

Capital Markets Outlook

U.S. STOCK MARKET OUTLOOK

Readers of previous issues know that we are fond of two particular pictures of the U.S. stock market. One picture is a chart of corporate profits as a percent of national income and GDP (figure CM0.1). The other is a chart of earnings per share, stock prices, and P/E ratios (figure CM0.2). The first picture shows that pre-tax corporate profits are at or near the highest level they have been since 1929. The second picture shows that—at least for large-cap stocks—earnings growth has outpaced the recovery in stock prices since the 2002 trough. Thanks to the strong growth in corporate earnings, P/E ratios are reasonable. The price to forward earnings ratio for large-cap stocks is lower than it has been for most of the past twenty years. We take some comfort in the second picture, but are worried about the first.

Common sense tells us that when stock valuations are high, we should be wary of the potential for future declines and market value losses, which is nothing more than following the converse of the simple dictum “buy low, sell high.” But what counts as high? And how do we know that when prices are high, they won’t go higher?

Pu Shen, a senior economist at the Federal Reserve Bank of Kansas City, studied the correlation of the P/E ratio on the S&P 500 to subsequent price and earnings performance from 1872 to 2000.* Her study was in large part based on a study of the same subject done in 1998 by John Campbell and Robert Shiller. From 1872 to 2000, Shen found that the average P/E ratio (to trailing twelve-month earnings) was 14.5. Furthermore, she found a marked negative correlation between P/E ratios and stock market performance in the following ten years. Although the correlation was not a precise one, it showed that when the P/E ratio was above 20, stocks were nearly as likely to lose market value over the following ten years as to gain in value. If stocks did gain in value, however, in no case was the average annual gain more than 5% over the following ten years. Her study showed no significant correlation between the market P/E ratio and subsequent average earnings growth. In other words, when stock valuations are high, they revert to average not by an increase in earnings but by a decline in prices.

The S&P 500 was trading at a P/E ratio of 17.8 (to trailing twelve-month earnings) when this article was written in early June. Although this ratio is above the long-term average of 14.5, it is low for the past twenty years. The median P/E ratio since April 1986 is 20.2. The ratio has been below 18.0 only three times during this period: since September 2005, due to increases in corporate earnings; from the end of 1994 through 1995; and from October 1987 through June 1991. Although the current ratio is above the long-term average, it is not overvalued by recent standards.

We prefer the ratio of price-to-estimated or forward twelve-month earnings, since investors buy the future and not the past. As of early June, the S&P 500 was trading at 16.2 times estimated forward earnings, compared to a median P/E ratio of 17.8 to forward earnings since April 1986. Since the price-to-estimated earnings ratio is discounted approximately ten percent from the price-to-forward earnings ratio, as shown on figure CM0.2, the current valuation-to-estimated earnings is just over the median, 16.2 versus 16.0 (90% of 17.8).

PRE-TAX CORPORATE PROFITS, SHARE OF GDP & NATIONAL INCOME

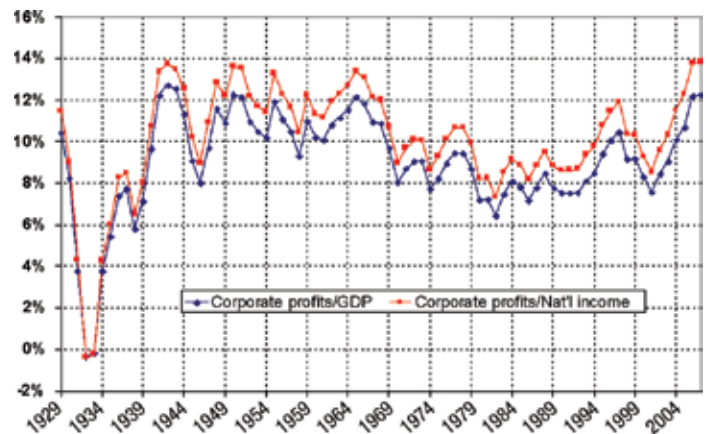


Figure CM0.1: Corporate Profits (Pre-tax) Share of GDP and National Income
Source: Bureau of Economic Analysis



According to Shen's study, when stock valuations have been high, they have reverted to average not by an increase in earnings but by a decline in prices.

*Pu Shen, "The P/E Ratio and Stock Market Performance." *Federal Reserve Bank of Kansas City Economic Review*, Fourth Quarter 2000. Also available online at www.kcfrb.org.

