2009, and exports declined almost 15%. Since then, capital spending has risen almost 16% and exports are up 14%. Growth in both areas is sustainable. Capital spending has significant room to expand to return to normal historical patterns. According to the Federal Reserve, industrial capacity has lagged economic growth over the past decade, leaving American businesses with an increasingly urgent need to update both its machinery and technology infrastructure. A typical replacement cycle would last several years. Short term trends are also very supportive. Core durable goods shipments, i.e. excluding defense and aircraft, are up 11% over the past three months. August industrial production figures showed factory activity continuing to expand and rising capacity utilization. The strength of corporate finances, strong manufacturing export trends and more comfortable corporate attitudes toward spending, indicate an extended capital spending cycle ahead.

Export patterns are highly positive for several reasons. The gains are very broad based. America's strength in agriculture has been well documented recently with news of droughts and other natural calamities affecting world grain supplies. The rise of a strong middle class in many emerging nations has increased demand for higher protein foods and consumer products, growing trends of particular significance to the U.S. Importantly, exports of manufactured products to the growing nations of Asia are up sharply. Even service exports appear to be gaining strength. Going forward, a relatively weak dollar underpins America's strength in exports. Efforts by some in the Congress to restrict trade and turn inward would be a serious impediment to the domestic recovery and result in a loss of jobs.

Continued signs of weakness in housing, sluggishness in new jobs, and the slowdown during the latest quarter, give rise to concerns about a renewed economic decline in the near term. Financial metrics in residential housing have improved considerably in recent months and some sections of the market such as multi-family have shown improvement. Housing affordability ratios are at record high levels and provide a floor under the market. Applications for refinancing are up dramatically this year. Refis are important to the recovery because they accelerate the decline in household debt service and add immediately to disposable income. Unfortunately relatively few homeowners qualify for refinancing due to

the decline in the appraised value of their homes. As things stand now the housing sector is bumping along a bottom but growth will remain subdued until employment and incomes rise further, leading eventually to rising home prices.

It bears repeating that this cycle is different from previous recoveries. Historically, consumer spending has led the way out of the recession and has propelled the economy to a rapid growth phase. This time around consumption has been slow to revive due to the depth of the recession, and the industrial side of the economy has led the advance. Corporate spending and exports will remain powerful contributors to further expansion. We believe other catalysts are rising which will improve the slow rate of new job creation. Census related hiring and subsequent lay offs have obscured some improving underlying employment trends. The rise of temporary workers, viewed by economists as a leading indicator of permanent employment, has continued to register gains and is at historically high levels. Manufacturing measures such as the length of the work week, average hourly earnings and new employment continue to improve. Continual expansion of durable goods generally precedes substantial job creation, as well as income growth. With single-minded emphasis on controlling costs and expenses in recent years, U.S. corporations seem to have reached the pinnacle of productivity enhancements. Further measures to improve sales and production will necessarily mean adding permanent hires. Finally, the fact is that the economy is still growing although growth has slowed, and new private sector jobs have risen this year. The government Employment Survey puts new private sector jobs at 763k through August. An alternative survey, called the Household Survey, places private sector job growth at 2.3 million. Government tax receipts are also up attesting to the increase in private sector wage and salary incomes this year. As more people rejoin the work force and incomes rise, consumption will also increase providing additional lift to our economy.

The financial markets have had a lot to contend with since the end of the first quarter. The recovery which appeared so enticing at the start of the year gave way to a sluggish expansion in the second quarter, causing a reassessment of our growth prospects. The explosion of the Macondo well in the Gulf in April dominated the headlines for several months. Disappointing employment numbers in July clearly upset the markets, and continued elevated levels of government deficit spending hit a raw nerve. Public anxiety is very high and the flight to safety has driven interest rates to extraordinarily low levels. Through it all the economy has grown, albeit at a slow pace. In our judgment growth is firm and self sustaining and will accelerate gradually as the recovery gains traction. We believe confidence in the future will return as employment improves. The outlook for equities remains compelling for long term investors, in our opinion.

Alfred A. Lagan, CFA, Chairman
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