

MARKET REVIEW

Third Quarter | September 2011

PINNACLE
ADVISORY GROUP, INC.



Rick Vollaro, Chief Investment Strategist
Carl Noble, Senior Investment Analyst
Sean Dillon, Technical Analyst

EXECUTIVE SUMMARY

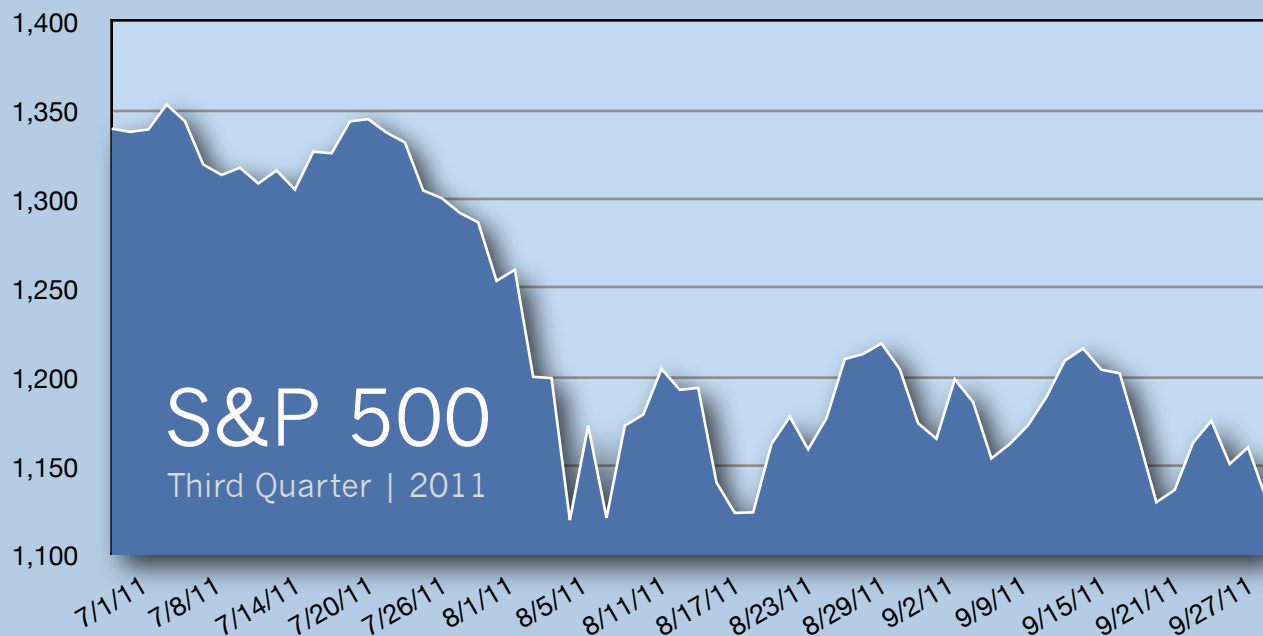
- ▲ The third quarter was characterized by a dramatic surge in volatility in financial markets, caused by bad politics colliding with poor economics and fresh systemic risk concerns. The result was a bear market that crushed risk assets across the globe.
- ▲ As markets lurched wildly, we did our best to follow our process and separate the signals from the noise. Ultimately, we concluded that the previous bull market has ended and a new bear market is underway, and that there is a high probability that a business cycle change is occurring.
- ▲ Pinnacle Advisory Group managed accounts declined as stocks suffered their worst quarter since the fourth quarter of 2008. It ended a string of four consecutive quarters of gains that began late last summer. Trailing 12-month returns remain positive for most composites, but have moderated.
- ▲ At the start of the fourth quarter, the global business cycle faces severe downside pressure. In the U.S. most data is currently in a downtrend, with the majority of the measures that we follow showing anemic levels of growth at best, with an increasing probability that a contraction is unavoidable without fresh stimulus.
- ▲ It now appears that the highs reached on April 29th by the major averages marked the top for this cycle, and that we are caught in a cyclical bear market for equities and risk assets. While picking a bottom with precision is folly, varying estimates of potential downside risk point to somewhere between 950 and 1000 on the S&P 500, which would be in line with average losses in previous bear markets.
- ▲ Markets will likely remain highly volatile, and vicious counter-trend rallies may develop on an intermittent basis, though they are unlikely to be sustainable until some combination of better fundamental and technical conditions materializes, or a high impact policy intervention occurs. When the weight of the evidence improves, we will respond appropriately. Until that time we are likely to maintain defensive portfolio positioning.

THIRD QUARTER REVIEW | 2011

The third quarter was characterized by a dramatic surge in volatility in financial markets around the world, caused by bad politics colliding with poor economics and fresh systemic risk concerns. The result was a bear market that crushed risk assets across the globe. The speed and ferocity of the decline presented a significant challenge in making real-time investment decisions in the midst of volatility not seen since the height of the 2008/09 market debacle. The U.S. debt ceiling debate and European sovereign debt worries received most of the blame, but when markets riot as they did in the third quarter, it is usually a confluence of

factors rather than one or two problems that are at fault. As markets lurched wildly, we did our best to follow our process and attempt to separate the signals from the noise. Ultimately, we concluded that the weight of the evidence shifted decisively enough to signal that the previous bull market had ended and a new bear market is underway, and that there is a high probability that a business cycle change is occurring.

Below, we recap some of the elements that factored into the quarter's market malaise, which ultimately contributed to our change in call.



INDEX	THIRD QUARTER RETURNS
S&P 500 Index (with dividends)	-13.87%
Russell 2000 Index (small cap stocks)	-21.86%
MSCI EAFE Index (international stocks)	-18.92%
Dow Jones/UBS Commodity Index	-11.34%
Barclays Capital Aggregate Bond Index	+3.82%
3-Month Treasury bills	+0.02%

Politics and Debt Downgrade

In late July a vicious political debate over the debt ceiling broke out and drew the public's attention to what is normally a routine government issue, giving the world a clear look at our dysfunctional system. In the end, political brinksmanship backfired after negative press magnified the long-term budget problems, and even though a debt ceiling agreement was

reached in the eleventh hour, the exercise was enough to move S&P to downgrade the U.S. debt rating to below AAA status for the first time. The loss of confidence in U.S. politics combined with the unknown of the debt downgrade played a major role in the waterfall decline in markets that took place in early August.

Continuing U.S. Economic Disappointment

At the end of the second quarter, we explained that the bullish economic case was predicated on a reacceleration in GDP growth in the second half of the year, driven by the end of the global supply chain disruptions caused by the natural disasters in Japan and lower commodity prices. We also cited continuing risks and expressed our doubts that early signs of an economic slowdown were entirely attributable to temporary factors (as was widely suggested). The third quarter

brought a broad-based deceleration in economic data that appears to have dismantled the reacceleration case and revealed growing risks of national and global recessions. This was evident in a variety of data, including leading economic indicators, manufacturing surveys, consumer spending, and employment trends, all of which took a definitive turn for the worse over the summer.

Europe Gets Worse

The situation in Europe, which we discussed in detail last quarter, worsened considerably in the third quarter. Europe suffered from policy mistakes, political dysfunction, and escalating banking risk. Economic growth in the Eurozone is worse

than in the U.S, with recession all but certain. The rapidly deteriorating economic backdrop, as well as speculation about countries like Greece exiting the monetary union, put heavy pressure on the value of the euro.

Emerging Markets Are Slowing

If subpar growth rates in developed economies were not enough, emerging markets also experienced a significant slowdown. China and other emerging countries have helped drive global growth since 2009, thanks to higher national growth rates and lower debt burdens than the Western world. Despite having positive

secular attributes, monetary policy tightening and a material slowdown in their Western trading partners appeared to matter more during the third quarter. Investors in emerging market equities and the commodity complex were not spared from the market carnage.

Technical Conditions Are Broken

The major bull market uptrends that had been in place in most global markets were almost uniformly broken during the summer. By the end of the quarter, several major market indices around the world had officially achieved bear market status (defined as a decline of 20% or more). It will take a sustained advance that clears some critical levels to undo the damage and restore technical conditions back to firmer footing.

The third quarter contained a combination of events that led investors to alter their economic expectations and

discount an increasingly risky environment. The business cycle and technical conditions were considerably damaged, and we felt it was prudent to make significant changes to portfolio allocations to reflect the shift in the weight of the evidence. Going forward investors must contemplate whether risk assets have already priced in the bulk of the economic and technical damage, or if negative forces will continue to have the upper hand. (For a detailed analysis of Pinnacle's views on these issues, please see the Market Outlook, on page 8.)

