

## 2009 Second Quarter Market Review

### Executive Summary

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- Investors entered the second quarter with mixed feelings and a sense of anxiety. After suffering devastating losses during first quarter through early March, the stock market turned on a dime and shot upward during the remainder of the month. For Pinnacle investors it was a very good quarter, and the gains were a welcome breath of fresh air.
- The upswing during the quarter was widely referred to as a “second derivative” rally by market analysts and pundits, which is the latest Wall Street lingo that simply means that the pace of contraction slowed across a broad swath of economic data, even though most were still in decline on an absolute basis. One example of an area that made tremendous advances during the quarter, but is still not firing on all cylinders, is the credit markets. During the quarter credit markets experienced a major thaw after their post-Lehman Brothers freeze.
- Pinnacle Advisory Group managed accounts benefited from the global asset market rally in the second quarter, enjoying sizable gains. Although portfolios show losses over the past year, they continue to outperform the major market averages as well as respective benchmarks. At the individual security level, holdings in more volatile equities and high yield bonds led the way during the quarter.
- As we enter the third quarter, our current outlook is that economic conditions seem to have stabilized on the back of massive injections of fiscal and monetary stimulus, and the evidence continues to build that the worst of the economic contraction has passed. The overall tone of recent economic reports has generally been better than expected, though we acknowledge that most of the data has merely been “less bad” as opposed to remarkably good.
- We believe that we are in the middle of a very wide trading range, with the low end defined by the March low of 666 and the upper end possibly being as high as 1,200 on the S&P 500 Index. Given mixed readings of the investment landscape, and believing that we are about halfway between the top and bottom of the probable range, we are currently positioning portfolios for neutral levels of volatility.
- We end the quarter encouraged by some of the recent economic news, and hopeful that the evidence will continue to turn in a direction that confirms that we are past the economic contraction and are entering a new cycle of expansion. At the same time, we are keenly aware that some aspects of financial markets are undergoing significant structural change, which may create long-term headwinds and choppy seas than normal to navigate. This is not catastrophic news, and we are confident that there will be plenty of opportunities for investors to meet their longer-term goals.

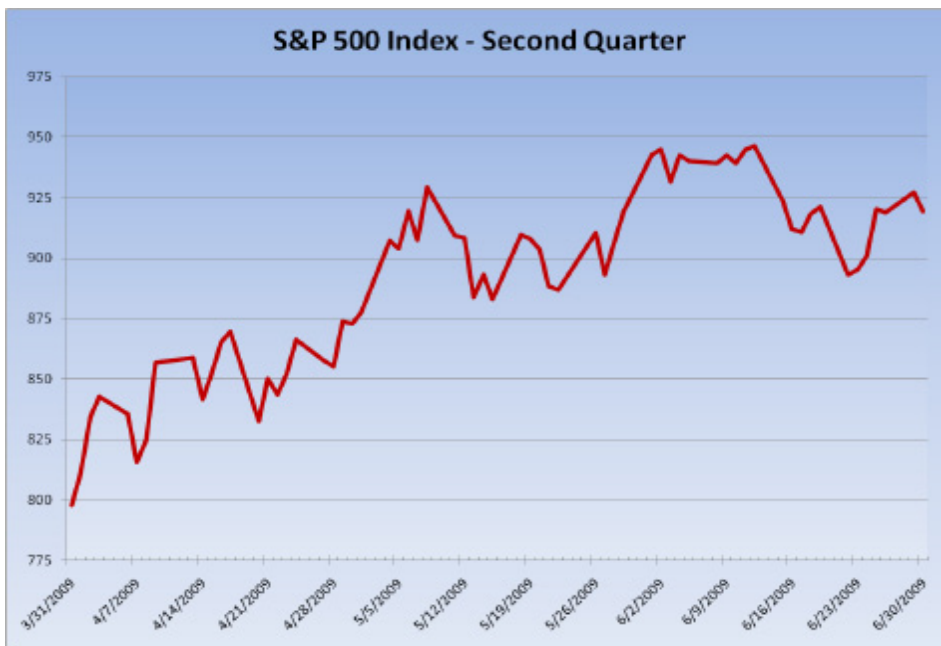
# Second Quarter 2009 Market Review

## Second Quarter Review

Investors entered the second quarter with mixed feelings and a sense of anxiety. After suffering devastating losses during first quarter through early March, the stock market turned on a dime and shot upward during the remainder of the month. In fact, the rally was so torrid that some investors felt the market had run “too far, too fast” as the second quarter began. The severe oversold condition that existed less than a month earlier was erased thanks to the rally, and markets were staring down the barrel of an uncertain earnings reporting season and expectations that economic data would continue to disappoint. But for all the worry about earnings and economic fundamentals, the bulls found a way to climb a very steep “wall of worry,” and risk assets came back into vogue with a vengeance. Not only did stocks have a spectacular quarter, with the S&P 500 Index gaining close to 16 percent, but virtually every asset class registered extremely robust gains on the back of data and earnings that were

“less bad” than expected. The bulls reasserted themselves by arguing that the worst was over and economic “green shoots” were a harbinger of better growth to come. The bears on the other hand, continued to dig in their heels and wait for the supposed green shoots to turn into brown weeds. For Pinnacle investors it was a very good quarter, and the gains were a welcome breath of fresh air.

Index	Second Quarter Return
S&P 500 Index (w/ dividends)	+15.93%
Russell 2000 Index (small cap stocks)	+20.69%
MSCI EAFE Index (international stocks)	+25.64%
Dow Jones/UBS Commodity Index	+11.62%
Barclays Capital Aggregate Bond Index	+1.75%
3-month T-bills	+0.05%



The upswing during the quarter was widely referred to as a “second derivative” rally by market analysts and pundits, which is the latest Wall Street lingo that simply means that the pace of contraction slowed across a broad swath of economic data, even though most were still in decline on an absolute basis. The bullish interpretation of this phenomenon is that the rate of decline must always slow first before the tide turns and the data series begins to rise again. If true, then the current rally would be consistent with economic growth resuming in the near future. The

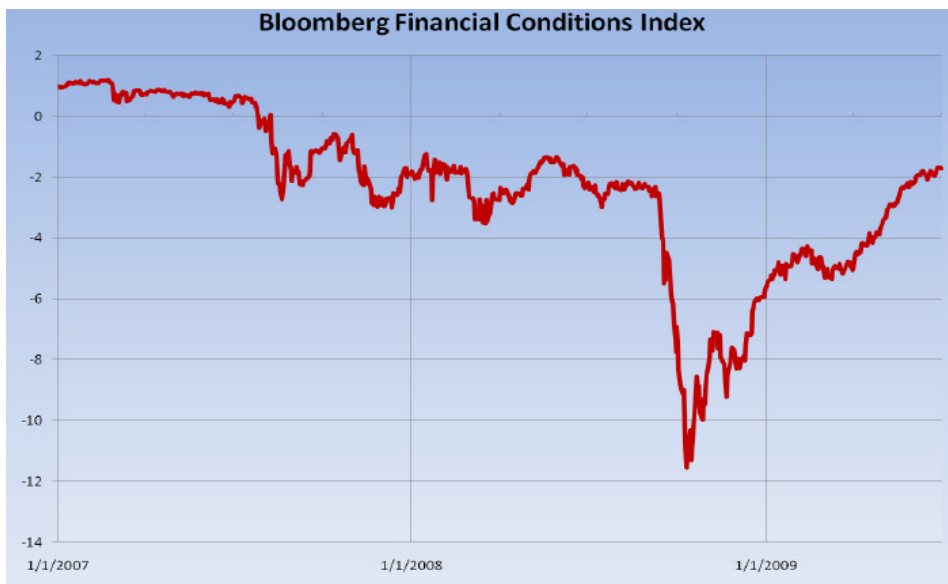
bearish viewpoint is that investors have overshot actual improvement in fundamentals, and those who are predicting a typical recovery pattern are missing a key fact that the world now faces long-term impediments to growth in the wake of both a financial collapse and a deep global recession.

