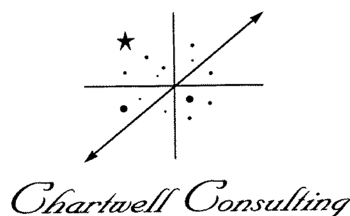
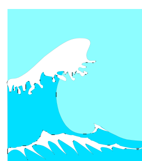


CHARTWELL REVIEW

July 2008 **SECOND QUARTER 2008** *Volume XV, Issue No.2*



C's of Trouble

Credit **C**runch – Over the past year, and continuing without letup in the 2nd quarter, the nation's credit providers have raised rates and cut credit availability. In effect, borrowed money costs more, and is much less readily available, than this time last year.

Capital Adequacy – Related to the above, the banking sector has written off $400B of assets, mostly related to very bad investments in mortgage-related securities, yet raised only $350B in new capital. Current guess is that another $600-900B of asset values are "impaired" in the short term. Will the banks need to raise that much new capital? Can they possibly raise that much new capital?

Currency valuation – The US$ was up versus the big three (Euro, £, ¥) in the 2nd quarter. Has it finally hit bottom? To what level will the Chinese renminbi rise? It is already up 21.5% since the fixed peg was removed.

Consumer **C**onfidence – is at its lowest levels since 1990. And, unemployment is still below 6%.

Commodity Prices – December oil trades at $120/bbl. It was $75/bbl a year ago; Wheat trades at $8.45/bushel. It was $6.47 a year ago.

Corporate Profitability – Since March, projections for 2008 operating earnings of the S&P 500 companies have declined by 10%. Even so, forecasts remain 1% above 2007 actual results.

Correction – We're past that. On July 15th, the market closed >20% below its previous high, reached last October 9th. We've been in a bear market since then.

Consumer Price Index – rose at annualized rate of 7.9% in 2Q08, and 5% over the past year.

Challenging Environment – you betcha!

Table 1: Index Benchmarks

Market Index	Q2 2008	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	(2.7)	(13.1)	4.4	7.6	2.9
U.S. Large-cap Stocks	(3.7)	(12.8)	4.0	6.4	1.8
U.S. Mid-cap Stocks	2.7	(11.2)	6.8	13.1	8.1
U.S. Small-cap Stocks	0.6	(16.2)	3.8	10.3	5.5
Foreign Stocks (**devel**)	(1.9)	(10.1)	13.3	17.2	6.2
Foreign Stocks (**emerg**)	(0.8)	4.9	27.5	30.1	15.5
LIBOR (3 month)	0.7	4.9	4.9	3.5	4.0
U.S. Aggregate Bonds	(1.0)	7.1	4.1	3.9	5.7
High Yield Bonds	1.8	(2.1)	4.6	6.9	4.9
Global Bonds, unhedged	-4.2	17.0	6.2	6.4	6.5
CPI, ***annualized***	7.9	5.0	4.2	3.7	3.0
Dow AIG Commodity	16.1	41.6	19.8	18.6	13.0
Chartwell Global 65/35	*(1.5)*	*(3.4)*	*8.5*	*10.8*	*6.8*

Table 2: Average Mutual Fund Returns

Fund Category	Q2 2008	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	(1.2)	(11.3)	5.1	8.3	3.9
U.S. Mid-cap	2.8	(9.6)	7.3	11.7	7.6
U.S. Small-cap	1.2	(15.8)	4.3	10.6	7.4
International Lg. Cap	(2.0)	(9.4)	13.8	16.8	6.9
International Sm. Cap	(2.7)	(15.3)	13.3	20.4	11.9
Emerg. Mkt. Equity	(0.2)	3.0	26.5	29.4	15.4
Balanced/Hybrid	(1.0)	(5.4)	4.8	6.9	4.8
General Bonds	(0.9)	4.4	3.4	3.7	5.2
Government Bonds	(1.4)	8.0	3.8	3.6	5.3
High Yield Bonds	1.7	(2.1)	4.4	6.5	3.9

* Annualized trailing returns for periods ending 6/30/08.

