



Quarterly Investment Update

January 9, 2012

Market Performance Recap

After huge volatility throughout 2011 and a dismal third quarter, the equities markets rallied sharply in the fourth quarter. When the smoke cleared at year end, the S&P 500 Index had ended the year where it started on a price basis. Larger cap “blue chips” represented in the Dow Jones Industrial Average managed an increase of 5.5% in 2011, while smaller cap stocks represented in the Russell 2000 Index closed the year down 5.5%. Fear over the euro zone debt crisis dragged The Global Dow down 13.7%, while China’s growth slowdown aided a yearly decline of 20.4% for the MSCI Emerging Markets Index.

In the fixed income markets, 2011 may be remembered as the year of the sovereign debt downgrade. Of the 24 countries classified as “developed” by MSCI, nine, including the U.S., were downgraded during 2011 and five others were put on CreditWatch negative. In spite of these ratings actions, U.S. government bonds benefitted from sharp flight-to-safety rallies, driving yields on the benchmark 10 year Treasury Note below the inflation rate and pushing the investment-grade Barclays Capital U.S. Aggregate Bond Index to a 7.8% annual gain. Municipal bonds rallied from the 2010 credit scare and enjoyed a similar 7.6% return in the Barclays Capital 1-10 Yr. Muni Index.

Market/Index	End of Quarter	Quarterly Change	YTD Change
DJIA	12,217.56	11.95%	5.53%
NASDAQ	2,605.15	7.86%	-1.80%
S&P 500	1,257.60	11.15%	0%
Russell 2000	740.92	15.02%	-5.45%
Global Dow	1,801.60	4.40%	-13.69%
Fed. Funds	0.25%	0 bps	0 bps
10-year Treasuries	1.89%	-3 bps	-141 bps

Equities data reflect price change, not total return

Market Environment and Events

To state the obvious, 2011 was a year of significant global events which created a very difficult investment environment. Political upheaval in the Middle East; a terrible earthquake and tsunami in Japan; a debt crisis that still threatens the world's largest economic union; U.S. political gridlock that seems to drown out most reasonable voices; S&P downgrades on the sovereign debt of nine developed countries and warnings on five others. Additionally, the blowup of investment bank MF Global, blamed on 40-1 leverage utilizing client capital invested in European sovereign debt, resulted in the 7th largest bankruptcy in U.S. history. With that as a backdrop, the U.S. stock market went exactly nowhere. The S&P 500 closed 2010 at 1,257.64, traded in a 296 point range through the year, and closed 2011 at 1,257.60. The index fell just four one hundredths of a point; quite a round trip and the smallest annual price change since 1947. Once dividends are included in the total return calculation, the index finished in the black, up 2.1% for the year.

As stated above, 2011 was a year in which credit rating agencies and investors began to doubt the credit worthiness of government-backed debt, even in the U.S. However, as fear gripped the markets in July and August, memories of 2008-09 surfaced and overrode the illogic of owning money market and government bond investments with negative real returns; that is, locking in purchasing power losses and capital losses as yields eventually rise.

The U.S. political environment also presented challenges to the financial markets. While the debt ceiling debate was resolved in August, the "Super Committee," a major part of the resolution, utterly failed to achieve any of its goals by its late November deadline. Just what that failure implies is hard to say as the mandated spending cuts do not go into effect until 2013. Between then and now we have a presidential election and a reshaped Congress that will significantly impact the strength of the efforts to reduce the U.S. budget deficit.

The euro zone's future is threatened as the debt crisis that began with Greece spread to the rest of the GIIPS countries (Greece, Ireland, Italy, Portugal, and Spain). While there has been a great deal of sword-rattling and brinksmanship, Europe's dilemma may come down to the rich countries' (Germany) willingness to backstop the debts of those countries with seemingly insurmountable debt loads. Should diplomacy fail to save the currency union, the question becomes what the disintegration of the euro zone might look like. On the surface it seems that everyone would lose; strong countries would see their newly re-established currencies skyrocket and kill exports (forecasts have been floated that a new German mark would immediately appreciate by as much as 30%) while weak countries would hemorrhage the capital needed to restart growth.

