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A Quarterly Review of Economic and Market Developments

2ND QUARTER 2007

BAILARD INTERVIEW

Mid-Year Review

With the year half over and the prospects of another solid year of performance in sight, we discuss the economic and market outlook with Arthur A. Micheletti, Bailard's Chief Economist and Investment Strategist.

Arthur A. Micheletti, CFA
Chief Economist and Investment Strategist

At the end of last September, with stocks moving to new cyclical highs, we asked you, "How much further do you think the stock market can run?" Your response at the time was decidedly upbeat. In the three quarters since then (from September 30, 2006 to June 30, 2007), the S&P 500 has advanced 14.1% and international stocks, as measured by the MSCI All-Country World Free (ex-U.S.) index (U.S.$), are up 20.6%. So let's start with the same question. "How much further do stocks have to run?"

No one knows how much further stocks have to run. We merely make educated guesses and weigh the expected risk and return of various outcomes. Our goal is to provide competitive, consistent returns for our clients within the context of globally diversified portfolios. That said, we remain optimistic about the outlook for the global equity markets and have tilted our clients' portfolios in that direction. Despite the persistent run up in stocks, valuations remain attractive, earnings continue to provide positive surprises, interest rates and inflation are relatively low, and the long-term trend of the market is up. As long as valuations, market fundamentals and the price trend are positive, we should remain overweight but not overexposed to global stocks.

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What do you mean by being overweight but not overexposed?

As our clients know, we make asset allocation decisions around long-term strategic norms (the long-term asset allocations we would pursue if we were completely neutral about the economic and investment outlook). These norms have been rigorously tested over time and have served our clients well in helping them pursue their risk/return objectives. The norms act as anchors around which we operate. We never want to undermine the long-term strategy by making too large or heroic a bet. When we make allocation decisions, we tilt around the norm strategy, seeking to keep portfolios balanced and not leaning too far in any one direction. Experience has taught us to be humble in our forecasting ability. It's not the 80% that you know that hurts you; it's the 20% that you don't know. Through multi-scenario analysis, we consider alternative economic or market outcomes in an effort to ensure that, regardless of what happens, portfolios aren't overly exposed to adverse outcomes.

The thing I worry about the most is being too optimistic.

What are some of the things that could trigger an adverse outcome? What do you worry about?

The thing I worry about the most is being too optimistic. Although many issues are currently keeping investors on edge (e.g., rising oil prices, problems with subprime mortgages and the housing recession), in analyzing each of them individually, I don't find them to be sufficient to derail the economy or the markets. The U.S. economy is well diversified and has proven to be extremely resilient as the baton of growth has passed from one sector to another. From a global perspective, the world's economy has never been stronger or more diversified. According to the IMF, fewer economies are now in recession than ever before. Zimbabwe and Lebanon are the only nations currently experiencing a recession, compared to an average of 25 countries in recession in any one year over the last 25 years. On the growth side, more economies than ever before have growth rates above 4%. Together, Brazil, Russia, India and China now have a larger GDP than the U.S.

It seems that every time the Chinese stock market takes a tumble, it pulls the rest of the global equity markets lower. Could a Chinese stock market correction trigger a downturn in the U.S.?

I don't think so. First, the Chinese stock market is not widely held inside or outside of China. The wealth effect from a decline in Chinese stocks should have only a minimal impact on the favorable long-term fundamental economic outlook. We believe the move from an agricultural based to an industrial based economy will continue to support Chinese growth well into the future. From the U.S. perspective, exports, while an important part of U.S. growth, comprise less than 12% of GDP. The U.S. is far more dependent on its domestic economy. Moreover, given our large trade deficit, the U.S. remains an important driver of global growth. If there is a global recession, it will more likely be triggered by a downturn in the U.S.

Why are Chinese authorities working so hard to cap speculation in their equity markets? What impact will this have on the rest of Asia?

