

Markets



Rising Global Tide

DESPITE INCREASED VOLATILITY,

stock markets ended an often scary October in the positive. The Dow eked out a 0.4% gain and the broader S&P 500 Index gained 1.6%.

Nasdaq climbed 5.8%. Besides natural resources, technology has been the strongest domestic sector this year. With two months left in 2007, Nasdaq may post its best annual gain of the decade; it's up over 18% through October. This compares to a 10.8% ten-month gain in the large-cap S&P 500 Index and a 5.1% gain in the small-cap Russell 2000 Index.

While large-caps continued to outperform small, growth continued to outperform value. As expected, the financial sector suffered most from the credit-market turmoil. After years of excess leverage prompted by low interest rates and irresponsible lending practices, it's no surprise that the chickens have come home to roost.

The combination of the Fed's rate cut and strong economic news encouraged investors who otherwise are constantly barraged by the media selling fear and gloom. While the housing recession and high energy price environment provide good ammunition for the fear mongers in the press, the U.S. economy expanded faster than expected in the third quarter, led by export sales. A surprisingly strong jobs report and an unexpected rise in factory orders provide further evidence of growth.

Indeed, the big story is strong global growth, especially in emerging markets. Global economic growth is a powerful force and gains from continued expansion of global trade and free flow of capital will be tremendous.

A tendency to let fear foster isolation is a real danger. While most of the world is embracing globalization, we are hearing some rhetoric about protectionism in the U.S. We hope that as fears give way to the realization that global free trade is in everyone's best interest, the U.S. will continue to take a proactive leadership role in this process as we have done so successfully in the past.

A market environment of strong global growth favors energy and natural resources, industrial and building materials and technology. Large companies are more likely to benefit from global opportunities and they are also better able to withstand challenges in the credit markets.

The dollar has continued to slide, hitting yet another low against the euro, as lower interest rates make it less remunerative to hold dollars.

Outside the U.S., stocks continued strong. The EAFE index gained 4.3% in October bringing 2007 gains to nearly 18%. International funds continue to dominate the top ranks in all classes. During the 1990s, the U.S. stock market was the hot place to be, but over the last five years, the average international fund has outpaced the returns of domestic equity offerings by almost 10 percentage points. Returns from funds focused in Latin America, China, India and other parts of Asia have been particularly high.

The world's market capitalization is rapidly shifting outside the U.S. As recently as 1970 the U.S. owned 67% of the world's market cap. A decade ago it was down to just 44%. Today the U.S. is about 40%. Yes, we're growing, but the rest of the world is growing faster.

Market leadership changes because economic conditions, sentiment, and associated fundamentals change. The Upgrading strategy works because we gradually move toward market leadership as it develops.

With Upgrading, we don't need to predict which funds will be the next leaders: all we have to do is stay flexible and move to those performing best.

Thank you for your business,

P. Michael Valley II

HAPPY THANKSGIVING!



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