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A Quarterly Review of Economic and Market Developments

2ND QUARTER 2008

BAILARD INTERVIEW

Darkest Before the Dawn?

Bailard's Chief Investment Officer Sonya Thadhani explains why we continue to overweight equities despite the negative news dominating today's headlines.

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Chief Investment Officer

The global equity markets' performance during the second quarter has to be viewed as both frustrating and disappointing. What started out so promising in April and May gave way to another sharp sell-off in June. What happened?

Early in the quarter, the equity markets around the world responded positively to the aggressiveness of Fed ease, the passage of the fiscal stimulus package, better than expected first quarter earnings, a stabilization in the dollar and a $10 drop in the price of oil. With stocks deeply oversold, the whiff of hope sent prices higher. Unfortunately, that hope turned to despair when oil prices went back to new highs and raised the specter of that most dreaded of all economic conditions, "stagflation." Meanwhile, concerns about more damage to the financial sector slammed financial stocks and sharply reduced investors' appetite for taking risks. Finally, the end of the Democratic primary season ignited uncertainty about future tax, trade and energy policies.

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Market bottoms are typically made when there is a great deal of despair and no hope.

All of this sounds pretty ominous. Are you still maintaining an overweight to global equities?

Yes. While we would have preferred not to have been overweight in the recent downturn, we believe that investors and the media are too pessimistic and that most of the gloom and doom is already embedded in stock prices. That's not to say that the markets can't go lower; however, in our opinion, the potential upside reward is much greater than the downside risk. The times when everybody has "thrown in the towel" usually offer the best risk/reward opportunities.

But how do you know everyone has thrown in the towel?

You never know precisely. No one blows a whistle for you when the stock markets reach a major turning point. What we do know is that stocks are extremely cheap from a valuation perspective, while earnings (excluding financial stocks that are facing major writedowns) continue to surprise on the upside. All of the sentiment gauges (investor sentiment surveys, put/call ratios, short interest) that we monitor are giving extreme negative readings. Market bottoms are typically made when there is a great deal of despair and no hope. As we write this newsletter, it seems like we may be there or very close to it.

If we are close to a bottom, when will the stock market turn around?

One of the reasons that we preach diversification and strict adherence to long-term strategies is that forecasting is a difficult business that should be approached with a great deal of humility. This is particularly true during periods of emotional excess. When markets separate from underlying fundamental value and emotions take over, crystal balls become very hazy. We are clearly in a period of emotional excess and the extent of such declines is hard to gauge. From experience, we believe that being opportunistic at times like these is more profitable than being fatalistic.

But why not wait until the smoke clears and there is more visibility?

It can be costly to wait, because markets are forward looking and typically turn long before the economy does. Almost by definition, at the market bottom the economic news will be at its worst. If you wait for good news, you risk missing a major part of the next market rally. Historically, the stock market has risen 20% on average before the start of the next economic up cycle, with the rallies typically beginning in the depth of despair.

So what turns the stock market?

When fear is high it is always hard to see a way out, as concerns about current conditions become exaggerated and extrapolated well into the future. Currently, we think the market is overreacting on almost every front. Let's look, for example, at the fear of perpetually higher oil prices. Our research suggests that the fundamentals are not as bad as currently perceived. Supply and demand have been balanced over the last five years, there are no structural inventory shortages, the world has plenty of recoverable fossil fuel reserves, and alternative energy solutions are making great strides toward being cost competitive. The supply of energy may only be limited by our willingness to move forward, technological creativity and government policies. Higher prices are sending signals to change our behavior in ways that should increase the supply of, and reduce the demand for, energy. In our opinion, that's what is likely to happen.

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Darkest before the dawn? (continued)

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What about the housing and financial crises?

Here, too, we think the markets are overreacting. Despite massive writedowns, bank capital ratios remain relatively high and cash flows are positive. Although the financial sector has become extremely conservative and risk averse, over time this should change. Banks are in the business of making money. When the bank writedowns end, bank earnings are likely to surge. Banks should also become less risk averse, and they should begin to aggressively lend again. Our analysis suggests that we are closer to the end of the write-down period than the market is anticipating.