Chinese shares have risen over 100% in the last year. Healthy stock markets typically do not go straight up. Such market movements usually lead to an inefficient use of capital. Chinese stocks have soared in part because restraints on capital outflows and low deposit rates have left the Chinese people with few options other than to invest in stocks, real estate or gold. However, the Chinese government is moving swiftly to free up the financial system and allow excess liquidity from strong economic growth to flow more freely. Over the last few months, it has increased the deposit rate at banks and issued

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the first domestic corporate bond, creating a new outlet for liquidity. It is also considering eliminating the 20% tax on interest income. To cool down economic growth, the government has raised bank reserve requirements to restrain bank lending. To slow down speculation, it has increased the stamp tax, a transaction tax imposed on stock trading. The government has also allowed the dual listing of major Chinese companies on both the Shanghai and Hong Kong exchanges, which gives Chinese investors greater access to higher quality companies. However, in my opinion, the most important change is allowing qualified domestic institutional investors (QDII) to invest offshore in Hong Kong shares. Through Hong Kong mutual funds, QDIIs will gain access to the rest of the world. Chinese investors are likely to jump at the chance to diversify overseas. With about $3 trillion held in QDII funds, the amount of money going offshore could be significant.

Some market bears are concerned that U.S. stocks have been artificially propped up by strong liquidity flows from buyouts, mergers and share repurchases. What happens when this virtuous cycle of liquidity dries up?

Fortunately, there is more to the U.S. stock market's rise than the speculative behavior of irrational investors. If the rally was caused purely by speculative rather than fundamental factors, price-earnings (P/E) multiples would be expanding, not contracting. We believe the stock market has been driven by strong earnings growth, and part of this growth can be attributed to the financial restructuring of corporations.

The availability of capital has allowed companies to sell off underperforming businesses to strategic buyers. This strengthens balance sheets and allows corporations to focus resources on more profitable business segments. Hence, profits continue to rise in a surprising fashion. Liquidity can be bad when it overstimulates the stock market (i.e., forces P/Es higher), but positive when it enhances earnings. Buyers of less profitable or ignored businesses presumably have the talent, expertise, focus and financial muscle to turn these businesses around. The biggest winner in all this is the American economy, because it operates the best when resources are most efficiently utilized.

So how do the good times end?

Putting aside geopolitical risks, the good times will likely end the way they always do—through overindulgence. At the end of a typical bull market, investors become overexuberant, P/E multiples rise sharply, and fear is in short supply. In this environment, economic excesses build as corporations overexpand, inventories rise, inflation heats up and interest rates rise sharply. Currently, none of these conditions appear to exist.

Government intervention can also kill the golden goose. Interventions that lead to inflationary monetary policy, excessively high interest rates, punitive taxation, or significantly increased regulation or protectionism can undermine the "animal spirits" that drive growth.

We expect U.S. growth to pick up as the year progresses

The U.S. economy should be able to achieve a trend rate of 3.0% to 3.5% growth.

As expected, the U.S. economy downshifted from a buoyant 3.3% growth rate in 2006 to a sluggish 0.7% annualized rate in the first quarter of 2007. Much of the slowdown was attributable to housing and more severe winter weather. Second quarter growth appears to have reaccelerated, but is likely to again be below trend. However, we expect growth to pick up as the year progresses.

The death of consumer spending is premature

For years, we have heard that too much debt, too little savings, a housing slowdown and rising gasoline prices would curtail consumer spending. Despite these concerns, consumers continue to spend, supported by rising income and employment growth. Although job growth has moderated, it still rose 1.4% year over year. The unemployment rate is a low 4.5%, and personal income is up over 6% year over year. As long as incomes are rising and consumers feel confident about job security, they should continue to spend.

In addition, consumer balance sheets are in great shape and should support spending. Household net worth (assets less liabilities), the broadest measure of saving, grew by $2.9 trillion in the first quarter to $56.2 trillion, or 30% of disposable personal income (DPI). Excluding real estate assets, financial net worth rose $1.5 trillion, or about 15% of DPI.

The corporate sector is reaccelerating

Over the last few quarters, business activity was restrained by a modest inventory overhang. Inventory reduction lowered overall Q4 2006 growth by 1.2% and Q1 2007 growth by 1.0%. The drag from inventory reduction now appears to be over. Thanks in part to accelerating business sales, the inventory/sales ratio has fallen to 1.27 months supply, approaching the cyclical low of 1.25 set in March of 2006. Inventories look set to be a net contributor to future growth.

