Pinnacle Capital Management, LLC

Quarterly Economic Update

OCTOBER 1, 2011

There is a strong chance that this flight to safety will end with as much disappointment as the blind pursuit of high returns.

Gridlock vs. Growth

It's difficult to be optimistic. The U.S. economy is near stall speed while serious attempts to rectify fundamental problems have come to a complete standstill. It does not matter whether Democrats or Republicans have the answer. The fact is, both factions have drawn their lines in the sand, demagoguing the other, and are highly unlikely to come to any compromise prior to the 2012 elections. Meanwhile, the Federal Reserve has run out of policy options. Despite some claims to the contrary, "Operation Twist", through which the Fed will sell short duration Treasuries and use the funds to purchase long duration Treasuries, demonstrates that its only policy option now is to go out and dance.

Across the Atlantic, Europe is also near a standstill. There is a debt crisis, centered on Greece at the moment, but potentially spreading to other major countries on the continent. When one has too much debt, there are essentially four options. First, you can pay it down. That implies you have sufficient income and/or that your income is capable of growing in the near term future. That is not in the cards for Greece. The second option is to default. Creditors get burned, and the borrower's ability to get funds will be cut off for quite some time. This is a real possibility. The third option is what we call a "soft default". That is, you print more money and pay off creditors with devalued currency. There are all kinds of implications associated with this option including all of the nasty

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Economic Statistics

	3rd Qtr (9/30/11)	2nd Qtr (6/30/11)	*% Change*	1 Yr Ago (9/30/10)	*% Change*
S&P 500 Index	1,131.42	1,320.64	*-14.3%*	1,141.20	*-0.9%*
10 Year Treasury Yield	1.92%	3.16%		2.52%	
Gold Spot ($ / oz)	$ 1,623.97	$ 1,500.35	*8.2%*	$ 1,308.35	*24.1%*
WTI Crude Oil (next future)	$ 79.20	$ 95.42	*-17.0%*	$ 79.97	*-1.0%*
GDP Qtr / Qtr	N/A	1.3%		2.5%	
CPI Y / Y	3.8% (Aug)	3.6%		1.1%	
Unemployment Rate	9.1% (Aug)	9.2%		9.6%	

side effects of inflation. As of now, Europe has chosen not to take this route. The chosen strategy appears to be option four – ask a relative to bail you out. In this case the relative is Germany. The Germans have been dragged kicking and screaming, providing incremental relief to the Greeks and, by extension, to the European banks. The Germans are getting tired of being nickeled and dimed, especially when those nickels and dimes add up so far to hundreds of billions of Euros. They have no idea what the total tab will be, and there is no final resolution in sight.

So for now, the economies of the U.S. and Europe are showing little progress. For some people, this would be enough to pack it in. Haven't we just made the case that the world is coming to an end? Isn't it best to sell everything? If we indeed believed this was the end of the story, we would have taken extremely defensive positions in client portfolios and hunkered down for the long haul. But of course, this isn't the end of the story.

Debt crises aren't anything new. Most recently, there were several severe crises and defaults among the emerging nations from Latin America in the late 1970s to Asia and Russia in the late 1990s. Simplistically, what these nations had in common was that their debts were denominated in foreign currency – primarily dollars. When their debt levels became excessive, their own currencies collapsed, which made it nearly impossible to obtain sufficient foreign currency to repay the debts. As these economies recovered, they focused on exports. They kept their debt under control and built up their foreign reserves so they wouldn't be forced into the same situation again. The end result is that today, the emerging economies have in general very sound balance sheets. In recent years, their middle classes have reached critical mass to spur internal growth. As a result, while the U.S. and Europe sputter, these countries keep chugging along.

