

Capital Markets Overview & Outlook

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President

Mr. Henderson established Cavanal Hill Investment Management's (Cavanal Hill) fixed income philosophy and process in 1993 while serving as the firm's Director of Fixed Income Strategy and as a Portfolio Manager for the taxable and tax-exempt fixed income and money market strategies. Prior to joining Cavanal Hill, Mr. Henderson was the Head Taxable Fixed Income Trader for Bank of Oklahoma's Capital Markets group. Mr. Henderson received a Bachelor of Business Administration in Finance from Southern Methodist University in 1989.

Keys to Watch

- Economic growth data
- Europe's banking industry
- Global stimulus

triggered the financial crisis in 2008, have been widely reported and remain with us today.

The United States and much of the developed world are experiencing anemic recoveries while their economies work off these excessive debt levels. Central banks around the world, including the U.S. Federal Reserve, continue to support the gradual unwind of excess debt in hopes of avoiding a sharp deflationary spiral. Although their approach seeks to avoid the Depression-era level of bankruptcies, it also extends the time necessary for a healthy economic recovery to develop, because the economy remains dragged down by too much debt.

Even the emerging markets, recently characterized by robust growth rates, have come under pressure. In many of these nations, economic growth has slowed due to their central banks' efforts to fight inflation. Emerging market currencies and equity markets most sensitive to worldwide growth expectations suffered sharp corrections during the quarter.

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PERFORMANCE RETURNS¹ QUARTER ENDED 9/30/11

S&P 500 Index	-13.87%
Russell Midcap [®] Index	-18.90%
Russell 1000 [®] Index	-14.68%
Russell 2000 [®] Index	-21.87%
MSCI EAFE Index	-18.95%
Barclays Capital U.S. Aggregate Bond Index	3.82%
Federal Funds Rate	0.00%-0.25%

Past performance is no guarantee of future results. Performance is derived from various unmanaged indices and is not intended to recommend any specific investment product. An investor cannot invest directly in an index.

Economic, debt woes send stocks tumbling

Earlier this year, stock and bond market investors generally had high hopes for a self-sustaining global economic recovery. Midway through the year, those hopes were quickly dashed, as economic data began signaling a possible recession.

In addition to the weak economic reports

of the past several months, other factors rattled investor sentiment during the third quarter. In particular, a disruptive U.S. debt ceiling debate that led to S&P's downgrade of the U.S.'s long-term sovereign credit rating to AA+ sent shockwaves through the financial markets. And just when the news couldn't seem to get any worse, fears of possible widespread sovereign and bank defaults in Europe further troubled investors.

In this environment, investors shunned riskier assets, leaving all the major stock market averages with double-digit declines for the quarter. High-quality bonds, on the other hand, continued to generate positive performance.

Sell off not a surprise

The severe stock market selloff in the third quarter provided a textbook lesson in the importance of positioning portfolios defensively when markets exhibit overconfidence and high valuation. In fact, the negative events of the third quarter really should not have been a surprise to most investors. Many of the imbalances, particularly the excessive debt levels that

¹ The S&P 500 Index is regarded as a gauge of the U.S. equities market, this index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. The Russell Midcap[®] Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000[®] Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap[®] Index represents approximately 31% of the total market capitalization of the Russell 1000[®] companies. Russell 1000[®] Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000[®] Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market. The Russell 2000[®] Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000[®] Index is a subset of the Russell 3000[®] Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The Barclays Capital U.S. Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors. Barclays Capital U.S. Treasury Index is an index of prices of U.S. Treasury bonds with maturities of one-to-thirty years. It is not possible to invest directly in an index. These indices are unmanaged and do not reflect the fees and expenses associated with a mutual fund.

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Eventually, we expect the fiscal health of the U.S. public and private sectors to improve, but it's going to take some time. Economic growth most likely will remain below trend in the interim.

Where are the markets likely headed?

There is a long list of reasons to be pessimistic regarding the economic growth and financial market outlooks. Nevertheless, valuations in the stock and credit markets have returned to levels that provide investors some downside protection. Unlike the beginning of the year, when a continuous stream of good economic news was necessary to sustain stretched valuations, the markets now appear primed to rise from any improvement in financial results or potential policy surprises out of Washington, D.C., on entitlement reform or pro-growth deficit reduction.

Expectations remain low for a positive resolution to Europe's ongoing sovereign debt crisis. Several large-cap European stocks are already trading below their levels of early-2009, when the financial crisis was in full force. Investors have prepared for a negative outcome, and we are starting to see opportunities in several developed markets.

Within the emerging markets, we expect overall inflation trends to start declining.

This should give the leading emerging economies the flexibility to initiate more accommodative monetary policies. As policymakers take their feet off the brakes, growth expectations in these nations should improve.

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