



## **Fourth Quarter, 2008 Commentary International Equity Growth (ADR)**

### **Portfolio Commentary**

#### **Global Summary**

Global economic activity deteriorated significantly during the fourth quarter of 2008 with major economies around the world falling into recession. Economic data suggests the U.S., U.K., Germany, France, Spain, Japan, Australia, and other major economies are in recession with the National Bureau of Economic Research suggesting the U.S. economy entered its recession in December 2007. Most analysts predict very negative fourth quarter GDP data. A massive credit crunch in the U.S. and Europe led to huge bank bailout packages in the U.S. and the U.K. during the fourth quarter and talks continue on fiscal stimulus packages. Pursuant to significantly deteriorating economic conditions, the IMF sharply lowered their expectation for global growth for 2009 to 2.2% (down from earlier estimates in the 3<sup>rd</sup> quarter of 3.7%) and also predicted the world's richest economies would contract by 0.3% in 2009. We continue to believe that recent trends will continue in the short-term including falling inflation, rising unemployment, low interest rates, weak or negative GDP, and high currency volatility. Amid this backdrop, central banks around the world not only launched coordinated interest rate cuts during the fourth quarter but some also cut rates aggressively, including the Bank of England and the Federal Reserve. The U.S. Federal Reserve (Fed) cut rates to a historic low range of 0% to 0.25% and adopted a quantitative easing strategy.

#### **Japan / Asia**

The Bank of Japan also followed suit by cutting rates for the first time in seven years to 0.3% and late in the quarter cutting them further to 0.1%. This followed grim economic data that showed confidence and industrial activity falling significantly. The Bank of Japan's Tankan survey of business confidence in December showed its sharpest decline in three decades. Central bank governors believe the Japanese economy will contract in its fiscal year 2009 and is already in a deeper recession than previously thought. In spite of this negative economic backdrop, the Japanese Yen appreciated by more than 15% versus the U.S. dollar during the third quarter as a flight to safety and risk aversion consumed currency markets. Japan is pursuing a fiscal stimulus package that includes tax cuts but most foresee Japanese consumers as continuing to be risk averse and saving any proceeds rather than spending. Similar measures may also be taken to accelerate public works projects as the rapidly appreciating Yen is hurting the economy's main growth engine, exports.

#### **Europe**

With the credit markets virtually frozen during the fourth quarter, the eurozone economy was in recession and manufacturing activity declined sharply. The banking sector in Europe is facing significant strains as severe as, or more so than, those seen in the U.S. Governments have tried to recapitalize the banking systems with some, like the U.K., placing more stringent requirements on this new capital. The European Central Bank is offering funding facilities to offset massive illiquid credit markets yet the ECB has not lowered interest rates as aggressively as other central banks or analysts would like. The Euro has fallen sharply versus the U.S. dollar, and the U.S. dollar has been gaining ground as the safer currency in a world dominated by flight to quality. Although the ECB cut its rates by 175 basis points (bps) in two months to 2.5%, they do stand well above most major economy's rates. Manufacturing activity is contracting, and the eurozone's purchasing managers index fell in December to its lowest level since the index began a decade ago upon the creation of the eurozone.

### **The Summit Program**



## **The Global Economy**

The U.K. economy is also contracting rapidly and the Bank of England is acting aggressively, having cut interest rates by 300bps since early October to a level of 2%. The economy is one of the weakest in Europe and this has translated to the British pound depreciating versus major currencies. The housing market bubble in the U.K. has burst, and the banking sector has received a lifeline from the massive bank bailout package, yet economic activity and the credit markets are likely to stay weak for some time to come in 2009.

## **Emerging Markets**

Emerging economies are feeling the effects of this major global slowdown, which is projected to be a developed world recession in 2009. Chinese data, especially electricity demand and the CLSA PMI manufacturing index, suggest the economy has slowed much more rapidly than earlier thought and 4<sup>th</sup> quarter and early 2009 GDP are likely to show this development. The government is also concerned having lowered interest rates and reserve requirements, as well as announcing a large fiscal infrastructure stimulus package to accelerate spending on major public works projects. Other emerging economies also slowed fast and emerging market currencies plummeted during the quarter. Most affected were those economies reliant on foreign funding (Central and Eastern Europe) and those reliant on commodity markets (Russia and Brazil) as credit markets froze and as commodity prices came tumbling down.