Regarding housing, we believe the worst is also behind us. Home prices have adjusted downward sharply and housing affordability is rising. With significant pent-up demand, at some point increased affordability should pull in homebuyers and housing inventories should be reduced, setting the stage for the next up cycle to begin.

What about the election?

As the election draws nearer and the prospects for fiscal policy changes increase, many investors are concerned about the potential impact of higher capital gain, dividend, payroll and marginal tax rates on the economy. One could argue that, if you raise the tax on investment or work you get less of it, which means slower growth and less tax revenue in the future.

Whatever the outcome of the presidential election, we will likely see a big tax increase on January 1, 2011 as the 2003 tax cuts expire. The only way for these taxes not to go up is for new legislation, originated in the House, passed by Congress and signed by the new president, to extend the 2003 tax cuts or make them permanent. That would be difficult to achieve with a Democratic Congress and a Republican president, and almost impossible to achieve with a Democratic controlled government.

Either way, Congress and the new administration will likely adopt some new tax policies before 2011. What those policies will look like we will have to wait to see. A lot of political rhetoric and posturing occurs during an election as coalitions are formed and election strategies are developed. Hopefully, when it comes time to govern and make real world decisions, that rhetoric will be tempered by reality, whoever the next president turns out to be. Moreover, if our forecast for an economic recovery by next year is correct, the economy should be able to absorb the impact of modestly higher taxes. In fact, the U.S. stock market may be already digesting the prospect of higher taxes.

We believe the U.S. economy is at or near its cyclical low

We remain optimistic about the economic outlook, seeing the glass as half full rather than half empty.

Despite a long worry list, the U.S. economy continues to stumble along on a slow growth trajectory. After slowing to 0.6% in the fourth quarter of last year, economic growth bounced up to 1.0% in the first quarter of this year and appears to be on a positive track for the second quarter.

This growth occurred despite negative headlines, predictions of doom and gloom, and financial markets that are echoing these concerns. Late last year, we forecasted that the economy would "bend but not break" and that any recession would be a mild one. So far, the economy, which grew 2.5% over the last year, has yet to experience even one quarter of negative growth, when typically a recession requires two quarters of negative GDP growth or negative year-to-year growth. We remain optimistic about the economic outlook, seeing the glass as half full rather than half empty.

The anxiety closet is full

Over the last year, the U.S. continued to be hit by a major recession in the housing market and sharply lower home prices. According to the S&P/Case Shiller index of 20 Metropolitan areas, the median home price was down -15.3% over the last year, with a number of regions off over -20%. The damage in housing spilled over into the banking sector as subprime mortgage debt was written down by banks, brokers and hedge funds. This caused liquidity in the financial markets to seize up and bank lending to slow sharply. The continued decline in financial stocks suggests the stock market is expecting more bad news on this front. With oil above $140/barrel, headline inflation around the world is accelerating, and many central banks are tightening despite sluggish economic activity. The increase in the price of oil, while boosting inflation, has also worked to slow economic activity by acting as a massive tax hike. In addition, the price increase has shifted significant amounts of wealth to geopolitically unstable hands (Hugo Chavez, Ahmadinijad, and Putin). Finally, uncertainty about the upcoming presidential election, possible tax increases (particularly on dividends and capital gains), protectionist rhetoric and energy policy are also taking a toll on the economy and the financial markets.

The list could go on, but the point is made; it's easy to get depressed about the future. With everyone so gloomy, it's a good idea to look at what could go right.

What could go right?

Our base case scenario sees the economy as being at or near its cyclical low. Although we would argue that other fiscal measures would have been better long-term stimuli for the economy than tax rebates, the rebates are real and substantial. The economy should feel the benefits of higher income and consumption through the second half of the year. It should also receive a boost from prior Fed easing. Currently the real Fed Funds Rate is negative and the yield curve is relatively steep (short-term interest rates below long-term interest rates), conditions that typically precede an economic recovery.

