



CAVANAUGH
CAPITAL MANAGEMENT

Investment Review & Outlook

Third Quarter, 2009

Articles on the Web

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501 Fairmount Avenue
Suite 300
Baltimore, MD 21286
Phone: 410.769.6124
Fax: 410.427.4544
contact@cavcap.com
www.cavcap.com

HOW TO PROTECT YOUR PORTFOLIO AGAINST INFLATION

By Taylor Graff, Senior Associate

In early 2008, oil prices skyrocketed to \$140 a barrel, food prices were at all-time highs, the dollar was as weak as it had been in decades, and inflation became a significant concern throughout financial markets. But as the credit crisis accelerated, commodity prices collapsed, the velocity of money plummeted, and, for many, deflation replaced inflation as the primary danger. Has the danger of inflation since disappeared or just paused?

The U.S. has not experienced a significant, prolonged increase in inflation since the 1970's. Then, the inflation crisis caused pain throughout financial markets as both stocks and bonds floundered with negative real returns.

Federal Reserve Chairman Paul Volker's aggressive interest rate policy finally brought inflation under control in the early 1980's. Conversely, today's monetary and fiscal policy is highly accommodative in response to the credit crisis.

Will the extensive government stimulus turn into inflation once economic activity picks up? Only time will tell, but the inflation outlook is far less certain than at any time in recent memory. If inflation does make a comeback, how can you ensure that your portfolio is safe? Read CCM's full report on the firm's website: www.cavcap.com.

WHO IS GOING TO BUY ALL OF THESE TREASURIES?

By Tom Graff, Managing Director

Bond investors have never dealt with an influx of Treasury bonds quite like what has been issued in the last year. The combination of the TARP, federal stimulus initiatives, and falling tax revenues has resulted in record borrowing. In the 12 months ending August 31, the Treasury had issued over \$2 trillion in new bonds and bills. Putting aside questions of public policy, there is a very real question of who is going to buy all these bonds?

To read more of Tom Graff's article, visit CCM's website, www.cavcap.com.

ARE MUNI INVESTORS PRICING IN TAX INCREASES?

By James Dugan, Chief Investment Officer

Investors continue to pour cash into the municipal bond market. CCM previously wrote that most of that cash was put to work in short to intermediate bond funds. Now it appears that long-term funds are receiving significant inflows. For the most part, muni yields, as a percentage of Treasuries, are below historical averages. Normally, one would say that munis are therefore expensive relative to taxables. However, it may be that munis are actually "cheap" if one assumes that tax rates are rising.

To read more of Jim Dugan's article, visit CCM's website, www.cavcap.com.

EQUITIES, COMMODITIES, & REITs MARKET REVIEW

Another great quarter, but have we come too far too fast?

Financial markets followed up the tremendous rebound in the second quarter with an impressively robust rally in the third quarter. The S&P 500 gained 15.6% this quarter—nearly matching the 15.9% gain during the second quarter. However, with earnings growth still meager (and often negative), consumers still de-leveraging, and real estate markets still struggling, is this recent bull market set up for a second downturn? The answer depends on whether the modest recovery seen in the last few months is the beginning of a new economic growth cycle or just an easing of the continuing recession.

- REITs and Emerging Markets were once again the leading asset classes, with REITs posting the best quarterly gain in their history.
- The S&P 500 posted consecutive double digit quarterly gains for the first time since 1986.
- From March to September, the S&P 500 had its best seven-month return since 1938.
- EAFE outperformed the U.S. large-cap market due to strong performance from Europe and the weakening dollar.
- Asia underperformed the rest of the world with China and Japan posting the lowest returns.

Equity Index Returns (%)

As of 9/30/09

| Index | QTR | YTD | Last 12 Months |
|---|-------|-------|----------------|
| S&P 500 (large-cap U.S.) | 15.61 | 19.26 | -6.91 |
| Wilshire 4500 (small- and mid-cap U.S.) | 19.71 | 31.02 | -3.67 |
| MSCI EAFE (international - developed) | 19.47 | 28.97 | 3.23 |
| MSCI Emerging Market (international – emerging) | 20.91 | 64.45 | 19.07 |
| DJ Wilshire REIT (real estate) | 35.44 | 17.65 | -29.35 |
| S&P Goldman Sachs Commodity | -1.76 | 7.68 | -44.52 |

