Global Equity Markets — S&P Downgrade in Perspective

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The global equity markets have shown resilience during the year, however, in the wake of two momentous debates on the financial future of peripheral European countries and of the U.S, we have witnessed a crisis of confidence unfold. Despite the anxiety in the markets, we strongly believe this increase in downward volatility does not portend a repeat of 2008. The calamity in 2008 was driven by a full-blown banking crisis with the potential to suffocate the global economy as liquidity dried up. Although S&P's downgrade of U.S. debt is disappointing, it was not unexpected and we do not expect a material decrease in global liquidity. We are quite certain investors will not relive the negative experience of large financial firm bankruptcies as occurred in 2008. The U.S. downgrade will, however, have a negative psychological impact and bring the potential for lower consumer spending and continued slow job creation. We will continue to monitor talks coming out of Washington as policy makers look to reduce federal spending. For now, all eyes will be on the FOMC, which meets today. We would not be surprised to hear plans for increased liquidity creation.

Overall, we are not making any dramatic changes across our equity portfolios. We continue to focus on identifying solid companies across the global marketplace trading at attractive prices. Companies in general, have plenty of cash on their balance sheets. Banks, with the exception of select European banks, are well capitalized and are in a far stronger position than in 2008. Earnings for the most recent quarter were well above expectations and we believe, well positioned to handle a slowdown in global growth. In fact, with nearly 90% of S&P 500 companies having reported earnings for Q2'11, revenues and profits exceeded expectations for the 10th consecutive quarter. While evidence clearly indicates a slowing global economy, we do expect earnings estimates to decline moderately. Offsetting that however, are highly compelling valuations. We are already seeing signs of a flight to quality, with investors gravitating to larger companies with strong and highly liquid balance sheets. Given this, we expect larger capitalization, higher-quality companies will perform relatively well over the short term.

Depending on your viewpoint, there may be a silver lining in these recent events. With the U.S. slowdown and the settling of global activity, energy prices have declined markedly. In particular, oil (West Texas Crude) has come down from nearly $115 per barrel in April 2011 to $81 per barrel today. In some ways, this drop in energy costs may be viewed as a "tax cut" and will eventually put more cash in consumer's pockets through lower gas prices at the pump. Also, lower commodity prices will enable companies to lower input costs and support profit margins.

Globally, fiscal austerity is real as both the U.S. and Europe seek to lower their debt burdens. The outgrowth of lower government spending will likely lead to both slower growth and lower inflationary pressures. This latter impact should ease concerns of the central banks, particularly in emerging markets, which will then be less likely to implement further monetary tightening. This would be another positive outcome for company profits. As long-term investors, we seek to invest in companies with sustainable competitive advantages. We are confident the market will recognize the value in these stocks as fear and volatility decline. In the meantime, we will take advantage of volatility to add to high-conviction names where we believe valuations are compelling and the risk-reward is strongly in our favor.

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