



## *Quarterly Investment Update*

January 12, 2011

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### **Market Performance Recap**

A strong fourth quarter rally, punctuated by a December sprint, turned an okay year for stocks into a very good one. The large-cap S&P 500 Index gained 10.8% for the quarter and ended 2010 up 15.1%. Both the smaller capitalization Russell 2000 and Russell 2500 indexes garnered returns in the mid teens in the fourth quarter and increased their yearly gains to 26.9% and 25.5%, respectively.

Looking abroad, the story was similarly positive for emerging markets, with the MSCI Emerging Markets Index climbing 7.4% in the quarter and over 19% for the year. Developed-market foreign stocks also had a good year, but returns were restrained by concerns over Greece's fiscal problems earlier in the year and Ireland's later in the year, which drove the euro (and therefore returns to U.S. investors) lower. The MSCI EAFE Index nevertheless gained a healthy 6.7% in the fourth quarter and 8.2% for the year.

Turning to fixed income, the Barclays Capital US Aggregate Bond Index, a proxy for high-quality bonds, saw most of its 1.3% fourth quarter loss come in December. Still, its strong performance earlier in the year left it with a gain of just over 6.5% for the entire year. Foreign bonds also struggled through the fourth quarter, with the Citigroup World Government Bond Index falling 1.8% and the emerging-markets JPMorgan GBI-EM Global Diversified Index inching down 0.4%. Each index was in the black for the year, with emerging market debt returning a notable 15.7%.

### **Market / Economic Environment**

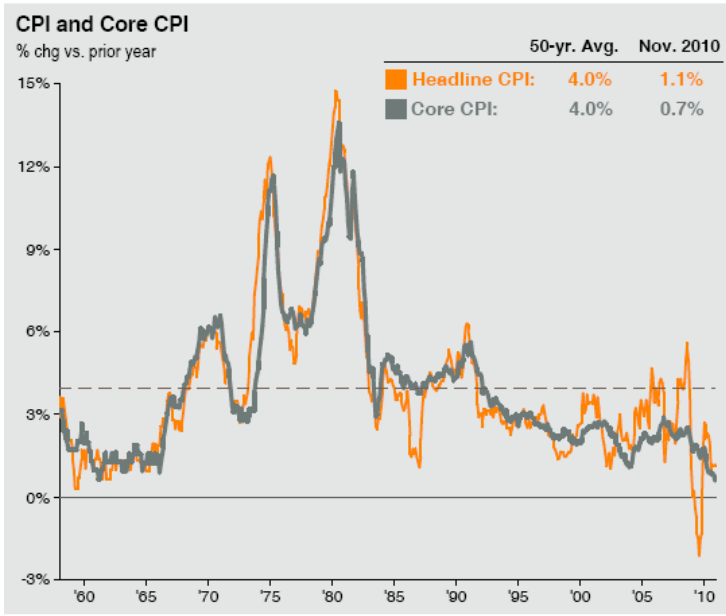
The quarter was full of headline grabbing events, many of which had meaningful impacts on the financial markets. The Fed's QE2 program was among the most significant of these events, instigating a 100 basis point (1%) increase in the 10-year Treasury yield in the two months following the announcement. However, Treasuries were well overdue for a correction, as investors had driven yields down to extremely overvalued levels in the prior months.

Also crossing the headlines was the announcement that the US Treasury expected to sell the last of its stake in Citigroup and would book a \$12 billion gain. Politicians seized on the announcement as a huge success, while pragmatists wondered about the true cost of clearing toxic assets from Citi's balance sheet and whether that figure was included in the calculation of investment gains.

Certainly a driving force in the fourth quarter rally was a recovery in consumer confidence. While high unemployment and weak job creation seem incongruous with rising consumer confidence, one must remember just how low confidence had fallen at its nadir in late 2008 to levels far below the long term average. Also worth considering is the fact that while over 9% of the workforce remains unemployed, and many more are under employed, those with jobs feel much more comfortable that they will remain employed and thus are more apt to increase spending.

