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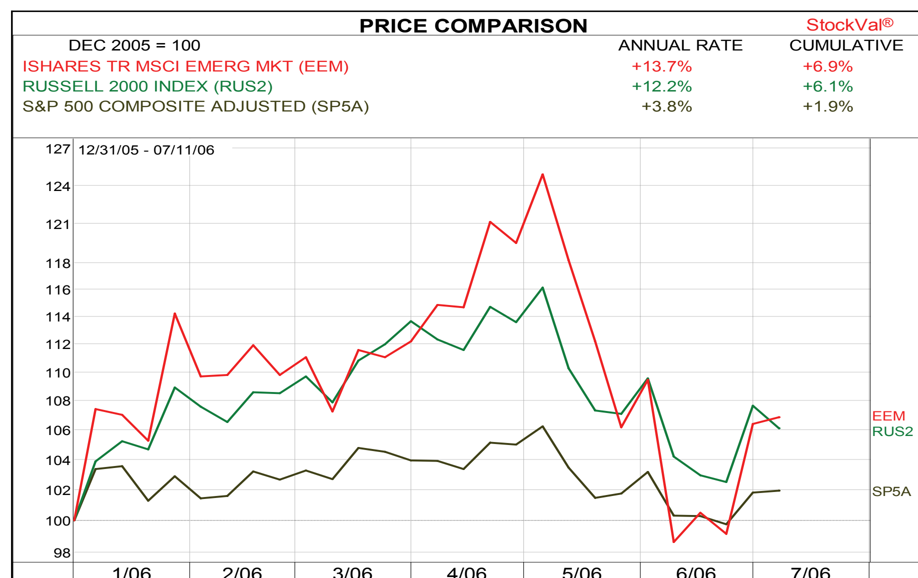
WEALTH ✦ FIDUCIARY ✦ INVESTMENT

Market Commentary June 2006

The equity markets staged an impressive correction in May and June. While the S&P 500 ended the quarter with a modest loss of -1.4%, a rally during the closing days of June masks the full breadth of the sell off. From its peak on May 9 to the trough on June 14, the S&P 500 declined 8.0%. Higher quality stocks held up better in the decline, but not enough to offset their underperformance in the first quarter. The declines were more pronounced in riskier areas of the equity market, notably small cap and emerging market issues. Over the same May 9 to June 14 time period the Russell 2000 returned -14.4% and the MSCI Emerging Market index returned -26.9%. However the returns for the quarter were a more sedate -5.0% for the Russell 2000 and -4.27% for the MSCI Emerging Markets index. Both indexes remain positive year to date with an 8.2% return for small cap stocks and a 7.3% return for the emerging markets. Spurred by concerns of inflation and possible Federal Reserve over-tightening, the ten year Treasury yield moved higher, reaching 5.3% at its peak. May core inflation data showed a 0.3% increase that brought the three month annualized rate to 3.8%.



Our view is that although the sell off was perhaps triggered by uncertainty over the direction of the Federal Reserve, it fundamentally was the result of investors rebalancing and reducing their risk exposures. While the market rallied sharply in the closing days of the quarter, signs of weakness in the economy may presage a broader slowdown. Recent economic data has indicated continued slowing in the housing sector. An analysis by Asha Bangalore of Northern Trust reveals that the real estate boom is responsible for as much as 43% of the employment growth since 2001. Michael Drury, the economist for McVean Investments further points out that mid cycle declines in construction employment have in the past been offset by new hiring in capital goods manufacturing. However, as he points out: "In the more integrated global economy, the capital good worker gaining a job is more likely to be outside the US while the construction worker losing a job is more likely to be inside the US". He goes on to point out that the foreign capital goods worker likely makes a lower wage, which leads to greater profitability in the short run but imposes a major drag on consumer spending, which hastens a faster end to the capital spending cycle than the history of past cycles would suggest.

While the emerging markets were the quarter's largest negative performer, they have been one of the best performing asset classes in recent years. The MSCI Emerging Market index over the past three years has returned 34.8% annually, which compounds to a cumulative return of 145%. Despite this performance, the P/E ratio of the MSCI Emerging Market index is around 10 on a forward basis, compared to 14.3 for the S&P 500. On an earnings yield basis (E/P rather than P/E) this translates to a 10% "yield" for the emerging markets compared to 7% for the S&P 500. With this 3% annual earnings yield advantage plus potentially higher earnings growth it is not difficult to see why these markets have

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become so popular with investors.

While South Korea and South Africa are the two largest countries in the MSCI Emerging Markets index, at 17.4% and 12.4%, respectively, it is the BRIC countries – Brazil, Russia, India & China, which are attracting the most investment attention. The source of the acronym stems from a Goldman Sachs report issued in 2003 that projects that by 2025 the combined BRIC economies could be half as big as the G6 (Italy, France, Germany, Japan, UK, USA) and by 2040 they would catch up and exceed the combined G6 economies. While the total GDP of the four BRIC countries may eventually be larger than the developed world, per capita income will remain substantially below that of the West and Japan. This will present opportunities and challenges for businesses and force investors to rethink their investment paradigms.

These four countries form a natural economic bloc where China's manufacturing ability is combined with India's strengths in the service sector and Russia and Brazil supply the natural resources necessary for continued expansion. The leaders of the BRIC countries have recognized this and are beginning to work closely together. For example, Russia and China are cooperating on defense issues. Russian natural gas giant Gazprom is building LNG plants in Brazil while Brazil has struck a deal with India for preferential tariffs for selling its sugar, biofuel and oil to the Subcontinent. As everyone is well aware, the growth of the BRIC economies has created intense competition for natural resources, boosting commodity prices to record levels. This century will likely see continued tension as the BRIC countries grow in power and wealth.

Of course the BRIC nations have many problems that may prevent them from reaching these projections. China faces a corrupt, inefficient banking system that serves as a patronage system for the ruling Communist party. So far the party has managed to keep political tensions in check with a growing economy, but it is uncertain how the system would survive a prolonged downturn. Russia faces a declining, aging population and an increasingly autocratic government. Brazil and India have large impoverished and undereducated populations that have not benefited from recent growth and have a history of voting for populist economic programs. Finally, the quality of the legal and ethical business environment for minority shareholders is well below that of the US and Western Europe. The economic linkage of these markets with the developed world ensures a high level of correlation with the US and other large Western economies.

Investors in the US have embraced global investing over the past few years. Many are invested in emerging markets for the first time. How they will react to a severe economic downturn in these markets such as the 1997-1998 period remains to be seen. While the emerging markets and the BRIC countries in particular offer an opportunity for long term macroeconomic growth unlike anything likely to be found in the West, it is a certainty that there will be substantial volatility along the way. Factor political and event risk into the equation and it should be clear that emerging markets should have a limited, subordinate role in equity portfolios. Investors should remain diversified and focused on quality investment opportunities. Many large cap, blue chip US companies stand to benefit from the economic growth outside the developed world. As always, it pays to be skeptical of widely believed investment stories and to look for under followed angles to play them.

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