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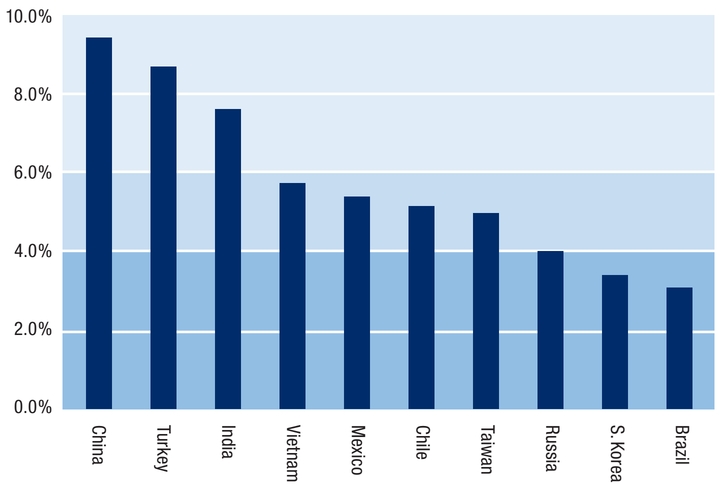
The internal growth generated by this middle class has been a theme we have espoused for some time. To illustrate this point, in the second quarter the U.S.'s trade deficit fell by 1.9%. That is, on net we were importing less. At the same time, the Eurozone's net exports increased by double digits. That is, they were exporting on net significantly more. So if the U.S. imported less, and Europe exported more, one would expect that emerging nations' growth rates would have been abysmal, if not negative. The chart below shows second quarter GDP growth rates of several emerging nations ranging from China at 9.5% to Brazil at 3.1%. Obviously, something more than export growth is happening here.

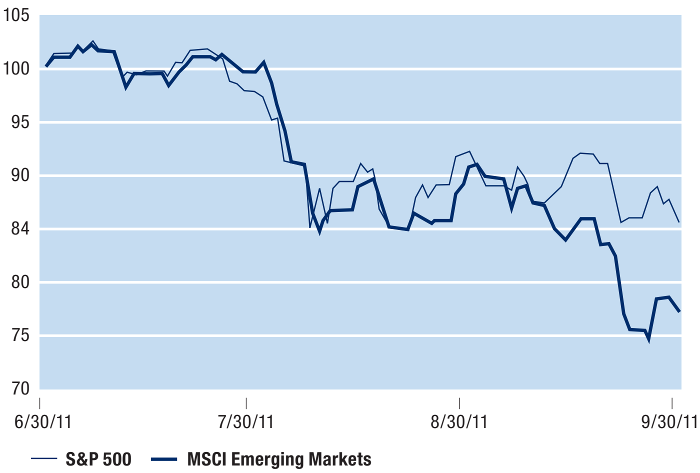
2nd Qtr GDP Growth



The growth in the emerging nations isn't the only positive. Despite high levels of debt among individuals and governments, and despite abysmal employment numbers, corporations are doing remarkably well. As of the second quarter, the profits generated by U.S. corporations exceed the peak levels achieved prior to financial meltdown. At the same time, corporations are holding record amounts of cash. Although one might think this is a sign that corporations aren't spending any money, U.S. equipment & software spending was up 9.3% in the second quarter vs. a year ago and was within 2% of prior peak levels.

With all this in mind, imagine a visitor from another planet had been presented with the facts regarding the two major blocs of countries. The U.S. and European bloc has excessive debt, low growth, and political gridlock. The only real bright spot within this bloc is the corporate sector. The emerging nation bloc has robust growth, manageable debt levels, and a growing middle class. An alien to this planet might conclude that investors would flock to the emerging nations and avoid Europe and the U.S., except for, perhaps, its corporations. The space traveler would be wrong. Investors have grabbed up government debt of the U.S. and Germany, sold off equities across the board, and in particular punished the stocks of the emerging nations and those European and American companies that export to the emerging nations. For example, while the S&P 500 was off 14.4% for the prior quarter, the MSCI Emerging Markets Index was off 22.6%. On the other hand, U.S. Treasury prices continued upward as the yield on 10 year bonds plunged from 3.2% on June 30th to 1.9% on September 30th.

Comparative Performance 6/30 - 9/30/11



While investors rightly have things to be concerned about, it appears that they have ignored all positives. In fact, investments with positive attributes have often been punished the most. It seems to us that we are witnessing the mirror image of investors chasing returns. Throughout history, investors have ignored reality and valuation, pursuing easy money by gambling on potentially high returns. We saw this with the dot com bubble in the late 1990s and most recently with the real estate bubble. Ultimately, investors were burned. Today, investors are pursuing so called "safety" as passionately as they pursued excessive returns in the past. As a result, investors are overpaying for U.S. government bonds, and sticking with investments that have been safe in the past. The world is changing, investors are ignoring this, and there is a strong chance that this flight to safety will end with as much disappointment as the blind pursuit of high returns.

Despite this impassioned warning, we do share some concerns with the bulk of investors. For starters, growth in the U.S. has clearly slowed. We now see little chance of a resumption of significant growth in the absence of signs of direction on the political front and on the debt front. Further, inflation – which has been gradually accelerating – should subside due to less than robust demand. As a result, we have made some adjustments to portfolios which we will further discuss in the Equity and Fixed Income sections.

