



Quarterly Economic Update

July 9, 2010

Brief Market/Economic Recap

Equity markets around the world stumbled during the second quarter, ending a winning streak dating to March of 2009. Renewed concerns of the possibility about a double dip recession in the US, combined with anxiety over the credit market instability of the heavily indebted countries of southern Europe, sent stock markets down worldwide. These concerns were further fueled by an environmental disaster in the Gulf of Mexico. By the end of the quarter, new concerns emerged regarding the health of the real estate market, while on Capitol Hill a momentous bill that would bring significant reforms to the financial world awaited Senate approval. Conversely, we also witnessed a decent amount of good economic data points during the quarter. Considerably stronger corporate balance sheets, improving year-on-year earnings reports, and optimism from corporate CEOs all point to a strengthening economic recovery.

Market Environment

The 14-month old equity recovery showed signs of cracking in May as market participants staggered from wave after wave of gloomy news reports. The world watched a catastrophic environmental disaster unfold through streaming video of oil spewing from the seafloor in the Gulf of Mexico, some 5,000 feet below the surface. Echoes of the 2008 debt crisis reverberated as Greece and the other "PIIGS" (Portugal, Ireland, Italy, Greece, and Spain) tottered on the edge of credit downgrades; indeed some fell to junk status.

In early May, the Dow Jones dropped precipitously by 1,000 points intraday in what was subsequently dubbed the "Flash Crash." After a robust start to the year, fueled in large part by significant government stimulus, the US housing market appeared to roll over in May and June as the government triumvirate of attempts to prop up prices faded; the \$8,000 tax credit for new home purchases expired, the Federal Reserve ceased its purchases of mortgage backed securities, and HAMP mortgage modifications are predicted by some to encounter re-default rates of more than 50% within the first year. While bad news on the housing front was expected as the stimuli faded, the degree of weakening was rather shocking. For example, new home sales in May fell by an alarming 33% on a year-over-year basis. Meanwhile, US unemployment persistently hovered just below 10%; seemingly good news until one acknowledges that the rate was heavily influenced by the total size of the workforce falling (people giving up on their job search) and not by an increase in the number of people actually employed. However, consumer spending (the ultimate driver behind any US economic recovery) increased by 0.2% in May after a flat April. This was after month-to-month increases of 0.2%, 0.5% and 0.6% in the first quarter of the year. We also saw sustained growth in manufacturing, another big cog in the economy.

The Fed did not hike the benchmark interest rate, and there were clear indications that it would not increase short-term rates so long as the recovery is in doubt. Congress settled on a huge

financial reform bill destined for President Obama's signature in July, which would create a Bureau of Consumer Financial Protection and an Office of Credit Ratings to regulate agencies like Standard & Poor's and Moody's. In the biggest victory for Wall Street, the bill permitted banks to continue foreign exchange dealing and interest-rate swaps.

In perhaps the most startling political shift, some European countries began to call for significant austerity plans. Even the French proposed an increase in the retirement age to shore up their pension system. These austerity rumblings have taken hold in some factions of the US populace, touching off yet another fierce debate between the Keynesians and those in favor of controlling deficits. Unfortunately for the Keynesians, nations must have run surpluses in flush times (politically rather unpopular) in order to avoid excessive borrowing or their creditors must believe that their sovereign borrowers will have the future capacity to run surpluses. Neither scenario appears all that likely. Conversely, those in favor of budget restraint are contending with the widely accepted historical belief that austerity plans in the 1930's were one of the primary reasons for the Great Depression.

Market Performance

Within the US equity markets, small companies fell less than their larger counterparts while midcaps performed in line with small. From a style perspective, value outperformed growth among large cap issues yet among small cap issues the reverse was true. Additionally, higher quality issues outperformed in the downdraft, a significant change from the previous 12 months during which low quality massively outperformed.

As compared to US equities, developed foreign stocks struggled notably, albeit largely due to the strength of the US dollar versus the euro and the pound. The MSCI EAFE fell 14% in dollar terms with the aforementioned PIIGS occupying the lowest rungs of the ladder and Greece at the bottom of the heap. The Japanese yen strengthened versus the dollar; however, Japanese equities fell sharply, erasing the currency translation advantage to the dollar and posting net declines similar to US equities. On a style basis, developed equities mirrored the US small caps with growth solidly outperforming value. Emerging markets equities also declined but outperformed both US and developed foreign markets during the quarter.

Fixed income benchmarks largely earned low single digit results during the quarter. US Treasury issues fell to the lowest levels in recent memory on a yield basis and brought borrowing costs down across the board. The Barclays Aggregate Bond Index was the best performing major US financial index in the quarter with a 3.5% rise. High Yield treaded water while hedged sovereign debt and emerging sovereign debt both rose slightly. The US dollar was the dominant currency as economic concerns grew during the quarter, affecting net results in non-hedged sovereign debt.

Volatility in commodity markets persisted during the quarter and was obvious in the bifurcation of results between several precious metals and energy-related commodities. For instance, Gold was a strong performer for the quarter with an 11.9% gain, while copper fell 17.2%. Oil futures had their poorest quarter since the fourth quarter of 2008 with a 9.7% decline; however, natural gas managed a 19.3% quarterly gain.

June Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Jun	2Q	YTD
Vanguard 500 Index	-5.2%	-11.5%	-6.7%
Russell 1000 iShares	-5.5%	-11.4%	-6.4%
Russell 1000 Growth iShares	-5.5%	-11.8%	-7.7%
Russell 1000 Value iShares	-5.6%	-11.1%	-5.2%
Mid-Cap Benchmarks			
Russell Midcap iShares	-6.2%	-9.9%	-2.1%
Russell Midcap Growth iShares	-6.3%	-10.2%	-3.4%
Russell Midcap Value iShares	-6.1%	-9.6%	-1.0%
Small-Cap Benchmarks			
Russell 2000 iShares	-7.7%	-9.9%	-2.0%
Russell 2000 Growth iShares	-6.7%	-9.2%	-2.3%
Russell 2000 Value iShares	-8.7%	-10.6%	-1.7%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-1.2%	-13.3%	-12.0%
Vanguard Emerging Mkt Stock Index	0.0%	-9.1%	-6.9%
Vanguard REIT Index	-5.2%	-4.0%	5.6%
Vanguard Total Bond Mkt Index	1.6%	3.6%	5.3%
Merrill U.S. High Yield Cash Pay	1.3%	0.0%	4.8%
Barclays 7 Yr Muni Bond Index	0.3%	2.3%	3.6%
Citigroup World Govt. Bond Index	1.7%	0.3%	-1.0%
JPMorgan GBI-EM Global Div. Index	0.9%	-2.0%	3.4%
DJ-UBSCI (Commodity Futures)	0.3%	-4.8%	-9.6%

Source: AdvisorIntelligence

Investment Outlook

There is a tug of war between cyclically improving economic and company fundamentals on the one side, and structural concerns about debt-related stress points and the longer-term strength of the economic recovery on the other. The tension between these opposing forces has left investors uncertain and the stock markets stuck in the lower end of a trading range. We think that unusually high uncertainty could be with us for years to come, because the economic challenges we face are serious and will not be resolved quickly.

The recovery continues but it is not inspiring, and we see above-average macro level risk in spite of being early in a recovery cycle. If the recovery is sustained, which is more likely than not, we still face big intermediate- and long-term questions that make a wider-than-typical range of outcomes possible. It's also an environment that requires a high degree of intellectual honesty to think through the ramifications, risks, and opportunities without being constrained by a frame of reference based on the typical cycles, return assumptions, and risk assessments that have characterized most of the post-WWII period.

Given this uncertainty, we continue to recommend prudent asset allocation and risk assessment based on future capital needs for both institutional and individual investors. Due diligence reviews and an adherence to a well-developed investment policy remains the most prudent long-term course for investors.

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 may no longer be reflective of 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. Please remember to contact Capital Advisory Group 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.