June 2008 Outlook – Fundamentals Matter; Consider Rebalancing Diversified Portfolios; Turbulent Financial Markets

- U.S. markets had another volatile quarter as oil price concerns took control of the economy. Valuations for U.S. stocks appeared reasonable on a relative basis compared to previous peak-to-trough periods. In Europe, relative valuation levels continue to look attractive as companies continue to grow their earnings near or above expectations. In the emerging markets and Asia (ex-Japan), stocks appear slightly above fair valuation, but are supported by demonstrated above-trend growth. Within non-U.S. equity markets, **we continue to favor a systematic overweight in Europe** and explicit exposure to emerging markets.

- We believe larger-cap stocks exhibit more attractive valuations and earnings potential relative to smaller-cap stocks. It remains our view that there is currently a higher risk/reward tradeoff for systematic portfolio exposure to companies with higher credit quality and greater liquidity. **Certain "value-oriented" sectors of the U.S. equity market have been hit hard due to ongoing problems in the credit markets** and the slowdown in household consumption.

- We expect that corporate earnings will continue to ease relative to earlier double-digit robust levels. In our opinion, **there is still no clear sign of a bottom in the housing market**, and with mortgage security-related difficulties and more stringent lending criteria, it is uncertain when this drag on the broader economy will subside. We believe that consensus expectations for growth in 2008 are too optimistic. **Real economic growth is expected to come in far short of the long-term average trend rate**; thus, we expect that consensus expectations may be revised lower. Some signs of economic stress are now showing in the Europe region, as growth has started to show signs of slowing. Forecasted growth rates remain more attractive in Europe relative to both the U.S. and Japan.

- **The current debate has shifted from are we in a recession to how deep and long the current contraction will last.** Higher food and energy costs, declining home equity, depressed consumer confidence, and tougher credit standards have sharply slowed discretionary household consumption, although exports and overseas activities of U.S. companies remain reasonably robust. Evidence of a slowing economy, lower corporate profits, and a slowdown in household consumption suggest offsetting pressure on price levels. Given these considerations, our long-term inflation forecast remains between 2.2% and 2.5%. (we know you might question those numbers)

- We believe that the near-term opportunities in the U.S. bond market are minimal. As a result, there appear to be few opportunities for duration plays. In addition, due to credit widening and default risk, **we believe that it is not an opportune time to "take on" additional credit risk.** In light of current bond market conditions, we continue to maintain a shorter duration and higher credit quality bias.

- There continues to be a high level of uncertainty as to the actual level of leverage that still remains in the U.S. economy. What began as an increase in defaults in the sub-prime mortgage area has now progressed into other areas of the credit markets. **Banks are reluctant to lend to even their most credit-worthy customers**, and non-U.S. banks are reluctant to lend to other banks. This loss of confidence in the financial system may take time to repair and, until such time, we believe that uncertainty in the markets will continue to be higher than normal.

- During difficult markets, **it is important to remind clients that investing is a long-term endeavor, and, in the short-run, markets and economies are often noisy and tumultuous.** As we have often indicated, **volatility is a normal and expected part of investing in equities.** In addition, correlation among asset classes has been rising over time; therefore, we believe that diversification and proper portfolio positioning, consistent with investor objectives and risk tolerance, are as important as ever.

- In our opinion, a better approach for investors (those who do not need access to their investments over the next three years) would be to reevaluate their strategic asset allocation targets and "rebalance" their portfolios back to a long term objective.

- We view the current market environment as challenging, but **we remain focused on the investment and economic factors that we believe drive long term security prices:** valuation, corporate earnings growth, real economic growth, and the overall level of interest rates.