Pinnacle
ADVISORY GROUP, INC.
Private Wealth Management

October 2010

2010 Third Quarter Market Review

Executive Summary

- The third quarter started with a jittery investing backdrop. Investors, fresh off of large declines during the second quarter, had legitimate reasons to fear that the global cycle had taken a sharp turn for the worse. However, just as it appeared that a perfect storm was building, the clouds broke during the third quarter, paving the way for robust gains in risk assets.

- If there was a positive aspect to the deterioration in economic and technical data that occurred during the second quarter, it was that it may have given the authorities exactly the excuse they needed to draw up plans for another round of reflationary policy. Financial markets began to price in the notion that the action was simply a prelude to another round of high powered asset purchases by the Fed. The name given to this potential new round of stimulus was Quantitative Easing 2 (QE2), and it has been the recent buzz reverberating through the investment community.

- Pinnacle Advisory Group managed accounts gained nicely in the third quarter, more than reversing losses from last quarter and pulling returns comfortably into positive territory for the year. In addition, returns measured over the trailing 12-months continue to be positive, but have moderated somewhat as the market rally has lost some steam as its aged.

- As we enter the fourth quarter, markets are drifting upward toward their April highs largely based on the idea that the Federal Reserve will soon be riding to the rescue with more high powered money. Despite the improvement in business cycle dynamics, however, pockets of weakness that have the capacity to undermine the economic recovery continue to linger.

- Our defensive portfolio positioning since the summer has been aimed squarely at managing risk due to cyclical concerns regarding economic growth, and the presence of substantial structural headwinds that are the byproduct of the post-financial crisis world we live in. The latest month of data and market action contained some evidence that the recent deceleration may end up being a benign mid-cycle slowdown rather than a new economic contraction that would be damaging for financial assets.

- Presently, we believe that it's prudent to maintain a moderately defensive approach and allow additional fundamental and technical evidence to materialize before committing to a less defensive allocation in client portfolios. If we can pass through the remainder of this typically tough seasonal period unscathed, and if the backdrop continues to improve, then we may be willing to add some degree of risk back into portfolios in the fourth quarter.

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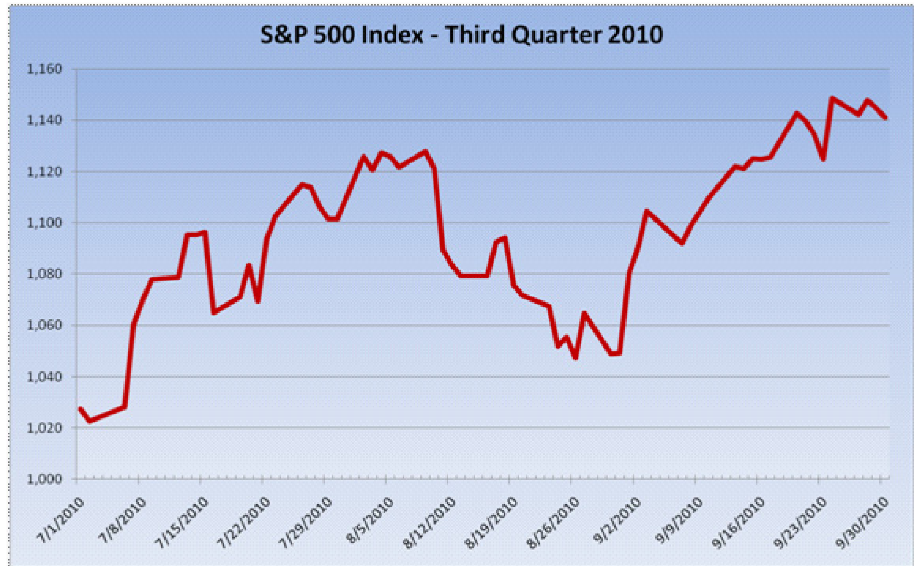
Third Quarter Review