S&P 500 LARGE-CAP INDEX: PRICE, EARNINGS & P/E RATIOS

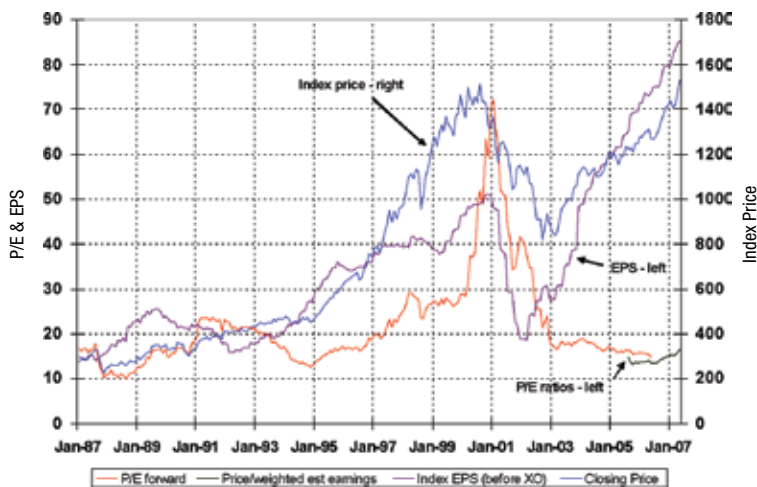


Figure CMO.2A: S&P 500 Large-cap Index: Price, Earnings & P/E Ratios
Source: Bloomberg and *Advisor* calculations

S&P 600 SMALL-CAP INDEX: PRICE, EARNINGS & P/E RATIOS

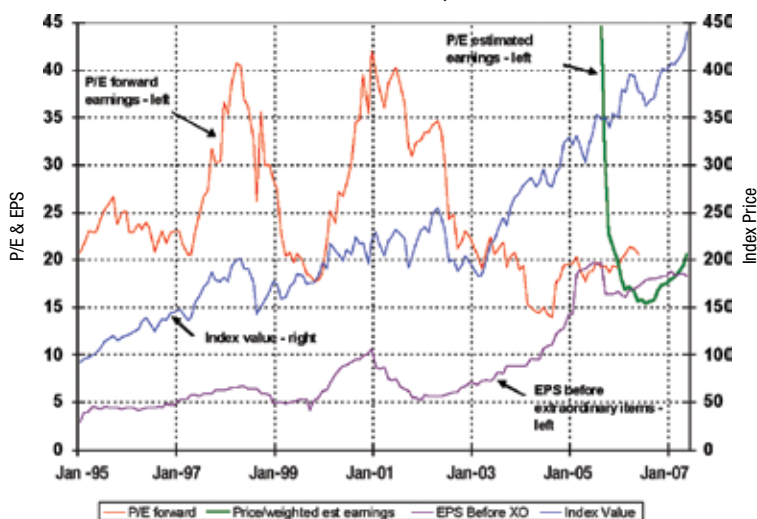


Figure CMO.2B: S&P 600 Small-cap Index: Price, Earnings & P/E Ratios
Source: Bloomberg and *Advisor* calculations

Price-to-earning ratios are not static, however, and vary over time as market conditions—especially interest rates—change. As interest rates increase, the opportunity cost of investing in stocks versus bonds increases and the value of the uncertain and residual cash flow from a stock drops. The reverse applies as rates decrease. All other things being the same, therefore, we should expect P/E ratios to be higher in low-rate environments and lower in high-rate environments.

We term a P/E ratio that is appropriate given the fundamental conditions of the market as the “warranted” P/E ratio. The Federal Reserve purportedly uses the inverse of the yield on 20+ year Treasury bonds as a proxy for the warranted P/E ratio. As of early June, with long-term Treasuries yielding approximately 5.25%, the warranted P/E ratio would have been 19.0—higher than both the P/E ratios to trailing twelve-month earnings and to estimated forward earnings.

Factors other than interest rates also impact the warranted P/E ratio. A variety of studies has shown that additional factors include inflation, GDP growth, earnings growth, growth in the money supply, dividend yield, the dividend payout ratio, recent stock market returns, and stock market volatility. Regression analyses done by C. Barry White on the S&P 500 P/E ratio from 1926 through 1997 arrived at a model that explained 88 percent of the variability in the P/E ratio over that time period in terms of the factors just mentioned in addition to the Treasury bond yield.† This model resulted in a warranted P/E ratio of between 13.8 and 15.0 on a trailing twelve-month basis with current economic and financial inputs. The current value of 17.8 is high compared to the warranted ratio. The two factors that were out of trend and depressed the warranted P/E ratio the most were inflation and recent stock market returns. Reducing the inflation rate (as measured by the change in the total CPI index for the most recent quarter) from 7.0% to 2.4% annualized, and increasing stock market returns from 2.6% to 10.0%, increased the warranted P/E ratio range to 14.8 to 15.7—still less than the current ratio.

After all of these comparisons, what conclusion do we draw about the current market valuation? We believe the market is reasonably valued today. Although current P/E ratios are above the long-term average and the warranted P/E ratio based on the multi-factor model, they are at or below median levels for the past twenty years and are below the warranted level based on current Treasury bond yields. What’s more, the multi-factor model may be understating the warranted P/E ratio because of a distortion in the data for the factor with the largest impact: the dividend payout ratio. Overall, White’s multi-factor model tells us that stocks are more highly valued when companies distribute a larger share of earnings to stockholders through dividends. The current dividend payout ratio of 32% is appreciably lower than the 40% ratio White observed in 2000. With a 40% payout ratio, the warranted P/E ratio today would be between 16.0 and 17.0. Combined with a normalized inflation rate, the warranted ratio would be between 17.2 and 18.4—right at the current level.

