



Quarterly Investment Update

October 5, 2011

Market Performance Recap

It was a roller-coaster quarter for equities, as weeks and even days when the Dow swung several hundred points in both directions seemed to become commonplace. By the end, the volatility had cost the Dow almost 15% since its April high. The small caps of the Russell 2000 suffered the most; by the end of the quarter the index had lost roughly a quarter of its value since April, putting it in bear-market territory. The S&P 500 lost 17% in the same time, while the Nasdaq has declined almost 16% since April. The Global Dow continued to slump under the weight of concerns about the global impact of Eurozone debt problems.

The deficit/debt ceiling debacle was eventually overshadowed by debt issues abroad. Despite Standard and Poor's downgrade of the U.S. credit rating, demand from nervous investors sent Treasuries soaring, pushing yields on the 10-year note below 2% to levels not seen in decades and just over half the current rate of inflation. Gold benefitted from the anxiety for a while, hitting a new record just under \$1,900 an ounce before plummeting below \$1,700 in September as the dollar strengthened against the euro. After surpassing \$100 a barrel, oil prices dropped back to around \$80 on fears of the potential for renewed global recession. Other commodities were hit at quarter's end as well, as markets discounted a global economic slowdown.

Market/Index	End of Quarter	Quarterly Change	YTD Change
DJIA	10,913.38	-12.09%	-5.74%
NASDAQ	2,415.40	-12.91%	-8.95%
S&P 500	1,131.42	-14.33%	-10.04%
Russell 2000	644.16	-22.15%	-17.88%
Global Dow	1,725.68	-19.15%	-17.33%
Fed. Funds	0.25%	0 bps	0 bps
10-year Treasuries	1.92%	-126 bps	-138 bps

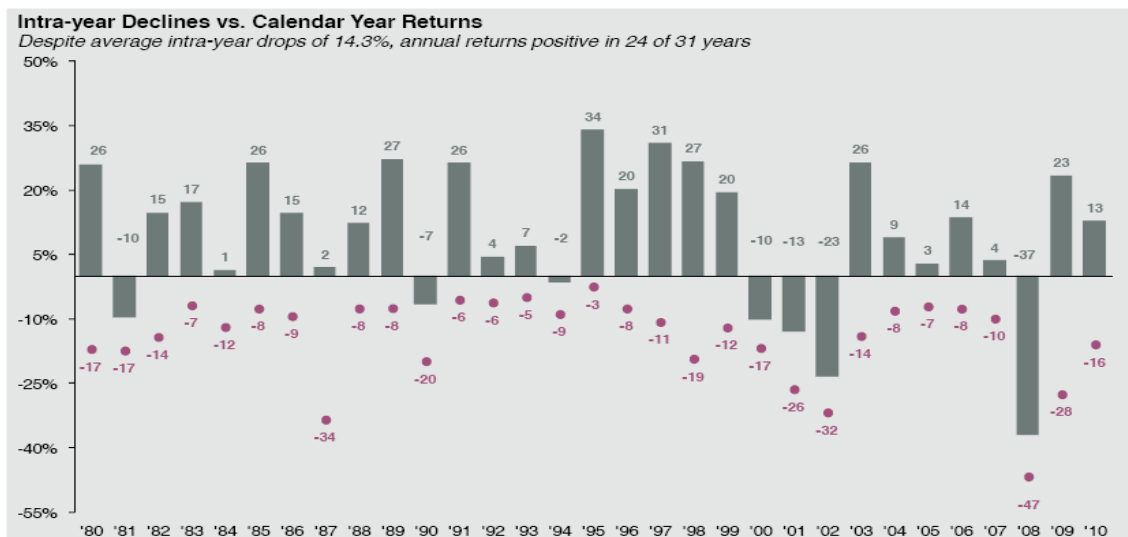
Equities data reflect price change, not total return