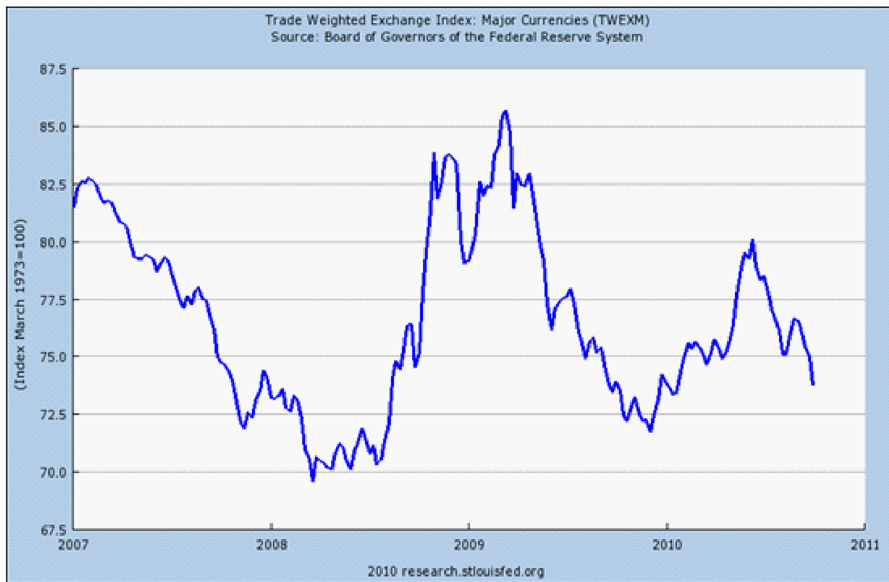


The third quarter started with a jittery investing backdrop. Investors, fresh off of large declines during the second quarter, had legitimate reasons to fear that the global cycle had taken a sharp turn for the worse. From the market peak in April, through the end of June, a combination of system risk, slowing economic data, and rapidly deteriorating technical conditions had many believing the worst was yet to come. However, just as it appeared that a perfect storm was building, the clouds broke during the third quarter, paving the way for robust gains in risk assets. Though the quarter was rewarding, it was anything but a smooth ride. Mixed data intermittently appeared to support both the bull and bear cases, and made for a rollercoaster ride that wreaked havoc on trend-following investing methodologies. By the end of the quarter it was the bulls that had gained the upper hand on the back of the best September for stocks since 1939.

Index	Third Quarter Return
S&P 500 Index (w/ dividends)	+11.30%
Russell 2000 Index (small cap stocks)	+11.29%
MSCI EAFE Index (international stocks)	+16.57%
Dow Jones/UBS Commodity Index	+11.57%
Barclays Capital Aggregate Bond Index	+2.15%
3-month T-bills	+0.035%

Reflationary Impulse

If there was a positive aspect to the deterioration in economic and technical data that occurred during the second quarter, it was that it may have given the authorities exactly the excuse they needed to draw up plans for another round of reflationary policy. Midway through the third quarter the Federal Reserve (the Fed) announced that it would reinvest the proceeds of its maturing mortgage backed and agency bonds into freshly minted U.S. Treasury bonds. The announced repurchase program by itself wasn't that large and appeared to be aimed at making sure that the size of the Fed's balance sheet doesn't shrink at a time when economic data seems to be on shaky ground. But despite the somewhat tepid magnitude of the reinvestment program, financial markets began to price in the notion that the action was simply a prelude to another round of high powered asset purchases by the Fed. The name given to this potential new round of stimulus was Quantitative Easing 2 (QE2), and it has been the recent buzz reverberating through the investment community. The repurchase program in August started the QE2 chatter, but the market really began to embrace the idea in late September, when the Fed explicitly stated that measures of inflation are running at levels somewhat below their mandate for price stability – implying a need for action to support broad price levels.



One area in particular that seemed to be discounting a material QE2 program was the Foreign Exchange (FX) market. FX movements are very sensitive to changes in growth rates and inflation-adjusted interest rates. In this case, the supposed need for QE2 is a direct result of the slowing nature of growth in the U.S. Consequently, expectations for additional monetary policy easing to combat depressed growth should widen the interest rate differential between the U.S. and other countries. Currencies are a relative game, and the fact that the Euro-zone is implementing austerity measures while the U.S. contemplates additional money printing helps build expectations for higher real interest rates outside of the U.S. Given those dynamics, it's not that surprising in hindsight that the trade weighted dollar index dropped 7% during the quarter, and that losses accelerated to the downside after the Fed's September statement.

