

Executive Summary

The capital markets surged in the third quarter with all major equity market indexes, foreign and domestic, posting double digit returns. The quarter's retracement of second quarter losses put equity markets back in the black for the year.

Fixed income markets continued this year's consistent upward march. Assistance came from a decline in rates across the entire Treasury yield curve as well as tightening of credit spreads. While fixed income markets lagged behind the rise in equities during the quarter, they remain the better performing asset class for the year.

Currency movements were particularly eventful as the dollar, euro, and yen engaged in an ugly contest. The dollar was the hands down winner, slumping 5.6% against the yen and 10.3% against the euro. The yen's rise during the period was sufficient for investors and the Japanese government to grow concerned about the country's exporters. Japan's equity market slumped and the government eventually intervened in the foreign currency markets to take wind out of the yen's sails.

Dollar weakness aided international investment returns and drove commodity markets higher. Oil gained 10%, copper rose to a two year high, and gold climbed about \$110 an ounce to new all time highs.

The story told by the capital markets was clearly one of growth and prosperity. The macroeconomic fundamentals, on the other hand, weakened. U.S. second quarter growth came in at a disappointing 1.7% with economists ratcheting down growth expectations for the remainder of this year and next. The story was similar in Europe as Germany's 9.0% second quarter growth is expected to recede

to less than 1.0% for the remainder of the year. European sovereign debt issues continued, punctuated by various rating agency downgrades and interest rate spikes. The U.S. employment picture weakened as job growth stalled and jobless claims remained at elevated levels. Housing weakened considerably following the expiration of the government's home buyer tax credit. New and existing home sales fell to new all time lows and prices declined sequentially. Currently elevated inventory levels are consistent with future price declines. Manufacturing weakened globally during the summer with the U.S., Europe, and China all reporting weaker statistics from their manufacturing sectors.

As we look forward, we note that the strength of an already weak global recovery is declining. Economic bursts in Japan and Germany are waning and emerging market growth has slowed. At the same time, supportive programs are winding down and growth impediments are rising. The U.S. has already spent over 68% of the fiscal stimulus package and 89% of funds have been made available. A material GDP boost from inventory rebuilding will fade in future periods. Absent Congressional action, taxes increase materially at year end. Lastly, fiscal challenges at the state and local level will result in economically restrictive belt tightening measures over the next two years. Unfortunately, policy options are limited.

In closing, while we are encouraged by investment gains during the past quarter, it should be kept in mind that recoveries from consumption driven recessions are often quick and dramatic. Conversely, recoveries following financial crises are normally more muted and take, on average, seven years.

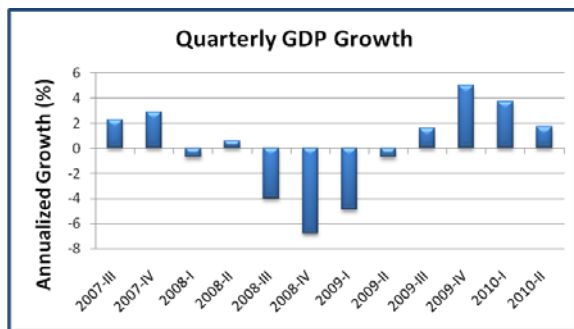


Economic Review and Outlook

Economic Growth

The National Bureau of Economic Research (NBER) declared the recession that began in December of 2007 officially ended in June of last year. This recession was the longest, 18 months, and deepest, 4.1%, since the Great Depression. During the recession, household wealth declined 21% and 7.2 million jobs were lost.

In the following year of recovery, 70% of lost economic output was restored. This included a 1.7% annualized rate of GDP growth in the second quarter. During said quarter, strength was observed in personal consumption as well as investment in equipment and software. Inventory restocking was once again a positive, accounting for 50% of the expansion. Partially offsetting these positives was a sizable jump in imports.



Data Source: U.S. Department of Commerce

Growth dynamics slowed toward the end of the second quarter and throughout much of the third. In response, forecasters dialed down second half growth expectations from a range of 3.0 – 3.5% to 1.5- 2.0%.

