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Perspectives

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The short-term future of the economy and financial markets remains clouded half way through 2008, but we continue to anticipate longer-term positive trends and position portfolios to capitalize on these trends. A combination of lower inflation expectations, reduced interest rates, attractive valuations, increased transactional activity, and other factors should be positive for the equity markets over the longer term. Economic sentiment is severely depressed, and even a modest improvement could have a material, positive impact on equity prices.

THE SECOND QUARTER IN REVIEW

Investors entered the second quarter of 2008 with hopes of higher earnings, an end to the credit crisis, and a general recovery from the turmoil wrought during the prior two quarters. By mid-May, however, those hopes had been shattered, leaving investors looking toward the third quarter and beyond for potential relief.

U.S. Equities. The S&P 500 Index closed the second quarter down 2.7%, while the Dow Jones Industrial Average was down 6.8%. The NASDAQ Composite finished ahead for the quarter, gaining 0.8%.

These results, if viewed independently, might suggest some level of stabilization from the downward trends of the past two quarters. Nonetheless, one must look at the second quarter of 2008 as two distinct performance periods. Investors actually drove stock prices higher in April and in the early days of May. By mid-May, however, stocks began yet another precipitous descent, caused in large part by a 38% surge in the price of crude oil. The Dow Jones had appreciated nearly 9% by the beginning of May, but, between May 2nd and June 30th, it declined over 13%. Similar trends occurred in both the S&P 500 and the NASDAQ.

To lend perspective to the severity of this shift, June provided its worst monthly return for the S&P 500 since 1930. Of the S&P 500 stocks, 288

were down more than 10% in a month.

As in prior quarters, the financial sector led the way downward, falling an additional 18.3%. The industrial and consumer-discretionary sectors also fueled the contraction, with returns of -10.1% and -7.8%, respectively. More troubling was the scope of the decline, as the ratio of companies with rising share prices to those with declining share prices hit its lowest level since 2002 and, before that, 1974.

Only the energy, utilities, materials, and technology sectors managed gains for the quarter. By the close of the second quarter, nearly 25% of all companies comprising the S&P 500 Index were greater than 40% off their 52-week highs.

U.S. Fixed Income. The second quarter began with bond investors gaining confidence that the credit crisis was ending and that the Federal Reserve would take all necessary measures (such as providing increased liquidity for broker-dealers) to avoid a systematic

collapse in the financial sector. This renewed confidence led to increased demand for riskier fixed-income assets and decreased demand for the safety of risk-free U.S. Treasuries.

As a result, in May, investment-grade bond issuers set a record for new issues, raising over \$141 billion in 134 bond deals. For the quarter, investment-grade companies raised over \$309 billion in bond issuances. Even companies with weak credit were able to issue bonds, with prices rising and yields falling for junk bonds.

In contrast, the first-quarter trend of higher prices and lower yields for Treasuries was reversed during much of the second quarter. Yields for 3-month, 2-year, 10-year, and 30-year Treasuries rose to 1.9%, 2.6%, 4.0%, and 4.5%, respectively.

The fixed-income markets, however, did yet another about-face when, at the end of the quarter, investors reversed course again and began to seek out the safety of Treasuries (while pulling out of riskier fixed-income assets). The possibility of further losses in the financial sector, the questionable viability of bond insurers, and concerns about food and energy inflation all contributed to this last-minute reversal.

Commodities. For the quarter, the S&P GS Commodity Index rose 29%, led by the energy and food components, which

continued their relentless price increases. The price of oil rose \$38.42 per barrel, or 37.8%, the largest percentage gain since the first quarter of 1999. Corn and soybeans were up 28% and 34%, respectively, partly as a result of flooding in the Midwest.

Gold finished the quarter up 1.1%, and silver was up 0.8%. Industrial metals, however, suffered from lower global demand, with zinc, nickel, and lead all experiencing significant deflation.