There are many examples of economic series that have improved on a second derivative basis, including housing, manufacturing surveys, employment, and leading indicators. One example of an area that made tremendous advances during the quarter, but is still not firing on all cylinders, is the credit markets. During the

Despite noticeable improvements, however, the credit story is not uniformly positive. There is a darker side to credit that may not be so easy to erase by the government simply running the printing press and implementing creative fiscal and monetary programs. Lending standards have risen to historically tight levels, banks are still hoarding cash rather than lending it, and the velocity of money, which measures how fast money moves through the economy, is still falling. So far the evidence implies that there has been a long-term shift in the credit environment, and that the pendulum has swung from an era of extremely lax credit standards to one that will

be much more restrictive. Given that an explosion in debt was largely responsible for fueling consumption over the past few decades, it's probably unrealistic to believe the economy will simply revert to growth rates that existed when the credit taps were flowing more freely.

For Pinnacle's current view of how these opposing forces will ultimately play out, please read the section titled "Market Outlook."



quarter, credit markets experienced a major thaw after their post-Lehman Brothers freeze. The resurgence is very apparent when looking at the Bloomberg Financial Conditions Index, which is a composite of ten different credit market indicators, and was designed to gauge the availability and cost of credit in U.S. financial markets. The chart shows clear improvement in that the line has risen significantly, even though it hasn't quite breached zero yet.

### **Pinnacle Performance Analysis**

Pinnacle Advisory Group managed accounts benefited from the global asset market rally in the second quarter, enjoying sizable gains. Although portfolios show losses over the past year, they continue to outperform the major market averages as well as respective benchmarks. While impossible to accurately predict returns over shorter timeframes, we feel that the stunning

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declines of late last year as well as the huge gains just experienced are both well outside the norm of typical quarterly results. We expect a return to more subdued quarterly performance going forward.

Composite	Second Quarter Composite Return 3/31/09 to 6/30/09	Trailing 12-Month Composite Return 6/30/08 to 6/30/09
Dynamic Conservative Growth	+5.56%	-8.28%
Dynamic Moderate Growth	+9.19%	-10.02%
Dynamic Appreciation	+12.55%	-15.07%
Dynamic Ultra Appreciation	+15.39%	-16.93%

*Please see the last page of this report for important performance-related disclosures.*

At the individual security level, holdings in more volatile equities and high yield bonds led the way during the quarter. Many positions posted gains in three months that would normally be desirable over the course of an entire calendar year, or longer! Of course, the outsized gains were also coming after precipitous declines, in many cases. All equity sectors posted positive returns. Cyclical sectors such as materials, energy, industrials, technology, and consumer discretionary were the leaders, while the non-cyclical consumer staples and health care sectors trailed. Treasury bonds were the worst performers, as investors responded to tentative signs of economic recovery by selling safer holdings in favor of riskier investments across a variety of asset classes. The losses on Treasury bonds were more than offset by the gains across the rest of the portfolio, though. Other

holdings in fixed income performed very well, including investments in mortgage-backed bonds, corporate bonds, and international bonds.

### Top 5 Performers of the 2nd Quarter

Oppenheimer Developing Markets Fund	+38.26%
Energy Equipment & Services SPDR	+30.41%
High Yield SPDR	+24.34%
Metals & Mining SPDR	+23.52%
Matthews Asian Growth & Income Fund	+21.57%

### Bottom 5 Performers of the 2nd Quarter

Jennison Dryden Short-Term Corporate Bond Fund	+4.66%
Gold ETF	+1.00%
Hussman Strategic Growth Fund	-0.76%
iShares 7-10 Year Treasury ETF	-5.29%
iShares 20+ Year Treasury ETF	-9.71%

### Quarterly Portfolio Activity

There were no major shifts in portfolio positioning during the quarter. In early June, after stocks had rebounded off of their March lows, and amidst increasing signs that the economy was attempting to bottom, we increased equity weightings by a few percentage points in the models that we felt were behaving somewhat sluggishly in the market rally. However, even including the recent trades, portfolios are very close to neutral volatility across all models after combining equity weightings with several “equity-like” holdings in alternative investments and fixed income.