† C. Barry White, CFA, “What P/E Will the U.S. Stock Market Support?” *The Financial Analysts Journal* 56, no. 6 (November/December 2000): 30-38.

So why isn't the payout ratio higher? What are companies doing with their earnings? Should we be paying nearly 18 times trailing earnings or 16 times estimated earnings if our share of the earnings stream is less than 40%? The answers to these questions bring us back to our worries about our first picture of the stock market.

The share of national income attributable to pre-tax corporate earnings is at its highest level since 1929, the earliest time period tracked by the Bureau of Economic Analysis. This phenomenon is not unique to the United States. The same is happening in the UK and Europe. Figure CMO.1 shows the picture for the U.S. Investors would be right to worry about this picture. In the absence of a compelling explanation for why corporate earnings should comprise a larger share of national income than in the past, we should be concerned about a reversion to the mean—a reversion which would result in a marked slow-down in earnings growth or an actual decline. Casual commentators have speculated that returns to capital will comprise a larger portion of national income as productivity increases from capital investment reduce the relative weight of human capital inputs to production. To our knowledge, however, this is just speculation and has not been confirmed by analysis.

The picture becomes even more puzzling when one looks at projected earnings growth for U.S. stocks. Economists project aggregate corporate profit growth of between 6% and 7% for 2007 and between 5% and 6% for 2008, according to the economists participating in the most recent Livingston survey (June) or the Survey of Professional Forecasters (May), both conducted by the Federal Reserve Bank of Philadelphia. Stock analysts, by contrast, forecast much stronger earnings growth. Taking the median of the earnings projections for each of the constituent companies of the S&P 500 (nearly 8,000 analyst projections in total) and calculating a weighted average for the entire index results in projected earnings growth of 11.2% next year and 10.0% the following year. Similar calculations for the companies of the mid-cap and small-cap index result in even higher earnings growth estimates at 15.8% and 18.8%, respectively, for next year, and 11.9% and 20.0% for the following year.

But how can this be? How can corporate earnings continue to grow at a faster rate than the economy when corporate earnings already make up a larger share of national income than at any time in the last seventy-eight years? One answer is simple and has to do with the question we asked above about the dividend payout ratio.

Price-to-earning ratios are determined by per share earnings, not aggregate earnings. All other things being the same, a company can increase its stock value by increasing earnings per share. It can do this by increasing aggregate earnings or by reducing its share base or both. Earnings per share can grow more rapidly than the economy if the number of shares is decreasing, and this is exactly what is happening. Floyd Norris addressed this issue in his column in the *New York Times* on April 27, "Why Won't Companies Invest More?" As he reported, companies are not investing because they are using cash to buy back shares. Norris cites Howard Silverblatt, the senior index analyst at Standard & Poor's, who estimates that the combined payout of dividends and buybacks for companies in the S&P 500 is 5.3% of market capitalization, considerably higher than the current 1.75% dividend yield. In fact, in the most recently reported fiscal year, companies in the S&P 500 used more than \$490 billion of cash flow to decrease capital stock—an amount sufficient to retire approximately 3.5% of the outstanding shares in the index. Some share buybacks offset increases due to the exercise of stock options and other stock issuance, which in aggregate amounted to approximately 1.0% of the outstanding stock value. On a net basis, therefore, share buybacks by large-cap companies reduced outstanding stock by approximately 2.5%.

Not surprisingly, share buybacks are concentrated in larger companies. Among mid-cap companies in the S&P 400, cash flow allocated to decreases in capital stock amounted to approximately 2.5% of outstanding stock value for the most recently reported fiscal year and exceeded the cash from capital stock increases by only about 1.0%. For small-cap companies in the S&P 600, cash flow for capital stock decreases virtually balanced flows from increases.



U.S. NON-FINANCIAL CORPORATE PROFITABILITY

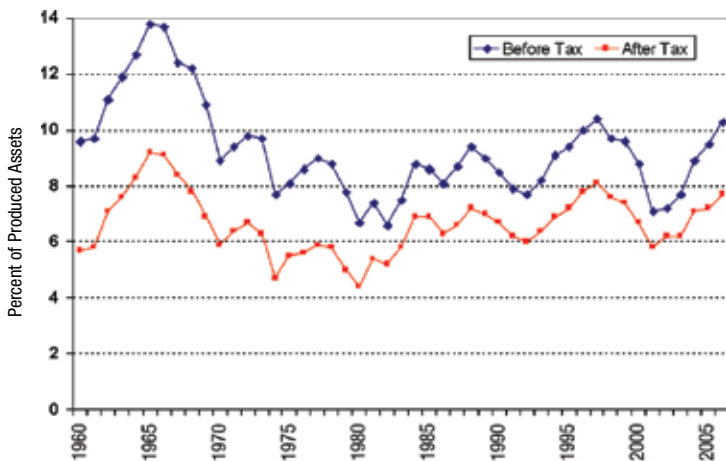


Figure CMO.3: U.S. Non-financial Corporate Profitability
Source: Bureau of Economic Analysis

