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Perspectives

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With the passing of one of the most difficult, turbulent quarters in recent history, it is too early to conclude with any certainty that the economy and financial markets will make quick recoveries. There are compelling reasons, however, to anticipate longer-term positive trends and to ensure that portfolios are positioned to capitalize upon these trends. While the precise timing of a return to economic and financial strength is unknowable, for a multitude of reasons it could occur as early as the latter part of the current quarter.

THE FIRST QUARTER IN REVIEW

Prior to offering our analysis, let us review the core results of the first quarter of 2008. It was an historic quarter.

U.S. Equities. The S&P 500 Index closed the quarter at 1,322.70, down 9.9%. The NASDAQ Composite finished at 2,279.10, down 14.1%. The Dow Jones Industrial Average closed at 12,262.89, down

7.6%, having suffered its largest first-quarter point decline ever – 1,001.93 points – and its worst quarter in 5 ½ years.

These equity losses continued the downward trend that actually began in October of 2007. The S&P 500 finished the quarter down 16.1% from its October high, while the NASDAQ and the Dow Jones finished the quarter down 20.4% and 14.1%, respectively, from their October highs.

Increased volatility also was reintroduced into the financial markets. The S&P 500 moved up or down by more than 1% on over half of the trading days during the quarter. The last time the S&P 500 experienced that magnitude of volatility was in 1934!

U.S. Fixed Income. The U.S. fixed-income markets effectively have priced themselves for a weakened economy. During the first quarter, demand continued for the safe haven of U.S. Treasuries, driving prices up and yields down.

Yields for 3-month, 2-year, 10-year, and 30-year Treasuries closed at relatively low levels: 1.3%, 1.6%, 3.4%, and 4.3%, respectively.

Not surprisingly, risk premiums, or “spreads” – the incremental yield offered by corporate bonds over Treasuries – also increased during the quarter, reflecting the perceived increase in risk associated with buying non-government bonds. For investment grade bonds, risk premiums increased by about 1 percentage point. For “junk” bonds, they increased by about 2 percentage points. To put these increases into perspective, risk premiums at the end of the quarter were at levels not seen since 2002. In contrast to 2002, however, when these premiums were justified by higher default rates, current default rates remain low, thus indicating an assumption that defaults could increase in the future.

Commodities. Commodity prices continued their upward trend, as the price of crude oil

increased to \$101.58 per barrel, up 5.8% for the quarter. Gold closed the quarter up 10.0%, at \$916.88 per troy ounce, and the price of natural gas increased by a staggering 32.2% for the quarter, closing at \$9.86 per million BTU. Agriculture followed suit, with the S&P GSCI Agriculture Index rising 8.1% for the quarter.

U.S. Dollar. While commodities continued their upward trend, the U.S. dollar continued its 6-year downward trend. Fueled in part by the Federal Reserve's interest rate cuts, the dollar fell another 7.6% against the Euro and 10.8% against the Yen.

International Markets. International markets offered little refuge for investors during the quarter. The MSCI EAFE (Europe, Australasia, and Far East) international stock index fell 9.5% for the quarter, while the Dow Jones World Index was down 9.2%. Some of the once high-flying emerging markets were hit the hardest, with the stock market indices for China and India falling 34.0% and 22.9%, respectively.

ANALYSIS

Examining these first quarter results out of context could startle even the hardiest investor. Yet, for several reasons, to do so would be a mistake. These results, coupled with

the trends and observations described below, actually suggest an opportunity and a consequent need to remain invested.

Aggressive Monetary and Fiscal Policy. The question that most people are asking is whether the U.S. economy is now in the midst of a recession. The term "recession" has probably been overused in recent months. Technically, a "recession" occurs when gross domestic product declines in 2 or more consecutive quarters. The media, politicians, and others recently have used the term more broadly to describe a general slowdown in the economy. Regardless of which definition is used, we believe that it is likely that we are now experiencing a recession.