As the dollar fell, it not only created the potential for higher exports for the economy, but it also acted to propel select markets that typically move inversely with the dollar. U.S. multinational companies with a large exposure to overseas markets helped drive U.S. indexes higher. Commodities, particularly precious metals like gold and silver, surged during the quarter and foreign stock investments benefitted from the currency gains that occur when the dollar weakens. Developing country funds also benefitted from an increasing belief that their economies may be decoupling from the developed world's slow rate of growth.

The trade in vogue during the third quarter was based on the QE2 theme, and investors who participated were handsomely rewarded as the market's knee-jerk reaction to the prospect of more liquidity was equivalent to Pavlov ringing the bell. The question of course is, how long will this trade last? It could be that excess money is in the midst of creating new asset bubbles that may reward investors for some time to come. On the other hand, investors must also consider what could happen if the stimulus being discounted comes in less than expected, doesn't materialize, or worst of all, is ineffective in boosting growth. As the fourth quarter gets underway, investors must avoid surrendering to the sense of complacency that seems to be building, and be thinking more than ever about how to position going forward.

For a detailed analysis of Pinnacle's current views, please read the section titled "Market Outlook."

Pinnacle Performance Analysis

Pinnacle Advisory Group managed accounts gained nicely in the third quarter, more than reversing losses from last quarter and pulling returns comfortably into positive territory for the year. In addition, returns measured over the trailing 12-months continue to be positive, but have moderated somewhat as the market rally has lost some steam as its aged.

Composite	Third Quarter Composite Return 6/30/10 to 9/30/10	Trailing 12-Month Composite Return 9/30/09 to 9/30/10
Dynamic Conservative	+2.70%	+5.67%
Dynamic Conservative Growth	+5.42%	+6.46%
Dynamic Moderate Growth	+6.97%	+8.37%
Dynamic Appreciation	+7.50%	+8.05%
Dynamic Ultra Appreciation	+6.38%	+7.94%
Please see the last page of this report for important performance-related disclosures.		

Equities and other risk assets were the best performers in the third quarter. All ten sectors of the S&P 500 rose. Gains were broad based across sectors. Cyclicals were very strong, but defensives also performed fairly well. International equity funds were also strong, partially due to the renewed decline in the U.S. dollar, with emerging markets among the best performers.

Fixed Income investments also produced widespread gains. High-quality U.S. Treasuries continued their relentless march higher in price (lower yields). Credit-related holdings, including Investment Grade Corporates, Mortgages, and High Yield Corporates were all very strong. Holdings in Alternative Investments were mostly positive. Diversified commodities soared, while gold and eclectic managers had more modest gains.

Top Five Performers of the Third Quarter		Bottom Five Performers of the Third Quarter	
Oppenheimer Developing Markets Fund	+20.74%	iShares Medical Devices ETF	+0.88%
iShares Networking ETF	+20.51%	Hussman Strategic Growth Fund	-0.67%
Consumer Discretionary SPDR	+16.38%	Metals & Mining ETF	-0.94%
UBS CMCI Commodity ETN	+16.30%	Financial Sector SPDR	-0.99%
Energy Sector SPDR	+13.35%	iShares Russell 2000 Growth ETF	-1.46%

Please note that the returns used for this illustration are based on Pinnacle's Dynamic Moderate Growth portfolio. The individual security returns for other Pinnacle strategies may vary due to trade execution or security selection differences. Securities may have been bought and sold during the quarter; therefore, Pinnacle client returns (which are shown here) may not reflect a security's actual quarterly return.

Quarterly Portfolio Activity

Back on July 1, we executed trades to reduce risk across all portfolios after the S&P 500 closed below 1,040. At the time, we were concerned that the market was "breaking down," and perhaps headed for substantial losses. Throughout the remainder of the quarter, with elevated risks as a backdrop, we used the increased volatility in markets to continue to rotate from cyclical to defensive equity sectors. Overall, the third quarter was characterized by a reduction in risk for Pinnacle investment strategies.

We currently view portfolios as being moderately below neutral on a volatility basis relative to their benchmarks. We continue to monitor portfolio performance and volatility on a daily basis across a variety of timeframes to help guide us as we consider further potential portfolio adjustments.