U.S. TOTAL EXPORTS, ACTUAL AND PROJECTED DOLLAR VOLUME

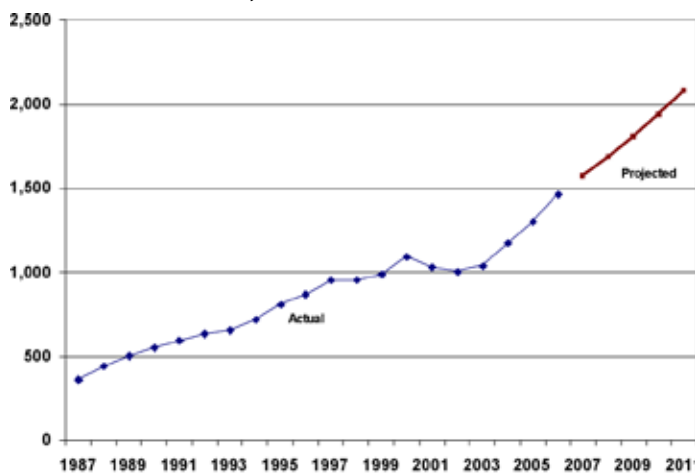


Figure CMO.4: U.S. Total Exports, Actual and Projected Dollar Volume
Source: Bureau of Economic Analysis and Advisor calculations

Share buyback plans amplify future earnings growth, but at a considerable cash expense. Although corporate balance sheets are strong right now and have sufficient cash to pay for continued buyback plans (the 411 non-financial companies in the S&P 500 index had an aggregate of \$522 billion in cash and cash equivalents at their most recent reporting date), it seems unlikely that share buybacks will continue at the recent pace. Accordingly, we have altered our projection of large-cap earnings growth to accommodate a 1.0% average annual reduction in the number of shares over the next three to five years.

Companies can also increase aggregate earnings in ways other than through growth, namely, through increases in profitability. Pricing power, resource costs reductions, and productivity improvements can all lead to improved earnings without growth. Opportunities to increase earnings through these channels, however, appear limited in our view. Non-financial corporate profitability has nearly returned to its 1997 peak level—the highest level of corporate profitability in nearly forty years (see figure CMO.3). In the face of global competition, companies have little pricing power. Labor and commodity costs are not likely to provide any opportunity for cost reduction. And productivity gains have been falling. We assume a modest 2% increase in productivity, shared equally between returns to capital and labor.

The impact of share buyback plans and productivity improvements aside, we continue to believe that long-term earnings growth projections by analysts are overly optimistic. In plain-speak, the pie is not growing rapidly enough for everyone to have as large a piece as analysts are projecting for each company. Although global growth and a declining dollar should increase export sales and shift some consumption to domestic production, we do not believe these effects will be strong enough to boost earnings growth to the ranges analysts are forecasting. Long-term earnings per share are projected to grow 11.3% for the S&P 500, 13.0% for mid-cap stocks (the S&P 400),

and 14.4% for small-cap stocks (the S&P 600), according to median analysts, projections as of early June. Compare these projections with economists' forecasts of between 4.5% and 5.5% annual growth for the overall economy and 5.4% to 6.7% for near-term annual growth in aggregate corporate earnings.

By our calculations, and assuming stable profit margins, export sales would have to increase over 19% per year to more than \$3.5 trillion by 2011 to boost earnings to the levels projected. Figure CMO.4 shows total exports in nominal dollars since 1987 and projections through 2011 at the average geometric growth rate of 7.3% from 2001 through 2006. At this growth rate, exports will expand by more than \$600 billion, but only reach \$2.1 trillion by 2011. At this rate, we expect export growth to add 1.4% per year to earnings on top of growth due to increases in domestic demand.

Our updated earnings growth and total return expectations for the U.S. stock market are indicated in the table in figure CMO.5. We expect EPS growth of 9.0% per year for large-cap stocks and 11.6% for small-cap stocks, with small-cap stocks benefiting from a higher base

U.S. STOCK MARKET TOTAL RETURN PROJECTIONS

	Large-cap Stocks (S&P 500)	Small-cap Stocks (S&P 600)
EPS growth per year		
Due to increases in domestic demand	5.4%	9.0%
Due to increases in productivity	1.0%	1.0%
Due to increases in exports	1.4%	1.4%
Due to share buybacks	1.0%	0
Total EPS growth per year	9.0%	11.6%
Current P/E (to estimated forward earnings)	16.0	19.9
Projected P/E	16.0	20.0
June 2011 Index	2,120	670
Price appreciation per year	9.0%	11.8%
Dividend return per year	1.8%	1.0%
Total return per year	10.9%	12.9%
Nominal GDP growth per year	5.4%	5.4%
U.S. Export growth per year	7.3%	7.3%

Figure CMO.5: Total Return Projections for U.S. Large- and Small-cap Stocks
Source: Advisor calculations

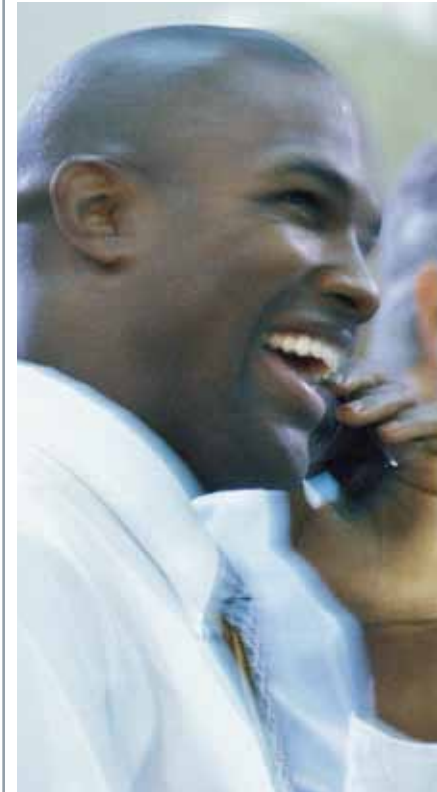
level of demand increase due to their typical location at an earlier stage in the growth cycle of company development. The higher risk associated with the relative immaturity of small companies is reflected in the higher P/E ratio applied to their earnings.

We have projected little or no change in future P/E ratios, which, in both cases, are below the medians for recent history. The table in figure CMO.6 reports valuation trends and comparisons with recent P/E medians. We resisted the temptation to project an increase in future earnings valuations. This temptation is strong as the U.S. economy appears to be shaking off the effects of reduced residential investment, and some commentators are beginning to talk about a long-term bull market in equities propelled by sustained global economic growth. As we argued last November, however, we see little reason for any of the fundamental determinants of stock valuation (earnings growth, dividend payouts, the real interest rate, expected inflation, and the equity risk premium) to drive P/E ratios to a sustained higher level. Although an enthusiastic market sentiment may push valuations higher temporarily, we do not expect valuations in three to five years to be above where they are today. The combination of projected earnings growth, valuations, and dividends results in projected total returns of 10.9% per year for large-cap stocks and 12.9% for small-cap stocks.

CURRENT VERSUS HISTORICAL PRICE/EARNINGS RATIOS
(Based on ratios to 12-month forward earnings, actual and/or estimated)

	Observed P/E Ratios			Median of Month-end Ratios	
	6/12/07	2/2/07	10/27/06	10 yr	20 yr
S&P 500 large-cap	16.0	15.9	15.8	23.2	17.8
S&P 400 mid-cap	18.7	18.5	17.6	20.2	n/a
S&P 600 small-cap	19.9	19.9	18.8	21.2	n/a

Figure CMO.6: Current versus Historical Price/Earnings Ratios
Source: Bloomberg and Advisor calculations



Earnings per share can grow more rapidly than the economy if the number of shares is decreasing, and this is exactly what has been happening.

TREASURY YIELD CURVES, MID-MAY VERSUS MID-JUNE

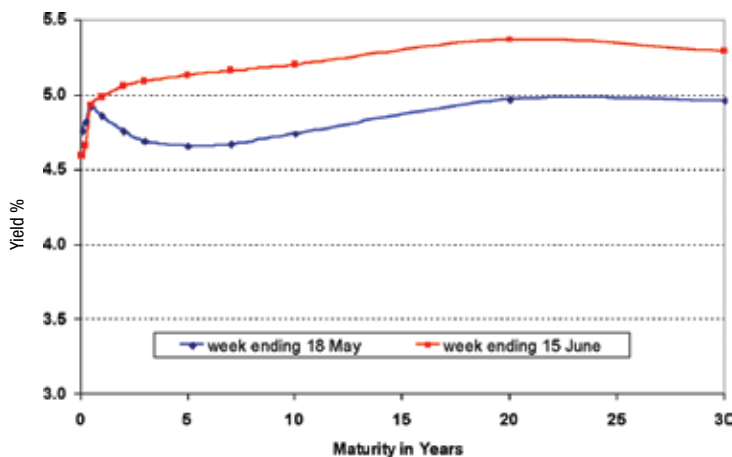


Figure CMO.7: Constant Maturity Treasury Yield Curves, Mid-May versus Mid-June
Source: Federal Reserve Board

TREASURY YIELD CURVES, MID-JUNE 2007 VERSUS SELECTED SINCE JUNE 2005

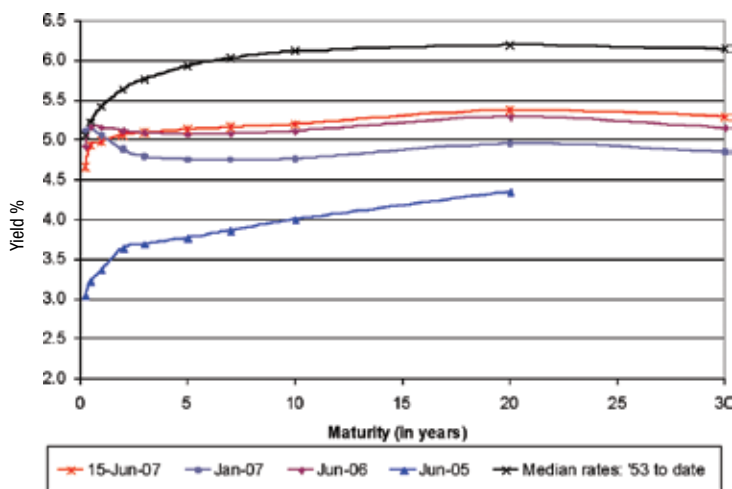


Figure CMO.8: Constant Maturity Treasury Yield Curves, Mid-June 2007 versus Selected Periods Since June 2005
Source: Federal Reserve Board

