



CAVANAUGH
CAPITAL MANAGEMENT

Investment Review & Outlook

Second Quarter, 2009

Articles on the Web

Read Managing Director **Tom Graff's** latest article "Bank Bond Run Can't Last" on our website, www.cavcap.com.

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CALIFORNIA NEARS THE CROSSROADS

As California entered a new fiscal year on July 1st, lawmakers appeared no closer to an agreement on a plan to deal with the state's \$24.3 billion budget deficit. Following the legislature's inability to pass a comprehensive budget solution, Governor Arnold Schwarzenegger exercised his executive authority by proclaiming a state of fiscal emergency. Under the terms of the declaration, a special session is declared and the legislature has 45 days to pass and send a bill(s) to the governor's desk addressing the budget crisis.

Since an agreement was not reached by the fiscal year-end, the state's controller has now begun issuing registered warrants, a form of IOU, for certain non-priority payments. An estimated \$3.2 billion in IOUs will be issued in July as payment to vendors, tax refunds, and certain social services.

From an investor's perspective, it is necessary to clarify that merely being late on a budget does not threaten the state's ability to make timely debt service payments. GO debt in California has a constitutional prior claim on all of the state's revenues, second in the capital structure only to primary education. The state's appropriation debt has a lesser legal claim, but the controller prioritized payment directly after GO debt service, ahead of other mandatory payments such as Medicaid, employee payroll, and employee pensions.

To learn more California's financial crisis and its impact on investors, read Vice President Steve Shutz's full article on our website, www.cavcap.com.

THE GATHERING STORM: IRAN'S ELECTION, ISRAEL, & THE PERSIAN SHOWDOWN WITH THE WEST

Predicting so called "exogenous political events" and their potential to violently move markets is difficult. The situation in Iran that has been evolving since the disputed June 12th presidential election is an example of one of these events, and its impact remains unclear. However, recent actions and statements from Iranian and world leaders can give us an idea of what to expect.

In the early morning of June 13th, only hours after polls closed, Iranian state television announced that hard-liner incumbent president Mahmoud Ahmadinejad won in a

landslide victory over his main challenger, former Prime Minister Mir Hossein Mousavi. In the weeks since the election there have been massive protests throughout Iran, and in response, a brutal government crackdown on Iran's citizens and the international media. While the violence has died down, returning tentative peace to Iran's cities, the battle over this election and its geopolitical significance has just begun.

To learn more about the election and its impact on political stability and financial markets, read Intern Keith Hinton's full article on our website, www.cavcap.com.

EQUITIES, COMMODITIES, & REITs MARKET REVIEW

Financial markets rebounded, but where do we go from here?

After two painful quarters, financial markets rebounded across the board with several asset classes posting the strongest returns in decades. In spite of the gains, all asset classes are still significantly negative for the last twelve months. Additionally, the quarter began with a roar but ended with a whimper. Since mid-May, financial markets have been mostly sideways, raising the question: is this the beginning of a new bull market or merely a bear market rally?

Equity Index Returns (%)

As of 6/30/09

- Emerging Markets and REITs were the strongest performers posting the best quarter in their history, gaining over 30%.
- Led by financial stocks, the S&P 500 had the best return since 1998, snapping a six quarter losing streak.
- From March to May the S&P 500 gained nearly 26%, the best three-month return since 1938.
- During June, markets were mixed with U.S. stocks and commodities posting small gains while REITs and international equities (both EAFE and EM) were both negative.
- India led the world in the second quarter with a 49% return and is among the few nations with a positive return over the last twelve months (5%).

Index	QTR	YTD	Last 12 Months
S&P 500 (large-cap U.S.)	15.93	3.16	-26.21
Wilshire 4500 (small- and mid-cap U.S.)	20.63	9.45	-27.59
MSCI EAFE (international - developed)	25.43	7.95	-31.35
MSCI Emerging Market (international – emerging)	34.73	36.01	-28.07
DJ Wilshire REIT (real estate)	31.46	-13.13	-45.35
S&P Goldman Sachs Commodity	19.24	6.55	-59.69

MULTI-ASSET CLASS (MAC) STRATEGY

The MAC strategy posted a very strong second quarter, outperforming traditional equity strategies, as REITs, commodities and international stocks all outperformed U.S. stocks for the quarter. In April, REITs returned 33% which fueled the MAC strategy's outperformance in spite of a negative performance from commodities. In May, commodities bounced back with a 20% return which, along with a strong performance from international stocks, made up for the underperformance of REITs. In June, the market

seemed caught in a tug-of-war between starting a new bull phase or reverting to another bearish downturn.

The outlook is as uncertain as ever as the economy is surrounded by questions of recession vs. recovery and inflation vs. deflation. CCM believes that a maximally diversified portfolio is the best option to protect investor's principal and provide long-term returns.

FIXED INCOME SECTOR RETURNS

- Treasury bond yields were sharply higher for the quarter, with the 10-year rising nearly 90bps. The 30-year Treasury declined in price by over 12%. Rising rates were partially due to the massive supply of new Treasury bonds and an increase in risk appetite.
- Credit spreads performed extremely well, with the Barclays Credit Index posting the #1 and #2 best monthly performance vs. Treasuries in April and May.
- Bank bonds performed well, as confidence improved and the threat of nationalization diminished. For the quarter, subordinated bank bonds in the Barclays indices returned over 20%. See website—www.cavcap.com.
- Rapidly rising interest rates caused lower-coupon MBS to perform poorly, while the higher coupon MBS, which CCM favors, performed relatively well.
- All eyes are on California and the limited time available for the state to enact a budget resolution. As a result, California and its municipal entities have come under some price pressure.

