

Fears of a doomsday scenario subsided during the second quarter of 2009. In the last three months, waning concerns about a global economic and financial collapse enabled all major equity markets to post positive double-digit returns. Even financial and other stocks with the most dubious fundamentals excelled in this rally – handicapping traditional investment disciplines and their performance benchmarks. For example, during last quarter, money-losing companies with the most debt were up an average of 38.0% in the MSCI World Value Index.

Although there are a few signs of the so-called “green shoots” pointing to a stabilization of global economies, there is a jarring lack of clarity about the economic outlook. The only certainty is that policymakers around the world will continue to adopt reflation policies to achieve economic growth.

In the short term, the environment remains more vulnerable to deflation than inflation. Manufacturing capacity utilization rate in the U.S. hovers around 65.0% and there is plenty of spare capacity throughout Asia. The U.S. unemployment rate is now at 9.5% and will probably exceed 10.0%. For now and the foreseeable future, wage gains, if any, will be modest – undermining U.S. consumer spending growth, still a key component of global growth. Longer term, Central Banks and policy makers will need to orchestrate a timely withdrawal of excess liquidity in the system to contain inflationary pressures and avoid allowing the formation of a new asset price bubble. Given the scale of the current stimulus, this will be a major challenge – the outcome of which will have critical long-term implications for investors.

Despite the many uncertainties surrounding any economic recovery we are of the opinion that the worst of the financial and economic crisis is behind us. The World Bank recently projected that the world economy would contract 2.9% in 2009 before returning to growth in 2010. Globally, our estimates for 2010 are: economic growth 2.2%; inflation 1.8%; short term interest rates at or below 1.0%, and earnings growth of 10.0% to 15.0%.

Given the recent rally, equities are no longer cheap, but still reasonably valued. Cash on the sidelines remains very high and most portfolios hold higher than normal cash positions, which should be redeployed in equities over time. Barring any new upheaval, equity returns should continue to exceed cash and fixed income returns between now and year-end.

In the U.S. most economists are forecasting the end of the recession by year-end. During the first quarter the economy shrunk at a 5.5% annual rate and at a 2.0% rate in the second quarter.

Although the June unemployment numbers were worse than expected, June business activity surprised on the upside. The Conference Board’s index of leading economic indicators, the best predictor of economic recovery, rose in April and May after being down nine of the previous ten months. The pattern of interest rates as represented by the yield curve has normalized and the savings rate has jumped to 6.9% - the highest level since December 1993. Consumer confidence improved in both May and June and the housing numbers point to a lower pace of decline. We are tentatively projecting U.S. economic growth at 1.2% for the second half of 2009 and 1.6% in 2010. In such an environment earnings could increase by 15.0% in 2010 resulting in a forward price earnings ratio of 12.5 X.

The Paris-based Organization for Economic Cooperation and Development (OECD) indicated that the Eurozone's economy, which grew 0.7% in 2008, would contract 4.8% in 2009 and stagnate in 2010. Despite Germany's reluctance to see interest rates below 2.0% we feel that Mr. Trichet's European Central Bank (ECB) will keep rates at or below 1.0% for the next 18 months particularly given the CPI level below 1.0% and a projected unemployment rate of 11.5% in 2010.

In an effort to revive the housing market and indirectly the broader economy, the ECB has committed to 60 billion euro to purchase covered bonds, which are used by banks to fund mortgages.

“Green shoots” in the Euro area would include a steady rise in German business confidence and a slowing contraction of the services and manufacturing industries. Overall, we do not expect a meaningful economic recovery before the second half of 2010, yet we continue to favor European large cap quality companies – excluding the banks, which remain among the cheapest in the world.

In Japan, Prime Minister Taro Aso's \$261 billion stimulus spending helped the economy grow at a 2.3% annual rate for the quarter ending June 30th. This was quite a recovery from the previous quarter's 14.2% contraction.

Unfortunately, Japan's recovery is expected to fade rapidly. Japan's latest quarterly Tankan Survey indicates that companies faced with excess capacity are planning to cut capital spending by 9.4%. Toyota Motor, Japan's biggest company, plans to reduce capital spending by 36.0%. Demand from China is not compensating weaker sales from Europe and the U.S.

Economists expect the unemployment rate to rise to 5.8% in 2010 – up from the current 5.2%. The OECD predicts that Japan's public debt, already the world's largest, will reach 197.0% of GDP next year. Given the current environment, we feel that deflation may worsen and become again a major negative for Japan. We remain underweighted in Japanese equities.