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 Growth	24 (+3)	57 (-4)	19 (+1)
Dynamic Moderate Growth	40 (+3)	41 (-3)	19
Dynamic Appreciation	51.5	28.75 (-1)	19.75 (+1)
Dynamic Ultra Appreciation	63.5 (-2)	14.5	22 (+2)

### **Market Outlook – A Turning Point Possible, But Then What?**

As we enter the third quarter, our current outlook is that economic conditions seem to have stabilized on the back of massive injections of fiscal and monetary stimulus, and the evidence continues to build that the worst of the economic contraction has passed. The overall tone of recent economic reports has generally been better than expected, though we acknowledge that most of the data has merely been “less bad” as opposed to remarkably good. In particular, we have noticed a major improvement in credit conditions, some signs of stabilization in housing markets, and preliminary evidence that job losses may be moderating. The second derivative nature of the improvement is somewhat unnerving and leaves the door open for a possible economic relapse without follow-through, but the probability that we may be approaching a cyclical turning point has increased materially from just a quarter ago. While we are currently encouraged with the economic progress that has been made, we continue to acknowledge that there is a wide array of risks confronting investors on both a cyclical and secular level. Cyclically, stocks have rallied to the point where they will soon require more than simply “less bad” developments in order to continue on an upward trajectory.

Longer-term, the market will be wrestling with a number of structural headwinds that will likely be part of the investment backdrop for some time.

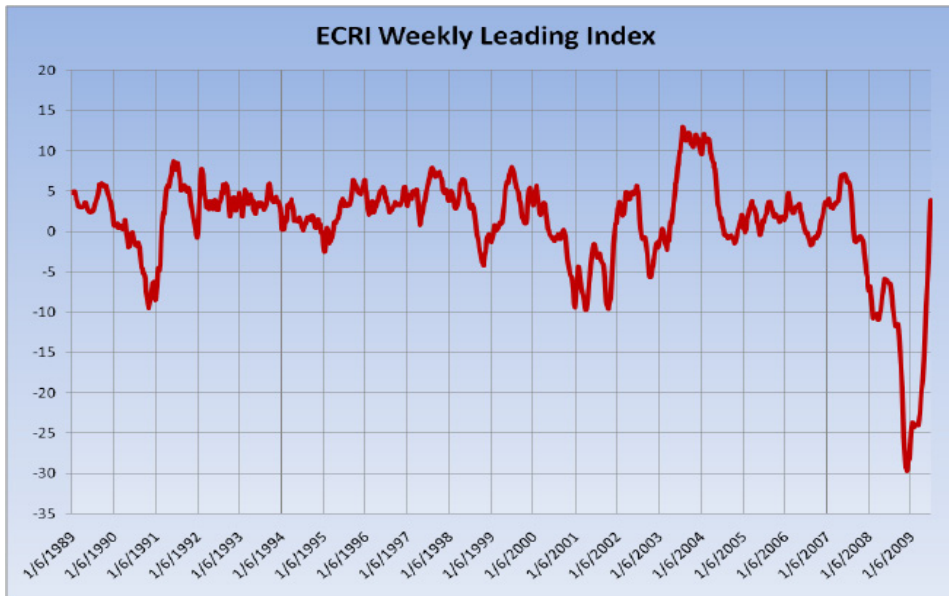
The combination of improving economic data at the same time of unusually high levels of cyclical and secular risks has created elevated levels of uncertainty that continue to leave us with a lower than average conviction in our forecast. We believe that we are in the middle of a very wide trading range, with the low end defined by the March low of 666 and the upper end possibly being as high as 1,200 on the S&P 500 Index. Given mixed readings of the investment landscape, and believing that we are about halfway between the top and bottom of the probable range, we are currently positioning portfolios for neutral levels of volatility. We will continue to follow our discipline in search of more evidence that we have turned the corner and are headed for a self-sustaining recovery, and are prepared to adjust portfolios if the weight of the evidence tilts decisively in either direction over the coming quarter.

### **Positive signs point to a possible turning point**

In contrast to economic data that was unambiguously dark not long ago, some bright spots began to emerge during the second quarter. Other than the progress made in credit markets that was previously mentioned, there were also improvements in initial jobless claims, consumer confidence, certain housing measures, and even corporate earnings. One of the most dramatic rebounds witnessed during the quarter was in one of the indexes of leading economic indicators of the economy. The Economic Cycle Research Institute (ECRI) is a private forecasting firm that has developed their own composite of various predictive economic series, which they call their Weekly Leading Index (WLI). We follow this measure closely, and the jump since late last year is impressive in both magnitude and duration.

