

CAPITAL INVESTMENT MANAGEMENT

Registered Investment Advisor

BOSTON • DENVER • SAN FRANCISCO

March 2008 Outlook – Slowing Economic Growth and Corporate Earnings; Continued Market Volatility; Fundamentals Matter

- In our view, equity valuations for the broad U.S. **stock market remain fair**, but are based on unrealistically optimistic earnings expectations. **Since the October 9, 2007 peak**, the broad U.S. stock market, as measured by the Russell 3000 Index, **has declined 14.5%**. In Europe, valuations are slightly better than in the U.S. and prospects for growth appear somewhat more solid. In the emerging markets and **Asia (ex-Japan)**, **we believe stocks are slightly above fair valuation**, but are supported by demonstrated above-trend growth. Within non-U.S. equity markets, we continue to favor a systematic overweight in Europe and explicit exposure to emerging markets.
- We believe that the odds of multiple expansion are low, given the current level of dividend yields and an expected slowdown in earnings growth. We believe in 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 on-going problems in the credit markets and the slowdown in household consumption. In our view, **valuations appear attractive and value exhibits the potential for superior return over growth**. As a result, we increased our U.S. large- and mid-cap value exposures during February.
- 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 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 2008 are too optimistic. Currently, 2008 earnings growth for the S&P 500 is forecasted to be 18% (compounded). However, real economic growth is expected to fall far short of the long-term average trend rate; thus, we expect that consensus expectations may be revised lower. **In Europe, we expect a somewhat better environment**, despite lower rates of growth in the U.S. and pressure on the export sectors as the euro remains near record levels relative to the dollar.
- We think that **the chances of a U.S. recession are now greater than 50%**, as a result of **lower household consumption precipitated by higher food and energy costs, the worsening housing market, slowdown in economic activity, tougher credit standards, and softening job growth**. On the inflation front, we continue to forecast an overall rate of inflation between **2.2% and 2.5%** over the next several years.
- **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**. As a result, there are

likely fewer opportunities for duration plays. In addition, due to significant credit widening and default risk, we believe that this **is not an opportune time to “take on” additional credit risk**. In light of current bond market conditions, we continue to maintain a shorter duration and higher credit quality bias in the fixed income portion of our discretionary portfolios relative to the bond market, as measured by the Lehman Brothers Aggregate Index. Given the correlation, dollar hedging, and yield differential features of non-U.S. fixed income, we introduced an allocation to non-U.S. sovereign bonds in the portfolios during February. Currently, the fixed income portion of the portfolio has an average duration of 2.75 years versus 4.18 years for the Lehman Brothers Aggregate Index.

- Since the full extent of the total exposure to leveraged investment positions in the credit **derivatives market is unknown, the global credit situation remains a wild card**.

Although the Financial Services sector has borne the brunt of the damage, it is unclear how or when the effect may bleed into the rest of the economy. Further damage may prompt lenders to **continue to “tighten the reins” in the credit markets, placing financial pressure on the corporate and household sectors**. Also an unknown is the total exposure in the market to marginal loans. Until the market has a better grasp of the total fallout from the current credit crisis, we expect that global markets will remain volatile and both monetary and fiscal authorities will respond appropriately.

- During difficult markets, **it is important to remind clients that investing is a longterm 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**.