CURRENT AND FORWARD SPOT RATE CURVES

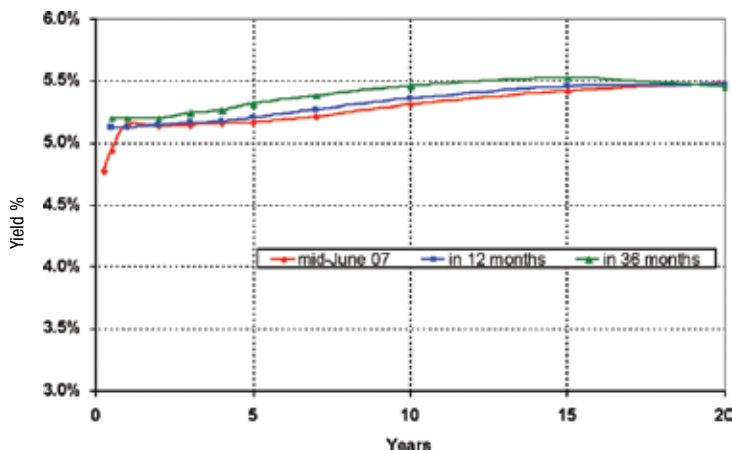


Figure CMO.9: Current and Forward Spot Rate Curves
Source: Advisor calculations

THE BOND MARKET

After remaining relatively unchanged since last October, Treasury bond prices and interest rates changed in late May in what appeared to be rather dramatic fashion. In a matter of three weeks, the yield curve went from the inverted slope, which had been characteristic of it for months, to being positively sloped. The difference between the ten-year Treasury and the three-month Treasury went from -0.12% in late May to +0.54 in mid-June. Figures CMO.7 and CMO.8 show how Treasury yields have changed in the short- and long-term, respectively.

The forward rates implied in the mid-June yield curve indicate that the market expects rates to increase modestly across the entire yield curve. Figure CMO.9 shows the mid-June spot Treasury rate curve and the implied curves in twelve and thirty-six months. The most notable change from the picture as recent as mid-May is that the short ends of the forward rate curves are above current levels. Rather than expecting a decline in the six-month rate to approximately 4.75% as market rates before late May implied, the market now expects an increase in the six-month rate to approximately 5.1% in twelve months and to 5.2% in thirty-six months. Forward long-term rates are higher by approximately 0.5%. The ten-year spot rate is projected to reach approximately 5.5% in three years.

The recent increase in rates is not due to concerns about inflation, contrary to some commentary. Inflation expectations are little changed since January. We can observe this directly from the market by the spread between the nominal yield on five-year Treasuries and the yield on five-year inflation-protected Treasuries (TIPS). When investors expect an increase in the inflation rate, this spread will increase. The spread at mid-June, however, was 2.40% compared to an average of 2.39% for the first five months of 2007. Figure CMO.10 shows the history of the market's inflation expectations since January of 2003.

As must be the case if rates have increased and inflation expectations have not, the real rate of interest has increased. We observe this directly from the rates on TIPS. From May to June, rates on TIPS increased to 2.75%, their highest level since January 2003 (as shown in figure CMO.11), and substantially in excess of the average and median levels for all maturities. Bond prices now reflect investors' expectations of a higher base level of "rent" for their capital. Since TIPS are a relatively new investment security, no long-term data is available to judge how current expectations compare with long-term historical expectations. Alternatively, we can look at the spread of the ten-year Treasury over the trailing twelve-month change in the CPI index. This spread has averaged 2.6% since 1953. Although this comparison is an imperfect one, since it uses historical results as a

proxy for future expectations, it indicates that at 2.75%, the real interest rate at mid-June was nearer to normalized levels than at any time over the past four years.

Although the real rate of interest has increased, credit spreads—the premiums over Treasury rates that borrowers other than Uncle Sam have to pay to compensate for their credit risk—remain low. The spread on AAA bonds at mid-June was 0.52% compared to the median spread of 0.62% since 1993. Non-investment grade bonds have enjoyed the same low credit spreads. The spread between the yield to maturity on a Merrill Lynch index of high-yield bonds and the twenty-year Treasury yield declined to 2.70% in May, the lowest level since September 1997, with the brief exception of November and December of 2004.