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Not only has it recovered from the depths reached last year, it recently crossed 0, implying that the green shoots may be about to blossom into something more substantive in the near future. This is not the only leading index to move up, as two other leading economic indicators belonging to the Conference Board and the Organization for Economic Co-operation and Development (OECD) have followed suit.



There have also been encouraging signs that global growth is attempting to recover, which is important since the recession has permeated almost every country around the world. Various market-based indicators like commodity prices and trans-ocean shipping rates have perked up, suggesting that the gears of global trade have restarted. In China, which many analysts believe will be the engine of growth in the next expansion, the manufacturing sector has recorded positive readings for five straight months. We realize there is still plenty of data that have only achieved second derivative bounces as opposed to real growth, so it is premature to claim that the weight of the evidence is giving the “all clear” signal. However, information from a variety of global growth barometers is clearly hinting that the

contraction is easing, and economic growth may be poised to resume in the near future.

### Secular Headwinds and the New Normal

“The new normal” is another new catch phrase that has been making its way through the investment community. It was coined by Mohammed El-Erian, who is the co-Chief Investment Officer alongside Bill Gross at

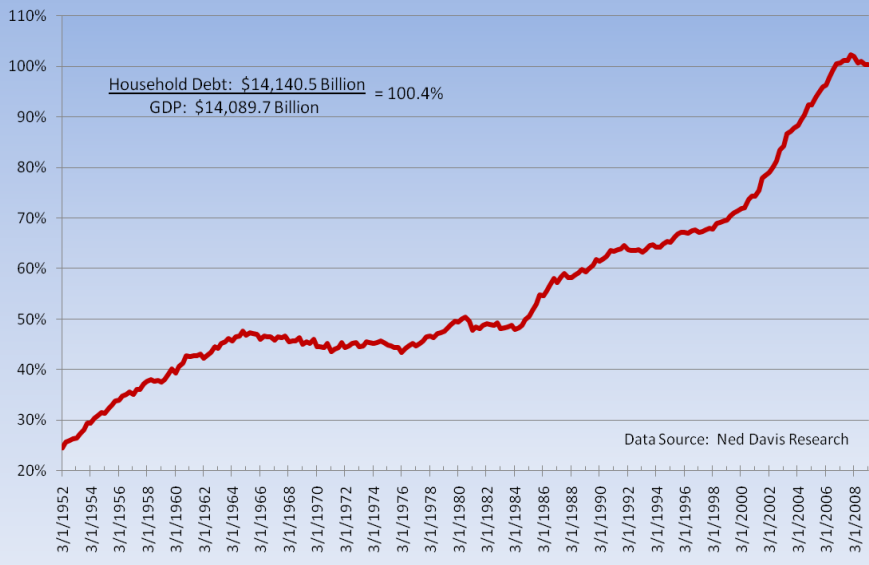
PIMCO, which is a very large and well respected bond manager. “The new normal” is meant to imply that the recovery from the latest downturn will likely be much less robust than past recoveries due to changes to the investing backdrop that appear to be more structural in nature than they are cyclical. Investors finally seem to be waking up to the sobering reality that this last downturn was not a garden variety inventory-led recession. Instead, we appear to have reached a turning point in the credit cycle at a time when

prior economic growth was largely supported by debt.

The chart on the next page shows the ratio of total household debt to GDP. As you can see, this relationship exploded during the past two decades as consumers borrowed more and more to support their free spending lifestyles. And although the economy has been in recession for 18 months, the line has just barely peaked and begun to drop. Because of this and other debt measures that paint a similar picture, many astute investors are rightly wondering what happens when an economy that was driven by an over-leveraged consumer is suddenly faced with de-leveraging, tighter credit conditions, and consumers who finally appear ready to repair their personal balance sheets after a

twenty year debt-laden spending spree. In our view, the most plausible scenario is that growth during the next cycle will not be as robust as the typical recovery that investors have enjoyed in the post-World War II era. Instead, the economy will most likely find a new, lower equilibrium level, or a new normal.