Another aspect of the equity recovery was the trend for companies to begin deploying some of their massive cash reserves. Cash on corporate balance sheets has continued to rise and now accounts for nearly 30% of total corporate assets. In recent quarters companies have begun putting the cash to work with dividend increases, share buybacks, capital expenditures, and merger and acquisition activity. That this can happen while companies are also increasing cash holdings speaks to just how cost conscious companies have become. Profit margins are quite high on a historical basis while sales as a percentage of GDP are at generational lows. This disparity has led some market forecasters to expect very little in the way of P/E expansion and to predict that equity market performance going forward will need to come from growth in sales and earnings.

As we mentioned last quarter, many pundits and market participants posit that the current monetary and fiscal policy environment is generating significant risk of inflation in the coming years. However, both headline and core (excluding food and energy) CPI remain quite low (1.1% and 0.7% respectively, through November), and are being held down by a persistence of excess capacity in labor and goods, creating the so-called global “output gap” that weakens aggregate demand and holds down prices.



Source: BLS, J.P. Morgan Asset Management.  
 Data reflect most recently available as of 12/31/10. CPI values shown are % change vs. 1 year ago and reflect November 2010 CPI data. CPI component weights are as of Dec. 2010 and 12-month change reflects data through November 2010. Core CPI is defined as CPI excluding food and energy prices.

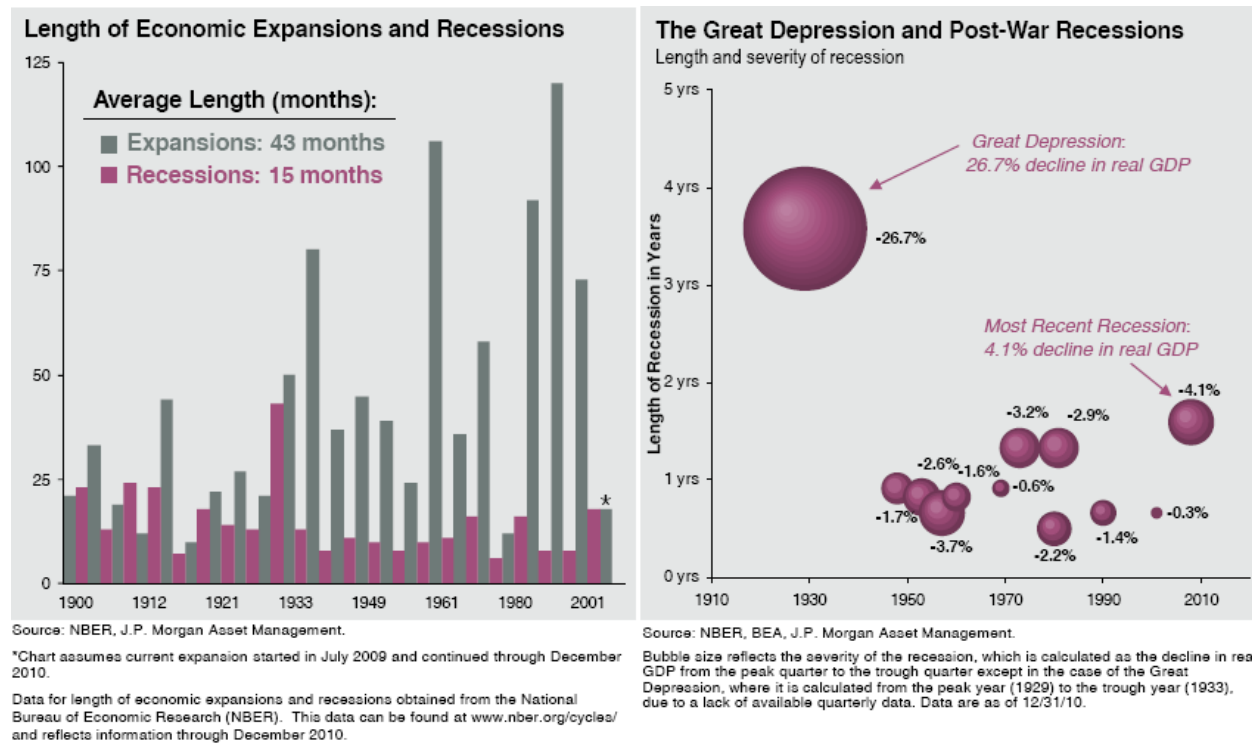
CPI Components	Weight in CPI	12-month Change
Food & Bev.	14.8%	1.5%
Housing	42.0%	-0.2%
Apparel	3.7%	-0.8%
Transportation	16.7%	3.8%
Medical Care	6.5%	3.2%
Recreation	6.4%	-0.9%
Educ. & Comm.	6.4%	1.6%
Other	3.5%	1.8%
<b>Headline CPI</b>	<b>100.0%</b>	<b>1.1%</b>
Less:		
Energy	8.6%	3.9%
Food	13.7%	1.5%
<b>Core CPI</b>	<b>77.7%</b>	<b>0.7%</b>

