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Market Comments

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Global equity markets experienced a sharp correction in the second quarter as safe-haven assets like gold and U.S. Treasury bonds posted solid gains. After posting a modestly positive return in the first quarter of 2010, the MSCI World Index slipped by 12.7% in the second quarter as Europe's sovereign debt crisis intensified while concerns also mounted about the sustainability of China's economic boom. The second quarter selloff leaves the World Index down 9.8% for the year to date.

Ironically, the market jitters have come at a time when economic reports and corporate news flow have generally supported the case that a self-sustaining global economic recovery is now underway. According to the most recent forecast by the International Monetary Fund (IMF), the world economy is expected to post real growth of nearly 4% in both 2010 and 2011, with emerging market economies likely to contribute a disproportionate share of growth as the developed nations struggle with painful after-effects of the global financial crisis of 2007-2008. But risks that the recovery will lose traction have clearly risen as a result of a deterioration of financial conditions in recent weeks.

Risk aversion came to the fore in the second quarter as worries about a potential sovereign default by Greece prompted flight from sovereign debt risk in Spain, Portugal, Ireland and Italy. Those fears also prompted investors to sell the euro aggressively against the U.S. dollar while punishing the shares of European financial institutions believed to be most exposed to potential losses on European sovereign debt. The European crisis has also triggered the adoption of austerity measures throughout Europe and the U.K. which are widely expected to dampen growth for years to come. Even the "shock and awe" European stabilization package of nearly \$1 trillion announced in early May has so far failed to restore confidence as many market participants may believe that a painful process of sovereign debt restructuring in Europe is now unavoidable.

Europe's crisis has also coincided with increased concerns that economic growth in China is slowing. After sharply boosting its economy in 2009, China's authorities have announced a host of measures in 2010 aimed at curbing real estate speculation and have set the stage for interest rate hikes by abandoning the fixed currency link to the U.S. dollar. Likewise, liquidity conditions have also begun to tighten in other leading emerging market nations like India and Brazil as monetary authorities have hiked interest rates to curb inflation pressures.

Given the enormous stakes, we continue to believe that European policymakers will do whatever is needed to work toward an orderly resolution of Europe's sovereign debt problems and avoid a "Lehman 2.0" shock to the global economy. That said, financial conditions have deteriorated so much in recent weeks that businesses may delay hiring plans and capital spending plans enough to considerably dampen global growth over the next several quarters. With little flexibility anywhere for additional fiscal stimulus, the onus will be on monetary policymakers in the developed nations to support the recovery through extended periods of low interest rates and, possibly, through coordinated quantitative easing later this year.

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