In addition, key economic indicators, although soft, have not been signaling recession. Personal consumption, while weakening, was stronger than expected in May. Housing affordability has risen back to levels last seen in 2003. There are also signs that home prices are starting to stabilize, which would take some of the pressure off housing. Of the twenty metro areas measured by the S&P/Case Shiller Home Price index, eight had positive year-over-year gains in April.

In summary, we could be entering a modest recovery period, as we did coming out of the last two recessions. In both those cases, economists underestimated the positive impact of simulative monetary policy, as well as the resilience and diversity of the U.S. economy.

Most international economies are slowing

International economies are facing the same headwinds as the U.S., with an additional drag for those countries whose growth still depends on exports to America. Although growth is not collapsing, it is clearly slowing. Europe is sluggish (with the U.K. looking more vulnerable than the rest), and emerging countries are slowing from high levels. Japan, while hardly in a renaissance, is faring much better.

European growth is decidedly slower

European growth headed decidedly lower during the second quarter. Even Germany and France have succumbed to ongoing financial market turmoil, rising oil prices and tight monetary policy. Most sectors of the Euro-zone economy are suffering. The strong euro has hurt exports, while retail sales, industrial production, factory orders, surveys and construction activity all show signs of weakness. The Euro-Zone leading economic indictor has also clearly rolled over.

Despite weakening economic activity, the European Central Bank (ECB) raised interest rates again in early July by 0.25% to 4.25% in an effort to keep inflationary expectations in check. The Euro-Zone's year-over-year headline inflation rate of 3.7% is well above its 2.0% target. However, excluding energy, inflation is up only 1.7%. We believe raising interest rates will not produce one more drop of oil, but will help destroy demand by slowing economic growth and strengthening an already strong euro. The good news is that, after its July meeting, the ECB signaled that it might not raise rates for a while.

The U.K. situation is even worse

The U.K. is probably the most vulnerable of the major countries to weaker growth. Since it is more dependent on debt than the rest of Europe, the U.K. may be more adversely impacted by turmoil within the banking sector. It is only about half way through the correction of its own housing bubble, which was even bigger than that in the U.S. With the exception of the consumer sector, recent economic data has been almost uniformly weak. Given the fragile state of the economy, the Bank of England is likely to continue to err on the side of ease.

Emerging country growth rates are slowing but still strong

Although emerging country growth rates are still strong (10% in China and 9% in India), growth expectations are declining in the face of greater inflationary pressures at home and slower growth in Europe and the U.S. Rising food and oil prices are a bigger problem in emerging countries because these economies are less efficient and consume more food and energy relative to their incomes. Skyrocketing food and oil prices severely affect their inflation numbers. The problem is made worse by the fact that a number of these countries had been easing aggressively over the last few years by inflating their money supply. Despite recent efforts to contain monetary growth, China's and India's monetary bases continue to grow at excessive rates. Unlike the U.S. and Europe where monetary growth is relatively tame, this raises the risk of energy and food-based inflation spilling over to the rest of the economy. As a result, many emerging markets are likely to face increasing pressure to raise interest rates to curb inflation.

Japan is treading water but more buoyant

The pace of Japanese economic growth accelerated in the first quarter to a 4% annualized rate. This followed a very solid 2.9% growth rate in the fourth quarter of last year. Unfortunately, the GDP deflator declined -1.5%, indicating that Japan is still locked into the deflationary trend of the last ten years. Although some indicators are showing strength, others are showing signs of continued weakness. One very positive development is that bank lending in June rose 2.7% year over year, increasing at its fastest pace in two years. Although this is hardly super growth, it shows that Japanese banks are increasingly able to lend.

Bonds struggled in the second quarter

During the tumultuous second quarter, the U.S. bond markets came under some pressure due to rising interest rates across the maturity spectrum. The yield on ten-year U.S. Treasury bonds, for example, increased more than 0.5% from 3.4% to 4.0%.