Quarterly Economic Perspective

- The world continued to worry about the possibility of global contagion from European debt problems. European leaders agreed to a second bailout for Greece, though individual member nations must agree to participate. However, problems began spreading to the larger economies of Spain and Italy, which saw their borrowing costs rise as investors feared that the European Financial Stability Facility wouldn't be able to bail them out. Despite Greece's attempts to balance its budget, at the end of the quarter it was still unclear whether the new measures would enable the country to qualify for its October round of assistance.
- The final estimate of U.S. economic growth during the second quarter was 1.3%. That's slightly higher than the Bureau of Economic Analysis's previous 1% estimate, and an improvement from Q1's 0.4%.
- Unemployment remained stalled at 9.1%, according to the Bureau of Labor Statistics.
- Citing concerns about "significant downside risks to the economic outlook," the Federal Reserve announced it will sell \$400 billion worth of short-term bonds in its portfolio and buy an equal amount of longer maturities. The plan, which echoes a 1960s maneuver called Operation Twist, also will involve reinvesting principal payments on the Fed's agency debt holdings in agency mortgage-backed securities.
- The last-minute resolution of the debt ceiling debate couldn't prevent Standard & Poor's downgrade of the U.S. credit rating (and ratings of various agencies linked to the federal government) from an impeccable AAA to AA+. Two other ratings agencies are watching to see what further measures are taken to tackle the deficit, including proposals from a "super committee" charged with finding at least \$1.2 trillion in additional deficit reduction.

Investment Perspective

The early days of the fourth quarter global financial markets have seen a continuation of the third quarter downturn. While it's painful to watch account values drop, the following chart shows that sharp declines are fairly common and have always been followed by a recovery.



Source: J P Morgan Asset Management

Economic Cycle Update

Absent further unforeseen geopolitical shocks or natural disasters, we continue to expect a continuing subpar recovery in the U.S. which struggles to sustain growth rates consistently above 2%. This argues for positive real returns in stocks and corporate bonds going forward, though probably lower than historic averages. Treasury bonds are likely to experience negative real returns to market losses over the next few years, as rates correct above artificially suppressed levels.

Current Headwinds center on negative psychology - the fear of a severe recession and perhaps another credit crisis like 2008-2009 originating in the Eurozone:

- Eurozone policymakers appear unwilling to take the steps need to deal with fiscal problems in the peripheral countries. A “TARP-like” approach is needed to wall off the debt of the weaker countries and stabilize the banks.
- The U.S. political stalemate is intractable in an election year, preventing meaningful progress in addressing our looming fiscal crisis.
- The expiration of fiscal stimulus programs now in place would serve as a drag on growth next year.
- Lack of clarity on a number of tax policy and regulatory issues are preventing cash-rich businesses from hiring and expanding capacity.

Current Tailwinds include a laundry list of positive influences that support our slow growth outlook and continue to defy comparisons with the fragility of the system in the fall of 2008:

- Accommodative monetary policy; better coordination with the ECB and other central banks.
- Stock market valuations are as much as 35-40% below long term trends; foreign markets are even lower. Markets are mean reverting.
- Healthy corporate balance sheets; corporate credit is stable and cash is at a record of \$2 trillion.
- Core inflation is contained and dropping energy prices should provide consumer relief.
- U.S. banks are better capitalized; interbank lending in the U.S. has stabilized.
- The de-levering of households is progressing at a steady pace with a personal savings rate of 5% disposable income and debt service ratios declining from 14% in 2007 to 11%.

Investment Responses

Although we expect the economic recovery to continue, thereby supporting a rebound in asset prices, we also expect the environment of heightened volatility to continue for several years. While we are maintaining our neutral positions in client asset allocation strategies, we are making adjustments in our asset class modules to mitigate downside risk:

- *Domestic Equities* – we are increasing allocations to more defensive managers who are likely to outperform in declining markets.
- *Fixed Income* – we are maintaining allocations to flexible mandate managers who seek to invest across the entire fixed income spectrum.
- *Alternatives* – we have reduced our exposure to stock and bond market risk (beta) by increasing our allocation to managed futures.

In summary, the market turmoil this summer appears to be driven more by fear than by economic fundamentals. Investors still fragile from the trauma of the financial crisis and the uncertainties being introduced by policy mistakes and political ineptitude are naturally tempted to capitulate. Throughout our thirty year history, it has never benefitted clients with a longer horizon to abandon their investment plans when markets are in turmoil. This time should be no different.

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