## **Political Influences**

In a quarter filled with economic fear, politics were not far behind. In Russia, President Dmitry Medvedev has proposed extending presidential terms by 2 years from 4 to 6 years in what is seen as a foreshadowing of a Putin return to power in 2012 that could lead to his ruling for an additional 12 years. China and Taiwan continued their slow migration to linking the two economies. Taiwan's new president Ma Ying-jeou has been a proponent of closer links to the mainland by proposing direct flights between the two countries. Moreover in Asia, protestors in Thailand took to the streets during the quarter, blockading the country's main airport for days in protest of the ruling party which ended in the constitutional courts banning of the ruling prime minister and dissolution of three parties in the ruling coalition. Terrorists gripped Mumbai, India in an attack that killed 192 people and led to the resignation of several government officials over the handling of intelligence data and the response of security forces to the attacks themselves. This attack has forced significant tension between India and Pakistan, home for the terrorists. As the new-year began we found ourselves with another crisis in the Middle East between Hamas and Israel in the Gaza strip as well as disagreements between Russia and the Ukraine on Russia's sales of gas to that country, a significant route for European natural gas supplies.

## **Stock and Portfolio Highlights**

Equity markets fell sharply across the world during the fourth quarter as the credit crunch and fear of sharply falling economic activity gripped the markets. The MSCI EAFE Index fell 20% for the fourth quarter bringing its return for 2008 to a negative 43.4%. Currencies were a major headwind for international equity performance as the dollar rallied versus most currencies except for the Japanese yen. In the U.S., the S&P 500 Index returned a negative 21.9% for the quarter leading to a negative 37% return for the year, its sharpest decline in one year since the 1930's. Monetary policy across the globe is close to reaching its limits while fiscal policy measures should provide some support to deteriorating economies. Valuations have declined significantly but we believe earnings estimates still need to be reduced for 2009. Size and style differences were not as pronounced as all equities fell in tandem with international equities falling further due to the strength in the dollar. For the year, large caps performed slightly better than small and mid-caps. Growth underperformed value during the quarter but finished ahead for the year. Emerging markets underperformed during the quarter falling 27.6%, taking their 2008 return to a negative 53.3%. The best performing developed markets for

## **The Summit Program**



the quarter and year were Japan, Switzerland, and Spain while the worst performing markets in the quarter were Austria, Greece, and Norway and for 2008 were Ireland, Austria, and Belgium. In the emerging markets the best performing for the quarter were China, Morocco, and Malaysia while the worst were Russia, Pakistan, and Hungary. For the whole of 2008, the worst performing emerging markets were Pakistan, Russia, and India, while the best performing were Morocco, Colombia, and Israel.

### **Outperformers**

Although underperforming for the quarter and outperforming the MSCI EAFE Index for the year, our portfolios still suffered significant declines for the quarter and year. Defensive sectors outperformed for the quarter with the best performing sectors in the MSCI EAFE Index being Health Care, Telecommunications, and Utilities while Staples, Health Care, and Utilities performed best for the year. The portfolio's underweight to the Financials sector and an overweight to the Telecoms sector aided performance as Financials were the worst performing sector and Telecoms were one of the better sectors. Eagle's increased cash weightings in the portfolio in the second half of the year also aided performance as equity markets tumbled. Our stock selection during the year in the Health Care, Telecommunications, and emerging markets helped performance while stock selection in the Consumer Staples sector added to out performance during the fourth<sup>th</sup> quarter.

### **Disappointments**

Although we have shifted the portfolio over time to a more defensive stance given the weak economic backdrop, a significant underweight to Japan (the best performing market for the year) and poor stock selection in the Energy, Materials, and Utilities sectors kept the portfolios from performing better. The Energy and Materials sectors hindered performance during the quarter and year as a sharp deterioration in economic fundamentals led to a fall in the price of most commodities including oil, copper, iron ore, and aluminum in the second half of the year, severely hampering equity performance in those sectors. Our allocation to emerging markets detracted from performance as those markets underperformed the MSCI EAFE Index. However, during the second half of the year, we significantly reduced the portfolio's exposure to the emerging markets. Stock selection in the Industrials and Materials sectors hurt fourth quarter performance while stock selection in the Energy and Materials sectors hurt the full year.

## **The Summit Program**

