



Second Quarter 2009

Quarterly Investment Commentary

What a difference three months makes! After plunging to multi-decade lows at the beginning of March amid a global, panic-induced sell-off, the markets posted exceptionally strong returns in the second quarter of 2009. Domestically, the Dow Jones Industrial Average rose 12.0%, the S&P 500 Index gained 15.9%, and the technology-heavy Nasdaq Composite recorded a 20.3% gain. Despite the strong quarterly gains, U.S. equities are still mostly flat for the year.

Overseas, the gains were even larger, especially in the less economically-developed parts of the world. French stocks advanced 11.9%, German stocks rose 17.7%, and Japan's Nikkei 225 was up 22.8%. But China increased a whopping 27.2%, and the returns in places like India and Brazil were equally impressive.

The willingness of investors to embrace risk during the second quarter also played out in the bond market. Investment grade corporate bonds and high-yield corporate bonds both suffered during the downturn last year, but gained 10.8% and 23.2%, respectively, during the second quarter, as credit spreads narrowed. Meanwhile, U.S. Treasuries, which provide a safe-haven for investors during periods of uncertainty, declined 3.1%, as the yield on the benchmark 10-year Treasury rose from 2.69% to 3.52%.

The Economic Outlook Improves

The second quarter's strong gains were directly attributable to two factors. First, efforts by the Federal Reserve and U.S. Treasury to stabilize the financial system have largely succeeded, easing concerns about a systemic collapse. As a result, the markets moved quickly from discounting a depression to discounting a recession.

Second, there's an increasing level of evidence that the worst of the economic downturn is behind us. Indeed, as we wrote in our last quarterly update, the economy appears to be past its recessionary low point, and many economists are predicting positive economic growth in the U.S. by the end of 2009.

Looking Ahead

Given the magnitude of the advance since the early March lows, we wouldn't be surprised to see the markets remain within a trading range, or even experience a pullback before the end of summer.

Rallies off market bottoms rarely follow a straight-line path upward – and there’s no reason to believe this one will be any different. That being said, short-term market predictions are always fraught with uncertainty.

Looking out longer-term, however, we do expect stocks and corporate bonds to continue their advance – although the ride is likely to remain bumpy. The reasons supporting our optimism include:

- The massive amount of fiscal and monetary stimulus that policymakers have pumped into the system, which is likely to support the economic recovery process.
- Several leading economic indicators, such as credit spreads and the shape of the yield curve, are now trending positive.
- Stock market valuations remain attractive, even after the recent rally.
- The amount of money on the sidelines parked in money market funds is less now than it was during the first quarter, but it’s still at very high levels. This suggests that the re-allocation by investors into stocks is still at an early stage.

Accordingly, we continue to view 2009 as an appropriate time for those who are underinvested to be moving slowly out of cash and short-term instruments and into higher-risk assets such as stocks and corporate bonds. We emphasize the word “slowly” to describe the process because of the still uncertain nature of the economic recovery and the extreme volatility that the market continues to exhibit on a regular basis.

Caution is Still Warranted

We also emphasize the word “slowly” because of concerns we have about the longer-term output potential of the U.S. economy. As the government attempts to spend its way out of the current downturn, the Congressional Budget Office (CBO) predicts that the deficit this year will be almost 15% of GDP (about \$1.87 trillion) and will likely remain above \$1 trillion over the next decade.

Part of the expected deficit is related to the bold but expensive policy initiatives being championed by President Obama in areas such as healthcare and energy policy. This massive level of federal spending has the potential to drive up inflationary pressures and interest rates as well as lead to a devaluation of the U.S. dollar.

Additionally, we will likely have to deal with a variety of structural headwinds after we emerge from the current recession. They include an increased level of government regulation, higher taxes on individuals and business, unemployment levels that we expect to remain stubbornly high, and continued tight lending standards by financial institutions.

We have become accustomed in this country to long-term economic growth rates in the range of 4%. In light of the headwinds we may face, a more modest growth rate of 1% to 2% is reasonable to

expect, and this could impair the returns on many financial assets. Adjusting to this new reality – or “New Normal” as some have called it – will likely be one of the largest challenges for both individual and professional investors in the coming years.

We hope this letter finds you well and enjoying the summer. As always, please let us know if you have any questions or concerns.

Disclosure: Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada.