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As we look back on a tumultuous first half of the year, we are struck by the degree to which conflicting signals characterize the investment and economic environment. After a horrendous 2008 and a dismal first quarter in 2009, the second quarter saw robust gains – stocks in fact had their best quarter in more than 10 years.

**The Market and the Economy – Uncertainty Reigns**

The conflicting signals on the economy include several positives that helped drive the market's rebound from its March low. The prospect of a meltdown of the financial system appears past; the government has demonstrated it will do whatever is necessary to avoid a disaster of this scale. And though economic activity continues to worsen, it is doing so at a slower rate, which suggests that we are getting closer to an economic bottom. However, the global economy remains in a fragile state as the effects of massive wealth destruction and the unwinding of the huge debt bubble continues to play out. The ultimate result will likely be lower spending by both consumers and businesses in the years ahead, as the economy in effect resets to the level where it might have been without the artificial boost of the credit bubble. While it probably allowed us to avoid a depression, the massive bailout and stimulus spending (along with longer-term demographic factors such as spiraling health-care and other entitlement spending) is causing the federal deficit to balloon, which could lead to dollar weakness and inflation down the road.

***Index Returns*** *Through 06/30/2009*

| | | | *Annualized Returns* | | |
|---|---|---|---|---|---|
| **Index** | **Quarter-To-Date** | **YTD** | **1-Year** | **3-Year** | **5-Year** |
| S&P 500 | 15.93% | 3.16% | -26.21% | -8.22% | -2.24% |
| Russell 1000 | 16.50% | 4.32% | -26.69% | -8.20% | -1.85% |
| Russell 2000 | 20.69% | 2.64% | -25.01% | -9.89% | -1.71% |
| MSCI EAFE | 25.43% | 7.95% | -31.35% | -7.98% | 2.31% |
| Barclay Capital US Aggregate Bond | 1.78% | 1.90% | 6.05% | 6.43% | 5.02% |
| Barclay Capital Municipals | 2.11% | 6.42% | 3.77% | 3.90% | 4.14% |
| Dow Jones AIG Commodity | 11.67% | 4.62% | -47.08% | -8.30% | -0.23% |
| CSFB/Tremont Hedge Fund | 6.27% | 7.18% | -13.71% | 1.51% | 5.17% |

Other conflicts are at play that will influence how the environment unfolds in the years ahead. One of these is housing, which started the cycle of damage we are now in. There have recently been a few positive signs including stronger demand and historically high levels of affordability. But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle. (There is more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments, and high unemployment will make things worse.)

Another question is whether we should be worried about inflation or deflation. At present, there is an enormous amount of excess manufacturing capacity and available labor so it is unlikely there will be higher costs to pass along. Demand-driven inflation also is unlikely.

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Over the intermediate-term there is even some concern that deflation could take hold if the global economy doesn't experience a sustained rebound. However, looking out a few years, the bigger risk is that policy makers' efforts to avoid a deflationary cycle are too successful and trigger a run up in the inflation rate to modestly high levels or worse.

That brings us to another issue, which is the tightrope that policy makers have to walk with respect to stimulus. We believe that in aggregate, government intervention mitigated the economic recession, but have we dodged the only bullet? Given the actions to date, the Fed and the Treasury are clearly committed to doing whatever it takes to help the economy find a floor so that it can grow again. On the other hand, if there are no more bullets to dodge, it will be difficult to know when the timing is right to unwind the stimulus. If it is unwound too early the economy could relapse (as happened in the U.S. in the 1930s and Japan in the 1990s) and if it is extended too long it will add to budgetary woes. In any event, there will be great political pressure to deal with on both sides of the issue.

Investment returns will also be influenced by investors' willingness to take on risk, which tends to build during bull markets and break down in bear markets. The degree of investor risk aversion is an unknown that will impact returns in the years ahead. Our working assumption is that it is more likely than not that higher-than-normal risk aversion will subside very gradually and that stock P/E multiples will remain average or below average for some time.

Fortunately, as we invest for our clients we are not limited to just what the markets give us, and this is a source of optimism for us. Because this is an environment in which many securities have traded at prices below what their fundamentals suggest they are worth, our managers have made investment selections that added a lot of value over their market benchmarks. While some of the lowest-hanging fruit may have been taken, pricing disconnects remain that we think could continue to give our managers a tailwind in the years to come. Importantly, this includes our bond managers, who are also using their flexibility to take advantage of undervalued areas of the bond market when they consider the long-term opportunity to be sufficiently compelling.

Pricing disconnects exist at the asset class level as well, though they are not as compelling as what we saw a number of months ago. We have already enjoyed strong returns from our tactical position in bonds and expect this will continue to add value. We also continue to consider additional tactical portfolio allocations in emerging markets, Treasury Inflation-Protected securities, small cap stocks, and commodities.

Looking ahead, we believe that prudence is called for given the high level of uncertainty in the economy and financial markets, but that good investment opportunities do exist. We will continue to work hard to identify and take advantage of these opportunities.

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