



Market Commentary

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Global Sell-off

Our defensive asset allocation continues to be justified, as 36 major global stock markets enter bear market territory and the MSCI Global Market Index is down roughly 17% – close to bear market levels (see chart below). This global sell-off in equities can be attributed to rising recession risk and credit system seizures here and abroad. Through the first two weeks of 2008, equity prices declined in response to growing evidence of a United States-led recession and the tepid response of both monetary and fiscal policymakers. Today's 75 basis point rate cut by the Federal Reserve was widely expected and does little to alter the near-term direction of the economy and the ongoing need for further credit market correction.



Yesterday's sharp global sell-off was triggered by the admission by a troubled financial instrument insurer that they failed to meet regulatory capital requirements that would have allowed them to meet their obligations to other financial institutions and investors. The possibility that such a failure is not isolated raises risk of further forced selling of distressed credit instruments and more liquid collateral such as equities.

It is our view that investors will be challenged on two fronts – a slump in the global economy (so much for the decoupling theory) and a multi-year workout of the housing market and credit system. The economy will continue to struggle as consumers are forced to retrench in response to falling home prices and will likely focus on paying down debt. We expect corporations to respond, in turn, with further job cuts and reduced capital spending. This has negative implications for our trading partners who rely on strong U.S. demand for their exports. Commodity prices could also experience declines due to waning demand.

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Meanwhile, the mechanism for credit creation is in need of repair. Moves by the Federal Reserve have helped to improve credit spreads (such as the TED spread), and the yield curve has assumed a more normal slope (using the 3-month / 10-year Treasury spread). Commercial banks are also responding by recognizing off-balance sheet liabilities, taking write-offs, and seeking new capital. Lastly, we notice some early signs of stability in the dollar, and housing oversupply appears to have stopped increasing.

Six Near-Term Implications for Investors

As global short-term interest rates come down and credit market dislocations intensify, we expect:

- 1) Longer-term bonds may become more attractive as they are seen as an effective hedge in times of recession and short-term interest rates come down.
- 2) The dollar and, by extension, U.S. assets become more attractive when foreign market expectations for global growth and "decoupling" are not met.
- 3) Large-cap stocks, which are more liquid, will likely fare better than less liquid small-caps in the early stages of contraction.
- 4) Growth stocks, which are less exposed to financials and commodity companies, appear more attractive based on their outlook and relative valuation.
- 5) Sectors with stable earnings (such as utilities, consumer staples, and healthcare) will appear more attractive relative to economically

sensitive sectors (such as energy, basic materials, and industrials).

- 6) Commodity and commodity-driven sectors are also at risk should global growth slip below current expectations.

We expect risk aversion to remain high and traders to be short-sighted and intolerant of negative surprises. Until adjustments are made and fundamentals once again begin to show positive momentum, equity markets may find it difficult to sustain rallies.

Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & DEFENSIVE	25%	50%	75%
Bonds & Cash Equivalents	23%	45%	68%
Money Market Fund	1%	2%	3%
Short-Term Treasuries	5%	10%	15%
Intermediate-Term Treasuries	3%	5%	8%
Long-Term Treasuries	2%	4%	6%
Inflation-Protected Treasuries	3%	5%	8%
Investment-Grade Corp Bonds	8%	16%	24%
High-Yield Corporate Bonds	2%	3%	5%
GOLD	3%	5%	8%
EQUITIES & GROWTH	75%	50%	25%
U.S. Equities	54%	36%	18%
Large-Cap Growth	27%	18%	9%
Large-Cap Value	12%	8%	4%
Mid-Cap Growth	9%	6%	3%
Mid-Cap Value	6%	4%	2%
Foreign Equities	21%	14%	7%
Brazil	5%	3%	2%
Germany	3%	2%	1%
South Korea	3%	2%	1%
EAFE Growth	11%	7%	4%
TOTAL PORTFOLIO	100%	100%	100%

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