**Household Debt as a % of GDP**



While the words “new” or “different” are always dangerous to use in an investment context, we believe there is a good probability that this assessment is fairly accurate. In addition to less credit availability for consumers, investors are also facing an era of tighter regulation, the probability of higher taxes, the potential for another jobless recovery, large and growing fiscal deficits, less financial innovation, and a housing market that may take a very long time to fully heal. While the challenges may seem daunting, none of this means that companies won’t make a profit, that consumers won’t spend money, or that there won’t be healthy cyclical bull markets along the way. “The new normal” to us at Pinnacle simply means that it’s probably not safe for investors to assume that a new long-term bull market has commenced just because the economy should soon exit from recession. Instead,

investors will have to be nimble, less dogmatic in their views, and more willing to shift allocations as the markets navigate the many headwinds that may be with us for an extended period of time.

### Conclusion

The second quarter offered some needed rays of sunshine after a particularly nasty storm that investors have endured. We end the quarter encouraged by some of the recent economic news, and are hopeful that the evidence will continue to turn in a direction that confirms that we are past the economic contraction and are entering a new cycle of expansion. At the same time, we are keenly aware that some aspects of financial markets are undergoing significant structural change, which may create long-term headwinds and choppier seas than normal to navigate. This is not catastrophic news, and we are confident that there will be plenty of opportunities

for investors to meet their longer-term goals.

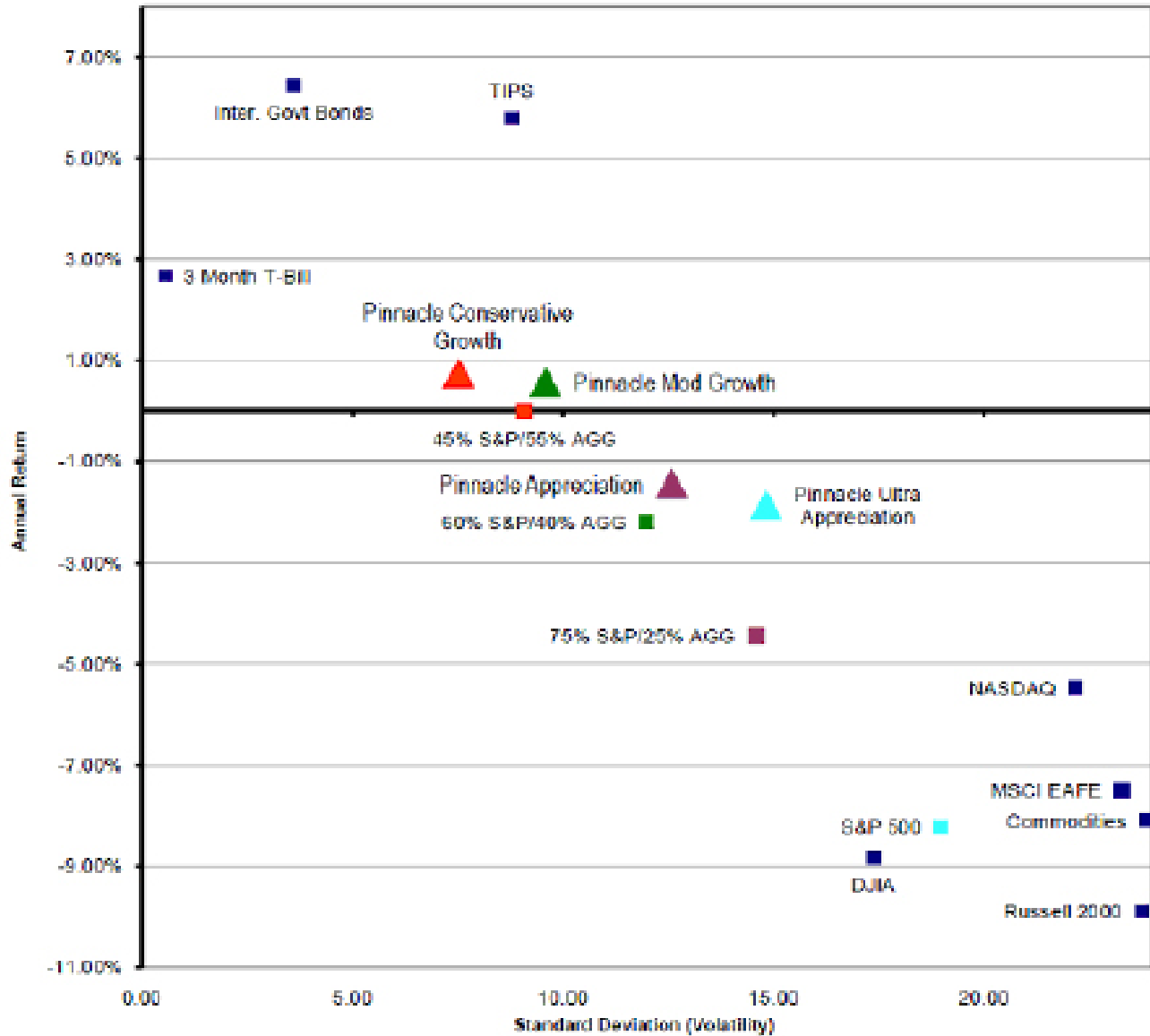
For now, we’ve positioned the portfolios to be neutral. If there’s another leg down in store for stocks, then we’re likely to be a buyer towards the bottom of the range as valuations improve. And if the current rally continues, we’re more likely to gradually scale back to underweight since we don’t believe the prospects are good that market will exceed its previous highs anytime soon. The good news is that we believe that our approach gives us the flexibility to successfully navigate portfolios through the new normal, whatever that normal may turn out to be.

