

Capital Markets Overview & Outlook

December 31, 2011



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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

- Central bank actions
- U.S. economic data
- Government Debt

countries in return for more austerity. While little has been done to reaccelerate economic growth trends in Europe, the financial markets were temporarily relieved that a major default was not immediately imminent.

'Financial distortion' in markets

Global central banks and fiscal authorities have demonstrated time and again they will do everything possible to postpone defaults by insolvent institutions, even if it may do more harm than good in the long run. Their approach has been to increase financial regulations, force structural reforms and deleverage to avoid another financial crisis.

One of the more difficult investment challenges in this climate is dealing with the central banks' distortion of financial asset prices by artificially supporting the prices of stocks, bonds and currencies. The massive amount of central bank buying has created "financial repression," a condition of negative real interest rates created by central banks and fiscal policymakers to control the speed of the debt deleveraging process by keeping financial assets propped-up above their fundamental value. While it is affecting all markets, financial repression is most obvious in the U.S. bond market, where the Federal Reserve funnels trillions of dollars to keep interest rates low.

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PERFORMANCE RETURNS¹ AS OF 12/31/11

	3 MONTH	12 MONTH
S&P 500 Index	11.82%	2.11%
Russell Midcap [®] Index	12.31%	-1.55%
Russell 1000 [®] Index	11.84%	1.50%
Russell 2000 [®] Index	15.47%	-4.18%
MSCI EAFE Index	3.38%	-11.73%
Barclays Capital U.S. Aggregate Bond Index	1.12%	7.84%
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.

Sentiment improved, stocks soared

Much of the extremely negative sentiment of the third quarter eased during the fourth quarter, fueling a strong stock-market rebound in which all major U.S. benchmarks recorded double-digit gains. Global central bank interest rate cuts, European Union (EU) summit agreements, and signs the U.S. economy was not contracting along with the rest of the global economy all contributed to the stock market rally.

Returns in the fixed-income sector remained positive, too, but the Treasury rally witnessed in previous quarters subsided. Reflecting investors' renewed preference for risk-taking, Treasuries lagged the broad fixed-income benchmark, while credit-sensitive bonds, particularly high-yield securities, sharply outperformed.

Policy moves drove optimism

Given how pessimistic investor attitudes were toward the end of the third quarter, we did not think it would take much to improve the stock market's short-term outlook. After seeing early indications that Europe's sovereign debt crisis was having a negative effect on real growth in the emerging markets, we thought the first set of policy surprises would be announced in Asia. The emerging Asian nations had been raising short-term interest rates to fight rising inflation. Therefore, there was plenty of room to cut rates. In addition, their fiscal positions provided the capacity to cut taxes or increase government spending to stimulate economic growth, if necessary. Falling commodity prices pushed inflation trends lower during the quarter, and several developing countries started easing monetary policy.

We also were not surprised that the financial markets improved after EU member countries agreed to provide even more leverage to the debt-laden peripheral

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Debt, not liquidity, remains core issue

Central banks do not want financial assets to fall to levels that reflect the real risks in the global economy. What this means for investors is stock and bond prices are not being allowed to find their intrinsic values. Despite central banks' efforts aimed at promoting liquidity, the global bond and equity markets are not experiencing liquidity problems. The core issue is too much debt, and there are really only three options to reduce debt:

- Restructuring
- Inflation
- Growth

Financial repression may buy time for the debtors at the expense of the savers, who ultimately earn lower returns on their investments. Yet, global policymakers need to be careful with delaying the inevitable, and doubling down on losing strategies that do not address the core issue.

If it weren't for these unconventional methods that buy time in dealing with excessive debt levels, risk assets would be trading at much lower levels. This is why our core neutral investment position for the time being is to remain defensive.

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® represents approximately 31% of the total market capitalization of the Russell 1000® companies. The 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. These indices are unmanaged and do not reflect the fees and expenses associated with a mutual fund. An investor cannot invest directly in an index.

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