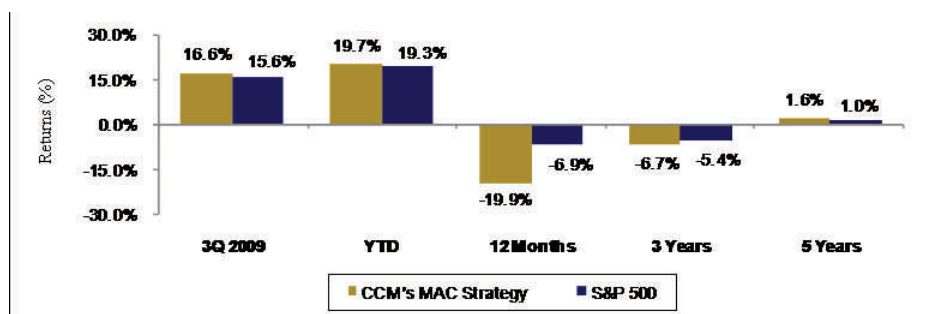
MULTI-ASSET CLASS (MAC) STRATEGY

The MAC strategy returned 16.6% last quarter, bringing the 2009 return to nearly 20%—outperforming the S&P 500 for both time periods. For the second consecutive quarter, REITs drove the MAC strategy's outperformance with a 35% return. REITs thrived as the financial market recovery gained traction during the quarter. Improving credit conditions allayed many fears about solvency. The outperformance of REITs compensated for the underperformance of commodities, which struggled during the quarter losing 1.8%. Commodities struggled due to concerns about oversupply and disappointingly low inflation data outweighing dollar weakness.

As the economy drifts between hope of recovery and fear of renewed weakness, CCM believes diversification is the most effective way to protect principal while still providing the return potential to help portfolios meet their long-term goals.

CCM's MAC Strategy* vs. S&P 500

Returns (%)



* Multi-Asset Class strategy (MAC) returns based on Dow Jones Total Stock Market Index (U. S. Equities), MSCI EAFE (Developed International Equities), MSCI EM (Emerging Market Equities), S&P GSCI (Commodities) and Wilshire REIT indices. Performance does not reflect the effect of trading, management, and/or ETF fees. Past performance does not guarantee future results. All returns greater than one year are annualized. The above statistics do not reflect allocation to U.S. Fixed Income which may be added depending on a client's tolerance for risk and/or income needs.

FIXED INCOME SECTOR RETURNS

- Despite continued evidence of positive economic growth, Treasury yields fell during the quarter as concerns about Treasury issuance and inflation subsided. The 10-year Treasury fell 23bps (from 3.53% to 3.30%). This marked the lowest point for Treasury bond rates since May 20.
- Shorter bonds fell similarly in yield. The 2-year Treasury fell from 1.11% at the beginning of the quarter to 0.95% on September 30.
- Investment-grade corporate bonds outperformed Treasuries for the second quarter in a row, although at a much more muted pace than the previous quarter. Improving corporate balance sheets and cost-cutting have resulted in an improved outlook for corporate default rates. In addition, strong mutual fund flows have increased the demand for corporate bonds.
- High-yield produced its second straight quarter of double-digit returns.
- Municipal bond yields were sharply lower for the quarter, with 10-year AAA GO yields dropping nearly 70bps. The ML 1-12 Year Muni Index posted the best quarterly performance since 1989.
- Demand continues to dominate supply as muni bond funds receive record cash inflows while the growing

Fixed Income Returns (%)

As of 9/30/09

| Index | Duration | Yield | QTR | YTD | Last 12 Months |
|--|----------|-------|-------|-------|----------------|
| Treasury | 5.21 | 2.16 | 2.10 | -2.29 | 6.26 |
| Agency | 3.24 | 2.03 | 1.82 | 1.63 | 8.06 |
| Credit | 6.15 | 4.58 | 7.47 | 14.86 | 19.49 |
| MBS | 2.97 | 3.89 | 2.31 | 5.29 | 9.85 |
| Barclays Aggregate | 4.35 | 3.55 | 3.74 | 5.72 | 10.56 |
| High Yield | 4.23 | 10.31 | 14.22 | 48.98 | 22.34 |
| Merrill Lynch 1-12 Year Municipals | 4.66 | 2.41 | 4.55 | 7.90 | 11.84 |

success of the Build America Bond (BAB) program cuts sharply into tax-exempt supply.

- An appetite for yield has pushed many investors further out the yield curve and lower on the credit spectrum. The long end of the yield curve has rallied sharply since yields peaked in late July. Additionally, spreads compressed in higher yielding paper, as BBB Revenue issues led performance.

FIXED INCOME PORTFOLIO ACTIVITY

TAXABLE BOND PORTFOLIOS

- Reduced holdings in taxable municipals, especially credits backed by smaller municipalities and/or more narrow revenue streams. Fundamentals in corporate bonds have been improving primarily because of cost cutting and an upgraded growth outlook. However municipal tax revenues tend to lag overall economic growth, and thus this could be the one major bond market sector where the worst is yet to come.
- Added to corporate bond positions, focusing on highly liquid names.
- Utilized high-yield ETFs for accounts where high yield is permissible.
- Maintained underweight of mortgage-backed securities (MBS). The Fed recently announced they will be ending the mortgage buying program in 1Q 2010. This may create the potential for significant underperformance for lower-coupon MBS as these have made up the bulk of Fed MBS purchases to date.