Economic challenges remain and in some cases will intensify as beneficial tailwinds diminish. In particular, the boost from the inventory cycle is waning, stimulus spending will fade going forward, and low interest rates are not spurring consumption or housing turnover in a similar

fashion as during previous post-recession periods. In light of challenging macro factors, a panel of 50 economists lowered growth expectations in September for the third month in a row. Lower expectations for consumer spending, business investment, and private construction were all cited as factors. Current estimates for 2011 growth range from below 2% to as high as 3%.

Employment

As of the September payroll report, 130.3 million people were employed in the U.S. As shown in the following graph, the economy first reached this level of employment back in December of 1999.



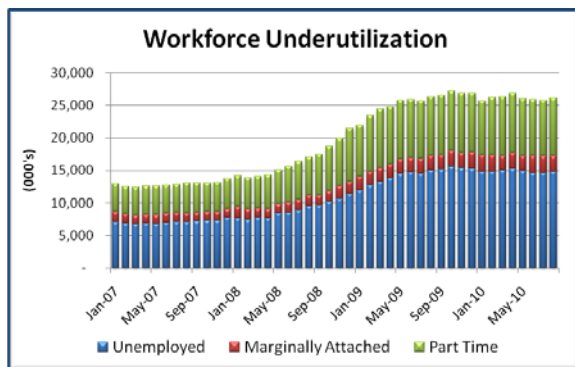
Data Source: U.S. Department of Labor

During this decade-plus period of time, government jobs grew by 2 million (9%), while private sector jobs shrank by an equivalent amount. Manufacturing jobs contracted by 6.6 million to a level last seen in April, 1941.

Economists increasingly point out that elevated unemployment in the U.S., currently at 9.6%, is more structural in nature than cyclical. Considering workforce growth of 13.9 million individuals over the past ten-plus years, with no net new jobs, we would tend to agree. Unfortunately, extended periods of cyclical unemployment (which we have been experiencing) tend to increase structural unemployment as job skills of the unemployed



degrade and/or lose relevancy. Challenges in the housing market further exacerbate structural unemployment as workers are less able to relocate to areas with more plentiful opportunities. Perhaps the best illustration of the current underutilization of the U.S. workforce is the Labor Department's so-called U-6 metric. Shown below, this gauge combines the unemployed with those that have been forced to accept part-time work along with others that would like to work, but have not looked for work in the recent past.



Data Source: U.S. Department of Labor

Currently at 16.7% of the workforce, the U-6 measure has remained stubbornly above 25 million people for 16 months.

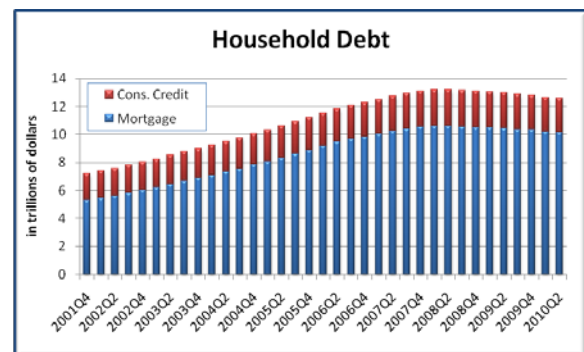
Forward expectations for the labor market are a challenge. Jobless claims, a leading indicator for the labor market, remain stubbornly in the mid to upper 400,000 range. This compares to a more normal level of 300,000. Furthermore, while corporations report comfort in revenue growth projections, managers are less sanguine when it comes to hiring. We do, however, note that net income margins hit 9.5% in the second quarter, near the record of 9.6% set in Q3 2006. We suspect managers will be challenged to extract more out of current employees. The fact that economic productivity fell by 0.9% in Q2, the first drop in 1.5 years, adds further credence to the possibility that hiring may need to pick up.

The Consumer

Despite the aforementioned challenges in the labor market, the financial health of the consumer is improving.

The personal savings rate, after bottoming at 1.2% in Q3 2005, has steadily risen to a Q2 2010 level of 5.9%. While this remains off the long-term historical average of nearly 9%, it is progress in the right direction.

Newfound fiscal responsibility is evidenced in debt trends as well. Household debt, illustrated below, has trended down for an unprecedented eight quarters in a row. The consumer's debt peaked just over 92% of GDP and has declined to a recent value of 86%.



Data Source: U.S. Federal Reserve

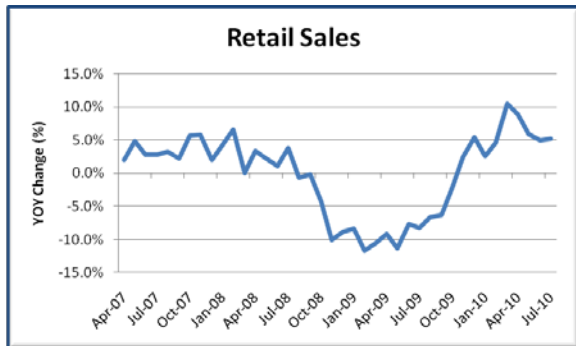
Increased savings and reduced debt improve the ability to pay bills. The Federal Reserve's Financial Obligations Ratio, a measurement of required debt service relative to disposable personal income, peaked at 18.9% in Q3 2007. It has since dropped dramatically to a reading of 17.0% - a level not seen since 1998.

Lastly, decreased obligations relative to financial means translates into improved credit trends. Indeed, delinquencies on consumer debt, both loans and revolving credit, have trended down since each peaked in the second quarter of 2009.

Interestingly, while consumers have focused on improving their balance sheets, they have not



altogether discontinued spending. Through July, retail sales have shown positive year-over-year growth for nine months in a row.

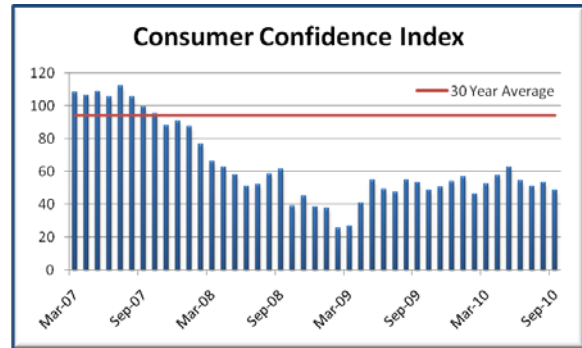


Data Source: U.S. Census Bureau

Furthermore, personal consumption expenditures have been a positive contributor to GDP growth for each of the previous four quarters. In real terms, this component of GDP was up 1.7% over the past year.

Despite positives, consumer challenges remain. The most pressing concern, of course, is the labor market and recently stalled job growth. As a matter of fact, total employment today is identical to that at the end of the recession. This compares to 3.9 million jobs created in the comparable 14 month period following the early 80's recession. On a comparable basis, adjusting for the size of today's [larger] economy, a similar recovery would have added 5.7 million jobs since June of last year!

Employment is not the only concern for consumers. The dust is still settling on healthcare and financial reforms, the ultimate reshuffling of Congress is an unknown, global growth is challenged, debt levels, although improved, are still too high, real estate remains a black cloud over many, the recession induced 21% drop in household wealth has only recovered by 4%, and impending year-end tax law changes are up in the air. Together, the resulting stew is not one for a refined palate and consumer confidence is mired at exceptionally low levels.



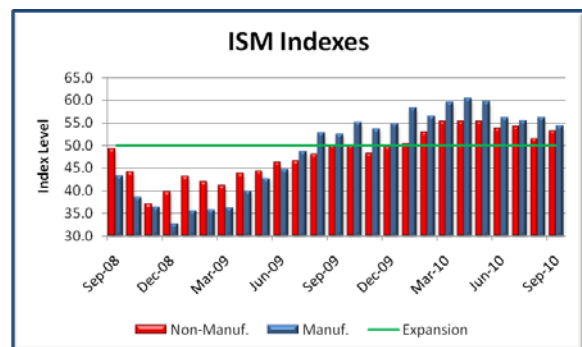
Data Source: The Conference Board

Manufacturing and Service

Many of the world's major economies lost manufacturing momentum during the summer. Feeling this economic chill, OPEC warned of weakening demand and cited discouraging economic conditions in most developed countries.