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

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3 Year Chart (6/30/06 - 6/30/09)

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 four 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.



Asset	Annual Return	St. Dev	Asset	Annual Return	St. Dev
3 Month T-Bill	2.67%	0.55	Pinnacle Dynamic Moderate Growth	0.57%	9.59
Barclays Inter. App. Bonds	6.43%	3.60	75% S&P/25% AGG	-4.44%	14.56
TIPS	5.80%	0.77	Pinnacle Dynamic Appreciation	-1.44%	12.57
30% S&P/70% AGG	2.18%	7.08	Pinnacle Dynamic Ultra Appreciation	-1.87%	14.62
Pinnacle Dynamic Conservative	0.79%	6.01	S&P 500	-8.22%	18.97
Pinnacle Dynamic Con Growth	0.74%	7.52	Commodities	-8.10%	23.63
45% S&P/55% AGG	0.00%	9.08	Russell 2000	-9.89%	23.73
NASDAQ	-5.47%	22.15	MSCI EAFE Index	-7.51%	23.27
60% S&P/40% AGG	-2.50%	11.97	DJIA	-8.84%	17.57

**Intermediate Government Bonds** – An unmanaged index based on all publicly issued intermediate gov't debt with an avg maturity of 4 years.

**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.

**TIPS** – These are inflation-protected securities issued by the US Treasury.

**Dow Jones Industrial Average Index (DJIA)** – An unmanaged, price-weighted index of 30 widely held stocks traded on the NYSE. The 30 stocks in the Dow Jones Industrial Average are all major factors in their industries and their stocks are widely held by individuals and institutional investors.

**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& 500 Total Return Index** – S&P 500 index including reinvestment of all dividends and distributions.

**AG Commodity Index (Commodities)** – This rolling index is composed of futures contracts on 19 physical commodities.

It is designed to be a highly liquid and diversified benchmark for the commodity futures market.

**Russell 2000** – An unmanaged, market-capitalization weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000 index.

**MSCI EAFE Index** – An unmanaged, market capitalization weighted index composed of stocks from 21 developed markets, but excludes those from the U.S. and Canada. The countries included in the index are located in Europe, Australia, Asia, and the Far East.

**NASDAQ** – An unmanaged, market-capitalization weighted index. The security types eligible for the index include domestic or foreign common stocks, ordinary shares, ADRs, shares of beneficial interest or limited partnership interests, and tracking stocks.

**45% S&P/55% AGG** – Composed of the S&P 500 Total Return Index and Barclays Capital Aggregate Bond Index.

**60% S&P/40% AGG** – Composed of the S&P 500 Total Return Index and the Barclays Capital Aggregate Bond Index.

**75% S&P/25% AGG** – Composed 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 class 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 time- 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 from a Pinnacle composite portfolio.