The Institute for Supply Management (ISM) Manufacturing Index jumped more than expected in June to 56% and is trending higher. The ISM Non-Manufacturing Index also jumped in June to 60.7%, its highest level in over a year. Above 50% is considered expansionary for both of these indices, suggesting economic growth will rebound sharply.

Corporate profits, one of the best leading indicators of growth, continue to surprise to the upside. Analyst earnings expectations have been revised up to 7.5% earnings growth in 2007 and 11.2% in 2008. As long as profits remain healthy, corporations should continue to expand and look for ways to enhance productivity.

The housing slump has slowed but the decline is not over

Residential construction has not yet bottomed, but falling home prices and builder incentives appear to be lending support to sales. Better sales and weak housing starts are bringing the inventory of unsold homes under control. The recent rise in mortgage rates is likely to further curtail home sales, but, as more time passes, pent-up demand should build and be a source of stronger activity in the future. If home prices continue to slip and/or mortgage rates dip, this demand could come into the housing market. Even without a big upswing in housing, an end to its decline would eliminate a 1% drag on economic growth.

If, as we expect, employment and wage growth remain healthy, corporate profits continue to expand, inventories are gradually rebuilt and the housing slump continues to moderate, the U.S. economy should be able to achieve a trend rate of 3.0% to 3.5% growth. The return to trend growth should also be supported by a healthy global economy and continued export growth. Whether the economy grows faster or slower will depend in large part upon how severe the housing slump will be. If housing stabilizes, look for above trend growth.

Global trade is booming, reflecting strong underlying growth overseas

Foreign economic activity continues to provide positive surprises, with Asia (ex-Japan) showing the strongest growth and best prospects.

Global exports are booming

During the 1990's, global growth was driven by the U.S. economy. Since 2000, with the expansion of free market capitalism, growth has become more widespread as the world's economies have become more open and integrated. This can best be seen in the rapid expansion of global exports, which have risen 111% over the last five years to $11.8 trillion.

Over the last year, global exports remained at or near record highs in most major economies. Exports are growing above 20% in Turkey, China, India, Germany, Italy and the EU; between 10% and 20% in Indonesia, France, South Korea and the U.S.; and in single-digits in Canada, Japan, Brazil, Russia and Mexico. Only the U.K. has seen a shrinkage in exports due to the strength of its currency.

Growth in Euroland is healthy but uneven

Euroland GDP was reported up 0.6% in the first quarter and 3.0% year over year. Growth was primarily driven by strong capital spending and exports; domestic consumption was a bit weak. France and Italy remain the laggards in Europe, while Germany and Spain are leading the way. In France, the election of Nicholas Sarkozy has raised hopes for economic reform. He is pushing for tax breaks for small businesses and first time homebuyers, a cut in taxes for overtime worked and an elimination of the inheritance tax. To help pay for the tax cuts, he has also announced plans to sell off 7% of France Telecom for $5 billion.

Japan continues to lag

Although first quarter GDP growth was revised to 3.3% from 2.4%, Japan's domestic economy is having a hard time gaining traction. Year-over-year wage growth continues to shrink and has fallen for six consecutive months. Real incomes and retail sales are flat. Industrial production is down year to date and inventories are rising. Only exports remain truly healthy, growing around 9% year over year as a falling yen strengthens Japan's competitive position.

Inflation slid to -0.2% in June from 0.0% in May. As long as the country is flirting with deflation and the domestic economy remains soft, the Bank of Japan is unlikely to raise rates.

The rest of Asia is booming

In China, despite efforts to slow growth, the economy continues to grow rapidly. Real GDP, after accelerating 11.1% year over year during the first quarter, continued to expand in the second quarter. Industrial production and retail sales growth exceeded expectations in May. China's trade surplus continued to soar, with year-over-year export growth outpacing import growth 28.7% versus 19.1%. Inflation accelerated to more than a two-year high of 3.4% last month, exceeding the central bank's target rate of 3%. Meat prices are rising because "blue ear disease," led to the slaughter of pig stocks. Although the increase in inflation is likely to be temporary, we expect the government will continue to look for ways to slow growth and stock market speculation.

India's first quarter GDP growth rate of 9.4% was better than expected and the fastest growth in nearly two decades. Although the Wholesale Price Index has come down 1%, the CPI at 7.5% remains elevated. Strong growth and elevated inflation should keep the Reserve Bank of India's bias toward tightening.

