

CAPITAL INVESTMENT MANAGEMENT

Registered Investment Advisor

BOSTON • DENVER • SAN FRANCISCO

July 2008 Outlook –Turbulent Financial Markets; Continued Economic Challenges

- **Valuations for U.S. stocks appear reasonable on a relative basis compared to previous peak-to-trough periods.** In Europe, relative valuation levels continue to look attractive though some signs of economic slowdown are appearing there as well. In the emerging markets and Asia (ex-Japan), stocks appear slightly above fair valuation, but are supported by demonstrated above-trend growth. Within non-U.S. equity markets, we continue to favor a systematic allocation to Europe and explicit exposure to emerging markets.
- After acknowledging that a number of market segments are attractive on a valuation basis, we think it is important to remember that an assessment of forward-looking valuations is necessarily dependent on future estimates of earnings. **In our view, earnings estimates remain too optimistic, and on that basis alone, we are cautious regarding the near-term prospects for equity market improvement. This is also, quite evidently, a period marked by shocks to the economy and to the financial markets.** In such an environment, investors can be surprised by events (subprime difficulties, short-term debt market seize-up, broad housing market collapse, consecutive quarters of multi-billion dollar write-offs by financial institutions, to cite a few examples) and they can be surprised by reactions to events (e.g., sharp interest rate cuts, crises of confidence that sink well-established firms, bailout plans that carry enormous price tags, and the sale of assets at depressed prices). An environment characterized by such surprises is one in which investors should be cautious.
- We believe larger-cap stocks exhibit more attractive valuations and earnings potential relative to smaller-cap stocks. **It remains our view that there is currently a higher risk/reward tradeoff for systematic portfolio exposure to companies with higher credit quality and greater liquidity.** Certain “value-oriented” sectors of the U.S. equity market have been hit hard due to ongoing problems in the credit markets and the slowdown in household consumption. In our view, valuations appear attractive and value exhibits the positive attributes for superior return versus growth.
- **We expect that corporate earnings will continue to struggle. In our opinion, there is still no clear sign of a bottom in the housing market, and with mortgage security-related difficulties and more stringent lending criteria, it is uncertain when this drag on the broader economy will subside.** We believe that consensus expectations for growth in the latter part of 2008 and 2009 are too optimistic. Real economic growth is expected to come in far short of the long-term average trend rate; thus, we expect that earnings estimates will continue their recent pattern of being revised lower as the actual reports approach. Some signs

of economic stress are now showing in the Euro region, as global credit difficulties and a strong currency take their toll. Forecasted growth rates remain modestly more attractive in Europe (ex-U.K.) relative to both the U.S. and Japan.

- **The current debate has shifted from will there be a recession to how deep and long the current contraction will last.** Higher food and energy costs, sharply reduced home equity, depressed consumer confidence, declining real earnings, and tougher credit standards have sharply slowed discretionary household consumption, although exports and overseas activities of U.S. companies remain reasonably robust. Evidence of a slowing economy, lower corporate profits, and a slowdown in household consumption suggest offsetting pressure on price levels. Given these considerations, our long-term inflation forecast remains between 2.2% and 2.5%.
- **We believe that the near-term opportunities in the U.S. bond market are low, and inflation and credit risks are relatively high.** As a result, we do not advise taking much duration risk. In addition, due to credit spread widening and heightened default risk, we believe that it is not an opportune time to seek additional credit risk. In light of current bond market conditions, we continue to maintain a shorter duration and higher credit quality bias.
- **There continues to be a high level of uncertainty as to the actual level of leverage that still remains in the U.S. economy.** What began as an increase in defaults in the subprime mortgage area has now progressed into other areas of the credit markets. Banks are reluctant to lend to even their most creditworthy customers, and non-U.S. banks are reluctant to lend to other banks. This loss of confidence in the financial system may take time to repair and, until such time, we believe that uncertainty in the markets will continue to be higher than normal.
- **During difficult markets, it is important to remind clients that investing is a long-term endeavor, and, in the short run, markets and economies 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.