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The slowdown settles in

The Commerce Department preliminarily estimates 2nd quarter real GDP grew at an annualized rate of 1.9%. This compares to a growth rate of +0.9% in the first quarter, and a *decline* of 0.2% in the 4th quarter of last year. The latter two figures were both revised downward, and now better reflect the reality of most persons' direct observations – the economy is simply not growing much right now (see table 3).

Table 3: Components of Real GDP Growth

Factor	% Change from Preceding Period (seasonally adjusted at annual rates) 3Q '07	4Q '07	1Q '07	2Q '08
Personal Consumption	2.0	1.0	0.9	1.5
Private Investment	3.5	(11.9)	(5.8)	(14.8)
Fixed - Businesses	*8.7*	*3.4*	*2.4*	*2.3*
Fixed –Residential	*(20.6)*	*(27.0)*	*(25.1)*	*(15.6)*
Chg. In Inventories ($)	*$23B*	*$(21)B*	*$(26)B*	*$(95)B*
Exports	23.0	4.4	5.1	9.2
Imports	3.0	(2.3)	(0.8)	(6.6)
Government Spending	3.8	0.8	1.9	3.4
Real GDP Growth	**4.8%**	**(0.2)%**	**0.9%**	**1.9%**
Disposable Income Growth	0.8%	0.1%	(0.1)%	11.3%

Despite a $400B increase in disposable income during the 2nd quarter (+11.3% in real terms) due largely to the Federal rebate program, personal consumption rose just 1.5% in real terms. Many people apparently decided to increase savings, at least in the short term, which rose to 2.6% of disposable personal income (up from 0.3%). We'll have to wait to see whether more of the rebate finds its way into the economy during the 3rd quarter, but economists are so far disappointed by the results (and politicians are gearing up for the next program).

Net exports contributed 2.4% of the quarter's 1.9% growth rate. The decline in net imports was especially powerful. Federal & state government spending (other than the rebate) added 0.7%.

Business spending on inventories contracted sharply in the 2nd quarter, dragging down GDP growth by -2.0%. This represented the third consecutive quarter business inventories have been cut, which hasn't happened since the last recession. Residential fixed investment declined at a double-digit rate for the ninth consecutive quarter, and was again a major drag on the quarter's growth.

- Manufacturing and Trade Sales – in nominal terms, business sales in May (latest reported) were +0.8% for the month, and +6.6% from May '07. But, the Producer Prices Index rose 1.4% in May, and +7.2% year/year, indicating that business sales have declined in real terms.

  As noted, inventory spend has also been falling, such that May's Inventory/Sales ratio of 1.24 was at the bottom of its range over the last 10 years. Tight inventories normally lead to increased future production activity, if new order rates stabilize.

- Industrial Production - declined at an annualized rate of 3.1% in the 2nd quarter, after a 0.1% decline in the first. For the year ended June '08, production rose just 0.3%, which compares unfavorably to 2.1% for all of 2007. At 80%, the broad capacity utilization rate remains below long term averages. It has fallen from 81% a year ago, implying little overall pressure for businesses to invest in new plant & equipment.
- Employment - The employment picture continued to worsen during the 2nd quarter, and beyond. After seasonal adjustments, household survey data revealed employment dropped 78k persons over the three months. At the business level, non-farm payroll employment declined by 191k during the quarter, and another 51k in July. Thus far in 2008, payroll employment has fallen by 463k. ***Un***employment levels have recently increased by 684k persons, the unemployment rate hit 5.7% at the end of July, and is up 1% over the past year. A good portion of that increase is the result of calculated increases in the labor force itself, which the sluggish economy has not been able to accommodate. Employment has declined by only 450,000 persons overall in the past year - not that much compared to the last two recessions. Pessimists would add "yet," to that sentence, pointing out weekly initial jobless claims have pierced the 400,000 level for the first time in five years.
- Personal Income – Real average weekly earnings fell each month of the second quarter, and were down 1.7% overall for the period. From June 2007 to June 2008, wages rose by just 2.8% in nominal terms and declined by 2.4% in real terms. The overall Employment Cost Index increased just 0.7% during the 2nd quarter, and was up 3.1% for the year through June. After adjusting for inflation, real employment costs have declined 1.7% over the past year, with the weakness accelerating so far in 2008.
- Inflation - During the 2nd quarter, Fed chairman Ben Bernanke made his semi-annual report to Congress, noting that inflation risk had intensified, there was an "unusually uncertain" inflation outlook, and that the Fed is watching to see if higher commodity prices are becoming embedded in wage expectations. Given the decline in real employment costs noted above, the answer to the latter question would seem to be "not yet." However, headline inflation has clearly taken off. Consumer prices rose at an annualized rate of 7.9% during the 3-months ended June, and are up 5.0% over the past year. Excluding food and energy, prices rose at a more benign 2.5% annualized rate in the quarter.

