

Quarterly Market Review

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Perspective

Whether or not the U.S. stock market is in a bear market now is really just a technical question for the academics. With the exception of the large- and mid-cap growth sectors, the Russell style indexes are down anywhere from 12% to 21% from their peaks, a lot of that damage coming from the dramatic losses in the final month of the quarter. Economic data, meanwhile, continues to indicate not just a slowdown in the economy but a rising specter of inflation pushed primarily by rising energy costs. And new job creation, although first quarter GDP was revised slightly higher, remained on its negative path throughout the quarter. Together with a weak and falling dollar, all of this has left the Fed in a precarious position: either raise rates in an attempt to slow inflation and support the dollar, or cut rates further in an attempt to stimulate the economy. This quarter, the central bank chose the middle ground, wisely we think, and did nothing, which also appears to be the market consensus for the third quarter.

Still, given the ongoing weakness in several major areas of the market, intermediate-term forecasts for prices remain generally dark. The most obvious problem spot is the financial sector, where the costs of the mortgage crisis continue to mount, and there seems to be no end in sight to the write-offs by the major banks, not to mention the collateral issues of falling housing prices and increasing foreclosures. Nearly as obvious are two heavily cyclical industries reeling from the rapid increase in the price of oil: airlines and auto manufacturers. For the airlines, several of which are being pushed into bankruptcy, rising fuel costs are at the very least forcing cutbacks in service and employment. For U.S. auto makers, the same rising costs are rapidly changing the desires of their customers. The Big Three, all of which tooled their product mix over the past decade to emphasize large trucks and SUVs, are feeling the pinch as these high-margin vehicles are very rapidly falling out of favor with consumers. With these three large and important segments of the U.S. economy struggling mightily, and with no easy answers to be had, the last six months of 2008 are likely to be as rocky as the first six...and they accounted for the worst first half since 1970.

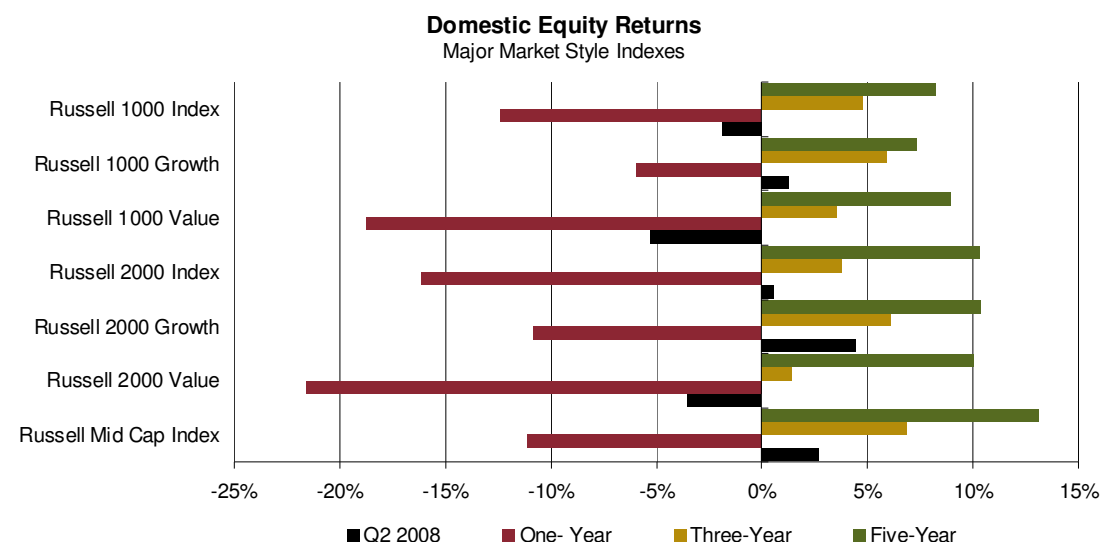
Domestic Equity Markets Overview

Second quarter results in the domestic equities actually belie the calm before the most recent storm. Of the nine major Russell style indexes, only three were negative for the second quarter, and both the Midcap Growth and Small Cap Growth Indexes were up more than 4%. But a closer look reveals that all nine indexes were down between 6% and 10% across the month of June. Hardest hit was the large-cap value index, where the struggling Financials remains the largest sector. The best performing segment of the market for the quarter was the mid-cap space, in which all three style indexes were positive, though the Midcap Value Index was up a mere 7 basis points.

The over all trend of performance favoring the growth style indexes continued in the second quarter, after taking a short break during the first quarter. Looking back over the last 12 months, the Russell 1000 Growth has outperformed the 1000 Value Index by nearly 1300 basis points and the gap is 1100 basis points between the Russell 2000 Growth and 2000 Value. This is, as one might guess largely due to the exposure to the Financials sector, clearly the worst performer over that period. In the Russell 1000 Value, the Financial sector is down nearly 50%, while accounting for nearly a third of the index weight at its peak. For the Growth Index, the Financials, making up less than 7% of the index, that number is "only" 22%. This accounts for nearly the entire differential in the two indexes. For the Russell 2000 the story is similar, though slightly less dramatic. The 2000 Value Index is also roughly a third Financials, though in this case only down 30%, compared to a 20% loss for the sector in the Growth Index with an

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8% exposure. When adjusting for the very bearish market in the Financial sector, the style indices are roughly in line.



