



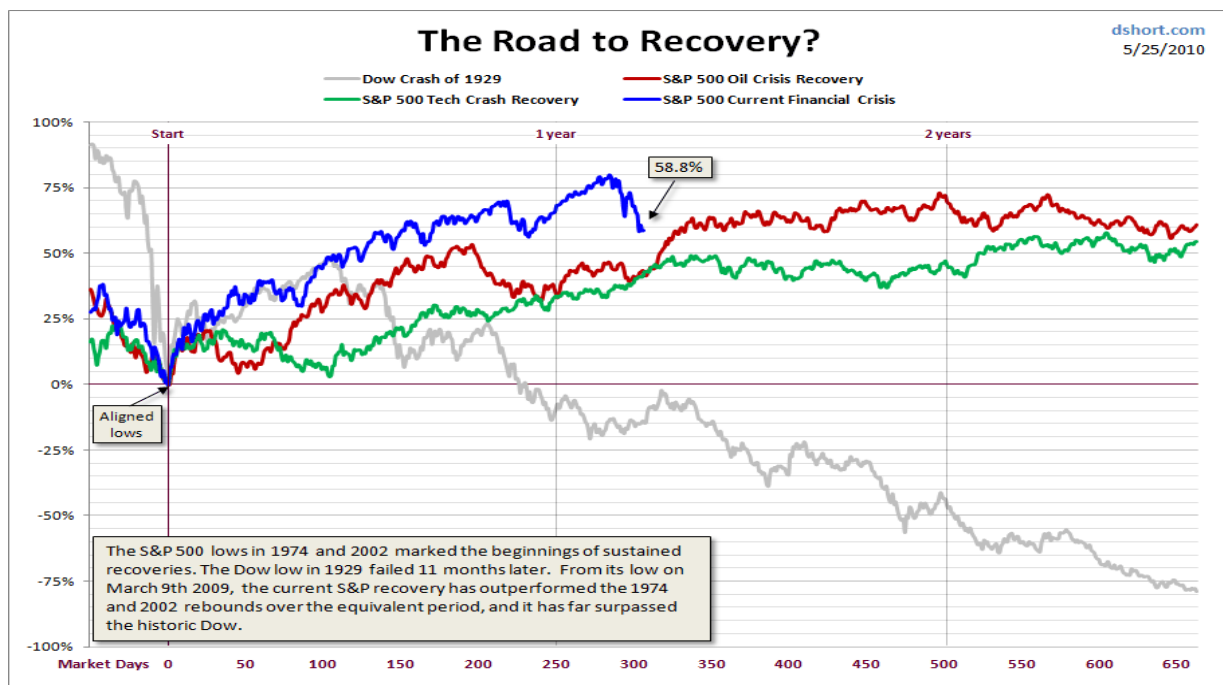
Client Memorandum

Market Correction or New Bear Market?

May 26, 2010

Given the significant drop in global equity markets over the past two weeks, investors are asking whether this is a normal (albeit severe) correction within a cyclical Bull Market or a cyclical top to be followed by another Bear Market. While recent market activity is troubling to say the least, we believe it is more likely a market correction, rather than the beginnings of a secular downturn.

Since the end of the first quarter, the S&P 500 has declined just over 8%, but close to 12% from the high point in April. Understandably, volatility has spiked upward as the VIX (widely viewed as the “fear index”) has doubled, bringing back painful memories of the violent market swings in the fall of 2008. We believe this drop in stock prices should be viewed in the context of a cyclical Bull Market that began in March of 2009. Since the lows in March 2009, the S&P 500 had climbed over 80% without a major interruption through late April. As we have communicated in our more recent *Monthly Economic Updates*, a rally of this magnitude without a 10% decline is unusual, and a correction was widely expected. Yet the relative severity and speed of the decline (see chart below) has prompted many investors to question whether this is a “healthy correction” or the start of something worse.



Corrections are often caused by major geopolitical or economic shocks, and this one is no different. For some time, investors have been aware of fiscal problems in peripheral countries in the European Union (“EU”), most notably Greece. These problems came to a boil in early May as concern about Greece’s ability to rollover maturing debt surfaced. Even if a successful rollover was accomplished, the likely cost to issue the debt would have exacerbated their deficit problem. To complicate matters, governmental debt problems in Europe are not limited to Greece; Spain, Portugal and Ireland all have deficits approaching 100% of GDP. While Greece is a relatively small economy, a default threatened to cascade into problems for other troubled countries prompting a serious meltdown in confidence. Meanwhile, the rest of the EU, most notably Germany, was having trouble coming to an agreement on a rescue plan. Failure to come up with a solution would have had severe repercussions on the European economy, as their banks hold about \$250 billion of bonds issued by the troubled countries. Significant write-downs by these banks would likely prompt a severe contraction in credit, which remains impaired by the crisis of 2008-09.

Finally, during the weekend of May 7-9, the EU and the International Monetary Fund (“IMF”) introduced a \$1 trillion rescue plan funded with \$640 billion from the European Union and \$320 billion from the IMF. Basically, the plan provided for:

- A direct loan of 110 billion euros to Greece;
- A 750 billion euro safety net, if the other weakened countries encounter problems; and
- A pledge by the European Central Bank to buy an unspecified amount of the bonds of the weaker countries aimed to keep rates low.

Despite these efforts, legitimate concerns about the longer term solvency of the weaker European economies remain, as the resolution of their debt problems involves extremely unpopular deficit reduction measures over a number of years. At this point, the credibility of the rescue plan (ok, bailout) depends on a coordinated effort by the Eurozone countries and, at a minimum, the guarantee of interbank loans by the European Central Bank and/or national governments.

Though the net result of restricted public sector spending will likely constrain economic growth in Europe, the effect on the U. S. economy is expected to be relatively modest and not enough to stall our strengthening economic recovery. As the earnings reporting season comes to a close for the quarter, many analysts have been surprised by the rate of increase, especially the effects of higher growth in “top line” revenues. Further encouraging news comes from the Labor Department as they report that nonfarm payrolls have grown in five of the last six months, and the unemployment rate is now expected to fall faster than projected even a month ago. Recently, the National Association for Business Economics (NABE) has raised its estimate for GDP from 3.1% to 3.2% for 2010, and the economists we follow are now expecting steady economic growth and improving corporate earnings for the rest of 2010 and into 2011.

The bottom line is that the magnitude of the drop in the equities markets so far is fairly typical for this stage of a Bull Market and has been expected for some time. Given the positive trends in the economic indicators we follow, we continue to remain cyclically positive on stocks and other risk assets like corporate bonds. However, the problems in Europe and elsewhere portend increasing volatility and increased investor diligence in managing asset class exposures. As always, we will keep you posted on important changes that are affecting your investments.

Important Disclosure: Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this memorandum, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content of this writing may no longer be reflective of our current opinions or positions. Moreover, you should not assume that any discussion or information contained in this memorandum serves as the receipt of, or as a substitute for, personalized investment advice from Capital Advisory Group, LLC. Please remember to contact us if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. Please also advise us if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. A copy of our current written disclosure statement discussing our advisory services and fees remains available for your review upon request.