The following table details the current asset mix across strategies (the net change from the prior quarter is indicated by the number in parentheses):

Composite	Equities	Fixed Income	Alternative Investments
Dynamic Conservative	6 (0)	69 (0)	25 (0)
Dynamic Conservative Growth	29 (0)	49 (0)	22 (0)
Dynamic Moderate Growth	45 (-2)	36 (+3)	19 (-1)
Dynamic Appreciation	56.25 (-5)	27 (+5)	16.75 (0)
Dynamic Ultra Appreciation	72.5 (-6.5)	4.5 (-1.5)	23 (+8)

Market Outlook

As we enter the fourth quarter, markets are drifting upward toward their April highs largely based on the idea that the Federal Reserve will soon be riding to the rescue with more high powered money.

Overall business cycle conditions are still mixed and muddled, but have improved from the second quarter when several indicators were flashing warning signs. Notable improvements during the quarter were seen in leading economic indicators, credit market relationships, and rebounding commodity prices. Despite the improvement in business cycle dynamics, however, pockets of weakness that have the capacity to undermine the economic recovery continue to linger.

Technical conditions have firmed in line with fundamentals as prices have risen, and most of the major market averages climbed back above key trend lines and erased bearish patterns that emerged in the second quarter. In the short-term, markets are approaching overbought levels, and there continue to be areas of concern such as low volume, divergences between price and other indicators, and increasingly optimistic investor sentiment. Market valuation has not changed meaningfully from prior quarters. Valuations generally appear to be stuck in a neutral range, which gives them very little weight in our asset allocation decisions at present.

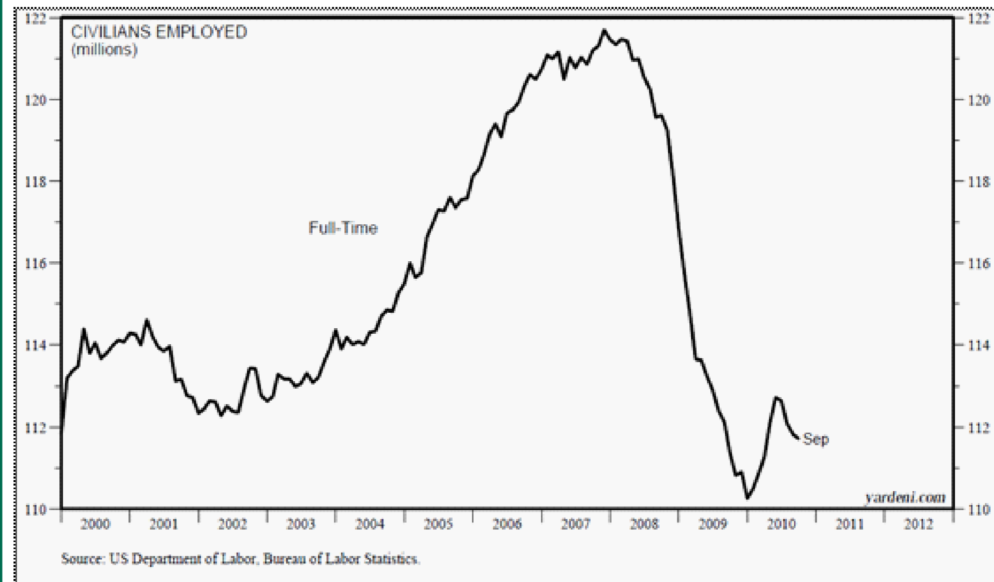
Our defensive portfolio positioning since the summer has been aimed squarely at managing risk due to cyclical concerns regarding economic growth, and the presence of substantial structural headwinds that are the byproduct of the post-financial crisis world we live in. Conditions are changing rapidly, and have recently been prone to whipsaw. The latest month of data and market action contained some evidence that the recent deceleration may end up being a benign mid-cycle slowdown rather than a new economic contraction that would be damaging for financial assets. While we are hopeful that data will continue to point towards a soft landing, we are also aware that one month does not equal a trend.

Presently, we believe that it's prudent to maintain a moderately defensive approach and allow additional fundamental and technical evidence to materialize before committing to a less defensive allocation in client portfolios. If we can pass through the remainder of this typically tough seasonal period unscathed, and if the backdrop continues to improve, then we may be willing to add some degree of risk back into portfolios in the fourth quarter.