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PINNACLE PERFORMANCE ANALYSIS

Pinnacle Advisory Group managed

accounts declined as stocks suffered their worst quarter since the fourth quarter of 2008. It ended a string of four straight quarters of gains that began late last summer. Trailing 12-month returns remain positive for most composites, but have moderated.

The highly defensive Utilities sector was the only one of the ten S&P sectors to deliver positive performance during the quarter. Other defensive sectors like Consumer Staples and Health Care declined, but delivered substantial relative

outperformance. Cyclical sectors were hit especially hard and led the declines.

Pinnacle portfolios carried large overweights to defensive sectors. International equity positions outperformed during the quarter, and gold continued to do well despite increasing volatility.

Within fixed income, U.S. Treasuries were the best performing securities due to another flight to quality episode on the part of investors, while credit-sensitive holdings and fixed income alternatives underperformed.

COMPOSITE	THIRD QUARTER COMPOSITE RETURN 6/30/11 to 9/30/11	TRAILING 12-MONTH COMPOSITE RETURN 9/30/10 to 9/30/11
Dynamic Conservative	+0.15%	+3.20%
Dynamic Conservative Growth	-3.50%	+3.31%
Dynamic Moderate Growth	-6.01%	+3.30%
Dynamic Appreciation	-8.35%	+2.15%
Dynamic Ultra Appreciation	-13.22%	-1.79%

Top Five Performers | Third Quarter 2011

POSITION	WEIGHT	RETURN
iShares 20+ Year Treasury ETF	3.5%	29.6%
iShares 7-10 Year Treasury ETF	4%	10.4%
Gold SPDR	3%	8.1%
ProFunds Rising Dollar Fund	4%	5.0%
DoubleLine Total Return Fund	5%	3.9%

Bottom Five Performers | Third Quarter 2011

POSITION	WEIGHT	RETURN
iShares Networking ETF	0%	-18.9%
PowerShares Aerospace & Defense ETF	2%	-19.3%
Energy Sector SPDR	4%	-22.2%
PowerShares Dynamic Media ETF	2%	-22.3%
Capital Markets SPDR	2%	-27.1%

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. Security weights are shown as of quarter end.

Quarterly Portfolio Activity

The third quarter marked a significant change in portfolios to a much more defensive allocation. Trading activity was heightened, and focused on reducing risk. This was primarily accomplished by selling cyclical U.S. equity sector positions. There were also relative trades that increased weightings in defensive sectors, and we tweaked some of our portfolio hedge positions in response to extreme price movements. The end result is below average equity weightings and increased cash positions. We realize that cash is not an attractive long-term investment, but are content to temporarily maintain holdings there while patiently searching for attractive investment opportunities in the current environment.

We now believe our portfolios are well below neutral levels of volatility, relative to their risk benchmarks. At this point, we think the 'heavy lifting' of this process is likely over. However, we are still evaluating whether enough risk has been removed from portfolios in the event of further market declines, or if further reductions may be necessary. As always, we continue to monitor portfolio performance and volatility on a daily basis across a variety of timeframes to guide us as we consider further portfolio adjustments.

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

COMPOSITE	EQUITIES	EQUITY ALTERNATIVES	FIXED INCOME	FIXED INCOME ALTERNATIVES
Dyn. Conservative	11(-2)	3(-1)	81(+10)	5(-7)
Dyn. Conservative Growth	32(-7)	6(-1)	57(+10)	5(-2)
Dyn. Moderate Growth	45(-10)	3(-1)	47(+13)	5(-2)
Dyn. Appreciation	60.5(-10.75)	3(-1)	31.5(+11.5)	5(+0.25)
Dyn. Ultra Appreciation	79(-13)	3(-1)	13(+9)	5(+5)

III

MARKET OUTLOOK

At the start of the fourth quarter the global business cycle faces severe downside pressure. In the U.S. most data is currently in a downtrend, with the majority of the measures that we follow showing anemic levels of growth at best, with an increasing probability that a contraction is unavoidable without fresh stimulus. Pockets of positive data surface sporadically, giving the economic bulls reason to cling to hope, but the trajectory of the intermediate trends are clearly down and the probability of a material economic reacceleration in coming quarters has decreased. This is clear in many of the forward looking indicators we follow, as well as jobs trends, housing data, commodity prices and a recent widening in credit spreads.