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Gimme a Little Credit

As the first quarter came to a close, market participants were breathing a collective sigh of relief after the Federal Reserve and Treasury Dept. orchestrated a resolution to Bear Stearns' problems. Once a systemic liquidity meltdown was off the table, risk in the credit markets was on a tear and April provided some of the best excess returns for non-Treasury bonds on record.

The euphoria didn't last. In fact June was a washout month for spread product, especially bonds rated below investment grade. When the dust had settled, it was a weak quarter for bonds, but the first one in a year during which non-Treasury sectors outperformed (see table 4).

Table 4: Bond Market Returns

Bond Index	**2Q '08**	**1 Year**	**3 Years**
Aggregate Bonds	**(1.0)%**	**7.1%**	**4.1%**
US Treasury, long	(2.2)	12.7	3.8
U.S. TIPS, 1-10	0.2	15.2	6.4
US Agencies	(1.5)	8.3	4.6
Mortgage Pass-throughs	(0.6)	7.9	4.8
Inv. Grade Credit	(0.9)	3.8	2.8
High Yield Credit	1.8	(2.1)	4.6
3-mo. T-bills	0.4	3.3	4.1
Non-US Gov't, Unhedged	(5.0)	18.6	6.4
Non-US Govt, Hedged	(2.4)	4.8	3.0
Emerging Local Markets	3.9	18.9	13.8

The first quarter's severe liquidity imbalances had engendered an atmosphere of pure fear, and demand for risk-free Treasuries, especially shorter term issues, skyrocketed. Further, the Federal Reserve was in the final stages of taking the Fed Funds target down to its present 2% target. This was a potent cocktail, and risk-free yields plummeted. This couldn't last either, and the 2nd quarter saw market yields rise across the curve.

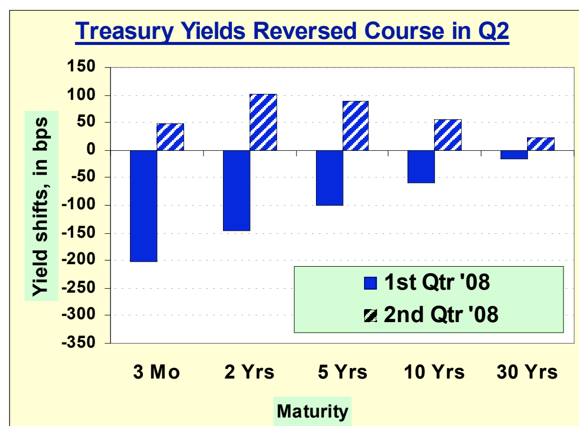

Table 5: Spread Sector "Excess Returns"

Bond Index	**2007**	**1Q '08**	**2Q '08**
	Duration-adjusted Excess Return (basis points)		
Lehman Aggregate	-207	-183	**64**
US Agencies	-52	-68	**7**
MBS	-177	-77	**52**
CMBS	-435	-777	**260**
Asset-Backed	-635	-594	**78**
Invest. Grade Credit	-646	-427	**134**
High Yield Credit	-777	-781	**398**
Emerging Markets	-451	-469	**490**
Subprime AAA	**-1313**	**-1244**	**-723**

Table 5 updates our review of the return impact from taking credit and structuring risks, by isolating each sector's "excess return" versus a duration-neutral Treasury portfolio (this takes interest rate shifts out of the equation). The 2nd quarter clearly provided some welcome relief, but not enough to sound the all-clear bell. The last twelve months have been especially brutal for traditional "core" and "core-plus" managers, who make their living by correctly discerning the relative value offered by non-Treasuries.

