



## Monthly Investment Update

December 5, 2011

### Market Performance Recap

Europe's ongoing debt problems hurt domestic equities last month, causing them to reverse much of October's strong gains. The tech-heavy Nasdaq took the biggest hit, while a strong rally on the month's final day helped bring the S&P 500 and Russell 2000 up to just below even. The Dow--the sole gainer for the month--bounced in and out of positive territory for the year, managing once again to regain the 12,000 threshold it has been criss-crossing for weeks. Not surprisingly, the situation in Europe continued to weigh on the Global Dow.

Demand nudged the yield on the 10-year Treasury downward to just over 2%. Meanwhile, anxiety about the euro's future caused the currency to fall from \$1.41 to \$1.33 against the dollar. Despite that dollar strength, oil prices rose, once again closing in on \$100 a barrel. And after a brief bounce back up to \$1,800, gold retreated before recovering to roughly \$1,740 an ounce.

Market/Index	2010 Close	Prior Month	As of 11/30	Month Change	YTD Change
<b>DJIA</b>	11577.51	11955.01	12045.68	0.76%	4.04%
<b>Nasdaq</b>	2652.87	2684.41	2620.34	-2.39%	-1.23%
<b>S&amp;P 500</b>	1257.64	1253.30	1246.96	-0.51%	-0.85%
<b>Russell 2000</b>	783.65	741.06	737.42	-0.49%	-5.90%
<b>Global Dow</b>	2087.44	1898.33	1822.42	-4.00%	-12.70%
<b>Fed. Funds</b>	0.25%	0.25%	0.25%	0 bps	0 bps
<b>10-year Treasuries</b>	3.30%	2.17%	2.08%	-9 bps	-122 bps

*Data source: All information is based on sources deemed reliable, but no warranty or guarantee is made as to its accuracy or completeness. Neither the information nor any opinion expressed herein constitutes a solicitation for the purchase or sale of any securities, and should not be relied on as financial advice. Past performance is no guarantee of future results. Equities data reflects price changes, not total return.*

*The Dow Jones Industrial Average (DJIA) is a price-weighted index composed of 30 widely traded blue-chip U.S. common stocks. The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. The NASDAQ Composite Index is a market-value weighted index of all common stocks listed on the NASDAQ stock exchange. The Russell 2000 is a market-cap weighted index composed of 2000 U.S. small-cap common stocks. The Global Dow is an equally weighted index of 150 widely traded blue-chip common stocks worldwide. Market indexes listed are unmanaged and are not available for direct investment.*

## **The Month in Review**

- Despite bond-buying by the European Central Bank, the overseas debt debacle spread from Greece, Portugal, and Ireland to larger economies, costing the Greek and Italian prime ministers their jobs in the process. Yields on Italian and Spanish debt neared or exceeded the 7% level that triggered the need for bailouts in the smaller countries. As investors became more reluctant to lend in Europe, even France and Germany showed signs of weakness. By the end of the month, six central banks, including the Federal Reserve, adopted measures that would facilitate currency exchanges among the banks to increase liquidity in the global financial system, especially in Europe.
- The congressional Joint Select Committee on Deficit Reduction (“Super Committee”) charged with finding ways to cut the national deficit by \$1.2 trillion admitted it had been unable to do so. As a result, \$1.2 trillion in across-the-board budget cuts, split roughly evenly between defense and other programs, are slated to be implemented in 2013. The dissent among committee members also raised questions about the potential for resolution of other issues, such as payroll tax cuts and unemployment benefits that are scheduled to expire at year's end.
- The U.S. economy grew 2% during the third quarter, a bit slower than the Bureau of Economic Analysis had previously estimated but still ahead of Q1's 1.3%. But there was good news on employment, as the Bureau of Labor Statistics reported that the unemployment rate edged down to 8.6% in November.
- Strong sales of electronics and appliances helped push retail sales up 0.5% in October, according to the Commerce Department. Also, the National Retail Federation said there were 6.6% more shoppers hitting the Black Friday weekend sales this year, and they spent an average of 9.3% more than they did last year. Clothing and electronics were some of the most popular purchases. However, durable goods orders fell 0.7%, hurt by lower demand for commercial aircraft.
- Lower energy costs helped reduce inflation at both the consumer and wholesale levels, according to the Bureau of Labor Statistics. The Consumer Price Index fell 0.1%, while the wholesale index was down 0.3%. Also, the Bureau of Economic Analysis said that personal incomes and spending rose by 0.4% and 0.1% respectively, while the savings rate edged up to 3.5% of income.
- Housing starts dipped by 0.3% after strong growth the previous month, but were still 16.5% higher than the same time last year, and the Commerce Department said building permits were up 10.9%. Meanwhile, home prices as measured by the S&P/Case-Shiller national index remained lackluster during the third quarter, up a scant 0.1%. Those prices helped bring out buyers, as the Commerce Department said sales of new homes rose 1.3% from the previous month and 8.9% from last year.

## **Eye on the Month Ahead**

Domestic equities will continue to react to the Eurozone's struggles and/or progress with a solution to its debt problems. Investors are closely watching the Eurozone debt crisis, which is in urgent need of near-term action by European policy makers. To that end, there are hopes that the European summit on December 8<sup>th</sup>-9<sup>th</sup> will produce a closer fiscal union and an expanded monetary solution to the solvency issues currently threatening weaker Eurozone countries and the banking system.

The failure to reach agreement by the “Super Committee” was disappointing, though expected by most political analysts. With frustrated voters now resigned to wait until 2013 for foreboding fiscal issues to be addressed, the focus has shifted to the fate of the unemployment benefits and reduced

payroll taxes due to expire at yearend. Most economists believe these programs should be retained into 2012 to provide added stimulus for the economic recovery.

## **Investment Strategy Summary**

Despite some signs of improving economic conditions in the U.S. and elsewhere, investors are faced with making judgments about the decisions of politicians who work behind closed doors, rather than basing decisions on an analysis of the underlying economic fundamentals. This period of extraordinary policy uncertainty promotes the “risk on versus risk off” mentality that has produced investor distress and erratic price movements in the equities markets over the past year. Those conditions are likely to persist at least for several quarters, further testing investor patience.

Meanwhile, the Fed and other central banks are implementing long-term policies to suppress interest rates below the inflation rate, thereby paying down excessive debt levels with cheaper dollars and leaving bond investors with principal losses on a real basis. Therefore, diversified investors with sufficient planning horizons of three years or more should be rewarded for enduring the additional volatility in equities and lower grade fixed income investments.

## **Current Investment Strategy Recommendations\***

- **Asset Allocation Strategy** – maintain neutral positions, although equities appear to be cheap relative to investment grade bonds.
- **Equities** – mitigate increased uncertainty/volatility by:
  - Increasing allocation to more defensive manager(s);
  - Emphasizing exposures to domestic/large cap/high quality/dividends;
  - Favoring active management over indexing; abnormally high correlations among S&P 500 sectors should diminish as fear subsides and investors focus on fundamentals (earnings).
- **Bonds** – mitigate interest rate and credit risks with flexible mandate fixed income managers. Current junk bond yields have spiked back above 9% and should compress as fear subsides.
- **Alternatives** – increase managed futures allocations to hedge global macro risks.
- **Rebalancing Recommendations** – increase equity allocations back to within policy in stages; money should be taken from core fixed income managers or cash/additions.

*\*CapGroup’s Research Team meets weekly to assess economic conditions and the primary headwinds and tailwinds influencing the investment markets. Our deliberations are updated each week in our Investment Strategy Notes, including an Investment Strategy Summary section which provides investment strategy guidance for our discretionary client portfolio strategies. This Summary is for the current Investment Strategy Session.*

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