ENHANCED CASH PORTFOLIOS

- Continued to utilize 1-2 year agency bonds in lieu of shorter securities. With the Fed not likely to hike short-term rates for 6-12 months, the additional yield

gained by longer bonds more than compensates investors for potentially higher rates.

- Continued to add to GNMA Project Loan positions with 0-2 year average 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.

MUNICIPAL BOND PORTFOLIOS

- Added short-term Agencies in lieu of high-grade tax-exempt munis. Short-term taxable bonds represent a significant pick-up in after-tax yield regardless of tax rate.
- Added exposure to long maturity tax-exempt bonds as the AAA municipal yield curve reached a record high slope.
- Maintained a modest overweight to BBB-rated credits which performed very well as spreads tightened.

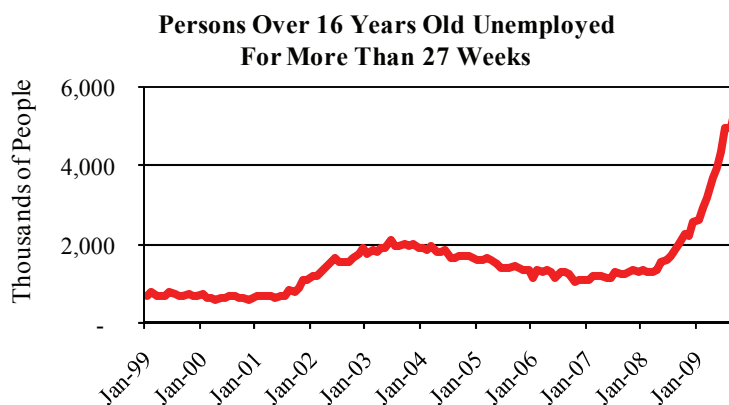
OUTLOOK

Employment is considered to be a lagging economic indicator, but we may have to rely on this rearview mirror perspective to better come to grips with the direction of the markets and economy ahead. Given the time, effort, and cost of hiring and training new workers, employers are not going to add to the permanent head count unless they feel very secure in the stability and pace of growth. Therefore, while the economy may technically be out of a recession, it is expected that the unemployment rate, currently at 9.8%, will continue to rise above 10.0% into 2010.

Rising, or stubbornly high unemployment, will have a strong influence on policymakers at the Federal Reserve and in Congress. In an October 2, 2009 report, the economic research firm BCA detailed that, in the last four interest rate cycles, the Federal Reserve did not begin raising short-term interest rates until 12-27 months after unemployment peaked. (The average duration was 19 months after unemployment peaked.) If the past is prologue, then the Fed will not raise rates until 2011. In addition, policymakers in Congress will be more sensitive to employment statistics than other indicators of economic growth. As we move into double-digit unemployment rates in an election year, we should expect to hear proposals of accelerating the current stimulus program or perhaps adding a second stimulus program.

These conditions set the tone for continued low short-term rates and expansionary fiscal policy—often the ingredients for an upward boost for the economy, the equity markets, and long-term interest rates. But maybe not this time. The personal savings rate has increased and consumer spending has been negative for the past year. A deeper question is whether or not this is a temporary or permanent reaction to the economic trauma of the last year. A follow-up piece ([*Will Households Save and Invest?*](#)) on our website suggests that the changes may be deeper and longer lasting.

Nevertheless, a consumer-driven economy needs a financially healthy consumer. This means rising employment and wage growth. But that is not happening. The graphic to the right shows the sharp rise in people who have been unemployed for over six months. These are the folks who will have likely exhausted their savings, are in arrears on their credit cards, or have defaulted on their mortgages. With a hamstrung consumer sector, future economic growth may be muted. Therefore, it is possible that interest rates remain low for an extended period of time and advances in equities and corporate bonds will be much more muted.



Source: Bureau of Labor Statistics

NEWS: NEW REGULATIONS FROM THE COMMODITIES FUTURES TRADING COMMISSION (CFTC)

The CFTC is currently considering new regulations in the commodities market designed to reduce the impact of speculation on commodity prices. Although nothing has been officially announced, the CFTC is likely to pursue one or both of the following tactics:

- Reduce position limits and/or volume limits on given futures contracts, especially front-month contracts which most affect consumer prices
- Tighten requirements for firms that qualify as “hedgers” instead of “speculators” (hedgers are less restricted in their actions in the commodities market).

In anticipation of the new changes, many commodity funds have ceased creating new shares to ensure that they do not become too big for the new regulations. These funds include GSG, USO and UNG. This has very little impact on investors who are already invested in the fund. However, new investors have been forced to pay a premium to purchase shares. Additionally, two Powershares funds have reacted by significantly increasing the number of holdings in their funds thereby reducing the size of each holding.

Most analysts believe that funds will be able to resume creating new shares after the CFTC makes its final decisions. However, the funds will not implement any new plans until the CFTC does announce the new regulations.