The South Korean economy is accelerating as consumers are benefiting from higher wages and incomes. Consumer confidence is turning higher, and bank lending to households is increasing. South Korean exports like the rest of Asia remain strong, rising a much better than expected 11.9% year over year in May. Korea now exports more to China than the U.S. As a result, it should be a major beneficiary of the secular growth trend in China.

Higher yields dampen bond returns

For those who had been lulled to sleep by the U.S. bond market over the past couple of years, the second quarter provided a bit of a startle. Subprime defaults, slippage in the equity markets and signs that the economy was growing faster than some had anticipated led bond yields to rise significantly before pulling back a little toward the end of the quarter. We view the increase in yields as a healthy normalization that more accurately reflects the economy's prospects for moderate growth and contained inflation, in which Fed policy is likely to remain on hold.

Long-term risk-free interest rates, as measured by the 30-year U.S. Treasury bond, rose from 4.85% to 5.13% during the quarter, reaching as high as 5.40% in mid-June. The yield curve, which had been negatively sloped for almost a year (long-term yields were lower than short-term ones), returned to a normal shape, boding better for future growth. In an equally important shift, the spreads for riskier debt (including mortgage borrowings) rose as anxiety from the subprime portion of the residential housing market migrated across the bond universe.

During the quarter, returns were negative throughout the investment grade bond sector. Led by corporate issues, the broad market, as measured by the Merrill Lynch Corporate/ Government Master index fell -0.5%. With the rise in yields, bond maturity mattered more than sector selection. Long-term U.S. Treasury bonds fared the worst overall. The Merrill Lynch U.S. Treasury Ten-Year+ bond index, for example, declined -1.9%.

Over the past couple of years, less risk-averse bond investors have been willing to buy risky debt with shrinking compensation compared to the yield on Treasury debt. This potential mispricing of risk is still extant in most sectors of the bond market, with the exception of the subprime area, where investors have awakened to the underlying risks involved. In other sectors, such as high yield debt, spreads have increased only slightly. The issue here is the large volume of debt that the market needs to absorb. Due to the increase in leveraged buyout (LBO) activity (borrowing money to take over companies), more very-low rated debt is being or is about to be issued. It remains to be seen whether the debt markets will continue to fund this without greater compensation from issuers. If not, increased debt costs could prove to be a limiting factor in the current LBO boom.

Real yields and implied inflation are still slightly below fair value, suggesting that bond yields could rise a bit further. We look for long-term yields to remain above shorter-term rates, with the possibility of a further steepening of the yield curve.

Foreign Exchange

During the second quarter, the U.S. dollar declined modestly against most of the major currencies and more substantially against some of the emerging markets and peripheral developed markets. Among the majors, the greenback advanced only against the Swiss franc and the Japanese yen (which declined more than 4% versus the dollar for the period). The euro bested the dollar by 1.4%, while the Canadian and New Zealand dollars each appreciated more than 8% for the quarter. Brazil, Turkey and India each saw their currencies rise by more than 5%.

A number of factors adversely affected the dollar during the quarter. The slowdown in U.S. growth exacerbated negative sentiment against the currency. In addition, even as long-term yields rose during the quarter, short-term yields—those having the greater impact on currency flows—fell, diminishing the attractiveness of the dollar to foreign investors. The weakness in the dollar is probably not over, but there are prospects for stability on the horizon. Analysts expect U.S. growth to accelerate, and even now there are signs that the economy is beginning to regain some traction. With most analysts underestimating the resilience of the U.S. economy, the dollar could surprise on the upside.

U.S. stocks soared in the second quarter

Investors showed a remarkable level of resilience in the second quarter, pushing all major U.S. stock market indices higher despite worrying headlines about geopolitical risks, fears of a subprime meltdown and concerns about Fed policy.

The well-recognized Dow Jones Industrial Average rose 9.1% for the quarter, while the broader stock market as measured by the S&P 500 index was up 6.3% over this three-month time period.

Merger and acquisition (M&A) activity was rampant in the second quarter this year. During the first half of 2007, there were 1,930 deals valued at approximately $347 billion, for a record $1 trillion run rate. U.S. private equity deals accounted for more than 40% of all M&A activity, a dramatic increase from the days when private equity only accounted for 5% of the total.

