



MARKET COMMENTARY • JULY 2010

OUTLOOK

The confluence of sovereign debt worries, Chinese policy developments and the continuing oil spill disaster in the Gulf of Mexico weighed on global markets during the last month. The recent meeting of the G-20 finance ministers highlighted the no-win situation of excessive debt levels — while the United States encouraged additional deficit spending to bolster the global recovery, the Europeans are choosing fiscal austerity to calm the bond markets. Even though the European approach is clearly defensible, it may backfire if the fiscal consolidation leads to a significant shortfall in economic growth and tax receipts. While we believe a continuation of the global economic recovery remains the most likely scenario, some soft spots have emerged — including the May jobs and consumer spending reports in the United States.

Even though signs of financial market stress, such as increases in the interbank lending market interest rates, have been a concern, we aren't experiencing difficulties comparable to those seen in September 2008. European debt markets have stabilized somewhat in the wake of the €750 billion joint rescue package arranged by the European Union (EU) and the International Monetary Fund. In mid-June, Spain found a reasonably receptive market for issuances of both 10- and 30-year bonds. Leaders of the EU also have agreed to publish the results of stress tests on European banks — a development that could calm investor fears in some banks while requiring additional capital to be raised in others.

The transition of the global economy from a stimulus-driven rebound to a self-sustaining expansion remains key to the outlook for risk taking. Emerging markets, which have emerged from the financial crisis in strong financial shape, are central to this successful transition. Chinese growth, bolstered by massive stimulus spending during the last two years, needs to become more consumption-driven. Current wage hikes, coming during an environment of increasing income inequality, are likely being viewed by policy makers as a way to boost worker income and domestic spending. Currency revaluation should also help rebalance China's economy over time.

U.S. EQUITY

- Growth and credit concerns pressured the U.S. stock market.
- Risk remained elevated at levels not seen since 2009.

The U.S. equity markets declined during the last month amid considerably higher overall market volatility. Equities fell almost 15% from April 16 to June 8 intraday lows. Given the higher risk aversion, investors have shifted their preferences from higher-risk and lower-quality companies to profitable and stable companies that seem more insulated from the macro-economic uncertainties. As the economic recovery continues, company earnings and revenue trends remain constructive. Valuation levels, particularly in the context of a low interest-rate and inflation environment, are supportive of equities. However, the global economic concerns related to

sovereign indebtedness, Chinese policy tightening, uncertain regulatory reform in the United States and the effect of long-term fiscal imbalances are likely to temper the upside potential of the equity markets.

EAFE & EMERGING MARKETS

- European markets help support the EAFE while Japan lags.
- If the Shanghai Composite Index is a leading indicator, China hasn't bottomed.

European stock markets have been among the world's best performers during the last month. Even though economic forecasts for the region have been downgraded for 2011, attractive relative valuation and some calm on the sovereign credit front have attracted investor interest. Depreciation of the euro should boost growth outlooks in 2011 and beyond, while the crisis pushes the European Central Bank toward continued accommodation.

While emerging market stocks have started to outperform developed markets during the last month, China is a notable laggard. The Chinese market seems to be waiting for evidence that policy tightening is nearing an end. Consumer price inflation looks set to moderate in the second half of the year, so some deflation of the residential real estate market is probably the key development policy makers are waiting for.

FIXED INCOME

- Risk markets are consolidating.
- Underlying trends supporting fixed income assets remain in place.

The recent move wider in investment-grade spreads is the first sustained market weakness in the asset class during the past 18 months. Investors have absorbed negative developments concerning sovereign risk, financial regulatory reform and energy policy. The unintended consequences of each of these developments are still being felt, but the fiscal belt tightening taking place across the eurozone and more stringent financial regulatory reform in the United States are likely to be disinflationary. Historically, markets have experienced a consolidation phase after a large move. Given the underlying trends in the economy, we think the tenets supporting an improving outlook for investment-grade valuations remain in place. However, we expect some of this support to be offset by the potential of gradually higher interest rates as the economic recovery continues.

GLOBAL REAL ESTATE

- Global real estate investment trusts (REITs) declined 8.4% in May, with Europe and Asia underperforming.
- U.S. REITs declined more than 5%, but outperformed equities.

Commercial real estate values in the United States appear to be bottoming and showing signs of improvement. Property prices in the NCREIF Property Index (NPI) fell in the first quarter to their lowest rates since mid-2008, and were offset by income generation of the properties sufficient to allow the asset class to generate a positive total return. According to NCREIF, 25% of the NPI by value reported positive appreciation in the first quarter of 2010, compared to 14% in the fourth quarter of 2009. Appreciation will remain under pressure due to falling property

incomes, which likely will persist at least well into 2011, but values may begin rising ahead of improvements in fundamentals. It appears that the 2010 calendar year total return is poised to be positive for the first time since 2007.

COMMODITIES

- Soft agricultural product prices have offset strength in other commodities.
- A stronger outlook for oil should help offset a weaker picture for metals.

The Dow Jones-UBS Commodity Index has dropped 7% this year because of concerns about global growth and disinflation. We expect higher oil prices going forward, as global growth collides with increasingly tight supplies. The Gulf of Mexico oil spill should incrementally tighten supply through reduced drilling and higher costs. With Asia (ex-Japan) now consuming more oil than the United States, long-term upward pressure on prices seems likely.

While the outlook for industrial and precious metals seems similar over the long term, we have shorter-term concerns about the level of demand and inventories for industrial metals in China. With China accounting for between 30% and 65% of major industrial commodities demand, we expect a slowdown in their demand to restrain prices near term.

CONCLUSION

We maintain our view that a continuation of the global economic recovery remains the most likely scenario. The developments in European sovereign credit markets, while raising risks, also generate some benefits, including lower interest rates, more dovish central bankers and reduced inflation expectations. Gold, one of the year's best-performing assets to date, continues to play a role as a hedge against sovereign credit problems.

A solid, if unspectacular, global economic recovery should continue to support corporate profits and, therefore, the stock markets. Investment-grade bonds, having benefited from massive investor inflows during the last two years, may see some modest pressure through normalization of the currently low-interest-rate environment. Finally, we continue to carry a tactical overweight to cash — giving us some dry powder to take advantage of opportunities the market may provide during coming months as the trajectory of the global recovery takes shape.

Commentary provided by Jim McDonald