As a result, the overall bond market as measured by the Merrill Lynch Corporate, Government and Mortgage index, declined -1.1% over the three-month period. Treasuries were the weakest component, with the Merrill Lynch 7-to-10 Year Treasury index returning -3.2%. Corporate debt came back a bit after being oversold the previous two quarters. For the past year, though, bonds have shown their value as insurance during financial disruptions; the Merrill Lynch Corporate, Government and Mortgage index rose 8.1%, while the Merrill Lynch U.S. Treasury Master index returned more than 10%.

The second quarter of 2008 also witnessed a shift in U.S. monetary policy. After consistently lowering the Fed Funds rate from 5.25% last August to 2.0% at the end of April to help provide badly needed liquidity to the financial markets, the Fed voted at its June meeting to leave this key interest rate unchanged. The shift to a neutral stance refocused attention on the Fed's role as an inflation fighter rather than a supporter of the capital markets.

Municipal bonds have also experienced turmoil

The municipal bond market has had its own turmoil through this period. The slowing economy, along with the broad downgrades to insurers of municipal bonds, has increased the pressure on this sector. Fewer issuers are choosing to purchase insurance; in fact, insured issuance is down 50% so far in 2008. On May 19th, the market received good news as the U.S. Supreme Court reversed a Kentucky Supreme Court ruling and decided to continue to allow states to tax interest on out-of-state municipal bonds while exempting interest on their own debt. Finally, the slowing economy and the disruptions to the housing market should be a concern for municipal bond investors. Issues that have narrow tax bases, such as school districts in areas where foreclosures are high, should be avoided.

Foreign Exchange

The U.S. dollar declined again in the second quarter. Overall, it fell -1.0% on a trade-weighted basis, turning in its weakest performance against the currencies of commodity-based economies like Australia, South Africa, Mexico and Canada. However, the dollar also rose 0.5% versus the euro, 2.8% versus the Swiss franc and 6.0% versus the yen.

For the past several years, a weak dollar was not viewed as a big problem. Most investors simply enjoyed the strengthening in the underlying currencies of their international equity holdings. Manufacturers were happy as the weak currency made U.S. goods cheaper to foreign buyers. And, policy makers were tacitly willing to sit back so long as the currency weakness didn't provoke inflation.

With oil prices rising above $140 per barrel and other commodity prices increasing equally quickly, the benefits of a weak dollar are becoming harder to discern, particularly since the falling greenback may be partly responsible for the higher prices. The good news is that there is light at the end of the tunnel. Much of the dollar's weakness has been due to unattractive interest rate differentials as the Fed lowered American short-term rates while other countries raised theirs. However, the Fed has now stopped lowering interest rates. If the stimulus provided by the tax refunds and the last six months of loose monetary policy proves supportive of growth, we are likely to see higher short-term rates in the U.S. later this year and a narrowing of interest rate differentials with other major economies. Given the longer-term undervaluation of the dollar and pent up sentiment, this could be a catalyst for a broader dollar rally.

U.S. stocks declined as pessimism rose

What started off well ended quite badly in the equity markets in the second quarter this year. Markets that had been behaving well in April and May lost significant ground in June. The Dow Jones Industrial Average fell -6.8% for the quarter, while the S&P 500 declined -2.7% for the same period.

So far, 2008 is not shaping up to be a benevolent year for the domestic equity markets. All of the major indices across all size and style spectrums lost money in the first half of 2008. The S&P 500 is -11.9% lower than where is started the year, and the NASDAQ 100 has lost -11.7%. Small cap value stocks, as measured by the S&P/Barra 600 Small Cap Value index, fared better in a relative sense, declining -8.7% over the past six months.

