

## Market Review and Outlook

As of March 31, 2008

### Credit Woes Expand to Bank Loan Market

The crisis in the U.S. credit markets continued to unfold in the first quarter of 2008, causing a range of market disruptions that dominated headlines. Skepticism about credit quality led to a belief that the assets on the balance sheets of many financial institutions were overstated, resulting in fears that financial firms would be unable to fulfill their obligations. Investment banks were particularly hard hit as they tend to be more levered and because they acted as counterparties to hedge funds. In March, hedge funds withdrew assets from investment banks at the same time as lenders began demanding more collateral, resulting in an environment much like the runs on banks of 1929.

The Federal Reserve responded by lowering the targeted federal funds rate two percentage points, to 2.25%; reducing the discount rate<sup>1</sup>; and expanding the terms of its securities lending program. The yield curve steepened dramatically as shorter term rates fell faster than longer term rates. Yields at the long end of the maturity spectrum remained relatively stable as inflationary indicators edged higher, driven by rising commodity prices, an increase in the U.S. money supply, and the weakening U.S. dollar.

As a result of these events, stock markets around the world lost ground during the quarter. The MSCI All Country World Index<sup>2</sup> fell 9.74%, with Turkey, India and China experiencing declines of 38.6%, 27.1% and 23.7%, respectively. Morocco, Pakistan and Chile managed to generate robust returns despite the difficult environment.

In the U.S., the S&P 500 Index<sup>3</sup> declined 9.9% for the quarter as the threat of recession became more likely. Consumer staples, which tends to outperform during economic contractions, was the Index's strongest sector, followed by basic materials. Within basic materials, the stocks of commodity exporters with ties to high-growth emerging markets fared especially well. Surprisingly, the consumer discretionary sector performed well, driven by a 20% rebound in housing stocks. Investors bid housing stocks higher in anticipation that the industry had bottomed out.

Information technology and financial services were the weakest sectors of the S&P 500. Technology suffered from expectations for a reduction in capital spending in the U.S. and abroad as a result of the economic slowdown, while financial stocks were impacted by the continuation of the credit crisis.

In an environment in which investors sought safety, Treasuries outperformed all other sectors of the fixed income market and yield spreads over Treasuries widened significantly in each of the spread sectors<sup>4</sup>. Within the spread sectors, government agencies generated the strongest performance, followed by mortgage backed securities, investment grade corporate bonds, asset backed securities and high yield, in that order.

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### U.S. Markets Likely to Remain Tenuous

In the months ahead, we expect equity market volatility to continue until the credit crisis shows signs of abating and confidence in the Fed's ability to maintain liquidity in the financial markets is restored. Much will depend on the outcome of first quarter earnings and whether write-downs are better or worse than investors expect. Once the magnitude of write-downs appears to be contained, investors will likely begin to discount an economic recovery over the next 12 to 18 months. The question remains, however, as to whether the U.S. economy can begin a recovery, while the housing market remains in a slump. Housing could prove to be a substantial drag on economic growth, leading to a more prolonged recession.

While we expect the Fed to remain active in its efforts to restore stability to the financial markets, we don't expect short term interest rates to fall much further from their relatively low present levels. We do expect inflationary pressures to abate somewhat as the economy slows. If inflation abates, the yield curve will flatten as long term rates come down.

Given these circumstances, the economy and fixed income markets are likely to remain tenuous for the near- to mid-term.

On a positive note, as the weaker dollar makes U.S. exports more attractive, the U.S. current account deficit is likely to decline, providing support for the dollar over time. U.S. exporters should benefit from this trend. In line with this view, the U.S. current account deficit has recently shown improvement, falling from more than 7.7% of GDP in May of 2006 to approximately 5.4% by the quarter's close.

### International Economies Expected to Fare Better

Despite problems in the U.S., much of the global macro economy remains fundamentally sound. Earnings growth for non-U.S. developed markets for 2008 is expected to be in the high single digits<sup>5</sup>. World economic growth for 2008 is forecasted at 2.3%, with the EU returning 1.9%, Japan 1.4%, and the emerging markets 6%<sup>6</sup>. As we mentioned last quarter, many emerging markets have become less dependent on the U.S. as profits from rising commodity prices have led to higher disposable incomes and increased local demand for goods and services. That said, while an increase in self-sufficiency should better enable many emerging economies to weather a global downturn, much of the outcome will depend on the severity of the slowdown.

1 The discount rate is the rate at which the Federal Reserve lends short term funds to its member banks.

2 The MSCI ACWI Index Net is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets. The index includes 48 developed and emerging market country indices and is calculated with dividends reinvested.

3 The S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the US economy. Unlike the Funds, the S&P 500 Index is market-weighted and focuses on the large-cap segment of the market. Returns reflect the reinvestment of dividends and do not reflect the deduction of any expenses or fees.

4 The term "spread sectors" refers to fixed income sectors that trade at a yield spread over U.S. Treasuries, and typically includes corporate bonds, asset backed securities, mortgage backed securities, and government agency issues.

5 Source: IBES aggregate estimates.

6 Source: Consensus Economics, Oxford, England. Emerging markets are defined here as including all countries in the MSCI Emerging Markets Index Net, excluding Jordan and Morocco and including Venezuela.

Indices are unmanaged, may not include the reinvestment of dividends and do not reflect transaction costs or management fees and other expenses. Unlike these indices, the portfolios are actively managed and may include substantially fewer securities than the number of securities comprising these indices. Investors cannot purchase interests directly in an index.

**Past performance is not an assurance of future results.**