From right to left:

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Acknowledging the Risks

- **Stocks prices reflect difficult times but not a 2013 global recession, in our view. We think the probability of a 2013 global recession is around 30% to 40%, i.e., not our base case but high enough to be taken seriously.** Thus, all of our portfolios are underweight beta relative to strategic benchmarks by about four percentage points, and we are willing to take further defensive action if we change our economic outlook. For now, we maintain our view of a 1240 to 1290 floor for the S&P 500 this summer and upside to 1450 over the next six to nine months.
- As emotions regarding the world economy in 2013 ebb and flow, we expect a summer trading range of 1240 to 1360. A decisive break outside this range would be a signal that something has changed. An upside breakout is what we expect in the fall, but should that break be to the downside and if a 2013 global recession occurs, we think the S&P 500 could fall 15% to 20%.
- Non-US stocks are significantly cheaper than US stocks based on price-to-earnings ratios. This makes sense to us, as most of the economic risk has been outside the US and the US has delivered exceptional earnings growth. Non-US stocks have consistently delivered higher beta (more volatility) and we do not expect that to change, but the lower valuation suggests relatively higher returns if and when investors perceive the risks have diminished. Our valuation estimates are as follows:

Price/Earnings Ratio based on

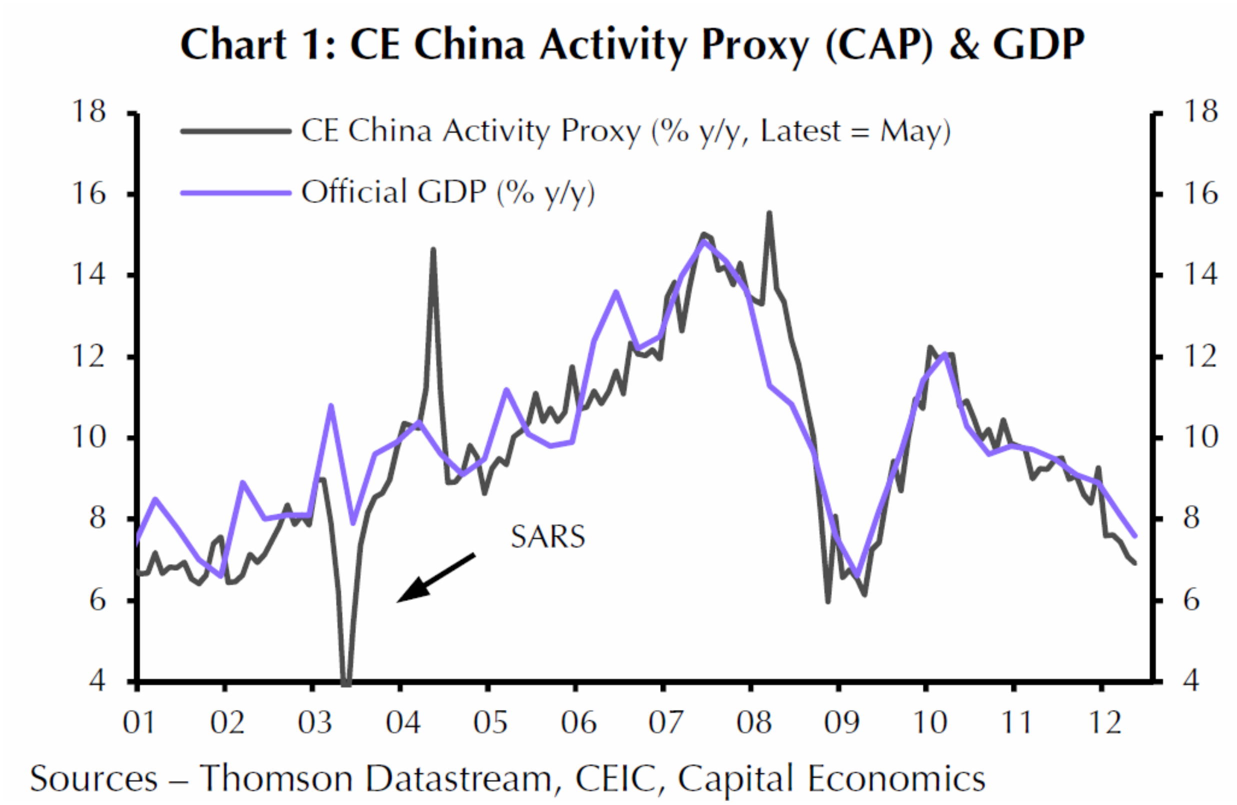
	Actual Earnings	*Trend Earnings*
US	13	16.5
EAFE	12	12.5
Emerging Markets	11	13

- We are broadly neutral to our strategic benchmarks in emerging markets and underweight developed non-US because we believe the long-term story for emerging markets is much better. Our underweight to Japan and Europe, despite their cheap valuations, reflects our concerns about their policymakers and their economic prospects.
- Cash has several short-term roles to play in our portfolios: volatility dampening (especially in our more conservative portfolios), and as part of a tactical strategy when our disciplines call for caution. However, we must remember that, since cash pays virtually no interest and inflation is positive, cash's purchasing power will erode over time. In addition, **investors who raise cash, and plan to reinvest when the environment 'feels better' need to recognize that they will be paying higher prices when they eventually return to the market.**
- We strongly believe higher yielding corporate bonds have a vital role to play in balanced portfolios. Less volatile than stocks and paying significantly higher interest than traditional fixed income, higher yielding corporate bonds are a potential substitute for both, in our view. That is how we are using them. Our significant allocation to high yield in our balanced portfolios is offset by lower allocations to both traditional bonds and stocks.

China's New Normal – No hard landing, in our view, but investors are not buying it. China reported second-quarter real GDP year-over-year growth of 7.6% last week, generally in line with expectations and consistent with the government's target of 7.5% for the year. However, with China's stock market making new lows for 2012, investors are clearly concerned and so far unimpressed by policy action. One explanation for the stock market's weakness is shown in our Weekly Chart, which suggests growth may be slower than reported. Policymakers, also worried about growth, have cut interest rates, stopped paying banks interest on reserves held at the central bank, and are considering other targeted fiscal strategies to stimulate economic growth without reigniting a property bubble.

Even though current GDP growth is well below the 2005 through 2008 10%-plus rates, it is still the highest among large countries. We believe 6% to 8% growth is more sustainable and reduces the likelihood of misallocating capital to non-productive or redundant assets. **Since emerging markets tend to take their lead from China, we expect emerging markets to outperform developed markets once China settles into its 'new normal' of sub-10% but sustainable economic growth.**

THE WEEKLY CHART: CHINA'S GDP GROWTH RATE APPROACING 2009 LOW



While China's official second quarter real GDP growth rate was reported at 7.6% year-over-year, there is evidence that growth could be slower than reported, including a slowdown in electricity consumption, bank lending, exports, and imports of raw material. China's GDP data release provides no sector detail (consumption, capital spending, government spending, trade, inflation) and is sometimes inconsistent with other reported economic statistics. In the chart above, Capital Economics (CE) compares official GDP to its China Activity Proxy, which attempts to blend Chinese economic data thought to be less manipulated by the government, to get a more accurate sense of economic growth. This measure suggests second-quarter GDP growth of 7%. We continue to expect a soft, rather than hard landing for China and view June's better-than-expected retail sales, cement output, and fixed investment spending as a hopeful sign that the second quarter will be the low for growth.

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