International Markets Summary

The international markets were down sharply as well during the final month of the quarter, with the modestly strengthening dollar creating slightly larger losses for U.S. investors. But while the Russell Developed ex-U.S. Large Cap Index was down 2.66% for the period, that global figure masked several opportunities for active managers to outperform through country selection. Canada was the leading market for the quarter with a more than 10% gain. Norway was the only European country with a positive return, though losses in both the U.K and Denmark were less than 1%. Australia and Japan were the leaders in the Pacific Rim, while New Zealand and Hong Kong had significant losses. Overall, Eurozone sharply underperformed the Pacific Rim.

And though the Russell Emerging Markets Large Cap Index was down a little more than 1%, the emerging markets were again one of the best performers in the global arena. As it was in the first quarter, Latin America led the markets in the second quarter with a more than 10% return. Both Argentina (35%) and Brazil (18%) posted double-digit returns, while Chile (-12%) was the biggest loser. The Asian markets were down sharply in the quarter with 20% or greater losses in India, Pakistan, and the Phillipines.

Fixed Income Summary

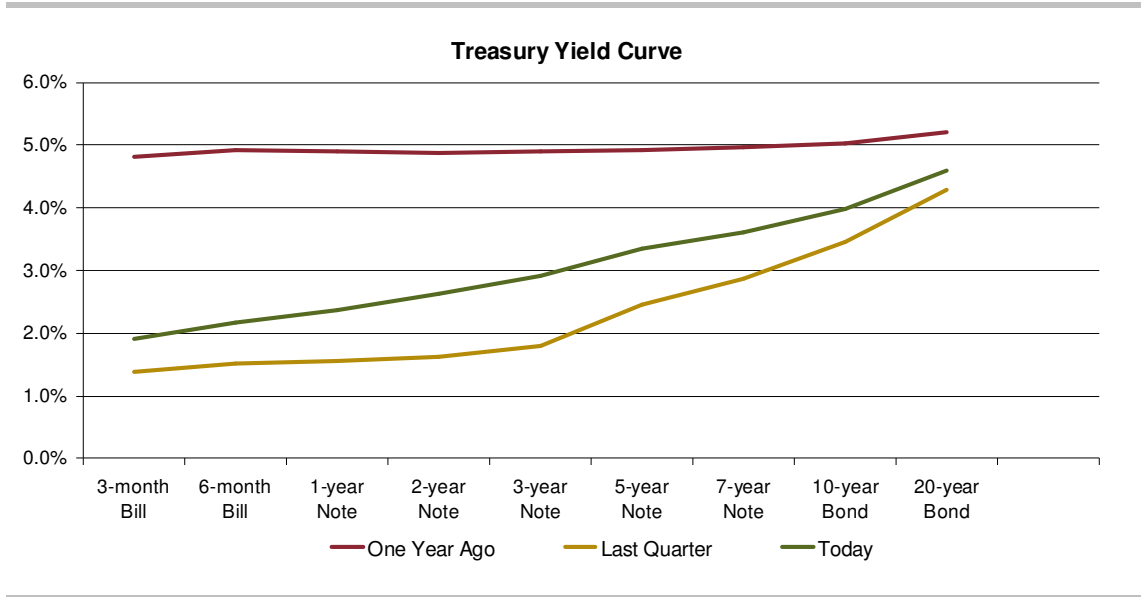
Although there was no action by the Fed during the quarter, the Treasury yield curve moved slightly higher at both the short end (+0.52%) and the long end (+0.54%), and by more than 100 basis points in the 2-3 year segment. In addition to the upward shift in the yield curve, there was a slight tightening of spreads over the course of the quarter, resulting in positive results from many of previously beaten down sectors, including high-yield (+1.76%) and adjustable rate MBS securities (+1.00%). Treasuries, meanwhile, the best performing segment of the taxable market over the last year, was the worst for the second quarter with the Lehman Brothers Treasury Index declining 2.10%. Interestingly, BBB-rated securities within the Aggregate Index were slightly positive for the quarter, while AAA and AA securities were down -1.09% and -1.67%, respectively. This would appear to mark a move back to a more risk-tolerant state by the same market participants who had run to the safety of Treasuries in the previous six months. Inflation-protected issues disappointed slightly for the quarter, with the Lehman U.S. TIPS Index down -28 bps, though that average is up a staggering 15.09% for the last 12 months.

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The municipal bond market also turned in a disappointing, though largely positive, quarter. Like the taxable market, the worst returns were found in the maturities that had performed best over the last year. Maturities from three to eight years generally suffered small losses while those shorter and longer had modest to significant returns in the quarter. Contrary to the taxable indexes, AA-rated and A-rated muni issues were up 1.00% during the quarter, with the lower rated BBB-rated issues up just 23 basis points.



Outlook

After a broad and deep decline through the first quarter, the domestic equity markets appeared to have righted themselves across the first two months of this one. But the sharp reversal during the final month--the stock market's worst June in 78 years--has left the Russell indexes down 8% to 13% for the first half of the year. And save for a few country-specific exceptions, the international developed markets are in much the same condition. Continuing economic weakness, both domestically and abroad, will no doubt affect the markets for the remainder of the year, with the direction of interest rates in the U.S. the big questions for the second half. While a weakening economy might lead to a call for a cut in rates to stimulate growth, the Fed might instead be pushed to increase rates to protect a weakening dollar and reduce inflation pressures. A further complicating factor will be the closing months of the presidential election and the market's reaction to, and anticipation of, the next administration.

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