February 2008 Outlook – Slowing Economic Growth and Corporate Earnings, Fundamentals Matter, and Flight to Quality

• In our view, most global stock markets are not unreasonably priced, but earnings expectations, especially in the U.S., have been unrealistic. **We believe that markets are currently re-pricing assets to better reflect more realistic (i.e., lower) earnings expectations.** In the U.S, we believe that the overall stock market is fair-to-cheaply priced with consensus earnings estimates being revised dramatically lower. In Europe, markets exhibit slightly more attractive valuation levels.

• We believe larger-cap stocks exhibit more attractive valuations and earnings potential relative to smaller-cap stocks. We continue to maintain a value bias in our large-cap equity segments. In our view, **only those stocks with high credit ratings,** lower P/E multiples, and demonstrated superior earnings growth **are attractive in the current market** environment.

• We expect that corporate earnings will continue to ease relative to earlier double-digit robust levels. In our opinion, **there is still no clear sign of a bottom in the housing market,** and with somewhat higher interest rates and more stringent lending criteria being applied, it is uncertain when this drag on the broader economy will subside. In the U.S., we expect lower earnings into at least the second quarter of 2008, with downward revisions continuing to outpace upward revisions. In Europe, we expect a somewhat better environment, despite pressure on export sectors as the euro remains near record levels relative to the dollar.

• Despite what seems like the avalanche of bad news during the month, ranging from a declining housing market to credit derivative write-offs, **we believe there are some positive factors at work; interest rates remain relatively low, core inflation is still under control** (though above the Fed's presumed target), and real wage growth remains positive (though it is slowing).

• We think that **the chances of a U.S. recession** into the first half of 2008 **are now greater than 50%,** as a result of lower household consumption precipitated by a worsening housing market, tougher credit standards, and a somewhat weaker job market.

• In the overseas markets, we expect a modest slowdown in some developed overseas markets. **In emerging markets, we expect demonstrated above-trend growth to continue.** Within the non-U.S. equity markets, we continue to favor a systematic overweight position in Europe, an active underweight position in Japan, and explicit exposure to emerging markets.

• With yields at historic lows and yield spreads expected to widen, **we believe that the near-term opportunities in the U.S. bond market are minimal.** In addition, credit spreads have widened and credit defaults are rising. Thus, **we believe that it is not an opportune time to "take on" additional credit risk.** In light of current bond market conditions, we continue to maintain a higher credit quality bias in the fixed income portion of our discretionary portfolios relative to the bond market.

• **During difficult markets, it is important to remind clients that investing is a long-term endeavor and that markets and economies in the short-run are often noisy and tumultuous.** As we have often indicated, **volatility is a normal and expected part of investing in equities.** In addition, correlation among asset classes has been rising over time; therefore, we believe that diversification and proper portfolio positioning, consistent with investor objectives and risk tolerance, are as important as ever.

• We **view the current market environment as challenging, but we remain focused on the investment and economic factors that we believe drive long-term security prices:** valuation, corporate earnings growth, real economic growth, and the overall level of interest rates.

• Our longer-term risk/return estimates for stocks and bonds remain unchanged. **We continue to expect that longer-term returns in both these major asset classes will underperform their respective long-term averages** due to higher-than-normal valuation levels and modest growth expectations.