Risk management can be a frustrating exercise at times, but savvy investors realize that avoiding the punishing effects of negative compounding that result from severe losses is a higher priority than catching every gain over the course of a market cycle. We continue to guard against becoming dogmatic in our views, and won't fight the Fed and a rising market indefinitely. However, for now we remain defensive, but also flexible and focused on the core tenets of our investment process. Should the evidence continue to change in a positive direction, we are prepared to adjust portfolios accordingly. Until then, portfolio transactions will be mostly based on rotation among asset classes and sectors that we believe present the most compelling opportunities.

Risk Still Elevated, Some Positives Building

One of the main reasons we have remained conservative is that we believe risks are still unusually elevated. Important areas of the economy, including the labor and housing markets, consumer and business confidence, and the velocity of money, are all still struggling. All of these areas continue to languish in spite of 0% interest rates and various government stimulus programs targeted directly at them. To some extent, these parts of the economy are all inextricably linked. When confidence is low, companies are reluctant to hire new workers, which contributes to high structural unemployment, stagnant wages, floundering home prices, and reduced capital expenditures due to the uncertainty in the outlook. With few companies borrowing to invest in capital equipment, money sits idle at the central bank in the form of excess reserves instead of multiplying across the economy through new lending and positively reinforcing the cycle.



While the possibility of QE2 has created great excitement and given risk assets a jump start, investors should be wondering why the next trillion dollars or so of stimulus will solve all of the problems that the last trillion couldn't. The old adage is that you can bring a horse to water, but you can't make it drink. The Fed has provided ample liquidity, but it's up to businesses to borrow, spend, and hire again. Furthermore, proponents of QE2 have another angle to worry about. They must now fret about whether the amount of future stimulus will be in line with current market expectations. Despite widespread investor anticipation, there is still the possibility of disappointment, either in the details of the next policy action or even a deferral on taking any action at the next Fed meeting on November 3.

Other relevant risks include the upcoming mid-term elections and uncertainty regarding whether the Bush tax cuts will be extended, ongoing debt and deficit problems in the Euro-zone, currency devaluations and increased trade tensions, and a renewed belief that developing economies can decouple from the developed world, even though they have never been more linked than they are now. These are just a few examples of the potential perils that exist in the marketplace right now, and we believe they offer good reasons for risk managers to be skeptical that the prospect of more "juice" from the Fed will be a cure-all for global economic ills.

Despite all the risks, we realize that bull markets often climb a wall of worry, and it could be that the list of concerns is actually setting the market up for more gains. During the quarter we noted improvement in market based leading indices such as copper and the CRB Raw Industrials Spot Index, both of which rose to new cycle highs. The U.S. leading economic index also reversed its decline and began picking up during the quarter, and the Economic Cycle Research Institute's (ECRI) Weekly Leading Index stabilized, albeit in negative territory. Although still not definitively positive, this is a much brighter backdrop than just one quarter prior, when seemingly all leading indicators turned sharply lower together. Additional signs of improvement in the fourth quarter would likely tip the balance clearly in favor of more robust growth prospects.

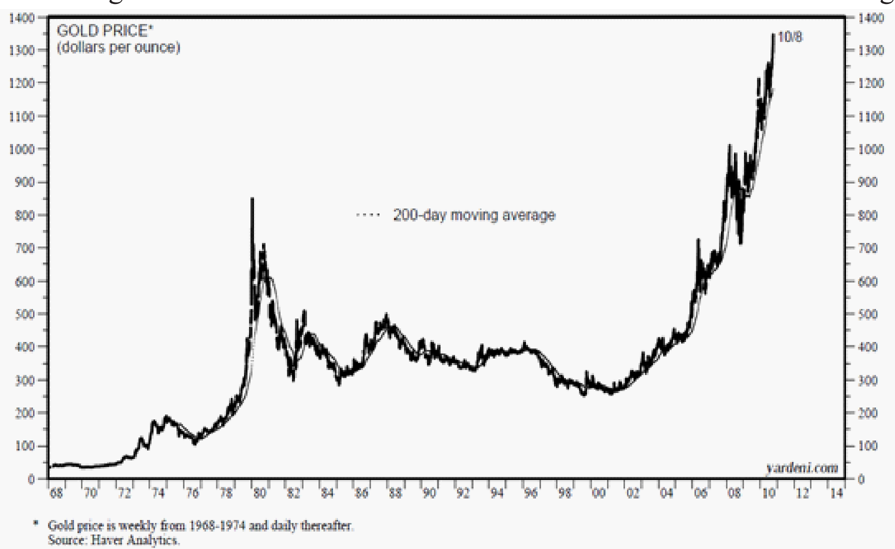
Market technicals also firmed during the quarter as major indices rose above their 50- and 200-day moving averages, advancing stocks outweighed decliners, and most negative patterns that formed several months ago were negated, implying that stocks have room to climb higher. One of the biggest changes going forward is that the seasonal profile will soon be past the riskiest months as we exit September and October and enter the typically positive fourth quarter, and post mid-term election period. The improved tone in the fundamental and technical data has kept us from growing too bearish, and even argues for a more bullish mindset. For now we are sticking with our conservative approach, but another round of favorable evidence could prompt a change in view and portfolio allocations.