An optimistic era

Let's take a walk down memory lane back to the late 1990s, in particular, to 1998 and 1999. It was the era of optimism. Even though stocks might have been overvalued, investors believed that the future was so bright that it was worth paying up a little to get a piece of the action. It was a momentum market where value didn't matter. Various measures of investor sentiment suggested that stocks were overbought. A crowd sentiment poll in December 1999 showed extreme optimism at 67%, and it was a time when approximately 80% of all stocks were above their ten-week moving averages. Investors felt invincible. Warnings of the unsustainability of the bubble were ignored and bearers of bad news were ridiculed.

A pessimistic era

We are in a diametrically opposite situation today. It is an era of pessimism. Stocks are trading at extremely low multiples, but investors do not want to own them. The future appears so bleak that selling has occurred at any cost. Interestingly enough, it is a downward momentum market where, once again, value doesn't matter. Crowd sentiment polls taken today are at pessimistic extremes, approaching what one saw in the third quarter of 2002. At the end of June, only 17% of stocks were above their ten-week moving averages.

Understanding investor behavior in extreme market conditions is crucial to investment success. Investor psychology makes it difficult to remain disciplined and there is a tremendous pressure to conform. While there is no dearth of bad news, the prudent thing to do is to ask one-self how much of the bad news has already been reflected in stock market prices. It's always darkest before dawn, and refusing to join the crowd in an irrational game becomes a real test of patience and discipline. However, we believe it is precisely at times like this that discipline pays off.

While there is no dearth of bad news, the prudent thing to do is to ask oneself how much of the bad news is already reflected in stock market prices.

International stocks also had a difficult quarter

From a valuation standpoint, the international equity markets are looking increasingly attractive.

The second quarter was a difficult one for most international equity markets. The MSCI EAFE index (U.S. $) of developed market countries declined -2.3% for the quarter and -11.0% for 2008 year to date. Similarly, the MSCI All-Country World ex-U.S. index (U.S. $) fell -0.9% in the quarter, bringing year-to-date results to -9.8%. The best performance came from Latin American and Eastern European markets benefitting from higher commodity prices. Developed and emerging Asia markets were the laggards for the quarter.

Higher food and energy prices have raised fears of inflation around the world. What is difficult to assess is how persistent this bout of inflation will be. Outside the volatile food and energy sectors, core inflation remains controlled, and even low, globally. If price increases can be confined to those two sectors, inflation could be exceedingly transient, disappearing when food and energy costs decline.

In Japan, the prospect of inflation has even been viewed as a positive that could promote more near-term demand while also improving purchasing power for corporations. However, this is likely to be true only if the prices for durable goods increase. For now, most of the inflation is on frequently purchased items such as food, while deflation still exists for bigger ticket durable items. Until prices in Japan rise on these durable goods, investors shouldn't expect the next major leg up in growth.

Inflation is hurting emerging markets more

The impact of inflation is much more severe for residents of emerging markets, where food and energy are a larger portion of consumption than in the developed world. Food can account for 50% to 70% of consumption in these countries. Additionally, the increase in energy costs makes these countries' exports more expensive and therefore less desirable to overseas demand, reducing a traditional source of income. Despite the pressure to manage this inflation by raising interest rates, these countries face a tradeoff. Higher rates would tend to strengthen their currencies, make their exports more expensive and undermine growth.

Unfortunately, aggressively fighting inflation usually entails constraining demand. GDP growth has already slowed in most markets globally, raising the specter of slow growth along with inflation (i.e., stagflation). The ECB has traditionally focused on inflation targets without respect to growth; we believe that this time the central bank will chose a course that balances these interests. We therefore expect less aggressive monetary tightening from European authorities.

From a valuation standpoint, the international equity markets are looking increasingly attractive. Comparing global dividend yields against bond yields, stocks haven't looked cheaper since the 1970s. On a trailing P/E basis, valuations have retrenched by more than 50% since their peak in 2000 at 35 times earnings. Stocks, now trading at 14.3 times earnings, are lower than at any time since the early 1990s. In the context of a world where economic growth is slowing but likely to remain positive and corporate earnings growth (excluding Financials) looks solid, these valuations continue to make international equities a compelling story.