Corporations also went on a stock buyback spree. The high level of stock buybacks is being fueled by the hordes of corporate cash, the immediate impact that a buyback has on earnings and the subsequent potential impact that it has on stock price.

Corporate earnings estimates have risen

Despite all of the fears regarding a housing induced economic slowdown, analysts actually raised their corporate earnings estimates for the second, third and fourth quarters of this year. This is a sharp contrast to one year ago, when analysts had reduced their estimates for the remaining three quarters of 2006. The current earnings estimates look very good.

Estimates for growth in the second quarter are at 5.1%, significantly higher than the 3.6% that analysts were expecting last April. Growth estimates for the full year stand at a healthy 8.1%. Much of the increase in earnings estimates has probably stemmed from the better than expected profit margins that we saw at the end of the first quarter.

Technology stocks attracted interest

The information technology sector was in the spotlight during the quarter. Technology companies had the highest profit margins of 11.5%. Much of the buyback activity occurred in this sector. Information technology companies accounted for 22.8% of authorized buybacks for S&P 500 companies while representing only 15% of the market value within the S&P 500. Finally, leveraged buyout firms continue to focus their attention on tech companies, specifically within the IT services and software industries.

Not surprisingly, information technology was the second best performing sector within the S&P 500, returning 10.3% over the past three months. (The only industry that performed better than technology was the energy sector, coming in with a 14.7% return for the quarter.) For the first six months this year, technology stocks were still playing catch up, falling behind the energy, materials, telecommunications and industrials sectors. Improving productivity, new product innovation, ever expanding global demand and reasonable valuations might set the stage for further upside for technology names.

Shift in a trend?

During the second quarter, large cap stocks did better than small cap stocks, and growth generally did better than value. While we don't call a three-month price move a trend, this might be the start of what many have been waiting for: the outperformance of large growth stocks relative to the small cap value universe.

The information technology sector was in the spotlight during the quarter.

International stocks also soared during the second quarter

International stocks continued on their upward trajectory in the second quarter, following solid, if unspectacular, first-quarter results.

While the first quarter saw international equities resilient in the face of a China market bubble scare, the second found them undeterred by a late-quarter global interest rate scare. The MSCI All-Country World Free (ex-U.S.) index (net dividends, US$ terms) returned 8.2% over the three months, extending a nearly five-year-long bull run of annualized returns in excess of 25%.

The world's stock markets rose rapidly in April and May, as investors anticipated a continuation of "Goldilocks" (not too hot, not too cold) conditions—steady global economic and earnings growth, with contained inflation and a neutral U.S. monetary policy. A stream of merger and buyout news also helped maintain the positive tone of the equity markets. In June, however, an interest rate hike by the European Central Bank rekindled fears of commodity-led inflation and a future of further rate rises—in which increased borrowing costs would damage consumers' spending power and corporate profitability. These fears put a halt to the rally, but in the end took only a little away from the quarter's gains.

China is following the U.S., Western Europe and Japan into the club of major industrialized economies.

Emerging markets outperformed

Continuing a five-year old trend, the emerging markets as a group outperformed developed markets over the quarter. Most emerging markets returned at least 10%, and several—including India, Brazil and China—rose more than 20%. Japan was a notable laggard, with subpar local market returns and a weakening yen leading to a small loss in U.S. dollar terms.

A closer look at China

China's stock market continued its impressive rise in the second quarter, despite more incremental attempts by regulators to restrain speculation. The speculative excesses have occurred primarily in the lofty mainland A-share (i.e. local) market. Hong Kong-listed China H-shares are trading at much more reasonable valuations. As of this writing, H-share prices are currently averaging 42% less than A-share prices.

China still has some major hurdles to overcome, including a mounting environmental crisis and an increasing wealth disparity between urban and rural residents. The country's lack of political transparency, questionable protections for intellectual property and recent unsafe product exports have all caused friction with its trading partners. But despite enormous challenges, China's leadership has proven itself a capable guide of the economy's rapid industrialization. The country's aggressive business sector has also proven itself well able to compete on the global stage.

Take a step back and China's transformation is not all that mysterious: it is following the U.S., Western Europe and Japan into the club of major industrialized economies. On balance, we believe the risk-reward equation favors participation in this transformation.

