Market Update

A Question of Confidence

Background

Global equity markets have fallen in nine of the last 10 days, erasing the gains of the first half of the year. Mounting stresses in the financial system have driven investors away from perceived risks and toward safety, as reflected by falling U.S. government bond yields, rising government bond yields in several euro zone countries, and sharp currency moves including gains in an already overvalued Swiss franc. Surveys of corporate leaders and consumers reflect reduced confidence in the economic outlook.

Market Pressures

Now that the U.S. debt ceiling crisis has been resolved in an eleventh-hour deal to avert an immediate downgrade by the credit rating agencies, the biggest near-term challenge is in Europe. Investors are demanding higher yields to own bonds issued by Italy and Spain, pressuring local banks that hold large quantities of these securities. While we believe recent plans announced by euro zone policymakers to aid struggling governments are a positive step toward mitigating the crisis, delays in codifying and approving the programs into early September heighten near-term uncertainty. Responding to difficult market conditions, the European Central Bank today announced new long-term loans for the banking sector and renewed purchases of government bonds to stem the rise in borrowing costs.

Most remarkable in the current market environment is an enormous thirst among investors for liquidity. For example, a major U.S. bank told us this week they are seeing unusually large jumps in the amount of cash their customers have placed on deposit. In response, the bank will shortly begin *charging* depositors for the privilege of holding abnormally high balances. While the stockpile of cash held throughout the global economy represents substantial future buying power, we don't foresee a shift toward growth-oriented assets playing out quickly as the European crisis lingers.

Defensive Measures

This is a critical time to retain defensive measures within a balanced portfolio. Entering the third quarter, our portfolios reflected the following strategic moves:

- Holding elevated cash levels in stock and commodity portfolios;
- Shifting some equity exposure into less-volatile corporate credit;
- Cutting government bond weightings; and
- Diversifying currency exposure away from countries with higher debt.

More recently, we have further increased our protectiveness. In our U.S. and Non-U.S. Large Cap portfolios, we have sold certain cyclically oriented securities to increase our cash holdings. Moreover, the Real Return team has added to the fund's higher-than-usual cash position through recent sales in energy, agriculture, and metals. Until European policymakers take more decisive steps toward a unified fiscal approach (e.g., issuance of Eurobonds), we will likely retain meaningful defensive measures.

The broad market selloff has put downward pressure on our portfolios, but our positioning has helped us protect on the downside: While the S&P 500 Index has fallen by more than 11% from its peak last month, our Balanced Growth allocation is down by about 6½% — bringing our year-to-date return to near breakeven.

Maintaining Balance

Even as we enhance the protection within our allocations, we believe it is essential not to overreact to the current environment. While global economic growth has slowed, it hasn't stopped. Among the more positive data points lately in the U.S. are rising same-store sales for major retail chains including Costco, Dillard's, Macy's, Nordstrom, Saks, and Target; increasing automobile sales as disruptions to global supply chains caused by Japan's earthquake/tsunami dissipate; some recovery in sales of existing homes; and modestly falling unemployment claims.

Some of these more encouraging signs are reflected in continued strength in corporate profits. With 80% of companies in the S&P 500 Index now having reported second-quarter financial results, revenues and earnings are both up 13% from the same period last year. Overall S&P 500 profits are running at $100 per share, so today's index level of 1200 translates into an attractive price-to-earnings ratio of 12x. Particularly with cash yielding nearly zero and five-year U.S. Treasuries at 1.2%, we see potential for stocks to outperform cash and bonds over the next several years. On the whole, stocks represent about 45% of our overall Balanced Growth asset allocation.

Recent turbulence underscores the importance of maintaining a balanced perspective and long-term orientation. Given the combination of lurking risks and potential improvements in the global economy, we believe our portfolios are well positioned for today's difficult market environment. As always, we will continue to monitor the investing landscape closely in the period ahead.

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