Commercial real estate prices are finally starting to reflect the market downturn

It is fascinating to watch investment property markets go through major turning points, because they happen in such slow motion in contrast to the public securities markets, which can experience a major re-pricing in a matter of weeks or months. Looking below the surface of the NCREIF National Property index (NPI) data for the past two quarters, we can see significant shifts in the commercial real estate landscape.

The fourth quarter 2007 NPI data is already some three to five months into the mortgage securities market meltdown. Yet the NPI showed a total return of 3.2%, with appreciation accounting for 1.9%, or more than half of that performance. Looking at the details, based on work done by Doug Poutasse, the executive director of NCREIF, we find that only 43 properties, out of some 5,700 in the index at that time, accounted for 1.0% of that appreciation. And, of those 43 properties, twelve were regional malls (averaging $683 million in value) and 27 were office buildings (averaging $470 million in value). Trophy properties were still being written up by the appraisers, as though nothing had happened to real estate liquidity! Only two of the 43 properties were actually sold—giving appraisers very little in the way of transaction evidence to use.

The office frenzy has ended

The NPI in the first quarter of 2008 clearly shows the end game of this cycle's office building frenzy. The total return to the NPI was 1.6%, with 0.3% of that in appreciation. This time, only 22 properties (out of 5,976 in the NPI) accounted for 0.4% of that appreciation. Yes, the average property experienced a write-down, with 55% of the properties by count showing negative appreciation. What were the 22 that made the NPI look good? Nineteen were Central Business District office buildings, and only one of those was actually sold. As the market liquidity has dried up, sales have fallen dramatically, and prices have begun to adjust downward. The percentage of properties sold out of the NPI was at the lowest level since the serious real estate crunch of 1993. Only 67 properties (mostly the "trophy" buildings, averaging $520 million in price) were sold. Even of these, more than half sold below their previous carrying value in the index.

Will market liquidity return in time to halt this price readjustment process? We think not. Even though there is finally a little life in the CMBS (collateralized mortgage backed securities) market, there has been only $10 billion of new issuance so far this year, compared to $135 billion last year during the same period. Further, the most recent bank lending surveys show that 80% of banks have tightened their lending standards over the past six months or so.

Strategies for the future

How can a real estate portfolio successfully weather the next few years of pricing re-adjustment? Several years ago, in anticipation of an eventual end to the real estate liquidity bubble and to the economic slowdown we are now experiencing, we began advocating a shift away from office buildings (which are historically the most volatile property type) to portfolios more dominated by apartment and industrial properties. We believe these more stable, income generating property types should be able to better weather current market conditions. We also recommend using new capital to gradually acquire new "value-added" properties, which our analysis suggests should offer better and better potential returns compared to, say, fully leased trophy properties, as sellers continue to adjust their pricing expectations downward.

We continue to overweight equities in our portfolios

Typically, when everyone has thrown in the towel, important market bottoms are made.

After the global equity markets put in a solid bottom in February and March, we slightly increased our allocation to U.S. stocks. Our analysis of valuations, the market environment and price action suggested that the worst could be behind us. Unfortunately, that was not the case. Although stocks enjoyed a nice rally in April and May, they moved sharply lower in June and continued their decline in early July. In such situations, prior experience has taught us to maintain our disciplines. It is important to avoid getting caught up in the emotional mood swings that can overwhelm the financial markets, whether it be the greed we saw during the Tech Boom or the current atmosphere of fear. So we are maintaining a diversified posture and making controlled bets around that diversified position.

U.S. Bonds: Underweight

We continue to see bonds as being extremely overvalued at current yield levels. We hold them in portfolios primarily as an insurance policy against adverse economic circumstances. We do see some value in most non-Treasury sectors of the bond market. However, we believe it will take an economic recovery for that value to be recognized, in which case we see more upside potential for global stocks.