The China theme has also been driving performance in other international markets this year. Resource producers from Canada to Indonesia are helping to support China's industrialization with energy, metals, and agricultural commodities. In Japan, Taiwan, Korea and other Asian markets without compelling domestic-demand themes, the leading stocks have been cyclical issues perceived to benefit from growth in China. Overall, Asia ex-Japan (both developed and emerging), with its favorable macroeconomics and strong long-term growth potential, is the region of the world we find most compelling at this time.

Recent focus on office buildings may be misplaced

Office buildings are the current darlings of institutional real estate investors. This is the part of the cycle in which office buildings should outperform. Job growth is finally reducing vacancies, yet current rents are not high enough to justify much new construction. If the economy continues to grow, the office sector should enjoy the highest rent growth of the four major property types. However, investors are paying handsomely for the opportunity to play.

Using capitalization rates (net operating income yield) from NCREIF, the first chart at the right compares the office sector to other property sectors. Capital improvements represent average annual expenditures for tenant improvements and leasing commissions, as well as general property upgrades. The net of these two represents basic property level cash flow.

These figures suggest investors are justified in their focus on office buildings. According to Real Capital Analytics, 44% of investment property transaction volume last year was in offices. The highlight of this frenzy was, of course, the buy-out of Equity Office Properties by Blackstone, at cap rates estimated at less than 5%. In tight and booming markets such as New York and Washington, D.C, perhaps such prices can be justified.

However, we believe investors are taking unwarranted risks to achieve these potentially superior returns. Offices will need more demand growth than the other property types to simply use up the existing vacant space. The second chart at the right shows vacancy rates by property type as of year-end 2006. As the chart indicates, the office sector had a significantly higher vacancy rate than the other property types.

Should the current economic sluggishness not recover substantial upward momentum, office investors could be locked into cash flow returns well below those of the other property types. Furthermore, should new construction begin to ramp up in this sector, we could see office buildings begin to enter the downside of their all too familiar cycle. With good current income, as well as opportunities for value-added plays, to be found in the other property types, we are inclined to leave the future potential growth returns in offices to other more speculative investors.

Of course, such broad generalizations about any property type are only generalizations. Metro areas or local markets can be in different phases of a cycle, or a particular property's redevelopment potential can be underappreciated. Each of these situations can present sound opportunities for investment, even in the office sector.

PROJECTED REAL ESTATE RETURNS BY SECTOR*

	OFFICES	APARTMENTS	INDUSTRIAL	RETAIL
12/31/06 Cap Rate	5.75%	5.25%	6.00%	5.50%
Less: Capital Improvements	(2.50)	(1.00)	(2.00)	(1.25%)
Equals: Cash Yield	3.25%	4.25%	4.00%	4.25%
Plus Est. Income Growth	5-6%	3-4%	3-3.5%	2.5-3.5%
Equals Est. Total Return	8-9%	7-8%	7-7.5%	7-8%

* These return projections are no guarantee of the future performance of these real estate property types. Investments in real estate entail significant risks. An investor may lose all or a substantial portion of the investment.

Source: National Council of Real Estate Investment Fiduciaries (NCREIF), Bailard Research

REAL ESTATE VACANCY RATES AS OF 12/31/2006

	OFFICES	APARTMENTS	INDUSTRIAL	RETAIL
Vacancy rate	12%	6%	9%	5%

Source: NCREIF, Bailard Research

We have moved to a more overweight position in global equities

Global stocks pulled back a little in June on weakness in Chinese stocks and fears that stronger U.S. growth would lead to rising inflation, higher bond yields and tighter Fed policy. Since our economic and investment outlook remained positive, at the end of June we added 2% to U.S. stocks and 1% to international stocks in many of our clients' portfolios. This followed a combined 5% increase in our recommended allocation to global stocks in late February and early April.

If our outlook for economic growth is correct, stocks should continue to move forward.

U.S. Bonds: Underweight

Despite an increase in bond yields during the second quarter, we believe bonds remain overvalued. The ten-year U.S. Treasury bond yield is still well below the 5.5% level our models consider to be fair value. Moreover, since we expect yields to remain within a fairly narrow trading range, investors are likely to do little more than earn the coupon on their bond investments. As a result, we continue to underweight bonds as an asset class. We see much better opportunities elsewhere.