Meanwhile, expectations for a robust housing recovery continue to remain elusive, and many forecasts are calling for 2011 to be another year of falling prices, high mortgage delinquencies

and continued foreclosure activity. Finally, the European debt crisis has intensified, with Portugal likely to follow Greece and Ireland into a state of semi-insolvency requiring financial assistance (read bailout) from the European Central Bank and International Monetary Fund and increasing the fear of a broader contagion to larger Eurozone economies like Spain and Italy.

## Investment Outlook

While the investment environment is certainly not without clouds on the horizon, the economic cycle appears to have moved decisively from recovery to expansion. Using the popularized healthcare analogy, the consensus prognosis is that the patient is healthy enough to go back to work full-time, but he will require close surveillance of his vital signs for awhile longer and needs to change his lifestyle to fully recover over time. Analysts continue to argue back and forth about the durability of the expansion, given the remaining headwinds from consumer deleveraging, government spending largesse and global economic imbalances. However, it has been only 19 months since the Great Recession officially ended in June of 2009, so this expansion is relatively young compared to the average expansion duration (since 1900) of 43 months; the odds are high that it will continue at least for another year or two.



Given the outlook for a continuing expansion, we remain optimistic that the demand for “risk assets” like global equities and commodities will continue, although equity prices are stretched and overdue for a corrective pullback at this point. Our optimism for increasing asset prices centers on the fact that the major driver of equity bull markets has always been a non-inflationary expansion of liquidity, a condition which is likely to remain in effect and for the next three to four quarters. Presently, the Federal Reserve is using monetary policy (QE2) to increase bank liquidity, hoping to increase imports with a lower dollar, while also forcing asset price inflation to induce a “wealth effect” for consumers. Fed policy is clearly aimed at reducing unemployment, as they do not see inflation as an immediate concern. So far, this tactic is putting

upward pressure on interest rates further out on the yield curve and reducing bond prices, though the correction in bond prices may be overdone at this point. Still, investors are expected to continue to reduce their holdings of fixed income securities and mutual funds over the coming months primarily in favor of stocks, as yields on cash equivalents are flat and investment real estate remains in disfavor.

In summary, we expect the excessive global liquidity that is not surfacing in consumer prices will likely work to inflate asset prices as it has to go somewhere. As corporate earnings continue their ascent in the expanding economy and consumer confidence gradually recovers, global equities markets should be primary beneficiaries; commodities, though more volatile, should also continue to find favor with investors.

### **Concluding Thoughts**

An important caveat to our sanguine macro outlook is that expanding liquidity is only positive for asset prices when the expectations for general price inflation are subdued. Once inflation expectations reverse into an uptrend, the monetary authorities will begin to use restrictive measures to limit the degree and duration of the next round of inflation. This means that investors will need to be attentive to the trends that portend inflation and reductions in liquidity to avoid overexposures to stocks and other asset classes that had benefitted from the liquidity boom. We have designed our Adaptive Risk Management investment process to anticipate changes in economic trends and to make portfolio structure adjustments that are primarily designed to mitigate downside risk. Therefore, we remain confident that we will be prepared for the cyclical changes ahead.

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