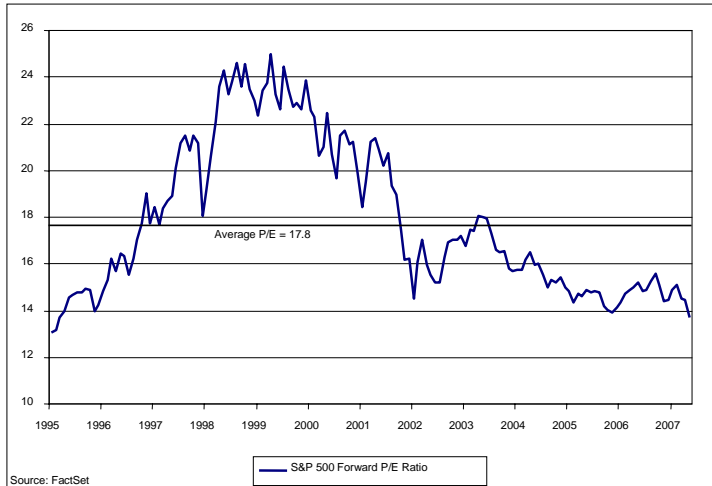
To a large extent, the financial markets agree, having discounted themselves to reflect the likelihood of a recession. The causes of this recession are undoubtedly multifaceted, but it is likely that one of the principal causes was the federal government's failure to act sooner to prevent it.

Perhaps having learned a lesson from its inaction, the federal government, not only through words but also by actions, made it clear during the fourth quarter of 2007 and the first quarter of 2008 that it is unwilling to allow the U.S. financial markets to fall fur-

ther without a fight. Consider the almost unprecedented stimulus implemented in recent months. The Federal Reserve has now reduced the federal funds rate by a full 300 basis points (3 percentage points) in the last 6 months, thereby dramatically reducing the cost of capital. These actions also are among the reasons why, in turn, the dollar has fallen so far. An undervalued dollar generally should be supportive of a stronger U.S. economy because it promotes investments in the domestic economy – although part of this support likely has been eroded through higher oil prices, which are quoted in U.S. dollars.

The federal government has been active in other important ways as well. In February, it passed a stimulus package worth, by some estimates, \$168 billion, offering tax rebates for individuals, accelerated depreciation and expensing of property for businesses, and increases in the maximum amounts that governmental agencies may lend to homebuyers.

These initiatives are projected to yield net positive results as early as this summer. In fact, when Federal Reserve Chairman Bernanke recently testified before Congress, he made the following optimistic statement about the prospects for near-term growth:



... much necessary economic and financial adjustment has already taken place. And monetary and fiscal policies are entrained that should support a return to growth in the second half of this year and next year.

Core Inflation Remains Contained. As the daily headlines clearly indicate, prices for food and energy have been rising. “Headline” inflation is a legitimate gauge of the current trend in living costs, but it typically is more volatile (and, from a long-term perspective, less meaningful) than “core” inflation, which excludes food and energy price trends, because it is subject to the effects of transitory events.

Core inflation for the past year has remained at about 2.3%, and it appears to be in check. As has been observed by the Federal Reserve, headline inflation typically trends toward

the core rate and not vice versa. Moreover, despite the rise in headline inflation, there has been little rise in wages, with employee compensation rising only 3.3% in 2007, unchanged from its average rise during the previous 3 years.

Some have argued that headline inflation will creep into the core rate. We think that this is unlikely, given that rising food and energy costs should ultimately decrease real spending power – particularly given the lack of wage inflation – and therefore restrict the ability of companies to raise prices further.

It must also be noted that some of the “bad” news that greets us every time we read a newspaper is actually good news for containing inflation. The housing debacle, the stalled equity markets, and the decline in consumer confidence are all profoundly deflationary in nature.

