Market Comments

September 1, 2008

August marked the third consecutive negative month for global equity markets in U.S. dollar terms. The MSCI World Index fell 1.4% during the month, which left it down 14.0% for the year. Emerging market equities suffered even greater declines in August, with the MSCI Emerging Markets Index posting a loss of 8.0% in U.S. dollar terms. That brought the year-to-date return for emerging markets to a dismal -21.9%.

Recent economic data has shown declining GDP growth in the second quarter for Europe and Japan, in contrast to stronger-than-expected second quarter growth of 3.3% for the U.S. The sharp contrast in economic data between the U.S. and other major industrial economies triggered a strong rally in the U.S. dollar in recent weeks, particularly against the euro and the British pound. Indications that recessionary forces had become global in nature also helped push commodity prices down sharply, with the CRB raw industrials commodity price index down by 6% in August and down by 15% since the end of June. The price of oil also declined sharply, with WTI crude falling to $115 a barrel by the end of August from a mid-July high of $147 a barrel. Weaker commodity prices have raised questions about the durability of economic booms in many emerging market nations which are highly dependent on commodity prices and on the strength of end markets in the developed economies.

The good news is that global inflation may well have peaked in July along with the peak in oil and other commodity prices. With unit labor cost growth in the major industrial nations running at generally subdued rates of 1%-to-2%, headline inflation rates in those nations should begin to decline rapidly. That could potentially reverse some of the equity-market multiple contractions that were triggered earlier in this year by the sharp rise in inflation spurred by the commodity price boom. A key swing factor is likely to be the tempo of the post-Olympics Chinese economy, which we suspect will slow based on a sharp slowdown in export growth and the lagged impact of tighter monetary policy. Although Chinese policymakers have ample resources to support growth, policy actions seem most likely to mute the degree of the slowdown rather than prevent it from developing. With the global credit crunch still acting as a drag on growth in the major industrial nations, the bottom line is that the world economy in the second half of 2008 is likely to experience the slowest growth since 2003. But with the inflation monster apparently having been tamed for now, the stage may be set for more normalized global growth in 2009. To be sure, unsettled credit markets remain an important wild card, with credit default swaps still suggesting the potential for further credit shocks ahead from troubled industries like airlines, auto manufacturing, or home building.

In our diversified global equity portfolios, we currently have approximately 48% exposure to North America, 27% to Europe, 12% to Japan, 7% to the emerging markets, and 6% to the developed markets of Asia-Pacific excluding Japan. In terms of sector exposures, we currently are tilted toward the information technology, consumer discretionary, and health care sectors and away from the industrial, financial, consumer staples, telecommunication services, and energy sectors.