U.S. Stocks: Overweight

After briefly going to neutral toward the end of last year, we are once again significantly overweight in U.S. stocks. With $100/share forward earnings on the S&P 500 and the index falling back below 1500, the market multiple has declined to 15 times earnings. Despite rising stock prices over the last few years, stocks are actually more undervalued today as earnings have risen faster than prices. Given still relatively low interest rates and inflation, stocks look cheap. It would take much higher inflation or interest rates before stocks become unattractive from our valuation perspective.

If our outlook for economic growth is correct, stocks should continue to move forward as earnings expectations are revised higher. In addition, without the prospect of significantly higher interest rates, Fed tightening or a surge in inflation, the market environment for stocks should be healthy. Finally, the long-term trend in stocks is up. As long as the market trend is up, we are likely to view periodic pullbacks as buying opportunities.

International Stocks: Overweight

Despite significant outperformance over the last four years, international stock valuations remain attractive. P/E multiples are relatively low, as earnings have grown much faster than prices have appreciated. Global market fundamentals also remain compelling.

Although many foreign central banks still have a bias to raise rates, we believe they are coming to the end of their tightening cycles. Rates are still historically low, and inflation overseas has also been much better behaved than in the U.S. Growth in Asia has been astounding, with structural shifts in China and India helping to lead the way. The long-term trend of the market is also up, reinforcing our bullish optimism.

Real Estate: Neutral*

Real estate continues to provide positive return surprises. Outside of a recession, we expect future returns to be driven by improving property fundamentals as the economy continues to strengthen, with the possibility of enhancing results by adding value at the property level. Although returns should be less than those we saw during the days of falling cap rates, real estate can also provide important risk-reducing diversification benefits to investors' portfolios.

Alternative Investments: Neutral*

We are constantly looking for ways to enhance returns and/or lower risks. Some alternative investments offer diversifying opportunities to offset the risk inherent in equity only portfolios, while others seek to enhance returns by applying specialized expertise and rigorous methodologies to targeted long-term investment opportunities.

*Real estate and alternative investments are not suitable for all investors.

U.S. INTEREST RATES	9/30/2006	12/31/2006	3/31/2007	6/30/2007
Cash Equivalents				
90-Day Treasury Bills	4.88%	5.02%	5.04%	4.81%
Federal Funds Target	5.25%	5.25%	5.25%	5.25%
Bank Prime Rate	8.25%	8.25%	8.25%	8.25%
Money Market Funds	5.14%	5.11%	5.10%	5.14%
Bonds				
30-Year U.S. Treasury	4.76%	4.81%	4.85%	5.13%
20-Year AA Municipal	4.12%	4.04%	4.05%	4.40%

Sources: Datastream International and Bloomberg L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 6/30/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 year Treasury Index	-1.30%	0.30%	5.50%
Merrill Lynch 7-10 year Agency Index	-1.18%	0.26%	6.22%
Merrill Lynch 5-10 year Corporate Index	-1.10%	0.70%	6.87%
Lehman Bros. Municipal Bond Index	-0.67%	0.14%	4.69%
International Bonds			
Citigroup non-U.S.$ World Government Bond Index, fully hedged	-0.93%	-0.02%	4.02%

Sources: Bloomberg L.P. and S&P Micropal

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 6/30/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	9.10%	8.75%	23.02%
S&P 500	6.27%	6.96%	20.57%
NASDAQ 100	9.24%	10.34%	23.38%
S&P/Barra 600 Small Cap Value	4.55%	6.82%	16.48%
International Stocks			
MSCI Japan, net dividends	-0.64%	2.85%	7.23%
MSCI Europe (includes UK), net dividends	8.31%	12.49%	32.44%
MSCI EAFE (Europe, Australia, Far East), net dividends	6.40%	10.74%	27.00%

Sources: Bloomberg L.P. and S&P Micropal

REAL ESTATE TOTAL RETURNS (US$) THROUGH 6/30/2007	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF Property Index*	3.62%	7.37%	16.15%

Source: The National Council of Real Estate Investment Fiduciaries

*Return for latest quarter is an estimate.

Past performance is no indication of future results.

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Since 1978, we've held a weekly companywide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as the 9:05.

Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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