Table 5 also hints at the impact of the housing credit crisis on investment portfolios of finance houses and institutional investors. The floating rate AAA pieces of non-agency MBS backed by subprime mortgage pools, which have suffered **zero** realized credit losses (i.e, all P&I payments have been made as agreed), have fallen in market value by over 30%, with the weakness continuing in the 2nd quarter. Portfolios subject to mark-to-market accounting (most institutional accounts, banks, broker dealers, etc) have had to price-in those unrealized losses. And, the BBB pieces? Fuhgeddaboutit!

Looking forward, we note that current Treasury rates across the entire yield curve are below current inflation rates. Normally this is a bearish condition, as bond investors ultimately expect to earn real returns on their invested capital. But, the 3mo. T-bill yields 1.70%, a level anchored to large extent by today's 2% Fed Funds rate, while the 10-year yield is 3.93%. That gives current investors a steeper than average yield curve of 223 bps. **If** the Fed stays on hold, long-term Treasury yields will probably find it hard to rise by very much. That makes them unattractive from a total return perspective, *except* in a risk adverse environment, but not disastrously so. Conversely, the credit debacle reflected in Table 5 has resulted in excess yields from "spread product" in the 250-700 bps range, even after the 2nd quarter rally. Those are seductively attractive levels for relative value buyers.

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U.S. Equity Markets - the Bear settles in

The technical signal of the bull market's end and a bear market's beginning didn't come until the second week of July, but most investors should be excused if they thought it all happened in June. The month was crushing, with the S&P 500's 8.4% decline the worst month since September 2002. And it felt even worse. By 5/19, domestic equity markets had rallied +12% from their March 9th intermediate lows. Then, some idiot rang a bell, and the index began a straight down -15% slide to our current cycle low close of 1215 on July 15th. This was 22% off the all-time high, bringing the 2002-07 bull market officially to a close on 10/9/07. The denial period also began, as in, "who decided that -20% is the right number?" and, "since we've had a nice rally off that bottom (+6.7%), isn't the bear market now over?"

Focusing just on the calendar quarter, the broad domestic stock market, as measured by the Wilshire 5000 index, provided investors with a total return of (1.5)% for the quarter, thus taking the year-to-date loss down to (11)%. In that context, the 2nd quarter represented a significant improvement over the 1st quarter, leading many to opine that the July 15th "Fannie Mae/Freddie Mac train wreck" capitulation might just be this cycle's low point.

Breaking the domestic market into its prime components, we see in Table 6 the size effect was once again mixed during the quarter. Larger cap *growth* stocks underperformed mid and small-caps by 5%, having outperformed them by 2-3% in the first. Among *value* stocks, both ends of the size spectrum, large-caps and micro-caps, were extremely weak, but midcap stocks were flat. If we extend our backward review, the size effect is clearer. Smaller cap stocks have rather sharply underperformed larger caps over the past 12 months.

In terms of style, value stocks declined much more than growth stocks during the 2nd quarter, after a modestly different outcome in Q1. The all-cap differential was nearly 7% in favor of growth, and is 4% year-to-date.

Table 6: U.S. Equity Market Size/Style Returns

Periods ending June 30, 2008

	2Q '08	Trailing Periods: 1-Year	3-Years	5-Years
Growth				
Large Cap	(0.3)	(5.7)	5.1	5.8
Mid Cap	4.6	(6.4)	8.2	12.3
Small Cap	4.5	(10.8)	6.1	10.4
Micro Cap	0.7	(22.8)	(0.3)	5.7
Value				
Large Cap	(7.1)	(19.3)	3.0	7.2
Mid Cap	0.1	(17.1)	5.0	13.0
Small Cap	(3.5)	(21.6)	1.4	10.00
Micro Cap	(7.7)	(28.1)	(1.5)	8.5

Extending our perspective back over the past year, growth biased investing has sharply outperformed value-biased processes across the entire market cap range. With portfolio valuation (P/E) distinctions having shrunk over the past two years, our research suggests that sector allocation and performance have been the driving factors in the past year's rotation from value to growth. This was again evident during the 2nd quarter.