U.S. Stocks: Overweight

Although this has been a frustrating period to be in stocks, we strongly believe that stock prices are fully discounting and overestimating a lot of bad news. The S&P 500 is currently trading at less than 12.5 times depressed forward earnings. Given the low level of interest rates and inflation, these multiples should be much higher. Earnings are depressed largely due to financial stocks, where asset writedowns have been brutal. In the first quarter, S&P 500 earnings fell -17.1% year over year; excluding financials they were up 16.4%. For the second quarter, analysts expect S&P 500 earnings to fall -10.2%, but to be up 11.5% ex-financials. If we are right on our base economic scenario, then we should be near the bottom of the earnings cycle. Once bank writedowns end, bank earnings should skyrocket. The trend in the market is decidedly down. However, it is extremely oversold, with bearish sentiment measured in various ways at extremely negative levels. Typically, when everyone has thrown in the towel, important market bottoms are made.

International Stocks: Overweight

International stocks and economies have been following the U.S. lead lower. The fear-driven stock market reactions in our opinion have been more severe than the underlying economic fundamentals would suggest. Price-earnings multiples have seriously compressed, with many markets sporting multiples approaching ten times earnings. Multiples this low are usually confined to periods of double-digit inflation and interest rates. Multiples in some high growth areas such as China have fallen from 50 times earnings to 18 times forward earnings. International stocks are cheap and maybe even cheaper than U.S. stocks.

Real Estate: Neutral*

Our allocation to real estate has served us well in the last year, helping portfolios mitigate some of the volatility seen in equity markets. With bonds offering little value, real estate has become our preferred low volatility portfolio diversifier. Capitalization rates (yields) on commercial real estate continue to be significantly above both short and long Treasury yields.

Alternative Investments: Neutral*

Recent financial market turmoil and the lack of perceived value in bonds reinforces our belief in using alternative assets to offset the risks inherent in more traditional stock/bond asset mixes. Given the lack of yield in money market funds and bonds, neutral long–short hedging strategies designed to reduce volatility can be an important addition to portfolios.

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

U.S. INTEREST RATES	9/30/2007	12/31/2007	3/31/2008	6/30/2008
Cash Equivalents				
90-Day Treasury Bills	3.81%	3.25%	1.33%	1.74%
Federal Funds Target	4.75%	4.25%	2.25%	2.00%
Bank Prime Rate	7.75%	7.25%	5.25%	5.00%
Money Market Funds	5.06%	4.59%	2.85%	2.23%
Bonds				
30-Year U.S. Treasury	4.84%	4.45%	4.29%	4.53%
20-Year AA Municipal	4.28%	4.38%	4.79%	4.64%

Sources: Datastream International and Bloomberg L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 6/30/2008	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 year Treasury Index	-3.21%	2.76%	12.98%
Merrill Lynch 7-10 year Agency Index	-2.43%	1.03%	9.75%
Merrill Lynch 5-10 year Corporate Index	-1.14%	-1.08%	2.56%
Lehman Bros. Municipal Bond Index	0.63%	0.01%	3.23%
International Bonds			
Citigroup non-U.S.$ World Government Bond Index, fully hedged	-2.37%	-0.28%	4.60%

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

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 6/30/2008	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	-6.84%	-13.36%	-13.26%
S&P 500	-2.72%	-11.91%	-13.11%
NASDAQ 100	3.20%	-11.68%	-4.54%
S&P/Barra 600 Small Cap Value	-2.45%	-8.74%	-19.00%
International Stocks			
MSCI Japan, net dividends	2.47%	-5.53%	-12.04%
MSCI Europe (includes UK), net dividends	-4.15%	-12.41%	-11.34%
MSCI EAFE (Europe, Australia, Far East), net dividends	-2.25%	-10.96%	-10.61%

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

REAL ESTATE TOTAL RETURNS (US$) THROUGH 6/30/2008	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF Property Index*	1.60%	3.23%	10.33%

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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About *the 9:05*

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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