To make matters worse, the decelerating growth profile is being accompanied by a policymaking environment that appears frozen. Monetary policy is pegged at the zero bound, the effectiveness of unconventional policies is highly questionable, and possible fiscal remedies are paralyzed with Washington already in pre-election gridlock mode.

Internationally, growth in Europe appears to be on the verge of contracting. Their situation is worsened by tighter monetary policy settings, strains in the banking

system and increasing political and structural dysfunction. Recently there have been some signs that leaders are finally waking up to the gravity of their crisis, but whether they will act in a commensurate manner is still in doubt. The emerging world continues to slow along with its trading partners, and recently China has shown signs of stress fractures within its housing market and banking system.

Intermediate technical market conditions turned bearish during the third quarter with new downtrends established, defensive equity sectors outperforming cyclical sectors, and fresh sell signals from long-term momentum indicators. There are a few small bright spots based on extreme bearish sentiment as measured by implied market volatility and investor sentiment surveys. Additionally, some positive divergences have appeared in certain inter-market relationships that bear close monitoring. These short-term positives could produce explosive, short-lived rallies, but the intermediate technical picture has been severely damaged and will require a significant degree of improvement before suggesting that risk has sufficiently dissipated. The overriding technical message is that it is still prudent to remain in capital preservation mode for now.

Valuation has clearly improved from a quarter ago, but our internal models continue to produce overall neutral readings. Despite a gradually improving profile, valuation has not reached low enough levels to feel confident that a healthy margin of safety has been priced in. Eventually, some combination of lower market values and continued earnings growth should produce an attractive valuation backdrop. However, we do not believe that we are at that point yet, and therefore valuation's influence is diminished relative to business cycle and technical considerations.

It now appears that the highs reached on April 29th by the major averages marked the top for this cycle, and that we are

caught in a cyclical bear market for equities and risk assets. While picking a bottom with precision is folly, varying estimates of potential downside risk seem to point to somewhere between 950 and 1000 on the S&P 500, which would be in line with average losses in previous bear markets. Markets will likely remain highly volatile, and vicious counter-trend rallies may develop on an intermittent basis, though they are unlikely to be sustainable until some combination of better fundamental and technical conditions materializes, or a high impact policy intervention occurs. When the weight of the evidence improves, we will respond appropriately. Until that time we are likely to maintain defensive portfolio positioning.

Europe, System Risks, and Another Grand Plan

Financial markets are suffering from a confluence of negative circumstances, but it is Europe that has recently taken center stage as the dirtiest shirt in the laundry basket. Europe has multiple problems, but what the market has been focused on recently is systemic risk in its financial system and fears of contagion. It has become apparent that the European banking sector is overleveraged, undercapitalized, and overexposed to the debt of risky European countries that face bleak growth prospects and have bloated debt-to-GDP ratios. This is evident in the performance of European financial companies which have plummeted recently. Perhaps more ominously, credit

markets have recently flashed visible warning signals in the form of rising sovereign bond yields, an increase in the cost of default protection, and rising interbank lending spreads that imply that counterparty risk is spreading within the European banking system. Some of these market indicators have soared beyond where they were in the 2008 global financial crisis, which is a very troubling development. Until investors are convinced that Europe is united and determined to contain system risk, it is hard to believe that any rally will be lasting. In order to successfully avert a financial calamity, Europe will likely have to implement a "shock and awe"



approach that soothes markets by making a specific commitment to defend the Eurozone at any cost. There has been some encouraging talk recently as Germany and France have discussed bank recapitalization and a “Grand Plan” to end the crisis. But so far the reports remain short on credible details, and the track record of European bailouts to date

is not favorable, as previous measures have done little more than provide short-term hope that ultimately fizzled. We certainly hope Europe is able to reach a comprehensive solution, but we think it is prudent to remain defensive until we see if they are able to follow through on recent promises and declarations with concrete actions.

Playing the Bear Market Averages

Our inclination is to play defense until we conclude that the weight of the evidence improves markedly. Some of the more bullish analysts believe that even if the economy falls into recession, markets have likely discounted most of the damage already. It is certainly possible that the U.S. economy could skirt recession and that corporate earnings will

remain resilient. But with the litany of evidence skewed towards continued economic weakness, earnings are at risk of substantially disappointing given the lofty expectations currently built into forward looking estimates. Therefore, we believe it is wiser to remain cautious and respect the historical track record for losses in cyclical bear markets.

According to studies from Ned Davis Research, in the 34 bear markets for the Dow Jones Industrial Average that have occurred since 1901, the average loss has been -31%, and the median loss was -27%. Narrowing that down to the 22 cyclical bear markets that have occurred within secular bear markets, which we believe is an appropriate subset to use given the stock market's general lack of direction over the past decade, the average and median losses are even worse

at -36% and -34%, respectively. So far the Dow has fallen about -17% peak to trough during this bear phase. Some will contend it is too late to sell, and that a negative outcome is already discounted. We disagree and believe the historical evidence suggests otherwise. We certainly are not part of the "doom and gloom" crowd that expects another 2008-like rout, but we do believe there are good reasons to defend at current levels.

What Causes Us to Turn Bullish

The silver lining in all of this is that bear phases are normal parts of market cycles. Eventually, this will pass and in doing so will set the stage for the next sustained advance. Therefore, at the same time that we have been repositioning portfolios to defend against further declines, we are also looking for reasons to be more optimistic about what lies ahead. It's always possible that the weight of the evidence gradually improves on its own. Absent major policy errors, economic and market downturns can simply run their

course. As usual, no single data point is powerful enough to give the 'all clear' signal. Instead, it will require broad economic and technical improvement, in both the U.S. and internationally. Market valuation could ultimately become cheap enough in time, although it tends to move more slowly. Lastly, and perhaps most likely, there could be massive government intervention in Europe to decisively face their financial crisis. There are a lot of moving parts with that situation, but it could be a game changer if it occurs.

Conclusion

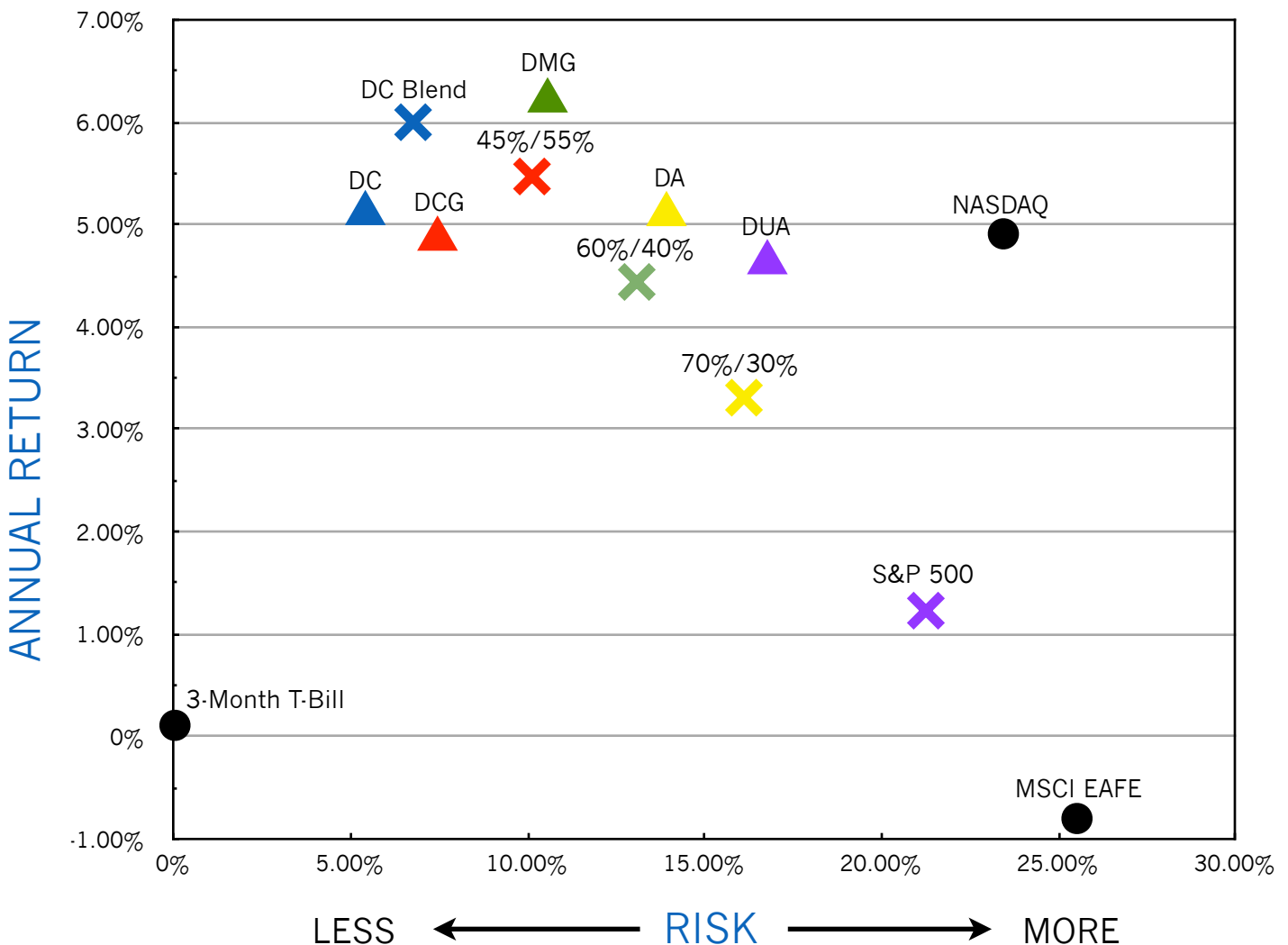
The third quarter served as a reminder that the world remains a risky place. At the moment global economics are trending in the wrong direction, system risk is pressuring Europe, and the previous bull market trends appear to have been broken. With the weight of the evidence pointing down, our process mandates that we stay in capital preservation mode. As we wait for greener pastures, we will continue to