U.S. Dollar. Bolstered by a more hawkish Fed and a downgrade in the outlook for foreign economic growth, the U.S. dollar found greater stability during the quarter, climbing 0.3% against the Euro and 6.5% against the Yen. Measured against a broader index of foreign currencies, the dollar was largely flat for the quarter.

International Markets. International equity markets again offered little refuge for investors. The MSCI EAFE Index was down 2.3%, yielding to fears of higher interest rates imposed by foreign central banks focused solely on fighting inflation. By some measures, more than 75% of the world's central banks already have tightened their monetary policies.

Few countries went unscathed during the quarter. The stock market indices for Canada and Japan were up 8.9% and 1.4%,

respectively, while they were down 2.4% and 20.0%, respectively, for China and India. Canada's success was partly tied to its abundance of natural resources.

ANALYSIS

Given the current conditions, the economy and financial markets are not likely to make immediate turnarounds from their recent swoons. Nevertheless, we believe that quality equities and corporate bonds are becoming more attractive and are positioned to generate decent returns over the next 12 months. Longer term, we expect the economy and financial markets to return to positions of strength.

Valuations Are Increasingly Attractive. With equity prices depressed, they have become increasingly attractive from a valuation perspective. Historically, the average forward price-to-earnings ratio of the S&P 500 is just under 18. As of the writing of this report, the forward P/E ratio of the S&P 500 was approximately 12, driving equity yields and risk premiums to historic levels.

Corporate bonds, too, are attractively priced by historical standards. We expect corporate spreads to tighten as investors gradually regain their confidence regarding credit quality and liquidity. We also expect municipal bond yields to fall as bond insurers eventually regain their footing.

Core Inflation Remains Contained, While Oil Prices May Be Limited By Demand Destruction.

We expect core inflation to remain contained by global competition, worker productivity, a weakened housing market, the slowdown in the U.S. economy, and a consumer with little discretionary spending power. As recently stated by Treasury Secretary Paulson, "There's no doubt that high headline inflation numbers are a real concern to Americans, but core inflation is relatively contained . . ."

Nonetheless, the high price of oil has become a major headwind for the global economy. Higher energy costs reduce consumer discretionary income and can increase the risk of price inflation for other goods and services.

We are, however, beginning to see signs of demand destruction brought about by higher oil prices. Consumers drove less as gasoline prices surpassed \$4 per gallon. Total U.S. vehicle miles traveled in March posted a 4.3% decline from a year ago, the largest drop since the data was first reported in 1942.

Moreover, the U.S. and foreign governments have begun to take measures to curb speculation and consumption. In the U.S., Congress is investigating the role that financial players (*i.e.*, speculators) are having on commodity futures. Elsewhere, several Asian countries,

including China, recently lowered their energy subsidies, which ultimately should lead to reduced demand in those countries.

Any stabilization or reduction in the price of oil should be positive for the markets, and, indeed, it does appear that such a phenomenon may occur under the current conditions. As explained by The Bank Credit Analyst:

"It is not an exaggeration to say that oil still rules the world: So long as oil prices keep rising, stocks will be under pressure, central banks will be hamstrung and the risk of recession will grow. But make no mistake: Oil is a fickle and volatile dictator that is very difficult to deal with. As demand destruction continues and the global economy slows, the oil game may need an ever-larger amount of new money to keep going higher."

Sidelined Cash Should Provide Buying Power. Investors now have accumulated over \$3 trillion in money market funds, double the level of only three years ago – despite the fact that these funds generally offer returns less than the current rate of inflation. This phenomenon suggests strong, latent buying power and ultimately should lead to increases not only in spending but also in purchases of higher yielding investment assets, such as stocks, bonds, and real estate. These increases, in turn, should be a

positive force for the economy and the financial markets.

Transactional Activity Continues.

Mergers and acquisitions continued throughout the 2nd quarter, albeit at a somewhat slower pace. Global deals were down, with 8,946 deals compared to 9,675 deals for the 2nd quarter of 2007. Yet, several large deals were announced during the quarter, including the acquisition of Anheuser-Busch by InBev for \$46.4 billion, as well as six other deals valued in excess of \$10 billion.