Asset Bubbles In The Making?

The bulls have been stampeding recently, and their contention is that a fast-growing economy isn't a prerequisite for asset markets to move higher. They believe that current conditions present a win-win situation at the moment, where good news and bad news should both play into the hands of risk takers. The theory is that good news for the economy means the expansion and corporate profits are on solid footing, while bad news will bring about more stimulus from the Fed, and in theory more monetary easing should be good news for risk assets. Investors who subscribe to this line of thinking are counting on an increase in liquidity, and the fact that easy money typically finds a home in asset markets. Despite some of our skepticism regarding any thesis that sounds too bulletproof, we can't rule out that Federal Reserve policy may be in the midst of creating new asset inflation and potential market bubbles. If this is the case, investors need to be on the lookout for asset bubbles that are building. While no one precisely knows an asset bubble until it pops, there are several asset classes that seem like they could be bubbles in the making.

Emerging markets have higher growth rates, current account surpluses, huge financial reserves, and many countries have exchange rates that allow them to import our ultra-low interest rate and cheap dollar policies. That leaves them vulnerable to gross over-stimulation and makes the asset class a candidate for further asset inflation. Indeed, emerging markets equities have already produced much more robust gains off of their 2008 lows than developed markets, and have recently broken out to new highs ahead of developed markets. Emerging markets appear to be a prime bubble candidate.

Gold has long been viewed by the investment community as a "super hedge" that provides protection against inflation, deflation, money printing, geopolitical events, terrorism, protectionism, broken banking systems, etc. A mania in gold may be in the making as monetary authorities continue to print money and debase currencies, and there is a growing camp that believes gold is the only place to hide as a long-term store of value in such an environment. If that's not enough to make the price go vertical, add trend followers and levered hedge funds that are piling in to one of the only asset classes currently in a clear long-term uptrend. Similar to emerging markets, the story here is not new, and the risks are building in this volatile asset class. However, with the likelihood of more money printing on the horizon, the shiny metal may continue to soar much farther than most anticipate is possible.



* Gold price is weekly from 1968-1974 and daily thereafter.
Source: Haver Analytics.

These are only two examples of assets that could be bubbling up on the back of excess liquidity circulating throughout the global

financial system. The downside of bubbles is that they form on the back of misallocations of capital, and are eventually prone to bursting and causing investors much pain in the end. But the reality is that bubbles usually make investors fortunes as they expand, and so investors should be looking to find future bubbles to invest. The trick, as always, is to get in early enough to earn substantial gains, and more importantly, to get out before the carnage unfolds. Our latest estimate is that approximately 25% – 40% of Pinnacle portfolios (depending on policy) are either directly or indirectly exposed to various bubble themes through domestic equity sector ETFs, foreign equity funds, and alternative investments. We will be keeping a close watch on potential asset bubbles that are forming in the sea of liquidity that central banks are creating.

Conclusion

During the third quarter markets found a way to confound investors once again, as they turned on a dime and rallied impressively off of their summer lows. In the process, Pinnacle clients enjoyed positive gains as a robust quarter was in store for investors who owned anything other than risk-free cash. Currently there is a one-way theme reverberating through risk assets and markets are riding the wave of liquidity that the Federal Reserve is creating. It could just be that that the Fed will be successful in both creating growth and asset inflation that rewards investors willing to play the game. But investors must balance the need for returns with the risk that this great financial experiment is not guaranteed to succeed, and will undoubtedly leave a trail of unknown consequences in its wake. Recent data has been encouraging, and recent profits may entice investors to take their eye off the ball. We remain committed to diligently weighing the overall evidence, and flexible enough to change with this fast moving and volatile world.