We are not concerned that high delinquencies on sub-prime mortgages will impact other asset-backed bond categories. There is no plausible reason for borrower behavior on sub-prime mortgages to impact other borrower behavior. Nor is there any economic reason for sub-prime delinquencies to cause hardship among other borrowers short of a broad-based economic downturn, which appears remote at present. The bond market is highly segmented, and investors have not changed their return expectations from other classes because of the problems in sub-prime mortgages, as evidenced by the fact that credit spreads on corporate and high-yield bonds continue to be below or well below average. Even in the mortgage market itself, spreads on agency-backed fixed-rate mortgages remain at the level they have been since the start of the year, approximately 1.1% over the ten-year Treasury rate.

Higher real and forward rates and concerns about downside versus up-side potential, however, have caused us to revise our three-to-five year expectations for all U.S. bond categories. The table in figure CMO.12 compares our current expectations with our prior ones.

BOND MARKET THREE-TO-FIVE YEAR EXPECTED RETURNS

Asset Class	Current Expectation	Prior Expectation
Treasury-bills	5.00%	4.8%
Intermediate-term Treasuries	5.15%	5.0%
Long-term Treasuries	5.25%	5.1%
TIPS (inflation-indexed)	5.10%	5.0%
Long-term corporate bonds	5.60%	5.9%
High-yield bonds	8.00%	8.8%
Mortgage-backed bonds	6.30%	6.1%
Inflation	2.50%	2.5%

Figure CMO.12: Bond Market Three-to-Five Year Expected Returns
Source: Advisor calculations

Three factors contributed to the changes in expectations: first, the increase in current interest rates beyond one year and the accompanying return to a positively sloped yield curve; second, increases in the forward rates implied by the changes to the current yield curve; and third, the use of multiple scenarios to determine a probability-weighted average return for each class. The first two factors are

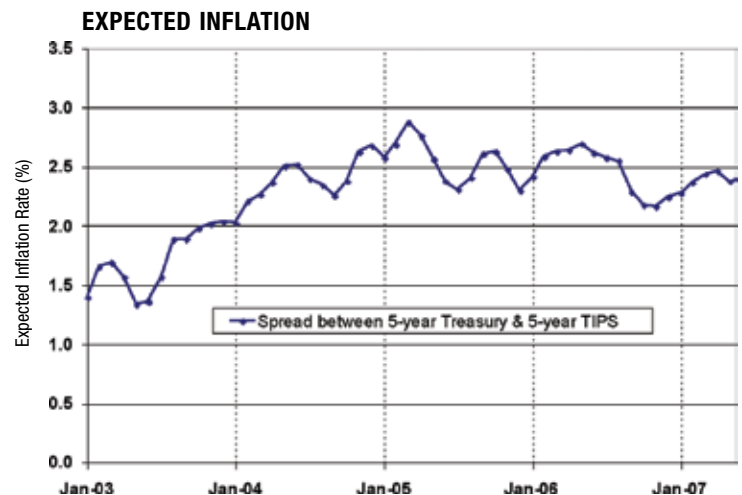


Figure CMO.10: Expected Inflation
Source: Federal Reserve Board and Advisor calculations

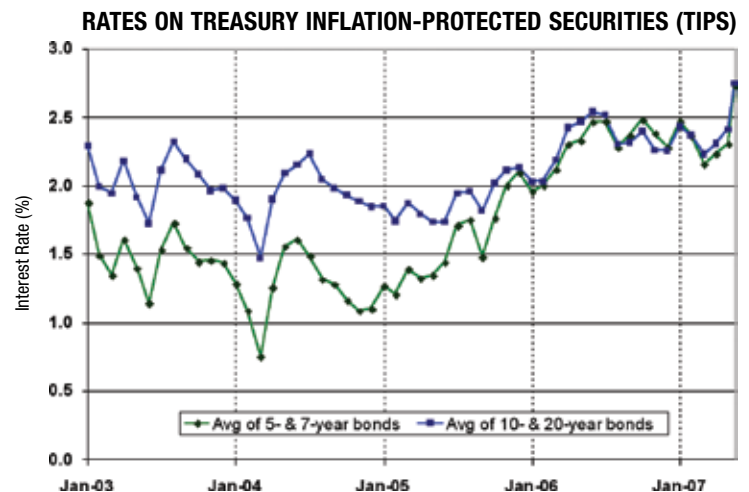


Figure CMO.11: Rates on Treasury Inflation-protected Securities
Source: Federal Reserve Board and Advisor calculations

The recent increase in rates has not been due to market concerns about inflation but to an increase in the real rate of interest.



a direct result of changes in the market. The third factor is designed to capture the non-symmetrical outlook for most bond classes. With interest rates still near to historic lows, despite recent increases, and credit spreads well below average, the chances that bonds will under-perform base level projections are greater than that they will out-perform.

In calculating return expectations, we discount simulated cash flows for each asset class using implied forward rates and assuming no changes in credit spreads. Cash flows are simulated using yields derived from current pricing. In general, a fifty percent probability is assigned to returns based on implied forward rates with no changes in credit spreads.