U.S. Federal Reserve policy has kept rates in the range of 0% - 0.25% for nearly three years. The Fed has committed to ZIRP (zero interest rate policy) at least until mid-2013 and will start announcing four times a year how long it plans to keep short-term interest rates at existing levels. These quarterly forecasts are a first in Fed policy. With ZIRP having an obvious lower bound, nominal rates cannot drop below zero, the Fed has also instituted a purchase program on longer dated Treasuries in an attempt to bring down longer term rates and further flatten the yield curve. "Operation Twist," as it has been dubbed in the press, appears to have been successful as 10-year and 30-year rates have fallen to historic lows.

Despite the political and economic turmoil that currently dominates the news, corporations continue to perform well. The third quarter earnings season posted record profits, eclipsing the peak levels of the previous quarter. Recently however, a number of analysts have cut 2012

earnings forecasts on the S&P 500 from about \$110 to \$100-\$105. The forward P/E on the S&P 500 rose to 11.8x during the quarter but remains well below the 20-year average of about 16x. Bullish investors cite those favorable valuations, strong dividend yields, and the very low yields available in bond markets as reasons to favor stocks. Bearish investors counter the low valuations with observations that slower growth is unlikely to support any P/E expansion due to the ongoing concerns about the risks that macroeconomic and geopolitical uncertainty places on the sustainability of the currently high profit margins. Margins are well above historical norms and appear unsustainable over the longer term. Additionally, cash balances continue to amass on corporate balance sheets as firms remain reluctant to return capital to shareholders. Cash as a percentage of current assets approaches 30% after climbing steadily since the 2008 recession. Dividends and stock buybacks dropped sharply during the recession and remain well below their 2007 peak.

Inflation data remain fairly benign. Headline CPI dropped slightly in November to an annualized rate of 3.4% while Core CPI (excluding food and energy) rose 2.2%. With 10-year Treasury rates again below 2%, investors are suffering negative real yields in exchange for the safety of U.S. Government obligations.

While American consumers remain defensive due in large part to high unemployment, stagnant wages, and weak housing prices, the holiday shopping season was reportedly reasonably strong on the back of major discounting by retailers. Unemployment has dropped below 9% (8.5% at year-end) and initial jobless claims are at a 3½ year low; however, it appears that declining labor force participation has as much to do with the falling unemployment rate as actual job creation. For those lucky enough to have a job, wages (adjusted for inflation) have been stagnant for a decade, according to a recent study by the U.S. Census Bureau.

Finally, while house prices have remained weak there has been some positive data of late. November housing starts came in well ahead of forecasts and homebuilder optimism is at a 1½ year high. Additionally, housing affordability is at a generational high. At current average house prices and mortgage rates, it takes just 10.3% of the average monthly income to cover the mortgage payment. The range in the 1990s and 2000s was between 15-20% and peaked above 35% in the 1980s when mortgage rates spiked to the high teens.

The Year(s) Ahead – Deleveraging Continues

As we enter the first quarter of 2012, the central investment thesis driving our investment advice remains the same as it has been since 2008. That is, over the past thirty years, the developed world took on massive and unsustainable levels of debt that in all likelihood will take a decade or more to fully unwind. This will reduce economic growth below the levels we had come to think of as normal; levels which themselves became distorted upward based on the spending of all this borrowed money. As that debt is reduced going forward, there will be less money available to spend, especially when inflation is considered. Therefore, in meeting critical personal and business financial goals, investors need to continue to focus on managing higher levels of market risk, as well as avoiding the purchasing power losses associated with tying up investment capital in low yielding fixed income investments like money market funds, CD's and Treasury securities.

Investment Strategy Recommendations

CapGroup's Investment Committee meets weekly to discuss economic conditions, the effects of these conditions on the financial markets and the appropriate investment response within our Managed Strategies. In these sessions, we process inputs from a variety of institutional quality resources, including Callan Associates, the Bank Credit Analyst (BCA), AdvisorIntelligence, and a dozen or more investment management firms with deep and talented research staffs. Our deliberations and insights are compiled and summarized in a bi-weekly piece called the *CapGroup Investment Strategy Notes*, which is used by our Advisors to discuss our current thinking with our Clients and other interested parties. A copy of our current edition of the Investment Strategy Notes can be accessed by clicking on this [link](#). Please feel free to call your CapGroup Advisor for a discussion of its contents.

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