Equity Valuations are Compelling. Concern for the economy has driven equity prices down to attractive levels. Historically, the average forward price-to-earnings ratio of the S&P 500 is just under 18. In contrast, the S&P 500 finished the quarter with a forward price-to-earnings ratio of just under 14, a greater than 20% discount off the historic norm. In a sense, stocks are “on sale.”

Sidelined Cash Should Provide Buying Power. On a relative basis, corporations are now flush with cash. Cash currently represents 11% of total balance sheet assets held by S&P 500 companies, compared with 10.2% in 2005, 8.8% in 2000, and 9% in 1995. This excess cash, amounting to some \$1.6 trillion, eventually should lead to special dividends, acquisitions, capital expenditures, and general spending, all of which would be positive for the markets.

Meanwhile, investor cash also has been accumulating in money market and savings accounts, leading to a “cash mountain” of over \$6 trillion, which, by the way, is earning less and less due to falling interest rates. In turn, this should lead to increased spending and increased investment in higher yielding vehicles such as stocks, bonds, and real estate – again a positive force for the markets.

Recessions do not always coincide with stock drops. Performance change in the S&P 500 Index before, during, and after recessions:

Recession Period	Six Months Before	During Recession	Six Months After
Dec. 1969 - Nov. 1970	-8.9%	-11.3%	20.5%
Nov. 1973 - March 1975	1.1%	-24.7%	6.5%
Jan. 1980 - Nov. 1980	5.8%	5.8%	18.8%
July 1981 - Nov. 1982	-3.8%	1.9%	23.0%
July 1990 - March 1991	-0.5%	2.5%	7.7%
March 2001 - Nov. 2001	-18.3%	-8.1%	-6.3%

Source: Wall Street Journal and Standard & Poor's

Much of Equity Slowdown Concentrated in Limited Sectors.

Finally, it should be noted that much of the pain experienced in the broader equity indices has been concentrated in a few sectors, notably the financial and consumer discretionary sectors, the only two sectors to finish with losses for 2007. These sectors experienced additional losses of 14% and 5.9%, respectively, in the first quarter of 2008.

Corporate profit growth has slowed during the past 2 quarters, but a disproportionate amount of the slowdown has occurred within the financial sector. Balance sheets and profit margins outside the financial sector were strong heading into the current slowdown, providing a "safety net" for the non-financial segment of the markets. Also providing support outside the financial sector has been a growth in exports, fueled not only by increased global demand but also by a declining dollar.

CONCLUSIONS

We remain mindful of the many and varied risks facing the economy and the financial markets. These risks include: the continuing tightness and uncertainty inherent in the credit markets; ongoing weakness in the housing industry; recent increases in unemployment; the possibility of further commodity price increases; the slumping dollar; the possibility of U.S. weakness spreading abroad; the possibility of higher taxes under a new political administration; and a dearth of consumer and business confidence.

In fact, we have been mindful of these risks for over a year now. During the past 12-18 months, we have positioned our portfolios for a U.S.-centric slowdown, focusing on companies that should benefit from international demand and higher commodity prices and avoiding companies that are overly exposed to the U.S. consumer and to the housing

industry. We have also underweighted the beleaguered financial sector.

It is impossible to predict with certainty when the equity markets will regain their composure. Yet, for the myriad reasons described above, we believe that a return to positive trends within the equity markets could occur as early as the latter part of the second quarter, and we are opportunistically positioned to take advantage of that turnaround.

In the fixed-income markets, we expect that corporate spreads will tighten as investors' concerns about credit quality and liquidity abate. We also expect that municipal bond yields will fall from their relatively high levels, which were precipitated by credit rating downgrades of bond insurers and the disappointing results of recent bond auctions.

We advise our clients to "stay the course" and not make the common mistake of allowing the fear of short-term negative conditions to interfere with long-term, strategic asset allocation decisions. Even in the likely event that we are now experiencing a recession, if history is any guide (and we think it must be), recessionary periods do not always coincide with market drops and, in fact, as the above chart illustrates, typically are followed by positive market trends!