Table 7: U.S. Sector Returns in the 2nd Quarter

	Large-cap Returns *(%)*		Small-cap Returns *(%)*	
Sector	2nd Qtr	1 Year	2nd Qtr	1 Year
Energy	17.0	24.9	39.1	46.6
Utilities	7.5	6.3	8.2	1.4
Materials	7.2	15.4	2.8	(3.8)
Info Tech	2.9	(6.6)	4.2	(16.5)
Telecom Svcs	(0.7)	(21.1)	4.4	(22.6)
Health Care	(1.3)	(11.2)	0.2	(9.7)
Cons. Staples	(5.3)	1.1	(7.2)	(17.2)
Cons. Disc.	(8.1)	(26.1)	(9.0)	(34.5)
Industrials	(10.3)	(12.8)	4.8	(4.9)
Financials	(17.6)	(40.2)	(11.2)	(27.2)

Per Table 7, four large-cap sectors rose in price during the 2nd quarter. These comprise 53% of the S&P Growth index, with the top-performing energy sector now comprising 25% and info tech 24%. Stocks in these sectors represent only 26% of the S&P Value index, with energy stocks now making up just 6%. The energy sector growth/value allocation has completely reversed itself over the last two years.

Conversely, four large-cap sectors declined more than 5% in the second quarter. These comprise 58% of the S&P Value index, including a 24% financial services weight. These sectors make up 33% of the S&P Growth index, including just a 6% weighting to financials.

Only three small-cap sectors declined in the 2nd quarter. These represent 48% of the Russell 2000 Value index, including a 33% weight for financial services firms. These sectors comprise just 20% of the R2000 Growth index, including only 4% in financial services names.

Swing sectors for large-cap portfolios have clearly been energy and financial services. Their nearly 35% return differential in the 2nd quarter, and 65% over the past year, appears to represent capitulation by both buyers and sellers. In the small-cap space, differential financial services weighting describes most of the growth/value return differences. Beyond that, return differences within sector (i.e., security selection) describe much of the remainder. For example, consumer discretionary *value* stocks underperformed consumer discretionary *growth* stocks by 9% in the 2nd quarter. Growth financials outperformed value financials by 10%.

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Int'l Equities – Commodities & Currencies

Through May 19th, the world's equity markets rallied on optimism the worst of the credit crisis was over, erasing most of the first quarter's losses. Hopes that steady monetary policies would create a floor beneath both the economy and equity prices eroded quickly, after hawkish inflation warnings by central bankers worldwide. Spiking commodity prices, amid expectations of higher interest rates, quickly reversed the market's momentum. This led to increased selling pressure in the financial, industrial and consumer sectors. The quarter's best performing sectors were energy (+17%) and materials (+9%), while the worst were financials (-11%), consumer discretionary and staples (-9% each).

Broad international indices outperformed our domestic market in both US$ and local currency terms. The World ex-US index dropped only (1.2)%. Currencies played a modest role during the quarter. A weighted basket of developed market currencies declined 1.4% versus the US$ during the quarter. The Euro fell 0.6%, the British pound was flat and the Yen fell 6%.