In addition, shortly following the quarter's close, Dow Chemical and Rohm & Haas announced an \$18.8 billion deal; Cleveland-Cliffs and Alpha Natural Resources reported a \$10 billion deal; and Teva Pharmaceuticals and Barr Pharmaceuticals announced a \$7.5 billion deal. Meanwhile, Waste Management has attempted to break up the recently proposed \$6 billion deal between Republic Services and Allied Waste with a better offer, and Microsoft and Yahoo continue to allow speculation regarding the possibility of a deal between the two giants.

Historically, merger and acquisition activity has provided fuel for the equity markets, so this continued activity is a positive indicator. Also positive is the fact that many of these deals are all, or nearly all, cash deals, suggesting that financing does remain available to companies with strong balance sheets.

Negative Sentiment Could Herald Positive Conditions.

We believe that the financial markets may be approaching an inflection point, as sentiment has become overwhelmingly negative. Consumer confidence is at a 28-year low, short interest is at record levels, bank stocks have plunged, and there are fresh concerns regarding the solvency of major financial institutions such as Fannie Mae, Freddie Mac, Lehman Brothers, and bond insurers MBIA and Ambac.

History demonstrates a general correlation between the point at which sentiment reaches its lowest levels and the point at which negative markets begin to become positive. It may be that we are nearing the territory of lowest sentiment, at which point the markets could begin an upward trend upon the first sign of any modest improvement.

But Housing Remains Weak, And The Credit Crisis Is Not Over. It goes without saying that national home prices have continued their downward march. By April, prices were down 15% for the year. These lower prices have begun to attract bargain hunters, with foreclosure sales accounting for some 40% of overall sales in some areas, but overall demand levels remain troubling. Recent data shows that the percentage of consumers planning to purchase a home in the next six months is at its lowest level since the early 1980s. As a

result, there continues to be an abundance of inventory that must be absorbed before any sustainable housing recovery can occur.

The housing market's woes are compounded by the continuation of the national and, indeed, global credit crisis. Financial institutions continue to write off billions of dollars of debt and have become increasingly vigilant about extending credit, particularly for real estate transactions. It is possible that housing construction activity and sales will bottom out over the next 6-12 months, but unless there is an accompanying increase in home values, banks will be further pressured to use restraint in making real estate loans, thereby potentially prolonging the problem.

CONCLUSION

Among the conditions to a comprehensive turnaround that have yet to be satisfied are a recovery in the housing sector, a conclusion of the credit crisis, and a stabilization of food and energy prices. We also have yet to see a cataclysmic sale of stocks or "capitulation" – that cathartic purging usually associated with market bottoms. As discussed above, however, many of the conditions for a recovery already have been satisfied, and we are therefore optimistic about the longer-term future.

Our process continues to focus on broad diversification across

sectors, and nothing has radically changed in our outlook over the past quarter except that we are experiencing heightened sensitivity to the spike in energy prices. Our portfolio positioning favors continued global economic growth, although we are mindful of the potentially chilling effects of higher energy costs. We are beginning to see signs of energy demand destruction, which could bring some welcome relief to corporations and consumers, resulting in a softer landing. We continue to emphasize more globally exposed companies and those furthest removed from the effects of the collapse in the domestic housing market. As a result, we remain underweight the consumer discretionary and financial sectors and overweight industrials, energy, technology, and materials.

We again remind our clients to "stay the course" and not make the common mistake of allowing short-term conditions to interfere with carefully planned long-term asset allocation strategies. Proper asset allocation and diversification are the best defenses during times of turbulence. We believe that we are positioned to mitigate the effects of further short-term weakness and to capitalize on positive conditions when they occur. As noted earlier, sentiment is severely depressed, and even a modest improvement could have a material, positive impact on equity prices.