KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

INVESTMENT STRATEGY
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The market was extremely volatile and down sharply during the past quarter as the debt situation in Europe increasingly occupied the headlines. Although many now predict a repeat of the 2008 financial crisis and a sharp economic recession, we do not, and there are few comparisons and many major differences between 2008 and today. The financial crisis and major economic recession in 2008 was caused by a collapsing credit-fueled housing bubble many years in the making. The consequent breakdown of the financial markets led to a freeze on all discretionary business spending and hiring. Today, housing and consumer spending are subdued, large companies are conservatively positioned with low debt and record cash balances, and U.S. banks are strongly capitalized and closely supervised. Fears are widely advertised, but it is clear that global central banks will go to almost any length to prevent a repeat of the 2008 credit freeze. While uncertainty about the European debt situation is dampening economic growth, it is highly unlikely to spark a U.S. or global economic slowdown anything like 2008.

Europe's problems stem from an incomplete union that has monetary coordination but no fiscal integration. As a result, irresponsible countries used the ultra-low interest rates provided by the currency union to spend beyond their means. In effect, this is no different than the irresponsible home loans that were created in the U.S. due to a complete lack of any loan standards. Europe is now left with at least one country that can not afford to pay back their debts in full. Although the most pressing issue is Greece, several other countries, including Portugal, Italy and Spain, have also begun to experience market pressure from rising interest rates on their bloated debt levels.

The European Union has several options to fix this fundamental flaw. The first option is to move to a fiscal union that would include some form of 'Euro bonds.' These bonds would be issued by a central authority and guaranteed by the entire union. This option would require far more coordination on budgetary issues and also require a new political system that supersedes the national governments on fiscal matters. In the end, the rich countries would help pay the debts of the irresponsible countries. Even though many economists and politicians have called for the issuance of Euro bonds, it has become obvious there is no political or popular will in Germany to enter a fiscal union at this time. However, German exports have benefited tremendously from the weaker Euro currency compared to their previously very strong Deutsch Mark. Therefore, we believe this option is the ultimate solution in Europe at some point in the future.

The second option for Europe is to expel Greece from their monetary union. We see this as the least likely and most damaging option. If Greece were to exit the Euro zone, banks across the continent would suffer massive losses as Greece defaulted on their loans. Their exit from the Euro zone would also result in huge defaults on consumer and business loans within Greece as well as the triggering of billions of dollars of credit default swaps linked to Greek banks, companies, and the sovereign debt itself. An unstructured default of this type would result in a Lehman-like shock to the financial system resulting in a domino effect across financial instruments and institutions. We do not see the Europeans purposely making this decision. The ramifications from such an event would likely mean the end of the Euro currency itself. However, a lack of leadership and political infighting cause us to not entirely discount such an event.

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The third option for Europe is for Greece to enter a coordinated debt restructuring in which their debts are extended and principal reduced while Greece remains within the Euro. We currently see this as the most likely solution. This option would also result in large losses for European banks who lent money directly to Greece. However, Greek consumer and business loan losses would likely be manageable and the deal could be structured in such a manner as to not trigger payments on credit default swap contracts. Before partially forgiving Greek national debt, the Europeans would need to recapitalize their major banks to cover the associated losses. Recently, the International Monetary Fund recommended an additional $410 billion in capital be funneled into European banks to cover "potential losses from the Euro-zone crisis." An infusion of capital into the European banking system is the key to a successful debt restructuring.

We believe the end result will be a restructuring of Greek debt (and possibly Ireland's and Portugal's) within the Euro currency framework. This sort of restructuring is not likely to be successful in larger countries such as Italy and Spain. The ultimate solution is for the Euro countries to move toward the first option, a full fiscal union. We believe once the worst offenders are dealt some harsh medicine, the Europeans will work towards a much closer fiscal union. There is a great deal of work politicians must complete for any scenario to be successful. Unfortunately, the behavior of politicians in both Europe and the U.S. has been one of denial and avoidance, resulting in market pressures that may force change before the proper framework is in place.

As previously mentioned, a chief concern for investors is the likely negative effect on economic growth from the current Euro zone crisis. Currently, the high amount of uncertainty is already dampening growth in the U.S. and Europe. However, unless there is a completely unstructured Greek default, the current Euro crisis will not be devastating to economic activity like the financial crisis of 2008. In 2008, politicians, businesses, and consumers were caught off guard by a sudden freeze in the financial system that shocked all parties into survival mode. Confidence evaporated from a formerly strong global economy with startling velocity, presenting the possibility of depression and ultimately resulting in a major economic recession. In contrast, today, consumers and businesses are already cautious and both have taken precautionary actions. In response to the crisis a few years ago, large companies have cut costs and built up fortress balance sheets with a record $2 trillion in cash. Alternatively, if European politicians find a successful resolution to the Greek crisis, it would likely unleash investment resources and stimulate worldwide growth due to renewed confidence.

A positive byproduct of the recent market volatility is a substantial drop in commodity prices. Commodity prices were driven to extremely high levels during the first half of 2011 due to speculative investment flooding into these markets. This speculation was based on Middle East unrest that spurred higher oil prices and the belief that China's high economic growth would continue unabated. Over the past few years, China's economy had been driven by a huge

infrastructure spending program as well as enormous private investment in real estate development fueled by cheap bank loans. In the past several months, China has been tightening lending standards leading to a slowdown in their economy. As a result, hedge funds and momentum traders have been moving out of commodities. This should lead to lower fuel, food, and mineral prices for stressed consumers. For example, copper has declined 24% from its peak earlier this year, oil is down 29.7%, corn is down 20.6%, soybeans are down 14.8%, and wheat is down 32.7%. A sustained reduction in these prices will prove better stimulus to stressed consumers than anything likely to come from the polarized and paralyzed U.S. Congress.

From a portfolio perspective, we continue to position portfolios very conservatively. We have been overweighting the non-cyclical consumer staples, healthcare, and telecommunications sectors for several years. Meanwhile, we are extremely underweighted in financials and we continue to underweight the most cyclical companies in the materials, consumer discretionary, and technology sectors. Companies in the consumer staples and healthcare sectors are less economically sensitive, provide above average dividends to shareholders, and have greater exposure to fast-growing emerging markets than the average company. In this regard, twelve large companies held in our client portfolios have increased their dividends by an average of 16.3% in just the past three months. Significant increases are led by Accenture (+50%), Microsoft (+25%), Harris Corp. (+ 25%), Philip Morris (+20%), and Intel (+16%).

Going forward, we expect the slow economic recovery to continue, barring a major financial event in Europe. The most recent economic data has been more encouraging. Major manufacturing indexes continue to show slow but positive growth in activity, initial jobless claims have declined, automobile sales are up, and housing prices have actually increased for four consecutive months. A reasonable resolution to the Greek debt situation as well as lower commodity prices should provide much needed stimulus to the global economy. In addition, despite a slowdown in major emerging markets such as China and India, both are still expected to grow over 6% during the next year. Unfortunately, elevated market volatility will continue due to high uncertainty surrounding European and U.S. political leadership as well as the slow economic recoveries in the developed world. It will take time to work through these problems, but any resolution to the European debt restructuring or a long-term agreement to put the U.S. on a credible fiscal path could lead to a sharp move higher in equity markets.

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