Fixed Income Returns (%)

As of 6/30/09

Index	Duration	Yield	QTR	YTD	Last 12 Months
Treasury	5.20	2.37	-3.02	-4.30	6.47
Agency	3.40	2.32	0.10	-0.04	7.22
Credit	5.99	5.60	8.81	6.87	4.08
MBS	2.95	4.34	0.70	2.91	9.38
Barclays Aggregate	4.30	4.12	1.78	1.90	6.05
High Yield	4.34	12.28	23.07	30.43	-2.40
Merrill Lynch 1-12 Year Municipals	4.79	3.03	0.95	3.20	6.55

- High-grade intermediate muni yields trended sideways during the quarter, though the curve flattened slightly as longer-term munis outperformed.
- Higher-yielding municipal sectors (hospitals, healthcare, tobacco, etc.) outperformed the high-grade market significantly as the market benefitted from a renewed interest in risk taking.

FIXED INCOME PORTFOLIO ACTIVITY

TAXABLE BOND PORTFOLIOS

- Added Build America bonds, which are a new form of taxable municipals.
- Utilized a high-yield ETF for accounts where this investment is permissible.
- Decreased Treasury positions, continue to concentrate duration stance in the longer-end of the curve.
- Utilized short-term Agencies in lieu of large cash positions, as money market yields decline.
- Maintained underweight of MBS, focusing on higher-coupon positions.

ENHANCED CASH PORTFOLIOS

- Continued to add to GNMA Project Loan positions with 0-2 year averages lives. These securities are directly backed by the U.S. Treasury but still carry yields above 2%.

- Added to callable agency positions, especially where the call option is highly likely to be utilized by the agency.
- Utilized short-term Agencies in lieu of large cash positions, as money market yields decline.

MUNICIPAL BOND PORTFOLIOS

- Decreased duration after munis rallied well through U.S. Treasury parity levels. 10-year Muni/Treasury ratio moved from 120% to 78%.
- Maintained exposure to slightly longer (10yr – 15yr) maturities which performed well during the quarter as the curve flattened.
- Maintained a modest overweight to BBB-rated credits which performed well as spreads tightened.

OUTLOOK

Now what?

In early March, investors continued to fear an economic and market collapse. Nationalization of major banks (Citigroup, Bank of America, among others) topped the list of concerns. It seemed like the world economy would continue to plunge, and no stimulus program would be adequate to prevent the demise. Three months ago, investors preferred the safety of Treasuries over equities.

In the 2nd quarter, investor sentiment rebounded. Demand for higher yields and returns was steady. All asset classes from equities and corporate bonds (especially financials) to REITs and commodities performed well. Treasuries were the worst performing asset class. Such gains suggest market fears are beginning to abate.

Yes, markets are functioning more normally, but a full recovery remains far away. Job losses in June were worse than expected, pushing the unemployment rate to 9.5%. Expect the unemployment rate to reach 10% in the months ahead. Though the (un)employment rate is a lagging economic indicator, it remains a key component for longer-term economic stability.

The positive side to rising unemployment is the realization that businesses are quick to shed labor costs. While business output is certainly down, leaner corporations have a better chance of maintaining their operating margins, protecting jobs that remain, and ultimately surviving. Such cost cutting measures enable greater productivity which drives corporate earnings and equity prices. Therein lays the coveted 'recovery'. However, it is entirely possible that the initial stage of such a recovery will be a "jobless recovery" like the one experienced in 2003 and 2004.

So while corporations begin to recover, certain economic segments that rely upon consumer employment and spending will remain under stress for a longer time. These segments include retail, residential real estate, and municipal tax receipts. This longer-term uncertainty combined with an extended period of high unemployment will have a continued negative impact on consumer attitudes. Since two-thirds of U.S. economic activity is driven by consumer spending, this negative impact is an important consideration.

As a result, one can expect the personal savings rate to either increase or remain elevated. While it is difficult to ascertain whether this is a temporary or permanent change in behavior, it is clear that elevated savings is not good for increased economic activity. Recall that the baby boomers and generations X and Y fueled the U.S. economy on spending and cheap credit. If the U.S. significantly changes its behavior and becomes a nation of savers, like the Depression-era "greatest generation," then this economic recovery will be much slower than previous ones, albeit more sustainable.

For investors, the near-term implications are that the rapid trajectory of equities will likely taper off. Volatility will remain high. Less demand for credit will limit rising interest rates, and keep high quality bond yields low. Inflation is not a near-term threat, even with the surge in deficit-related Treasury issuance.

CCM NEWS

RAHLEY GETS MARRIED

CCM's Brian Rahley, Associate, and Niki Stamos were married on June 13th in Baltimore. Congratulations, Brian and Niki!

CAREY COMPLETES MBA, ANNOUNCES ENGAGEMENT

Jennifer Carey, Communications Specialist, completed her Masters of Business Administration degree with a concentration in marketing and management in May. Jennifer also announced her engagement to Michael Svehla. Michael, a Baltimore native, works for Robert Half International. Congratulations, Jennifer and Michael!

CCM HIRES SUMMER INTERN

Keith Hinton, a senior at Tufts University, is interning at CCM this summer. Keith is a Quantitative Economics major with a minor in Comparative Politics. Keith will be assisting CCM with document management.