Table 8: International Markets Returns

(index level = gross)	U.S. Dollar Return %		Local Currency Return %	
	2nd Qtr 2008	One Year	2nd Qtr 2008	One Year
Developed Markets	**(1.2)**	**(8.8)**	**0.0**	**(18.2)**
- Int'l Growth	*1.6*	*(1.7)*	2.9	*(11.9)*
- Int'l Value	*(4.0)*	*(15.7)*	*(2.9)*	*(24.2)*
- Europe	(4.2)	(11.3)	(3.6)	(20.1)
- Pacific, ex-Japan	1.5	(1.8)	(1.9)	(10.6)
- Japan	2.5	(12.0)	9.1	(24.5)
- United Kingdom	(0.8)	(13.2)	(0.9)	(12.5)
Int'l Small Cap	**(3.6)**	**(17.4)**	**(2.3)**	**(25.9)**
Emerging Mkts	**(0.9)**	**4.6**	**(1.6)**	**1.4**
- EM Asia	*(9.1)*	*(7.2)*	*(6.6)*	*(5.3)*
- EM Europe & ME	*7.7*	*15.0*	*5.2*	*4.2*
- EM Latin America	*10.9*	*29.5*	*4.4*	*13.2*
- EM BRIC	*4.1*	*18.5*	*1.9*	*11.9*

On a regional or country basis, commodity-rich countries prospered, while those markets dominated by financial and consumer stocks fell sharply. Resource-rich Canada (+11% return) and Norway (+14%) had the best returns. Oil, shipping and fertilizer were all strong performers. Australia gained 4%, as metals and mining stocks followed soaring prices. Even tiny Austria gained 5%, led by companies tied to oil and gas.

The quarter's accelerated sell-off of financial services stocks negatively impacted many developed country markets. Belgium was most effected, dropping (19.5)%, as its largest stock - Fortis, plummeted 35%. Ireland and Portugal declined (18)% and (14)%, respectively, due to financial and housing stocks. Among major markets, Switzerland (-5%) and the Netherlands (-9%) were most affected.

Japan rebounded from early quarter losses to gain 2.5%, on the belief that the country is somewhat isolated from US sub-prime issues and its exporters will benefit from a weakening yen.

Broad emerging markets dropped only (0.9)% in US$ terms for the quarter, after declining nearly 14% in the first. Here, differential performance was decidedly regional. Asian emerging markets fell (9.1)%, while emerging Europe (+7%) and Latin America (+11%), were very strong. Asian emerging markets were pulled down by India losing (20)% and China dropping (3)%. After being top performers in 2007, the year to date performance of both these markets (-41% and –26%, respectively) represents a rather breathtaking correction.

European and Latin American emerging markets moved higher on the strength of commodity and energy-related stocks, as Brazil gained 18% and Russia 11%. Argentina was the best performing country during the quarter, gaining 29% (39% year to date), while Pakistan and the Philippines were the worst performers with (25)% results in US$ terms.

As in the States, small-cap international stocks continued the recent trend by falling more than their large cap counterparts. The World ex-US Small Cap index declined (3.3)%.

From a style standpoint, international value stocks have been punished much more than growth stocks during the past year, and the 2nd quarter was no different. The Value index was off (4)%, while the Growth index advanced 1.6%. For the trailing one-year period, the value index is down (16)% versus (2)% for the growth index. These results are not really surprising, with financials and consumer sectors dominating international value indices just as they do domestic ones.

As concerns about the economic climate have crystallized, we've also observed investors seeking refuge in steady earning companies and selling cheaper companies with greater pro-cyclical exposure. Investor caution during the past year has clearly increased, as bad news continued to abound. In local currency terms, developed international markets have rather sharply lagged the US over the past year, with positive currency effects more than making up the difference. Consequently, equity multiples of book value and estimated earnings are below 20 year averages in European and Japanese markets. Performance of certain sectors (energy, materials, industrials) appears to be extended, which may indicate a "changing of the guard" is in order. As with other periods of extended markets and valuations (Japanese stocks in the late 80's, TMT stocks in the late 90's), they do come to an end.

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Back Page Perspectives

We are passing through one of the most tumultuous periods in recent financial history. From the top of the market in March 2007 through the bottom on July 15, the S&P Financial Index fell from 511 to 225, a drop of nearly 60%. Past financial crises, such as the commercial Real Estate Crisis of 1990, the Emerging Market Crisis of 1998, and the Great Bear Market of 2000-2002 sent financials down 40% at most. Global finance sector market capitalization has dropped $1.6T the past year.