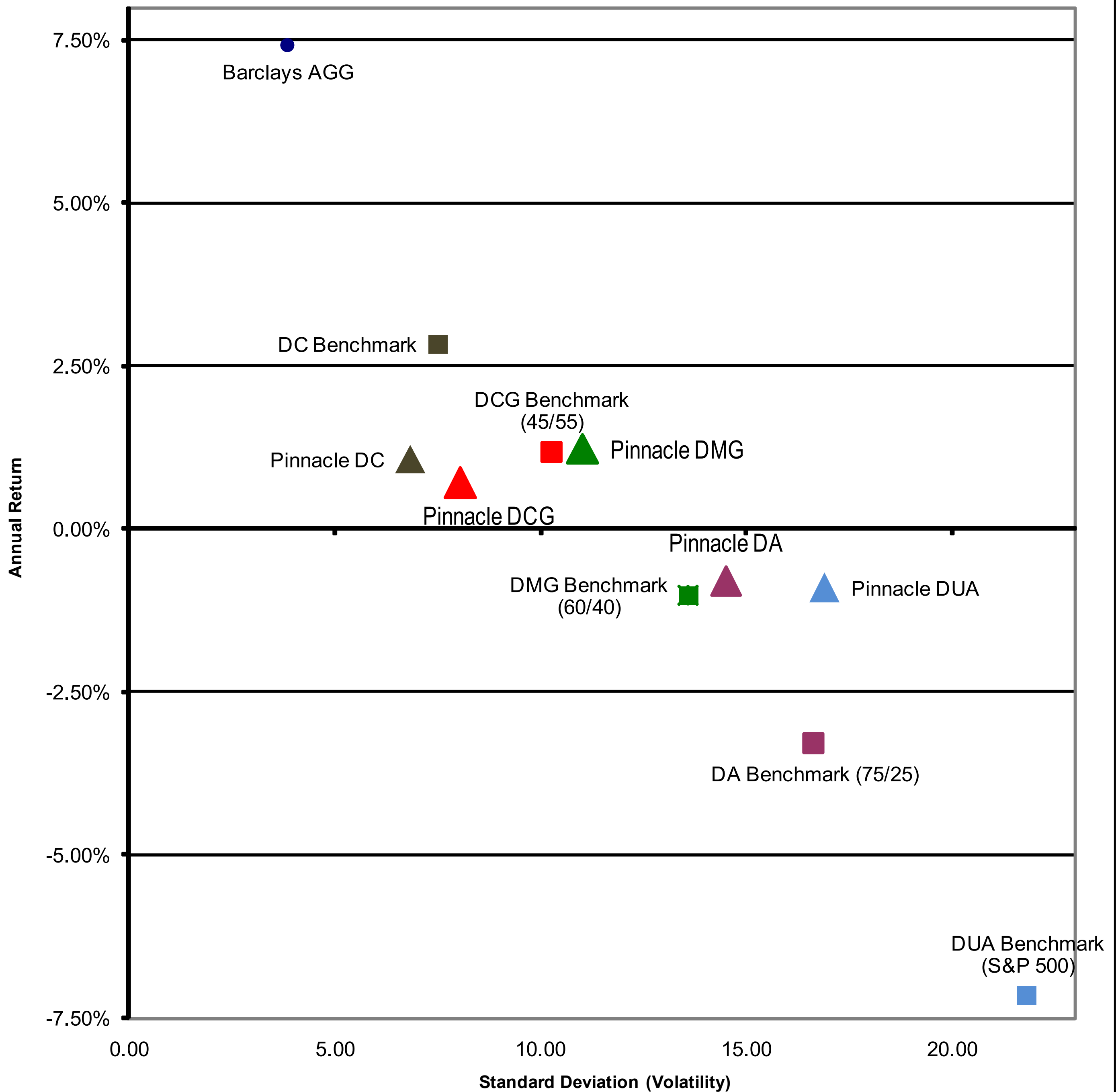
Pinnacle's views are current as of the date of this communication and are subject to change as economic and market conditions dictate.

