

ECONOMIC OVERVIEW SECOND QUARTER 2008

Real Growth

- Significant export growth and stronger than expected fixed investment demand have caused U.S. GDP growth to positively surprise.
- The U.S. economy performed better than expected in the first half of the year, but available evidence suggests that the rest of 2008 may bring a W-shaped downturn.
- The U.S. economy is suffering from an implosion of the financial system triggered by a teetering housing sector and record prices for oil and other commodities brought on mainly by external conditions.
- We expect slightly positive real GDP growth in the second and third quarters of 2008 followed by two quarters of negative real GDP growth, which are largely the result of high heating costs, inflated energy prices, reduced credit creation and lower export growth.
- We expect the monthly increase in retail sales to decline at a rate of half a percent per month starting in July and to turn negative by the fourth quarter. Retail sales were artificially elevated by the one-time tax rebate.
- We anticipate that oil and other commodity prices will continue to decline but much of the benefit from this reduction will be offset by higher than expected asset write-offs in the banking sector and substantially reduced lending capacity. There is an inverse relationship between the price of oil and consumer confidence.
- A recent bill passed by Congress will enable the prime mortgage market to continue to function by giving the U.S. Treasury the power to inject capital into the two government sponsored agencies (Fannie and Freddie) that purchase prime mortgages from banks. It will also help the housing sector by giving servicers more ability to negotiate existing Alt-A and subprime mortgages.
- After bottoming in the first quarter of 2009, real GDP should increase for the remainder of next year at an accelerating rate, as declines in residential housing investment finally diminish.

Inflation

- The year-over-year CPI inflation rate should increase from an estimated 2.7% rate in 2007 to 4.6% in 2008. This rise will be principally due to higher food and energy costs and higher import prices associated with the expected appreciation of Asian currencies and higher inflationary pressures within the Asian region.

- The sharply increasing marginal cost curve for oil makes oil prices very sensitive to demand changes. We expect global energy demand to fall due to pronounced weakening of economic growth in the OECD countries and to demand destruction as a result of a higher relative price of energy.
- For this reason and because of growing excess capacity, headline inflation in the U.S. should fall back to about 3.5% year over year in 2009.

Monetary Policy

- With a 25 basis point rate reduction in late April, there has been a cumulative 325 basis point cut in six and a half months. This cumulative cut within such a short period of time is more aggressive than in any beginning stage easing period under Chairman Greenspan, including that in 2001.
- The trough in the Fed Funds rate should be the current 2% level, which represents a significantly negative real rate of interest.
- The markets have recently gotten two different renditions of official views and their implications for near term monetary policy. There have been cautions raised in the FOMC meetings and in statements by at least one Federal Reserve Bank President about rising inflation and inflationary expectations due to sharp commodity price increases. However, commodity prices seem to be in the process of reversing and, despite the rhetoric, most Fed officials will have a tough time raising rates during the remainder of the year given rising unemployment, a highly strained financial sector, and an unprecedented decline in nominal home prices.
- Central bank easing is being offset by financial tightening as financial institutions delever their balance sheets.
- We do not expect a significant increase in the Fed Funds rate from current levels until the second half of 2009.

Long-Term Rates

- Treasury issuance has emerged as an important factor in the recent sell-off in the Treasury market and the recently announced bailout of Fannie Mae and Freddie Mac. Treasury issuance could increase if F&F decides to drawdown on the “increased Treasury credit line” and prime mortgage defaults increase as expected.
- The fair value for ten-year U.S. Treasury yields is around 4.5% to 5% (as compared with the current level of 4.11%). Currently, we believe that the stock market tumbles, together with panic in the banking system, will keep yields below this range despite concern about the F&F bailout and high headline inflation.
- Although we do not expect the ten-year Treasury yield to exceed 5% this year, a yield substantially above 5% is quite likely in the second half of 2009 if, as expected, the economy strengthens.

Exchange Rate Outlook

- The dollar fell substantially more against the euro than we expected in the second quarter. Our base case scenario calls for some further weakness of the dollar against the euro, largely because of a less than expected decline in European growth. However, we do not expect this weakness to last into 2009.
- We continue to believe that the U.S. dollar is undervalued against the major developed market currencies and should perform better over the longer term. In contrast to our previous overviews, we now expect some of the Asian ex-Japan and Latin American currencies to weaken against the dollar in the second half of 2008. This is because of the very high inflation rates in these regions. However, we expect an appreciating trend for the CNY to persist, as Chinese inflation declines.

Corporate Sector Profits

- We expect after-tax economic profits of U.S. companies to fall by 5% in 2008 and 3.1% in 2009, as compared with a 2.6% increase in 2007 on a year-over-year basis.
- After-tax book profits should decline by 11.1% in 2008 and increase by 3.9% in 2009, as compared with a 4.3% year-over-year increase in 2007.
- We anticipate that S&P 500 earnings per share should decline by about 16% year over year in the first half of 2008, but should be flat to slightly down in the second half of the year as a result of relatively easy comparisons and the continuation of relatively strong non-U.S. earnings.

Forecast Risks

- We are anticipating that oil prices will decline from current levels of about \$125 per barrel to about \$100 per barrel by the end of this year. However, if there is a supply shock and oil prices end the year at \$175 per share, headline CPI inflation in the U.S. will be two percentage points higher than we are projecting on a year-over-year basis by the end of the year. This would substantially postpone the recovery we anticipate in the last three quarters of 2009 and result in the Fed having to raise the target rate of interest much earlier than expected.
- If ongoing deleveraging of the U.S. economy and a fall in household asset values sharply weakens U.S. consumption, the economy might go into deep recession. U.S. fiscal deficits would then rise substantially and U.S. long-term interest rates might jump. The ratio of consumer debt to GDP falls substantially during periods of real estate recession and diminished lending capacity, such as the early 1990s (S&L crisis). The decline could be much greater this time.
- We are projecting that the U.S. economy will begin a significant recovery in 2009. However, if this does not occur, there could be a flight from the dollar in dollar bonds.

- We anticipate further monetary tightening in non-Japan Asia to reduce growth and control inflation in this region and bring commodity price inflation under control. This may not occur and domestic demand recovery in the U.S. may be slower than we expect, whereas U.S. export growth may be higher.

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