We all can now see the drop in financial stocks was initiated by the collapse of a sharply overvalued housing market combined with a narrowing of risk spreads and increased leverage of financial firms. The narrowing of risk spreads occurred because investors were willing to take on more risk to raise returns in light of record low interest rates. Leverage increased because company managements grew overconfident of their ability to manage risk (ego), they needed the leverage to pump up earnings (greed), and they could (lax regulation).

The credit tide continued to rush out in the 2nd quarter, further exposing those swimming without trunks on. Economic growth has only just stalled, but the slowdown has been enough to create a sea of unsold homes, and a sea of bad paper that financed the bubble. This represents an x-factor for all investors, because no one has experienced a nationwide environment where housing was as leveraged as it has been recently, and where prices have fallen so sharply.

Thinking globally, early data suggests Europe is in the process of experiencing a slowdown that might be **more** severe in certain countries (notably England and Spain) than what we experience in the States. The strong Euro and greater attention to inflation risk (e.g., higher local interest rates) will engender differential performance – but this is apt to be more timing related than fundamental. If the Dollar has put in a near-term low against the Euro and Pound, we think European stock markets will struggle to outperform the US, despite their low multiples. We think emerging markets, which have been de-rated this year on local inflation concerns, continue to merit overweighting. The easy returns have probably been made, and purely indexed investing should be de-emphasized.

Six months ago we cautioned against making new money commitments to stock markets, including the re-balancing of underweighted client equity positions. We said the S&P could retrace to 1230. Unfortunately, we were right about that. So, how come we didn't rush out with a "re-build your equity positions" letter?

First, because catching a falling knife is very difficult. Since the October 9th high, we've had a number of intermediate lows, all of which were lower than the prior one. In between each of these lows, we've had impressive "rally highs." But, only one of these, the one on 5/19/08, was higher than the previous rally high, and it got crushed. Lower lows, and lower highs. Hmmm.

Second, because a sustainable recovery in the U.S. and European stock markets, the kind you want to increase your strategic commitments to, is ultimately dependent upon the housing market reaching a level of price stabilization. For that to happen, the financial sector needs to recover its capacity and willingness to increase lending to credit-worthy consumers and businesses. Yet, notwithstanding the recent short-covering rally, we see a continued deterioration over the immediate future for banks. Capital raising activity will be constrained until the write-off cycle is completely done. We appreciate there is a catch-22 in this perspective.

We also expect continued high levels of volatility in equity markets over the next few quarters. Prop desks and speculators are able to trade higher volatility/higher risk markets, but not institutional investors who meet on a monthly or quarterly cycle. For them, a higher volatility expectation should result in reduced allocations to riskier assets, unless expected returns are also higher. We just don't see those higher expected returns coming onstream yet. That is because forward earnings estimates continued to be marked down as we moved through the second quarter (see table below).

S&P 500 Earnings Estimates

E = Estimated *A = Actual*	*As of 7/31/07*	*As of 12/31/08*	*As of 3/31/08*	*As of 7/31/08*
1Q08 Op. Earnings		23.37E	20.93E	**16.62A**
2Q08 Op. Earnings		25.06E	24.15E	19.40E
3Q08 Op. Earnings		25.62E	24.90E	22.80E
4Q08 Op. Earnings		27.19E	26.30E	24.73E
2H08 Op. Earnings	55.01E	52.81E	51.20E	47.53E
2007 Net Earnings	88.50E	81.43E	**73.94A**	**73.94A**
2008 Net Earnings	94.47E	83.70E	67.01E	72.01E
2009 Net Earnings			81.52E	67.66E

Thus, on March 31st, the S&P index at 1323 was priced to a 16.2 multiple of 2009 forecasted net earnings. At the end of July, the S&P at 1267 was priced to an 18.3 multiple.

If the stock markets' aren't "buys" right now, why not shed 20-30% of equity exposure? Historically, when the S&P dropped 20%, when the Fed and Congress are stimulating the economy, when you are in an election year, and when stocks are undervalued versus bonds….. you are *supposed* to buy. We just think not yet.

See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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