More specifically, in July, Chinese manufacturing grew at the slowest pace in 17 months, lower for the fourth straight month. Germany, the stalwart growth engine of Europe, is expected to slow dramatically from 9% growth in Q2 down to 0.7% in Q3 and 1.1% in Q4. Considering the slowing of Germany, its largest economy, the euro zone reported stagnant factory output during the third quarter.

The U.S. has not been insulated against the slowdown. As illustrated below, both of the purchasing manager indexes have been in decline since their peaks in April.



Data Source: Institute for Supply Management



Lastly, the Federal Reserve's most recent Beige Book report noted a widespread deceleration compared to preceding periods.

Real Estate

Real estate activity diminished following the April expiration of government tax rebates to home buyers. According to the most recent Case-Shiller home price indexes, the number of markets reporting price increases declined to just four out of 20. Furthermore, the overall sequential price change was negative in July. Considering the index methodology incorporates a three month moving average, we anticipate material price declines in coming reports.

In August, new home sales hit an all time low and existing home sales were just above the low established in July. The supply of existing homes, currently at 11.5 months, is nearly double what is considered characteristic of a healthy market. Anything higher than eight months is associated with downward pricing pressure. This should be expected going forward.

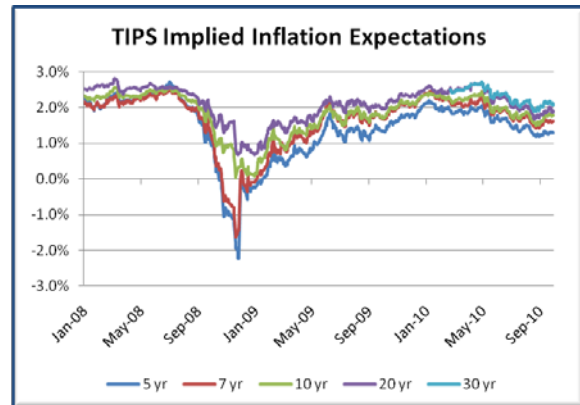
Inflation or Deflation

The U.S. is operating below potential, the pace of recovery has slowed in recent months, and growth will be more modest in the second half of 2010 than anticipated. During the quarter, this backdrop, along with an inflation rate at 40 year lows, had many concerned about the potential of deflation.

The Federal Reserve acknowledged the potentially detrimental impacts deflation can have on an economy, but Fed members see a very small risk of deflation occurring.

While it is helpful to know the Fed's position on the topic, it is beneficial to find confirming evidence present in the capital markets. For this, we turn to the TIPS market as the ultimate gauge of investor inflation expectations.

The following graph illustrates the inflation rates implied by the TIPS and Nominal Treasury curves.



Data Source: U.S. Treasury

Prior to the capital market downturn (left side of graph), inflation expectations were anchored in the 2.0 to 2.5% range. Current expectations (right side of graph), while lower, clearly illustrate the market's agreement that inflation will remain positive going forward.

The Government

As is typical, no shortage of uncertainty is being generated by Washington. The capital markets are keenly focused on:

- the likely composition of Congress following mid-term elections
- resolution of the Bush tax cuts currently scheduled to expire at year-end
- the potential, type, and effectiveness of further monetary and/or fiscal stimulus

The Feds, trust busters that they are, hold no monopoly over governmentally induced investment challenges. Fiscal imbalances at many state and local governments are acute. It is expected that, due to weak tax collections and the loss of federal support from the stimulus act, states will grapple with deep financial pressure for at least the next two years. On that note, Bernanke recently highlighted the "battered" shape of state and local budgets as part of the reason for national sluggishness. In response, these institutions are



planning layoffs of as much as 400,000 over the next year to help close budget gaps.

Monetary Policy

Forecasting a weak second half of the year, the Federal Reserve has chosen to prevent unintended monetary tightening by reinvesting proceeds from their maturing mortgage investments back into U.S. Treasury bonds. At the same time, members declared the economy would have to deteriorate significantly before taking further measures. Despite this fact (and the implication), investors appear encouraged by the potential for further action. This would presumably be additional quantitative easing, with analysts and economists casually throwing around estimates of a \$2 trillion expansion of the Fed's current balance sheet – a double from here. As to the potential effectiveness of the Fed pushing harder on the string, we need only point to the facts that:

- Commercial bank loan balances are down \$900B since the end of 2008.
- Commercial and industrial loans are down 25% since the peak in 2008.
- Loan declines continued up to and including a 1.3% drop in the second quarter of this year.

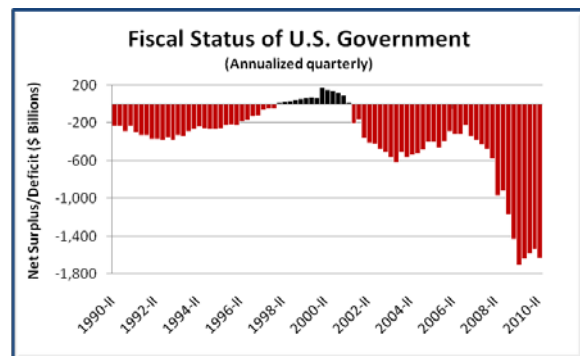
Fiscal Policy

Treasury Secretary Timothy Geithner believes the economy needs quick, additional support to businesses and individuals. On this point, he believes the biggest challenge to the economy is Washington paralysis. Presuming he is correct, those excited by Republicans commanding a post election majority of the House should rethink their position. In all likelihood, this will lead to more gridlock, not less.

In the meantime, the debate between fiscal stimulus and austerity rages on. In one corner, organizations such as the OECD believe governments may need to provide more stimulus and/or delay plans for budget cuts. In

the other corner, the IMF warned Greece, Italy, Iceland, Portugal, and Japan that they are perilously close to their "debt limit." Countries that are moving into dangerous territory, according to the IMF, include Ireland, the U.S., Britain, and Spain.

Not taking sides with either organization, we only note that a quick look at the U.S. government's fiscal position is certainly a sobering event.



Data Source: Bureau of Economic Analysis

Legislative Action

Interesting if not consequential legislative events during the quarter included

- Passage of the financial reform bill. Key provisions include:
 - Authority to take over and liquidate failing financial firms
 - Increased transparency into derivatives
 - Restrictions on banks from making risky bets with their own capital
 - Formation of a new agency to protect consumers – The Bureau of Consumer Financial Protection
- The climate bill collapsed due to a lack of broad support in Congress. For now, cap and trade is dead.
- The federal Centers for Medicare and Medicaid Services determined the health care reform acts will not change health care spending over next decade.



Capital Markets Review and Outlook

Overview

Second quarter earnings came in strongly with 75% of S&P 500 companies beating earnings expectations and nearly the same percentage outperforming on revenue. Net margins have expanded to 9.5%, just shy of the record, 9.6%, set in Q3 2006. A debate over the potential for further margin expansion and revenue gains has setup a fairly wide range of 2011 earnings expectations. Earnings growth forecasts range from 2% to 17% for the coming year.

Earnings induced equity market strength in July gave way to U.S. macro challenges in August. At the same time, investor concerns regarding European sovereign debt diminished following the late July release of [benign] European bank stress tests. Seemingly in the blink of an eye, the U.S. and Europe traded places between the penthouse and the doghouse. U.S. equity market weakness ensued and the dollar came under pressure.