hunt for pockets of relative value among different asset classes, but we'll also cherish the stability and risk-free nature of cash. At some point this correction will provide an opportunity to take advantage of the next bull market and allow us to accept more risk. Until then, we'll adhere to the proverb that in bear markets, "He who loses least wins most."

THREE-YEAR SCATTER PLOT | 9/30/2008 - 9/30/2011

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.

PORTFOLIO	RETURN	STAND. DEV.	PORTFOLIO	RETURN	STAND. DEV.
Dynamic Conservative	5.11%	5.41%	DC Blend	6.00%	6.76%
Dynamic Conservative Growth	4.86%	7.45%	45% S&P500 / 55% BarCap Aggregate Bond	5.47%	10.12%
Dynamic Moderate Growth	6.21%	10.56%	60% S&P500 / 40% BarCap Aggregate Bond	4.44%	13.08%
Dynamic Appreciation	5.10%	13.92%	75% S&P500 / 25% BarCap Aggregate Bond	3.31%	16.11%
Dynamic Ultra Appreciation	4.63%	16.77%	100% S&P500	1.23%	21.25%
			3-Month T-Bill	0.11%	0.03%
			NASDAQ	4.91%	23.44%
			MSCI EAFE	-0.80%	25.52%



Intermediate Government Bonds - An unmanaged index based on all publicly issued intermediate government debt with an average 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 the U.S.

TIPS - These are inflation-protected securities issued by the U.S. 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&P 500 Total Return Index (Commodities) - This rolling index is composed of future 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 3,000 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.

DC Blend - Comprised of the S&P 500 Total Return Index and Barclays Capital Aggregate Bond Index. 30% S&P 500/ 70% Barclays Capital Aggregate Bond Index from 10/31/02 to 8/31/09, and 20% S&P 500/ 80% Barclays Capital Aggregate Bond Index from 8/31/09 to present.

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 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. (hereafter "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. 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 weighting 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.

Pinnacle's Investment Team:

Ken Solow, CFP®, CLU, ChFC
Chief Investment Officer

Rick Vollaro, CPA
Chief Investment Strategist

Carl Noble, CFA
Senior Investment Analyst

Sean Dillon, CMT
Technical Analyst

Sauro Locatelli
Quantitative Analyst

Pinnacle Advisory Group, Inc.

6345 Woodside Court
Suite 100
Columbia, MD 21046
(410)995-6630
Fax (410)381-1628

5150 North Tamiami Trail
Suite 500
Naples, FL 34103
(239)692-8888
Fax (239)692-8878

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