

In July, the stock market was lower, but volatility returned to early year highs, while the bond market continued its sell-off.

Financial Markets Review

Although the Federal Reserve did not meet in July, speculation about their next move was on investors' minds. It was clear after the June 24/25 meeting that a pause, if not a rise in rates, was in the cards. However, events during July (Freddie Mac and Fannie Mae problems in particular), made a rate increase less likely anytime soon. Lower oil prices helped ease inflation fears as well.

The stock market was violently whipped around by company news, oil prices and credit market conditions. The bulk of the downside came in the month's first half. The second half rebound was helped by better-than-expected earnings reports by financials.

Bonds reacted in the opposite way to stocks. Prices rose in the first half as stresses to the financial system increased, then fell on news of unfriendly inflation numbers, and an easing of the credit concerns, as financial institutions reported manageable write-offs.

The U.S. Stock Market

In July, the S&P fell 0.8%, while the NASDAQ rose 1.5%. Value outperformed growth.

U.S. small stocks (Russell 2000) outperformed the S&P 500 (+3.7% vs. -0.8%). Within the Russell Index, the value component outperformed growth (+5.1% vs. +2.3%).

The third quarter got off to a shaky start. In fact, by July 15th, the -3.4% to -5.0% decline put most Indexes in bear market territory from the October 9, 2007 highs. Surging oil prices, which could spark overall inflation, heightened credit concerns (i.e., Fannie and Freddie), which could derail the fragile economy, and apprehension about second quarter earnings, put investors on the defensive.

Reports by some key banks (i.e., Bank of America, Wells Fargo, J.P. Morgan, and Citi) indicating a slight improvement in credit conditions, set off a record two-day rally in financials, which in turn rallied the overall markets. A \$20/barrel fall in oil added to the turnaround.

The rally was tempered by disappointing earnings by Google and Microsoft and lingering concerns about the economy and consumer.

For the month, within the S&P 500, stocks with low P/E's, low betas, and high yield performed well. The average stock fell 0.4%, 44 bps. better than the Index itself. The 10 largest holdings had a return of -3.3%; half lost money. The best was Procter and Gamble (+8.4%), a defensive play, while Chevron Corp. (-14.7%) was hurt by falling oil prices.

Sector returns within the S&P reflected a major rotation from the second quarter.

Hard hit financials surged (+7.2%) in July. Better than expected earnings (or less than expected losses), and a sense that the worst of the write-offs may be over, helped lift Bank of America (+37.8%) and J.P. Morgan (+19.7%), the two largest sector holdings.

On the other hand, energy (-14.0%), the recent star, encountered heavy profit taking. Sharply lower oil prices, caused by weaker demand, led to a dramatic shift out of this sector. No stock advanced, while 32 (82%) fell in double-digits.

The International Markets

In July, the U.S. Dollar was volatile but higher against most major currencies. Movements were highly correlated to the outlook for the U.S. economy. The first half saw weakness as markets reacted to the Fannie and Freddie debacle. Later in the month, stability returned and the U.S. Dollar rallied. The Canadian dollar was steady despite the commodities sell off.

CURRENCY	% CHANGE*					
	<u>12/07</u>	<u>3/08</u>	<u>6/08</u>	<u>7/08</u>	<u>July</u>	<u>YTD 2008</u>
British Pound (in U.S. \$)	1.9849	1.9837	1.9923	1.9841	-0.4%	0.0%
Japanese Yen (per U.S. \$)	111.74	99.69	106.21	107.91	-1.6	+3.5
Euro (in U.S. \$)	1.4590	1.5788	1.5755	1.5603	-1.0	+6.9
Canadian (in U.S. \$)	1.0016	0.9752	0.9789	0.9760	-0.3	-2.6

* Versus U.S.\$

EAFE (-3.2%) lagged the U.S. markets. The higher U.S. dollar had an impact on local returns (-2.0%).

The Pacific region (-3.9%) performed poorly. Japan (-3.4%) lagged for U.S. investors due to a weaker yen. Local returns were -2.2% and -1.5%, respectively.

Europe (-2.9%) performed better. Concerns continued that the inaction by the ECB to lower interest rates (they may raise rates to fight inflation) will hurt economic growth that is starting to falter; lower oil prices helped a bit to offset these concerns. Spain (-1.0%) and Germany (-1.1%) outperformed; the U.K. (-4.1 %) lagged.

Sector laggards included energy (-12.0%) and materials (-9.8%), which reacted to the plunge in commodity prices. Financials (+0.4%) was the only sector to rise.

The Bond Market

In July, the bond market continued under pressure. Corporates were the worst performers. Returns for the LB Aggregate Bond Index and the Gov't./Credit Index were flat (-0.1% and -0.0%, respectively).

Bonds, particularly Treasuries, rallied strongly early in July, as fears of the credit crisis intensified. In addition, a weak employment report (job losses for the sixth consecutive month) and softer-than-expected retail sales led investors to believe that an increase in rates was not imminent. By the 15th, yields on 10-year and 2-year Treasuries fell 15 bps. and 25 bps. to 3.82% and 2.37%, respectively.

The less-than-friendly CPI and PPI releases, solid industrial production, and most importantly, encouraging earnings reports from the hard-hit financials, caused a retracement of the rally.

Treasuries (+0.4%) outperformed corporates (-0.8%), which were led lower by longer dated credits (-1.6%).

Shortest term bill yields moved slightly lower. Yields traded between 1.34% (on July 15), and 1.87% (on July 1) in reaction to economic news.

Yield curve spreads remained sharply positive in July.

Treasury Yields (%)

MATURITY	<u>12/05</u>	<u>12/06</u>	<u>12/07</u>	<u>3/08</u>	<u>6/08</u>	<u>7/08</u>
30-Year	4.54%	4.81%	4.45%	4.29%	4.53%	4.58%
10-Year	4.39	4.70	4.03	3.41	3.97	3.95
2-Year	4.40	4.81	3.05	1.59	2.62	2.52
90-Day	4.08	5.01	3.24	1.32	1.74	1.67
Spread	+0.46	-0.20	+1.21	+2.97	+2.79	+2.91

The range of returns among maturities/quality was wide; intermediate maturity Treasuries performed best.

July Returns

	Treasuries	Mortgages	Corporates
Long Term	-0.6%	-0.1%	-1.6%
Intermediate	0.6	-0.1	-0.5

Treasuries (+0.4%) outperformed corporates (-0.8%) and mortgages (-0.1%).

Outlook

The credit markets and Fed policy, and earnings took center stage once again in 2008. The surge in oil prices added inflation worries to the list, although the July reversal eased those fears. More recent data points indicate that the worst for the economy and credit markets may *not* be over; however, earnings, ex. financials, continue to hold up very well. The markets have reacted in extreme ways since mid-May, particularly in the rapid rotation of sectors. Energy and financials were particularly noteworthy.

The 2008 outlook given in December still applies; most of the bullet points are on-track:

- o No recession (in the classic sense of two consecutive negative GDP quarters).
- o An economic rebound in the second half.
- o U.S. will outperform EAFE by a wide margin.
- o The U.S. Dollar will rally.
- o Growth will outperform Value in the first half, but will be more balanced thereafter.
- o Large cap will outperform small cap.

Return objectives unchanged – the first half of 2008 will be down, but the second half will make up most of those losses. In other words, 2008 will likely have feeble equity returns (+/-5%) at best. Bonds will return 5%.