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Equity Strategy

As we've stated in the past, equities are generally very inexpensive. With the S&P 500 trading at 12 times trailing earnings, 1.1 times revenues, and with a dividend yield of 2.3%, we think the markets have already discounted a highly negative environment. Nonetheless, with a slow U.S. economy, few signs of acceleration in the near future, and debt crises coming to a head, we decided to increase cash levels slightly so we could take advantage of opportunities as they arise. As our expectations of inflation have come down, we sold our positions in the Market Vectors Agribusiness ETF (MOO). In accounts utilizing the Active Asset Allocation strategy, we also eliminated positions in the Emerging Markets Index ETF (EEM) which has high exposure to commodities and utilized some of the proceeds to purchase the iShares Global Infrastructure Index (IGF). While this fund has similar exposure to global markets, its underlying investments should be more direct beneficiaries of the positive trends we have discussed with less direct impact from changes in commodity prices.

During the quarter, we also sold Hewlett Packard (HPQ). What became apparent to us is that in the face of a tough business environment, the company had little idea as to how it would adjust. While the stock was knocked down to excessively low levels, in this market environment there are many opportunities to purchase successful companies at the right price. We utilized the proceeds to purchase Embotelladora Andina (AKOB), a Chilean based Coca-Cola bottler which distributes products in Chile, Brazil, and Argentina. Some clients may have already held this stock, as we ceased purchasing it once it reached our price limits. In this recent market downturn, the stock fell below our purchase limits, and we are again placing it in client portfolios. We also purchased, in limited situations, Brasil Foods (BRFS). As readers may recall, we sold client holdings several months ago because of concerns regarding potential actions of antitrust authorities in Brazil. Since then all antitrust issues have been resolved. Again, with the broad markets selling off, the price became attractive.

Still, we must be careful. While we certainly want exposure to the Latin American markets – especially to consumer based companies – we must be cognizant of the total level of portfolio holdings in that region. As we hold Grupo Pao de Acucar (CBD) in addition to the stocks discussed above, positions in AKOB and BRFS will be limited.

Finally, we want to point out the high level of merger & acquisition (M&A) activity impacting our companies. In the past 6 months, there have been 10 acquisitions announced in the U.S. that have exceeded $2 billion in value. Four of those 10 were in client portfolios. Temple-Inland (TIN) was a target while United Technologies (UTX), Teva Pharmaceuticals (TEVA), and Microsoft (MSFT) are acquirers. Additionally, SAB Miller (SBMRY) is purchasing the Australian brewer, Fosters, while China Security and Surveillance (CSR) was bought out by management. On top of this, two of our companies, ITT (ITT) and Kraft (KFT), have announced they are splitting into multiple companies.

Given the number of individual equities we hold, this activity impacts an extraordinarily high percentage of client holdings. What's going on here? First, we believe the level of M&A activity reflects the value that now exists in the market place. It's always great when one of our companies is acquired, though we do believe the CSR acquisition price was too low. KFT and ITT's actions are attempts to unlock value which the market has ignored. We see in those companies similar values. The acquisition activity of UTX, TEVA, MSFT, and SBMRY reflect their recognition of the opportunities this environment provides. With after-tax borrowing costs of around 4% and equity prices at these levels, it won't take much for acquisitions to significantly boost profits. We also think it is significant because despite the low level of interest rates, only the soundest companies can receive financing to make large scale acquisitions. It says something that our companies are in such a strong position at this point in time. Notwithstanding the investment performance of the past quarter, we are very encouraged by the activity involving client holdings.

Fixed Income Strategy

What can we say about the bond market that we haven't already said? We're finding very few investments at attractive prices. We are keeping durations short and sometimes holding cash. There appears to be little rationality in the fixed income markets today. Why anyone would want to lock in a 10 year Treasury at 2% or commit to a 30 year Treasury below 3% is beyond us. We understand the logic of holding short term instruments with little or no return for either safety or as a place to park cash. But the rationale for committing to these longer term instruments at current rates can either be 1) a higher current yield is required and there is no regard for future returns or 2) there is nothing wrong with low yields if you can sell the security later to someone else at the same or higher price. The first rationale is extremely short sighted. Either future losses or subpar returns are likely to be the result. The second rationale depends on what is known as the Greater Fool Theory. There will always be someone more foolish than you to pay an even higher price. For an analysis of where this gets you, please revisit the dot com and real estate collapses.

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