August also witnessed the start of companies using their balance sheets more aggressively. Merger and acquisition activity picked up dramatically and corporations increased share buybacks. Considering the fact that many companies are paying higher dividend yields than bond yields, a considerable amount of debt was also issued at the lowest borrowing costs in 40 years.

Currency movements were of particular note during the period. Japan intervened in currency markets to weaken the yen after it hit a 15 year high against the dollar. Taiwan, South Korea, Thailand, Columbia, Brazil, Singapore, and Peru have all intervened to help control the rise of their currencies. China, owing to increased

political pressures from nearly all corners of the U.S. government, allowed the Yuan to rise by a low single digits percentage during the quarter. Much more progress needs to be made considering most economists believe the currency remains approximately 20% undervalued. Going forward, continued slow growth in developed markets raises the risk of competitive currency devaluations and/or protectionist measures.

In many ways, the macroeconomic backdrop in September deteriorated. Despite this fact, equity markets performed well and higher risk debt categories traded exceptionally well. Emerging market debt hit historically low spreads over U.S. Treasuries and high yield debt traded up to par for the first

time since 2007. Yet, interest rates continued to fall. In a very real way, a dichotomy has formed between high grade fixed income and stock markets. Fixed income yields suggest risk aversion, concern over a double dip recession, and/or deflation. Stocks suggest none of that. Bond investors suggest the Fed will fail and a Japan-like scenario will unfold. Equity investors are betting on success and the return of Goldilocks. Time will tell which group has the better crystal ball.

	3 rd Qtr 2010	Year-to- Date
U.S. Treasury Bills	0.1%	0.3%
Barclays Aggregate Bond	2.5%	7.9%
Barclays Municipal Bond	3.4%	6.8%
S & P 500	11.3%	3.9%
Dow Industrials	11.1%	5.6%
MSCI EAFE (Int'l Equities)	16.5%	1.1%
DJ UBS Commodity Index	11.6%	0.9%

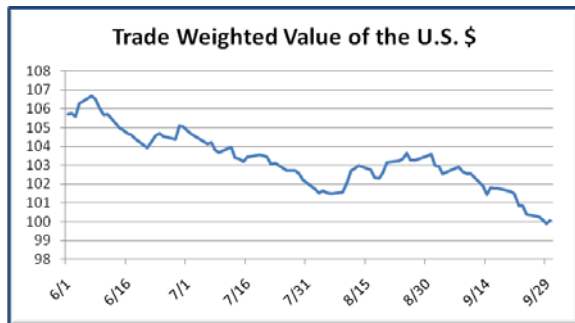
Data Source: Morningstar

Equity Markets

Domestic equity markets rallied strongly during the quarter. The S&P 500 closed the quarter up 11.3% for a total year-to-date gain of 3.9%.



International equity markets also performed well with an added kicker from dollar weakness. The MSCI developed markets index was up 16.5% for the quarter and is back in the black for the year with a total cumulative return of 1.1%. Emerging markets, many with attractive fundamentals, were up 18.0% for the quarter and are now up 10.8% for the year. For U.S. dollar based investors, dollar weakness (see graph) enhanced international developed and emerging market equity returns by 9.4% and 5.3%, respectively.



Data Source: U.S. Federal Reserve

Fixed Income Markets

Bonds underperformed stocks for the quarter but remain ahead for the year. The Barclays Aggregate was up 2.5%, municipals gained 3.4%, and TIPS returned 2.5% for the period. Corporate bonds performed particularly well. Investment grade corporates returned 4.7% as spreads over comparable Treasuries contracted by 25 bps to 1.84%. High yield debt delivered 6.7% as non-investment grade credit spreads tightened by 80 bps to 6.29%. The 10-year Treasury started the quarter with a yield of 2.9% and finished yielding only 2.5%.

On a final fixed income note, the yield curve is uncharacteristically steep. The gap between 10-year and 30-year Treasuries stood at 1.2% compared to a historical average of 0.20%. Likewise, the gap between Fed Funds and the 30-year Treasury stood at 3.6% at quarter end versus a historical average of 2.0%.

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