The following data corresponds with the chart on page nine:

September 30, 2007 to September 30, 2010		
Asset	**Annual Return**	**Standard Deviation**
Barclays Aggregate	7.42%	3.85
DC Blend	2.84%	7.50
Pinnacle Dynamic Conservative	1.07%	6.84
45% S&P/55% AGG (DCG BM)	1.18%	10.27
Pinnacle Dynamic Con Growth	0.71%	8.05
60% S&P/40% AGG (DMG BM)	-1.02%	13.58
Pinnacle Dynamic Moderate Growth	1.23%	11.01
75% S&P/25% AGG (DA BM)	-3.28%	16.64
Pinnacle Dynamic Appreciation	-0.79%	14.50
S&P 500 (DUA BM)	-7.16%	21.81
Pinnacle Dynamic Ultra Appreciation	-0.90%	16.89

Three Year Chart (9/30/07 to 9/30/10)

Pinnacle Composite Portfolios may be compared to a variety of asset classes, blends of asset classes, or mutual fund universes. This chart shows risk and return for five Pinnacle composites. Risk is expressed on the horizontal axis as standard deviation. A high standard deviation means a security is more volatile than a security with a low standard deviation.



Barclays Capital Aggregate Bond Index (AGG) – An unmanaged, intermediate term, market-capitalization weighted index used to represent investment grade bonds being traded in the U.S. The index includes Treasury securities, Government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.
S&P 500 – An unmanaged, capitalization-weighted index composed of 500 widely held common stocks listed on the NYSE. This index provides a broad snapshot of the overall U.S. equity market . The index selects its companies based upon their market size, liquidity, and sector.
S&P 500 Total Return Index – S&P 500 index including reinvestment of all dividends and distributions.
DC Blend - Comprised of the 30% S&P 500 Total Return/70% Barclays Capital Aggregate Bonds to September 2009 Comprised of 20% S&P 500 Total Return/80% Barclays Capital Aggregate Bonds after September 2009.
45% S&P/55% AGG – Comprised of the S&P 500 Total Return Index and Barclays Capital Aggregate Bond Index.
60% S&P/40% AGG – Comprised of the S&P 500 Total Return Index and the Barclays Capital Aggregate Bond Index.
75% S&P/25% AGG – Comprised of the S&P 500 Total Return Index and Barclays Capital Aggregate Bond Index.

Disclaimer
Pinnacle Advisory Group, Inc. (hereinafter “Pinnacle”) is an investment advisor registered under the applicable provisions of the U.S. Securities and Exchange Commission (SEC).

Pinnacle Dynamic Portfolios Any reference to “Pinnacle’s” portfolio volatility or portfolio performance is based on the actual performance of Pinnacle’s composite portfolio groups. There are five Pinnacle composite portfolios – Dynamic Conservative, Dynamic Conservative Growth, Dynamic Moderate Growth, Dynamic Appreciation, and Dynamic Ultra Appreciation – and each is managed within the constraints of a specific Investment Policy Statement. The composite portfolios are actively managed and the underlying securities and/or percentage holdings in each security can and do change as Pinnacle alters its market outlook based on a continuous evaluation of market and economic conditions. The composite portfolios typically own a diversified mix of no-load or load-waived mutual funds and exchange-traded funds that invest in U.S. and international equities, fixed income securities, and alternative investments such as commodities, real estate, and hedge-fund-like strategies. It is important to note that the returns and volatility shown are accurate representations of past performance, but are not necessarily predictive of future performance or volatility as market conditions can and do change. Returns are calculated using month-end portfolio values. Any and all return or volatility data for the composite portfolios are shown net of all Pinnacle fees and any other related fees (such as fund expense ratios or transaction/trading costs where applicable), include dividends and interest, and are size- and time-weighted. Policy composites include portfolios formerly categorized as “Stock” or “Mutual Fund,” which may have deviated slightly from target model weightings in the past. Policy composite returns may vary from individual Pinnacle client accounts due to deposits or withdrawals from the account, or other client-driven market timing or security selection issues. Pinnacle composite portfolios may be compared to various asset classes, blends of asset classes, indices, or mutual fund universes. The performance and volatility of these asset classes are for comparison purposes only and such performance can be materially different than a Pinnacle composite portfolio.