In addition to returns based on implied forward rates with no changes in credit spreads, we calculate returns based on plausible changes in interest rates, credit spreads, and prepayment speeds, as applicable. Scenarios include those using implied forward rates but assuming changes in future credit spreads or prepayment speeds, as applicable. Additional scenarios include those using increasing and decreasing interest rates combined with changes to credit spreads and prepayments. The table in figure CMO.13 summarizes the scenarios and the weightings assigned to each. Our revised return expectations in figure CMO.12 are based on the weighted average of the returns under each scenario.

ALTERNATIVE SCENARIOS AND PROBABILITIES FOR BOND ASSET CLASSES

	Treasury Bonds	Corporate Bonds	High-yield Bonds	MBSs*
Assuming implied forward rates	60%	60%	60%	60%
with no change in credit spreads*		50%	50%	35%
with spreads increasing		7%	5%	20%
with spreads decreasing		3%	5%	5%
Assuming rates increase 0.25% per year	30%	30%	30%	30%
with no change in credit spreads*		25%	25%	15%
with spreads increasing		5%	5%	10%
with spreads decreasing		0%	0%	5%
Assuming rates decrease 0.10% per year	10%	10%	10%	10%
with no change in credit spreads*		10%	5%	2%
with spreads increasing		0%	0%	7%
with spreads decreasing		0%	5%	1%

**alternatives for MBSs are for prepayment speeds*

Figure CMO.13: Alternative Scenarios and Probabilities for Bond Asset Classes
Source: Advisor projections

Expected returns from international bond classes have also been adjusted. Ten-year sovereign debt rates in the UK, Germany, and Japan all reached five-year highs recently. Credit spreads, however, in the euro area and Japan continue to be below ten-year averages, despite a very modest increase in Japan since mid-2006. Spreads in Europe and Japan are less than half of comparable spreads in the United States. Spreads on emerging market sovereign debt relative to U.S. Treasuries continue to decline as ratings on emerging market debt have generally improved. Higher base rates caused us to increase the expected three-to-five year return on foreign investment grade debt from 4.5% to 4.9%. Lower credit spreads on emerging market debt caused us to decrease the expected return on emerging market sovereign debt from 7.5% to 7.4%, despite the increase in base level rates.

INTERNATIONAL STOCK MARKETS

As noted in the article, “2006 Revisited,” returns from several foreign stock markets to U.S. investors exceeded 30% last year through a combination of strong market performance and currency appreciation—with Japan being the notable exception. In view of the rapid appreciation of the pound and the euro and the forward projections in the foreign exchange market that indicate that both currencies are not likely to appreciate further against the dollar, we have adjusted the expected returns from UK and euro area stocks. Projections for both markets have also been adjusted for modest decreases in projected earnings growth.

The expected three-to-five year total return from UK stocks was reduced from 13.3% to 10.9%. Projected returns are based on earnings growth of 8.5%; no change in earnings valuation levels, which are moderate and sustainable; a 3.3% dividend yield; and a projected 1.0% per year depreciation in the pound relative to the dollar. Previous return projections included no currency gain or loss for the pound relative to the dollar.

The return from euro area stocks was reduced from 12.5% to 11.1%. Projected returns are based on earnings growth of 8.4%, no change in earnings valuations, and a 2.5% dividend yield. The projection includes no change in the value of the euro relative to the dollar, compared to earlier expectations of a 1.25% annual appreciation in the value of the euro.

The projected returns from Japanese equities and emerging market equities remain unchanged at 13.0% and 15.0%, respectively.

REAL ESTATE, COMMODITIES, AND VENTURE CAPITAL

We conclude the capital market outlook with some brief comments about non-traditional assets classes.

As noted in the article “2006 Revisited,” real estate valuations had increased to the point in early 2007 where they were at all-time highs for the past ten years on a price-to-earnings, price-to-cash-flow, and price-to-book-value basis. Since reaching those peaks earlier this year, however, valuations have decreased—in some cases, dramatically. Price-to-forward earnings on office building REITs, for example, declined from a peak of 18.3 in January to 14.6 by mid-June.

The decline in valuations makes us more sanguine about maintaining our three-to-five year projected return of 7.5% for the asset class, despite the fact that current investors are experiencing losses. Should valuations continue to decline nearer to median levels, the opportunity for future price appreciation will increase and, with it, the possibility of long-term returns nearer to the geometric average return of 14.0% for the class for the last thirty-five years. This asset class will merit close monitoring throughout the remainder of this year.

We have increased our projected return on commodities futures from 8.8% to 9.0%, in keeping with the increase in the projected average Treasury bill yield. Commodities futures are projected to return 4.0% over the Treasury bill yield. The basis of this projection is explained in the article “Commodities as an Asset Class” in the last issue of the *Asset Allocation Advisor*. A copy of the article is available online at www.aametrics.com.

Finally, for endowments with venture capital exposure, we maintain our prior projection of a 16.0% return per year from the class. On average, venture capital returns have fallen far short of this projection for the past three years. However, this is an asset class where it is impossible to own the class and where actual returns are highly dependent on the skill of the individual venture fund manager.

