



# Hefren-Tillotson

## QUARTERLY MARKET REPORT

July 1, 2010

### Cyclical & Secular Forces Collide

Leverage has once again sent shockwaves across the global financial markets, but this time, governments in the Developed world are in the spotlight. For some time, we have viewed the impact of record debt levels as the key secular risk in the outlook, but anticipated the impacts to be felt further along in the economic cycle. After all, the economic recovery is still very young, only 11-12 months old by our estimate. Central banks around the world continue to maintain very accommodative policies by keeping borrowing rates low in order to support a cyclical rebound in growth. Furthermore, inventories are being rebuilt, rapid growth is occurring in emerging market economies, and companies are beginning to hire new workers. Nevertheless, over the past three months, these positive cyclical trends encompassing the economic recovery have collided with the secular headwinds posed by heavy debt loads across Europe, Japan, and the U.S.. The underlying reason for recent market weakness appears to be fear that governments will be forced to cut spending and raise taxes at a time when the economic recovery appears tenuous, thus forcing the world economy back into recession.

We believe portfolio strategy in such an environment should strike a balance between conservative and opportunistic positioning. The setback in stock prices is signaling a moderation in the pace of the economic expansion, which is likely to prove uneven and sub-par by historical standards, but continue nonetheless. Conservative positioning should take into consideration the sovereign debt risks looming around Developed Markets, while opportunistically exploiting the long-term opportunities being presented in Emerging Markets. The recent troubles in Greece and other countries have provided valuable insight for investors into the likely market reaction should governments fail to address their fiscal issues and in the event debt troubles spread to larger, more impactful countries. Since correlations (the extent to which assets classes move together) remain stubbornly high following the 2008 crisis, investors should be careful to seek out reliable diversification benefits. The following pages provide more insight into our recommended strategies as well as the cyclical and secular forces that are colliding in the global economy and financial markets.

MARKET SUMMARY						
INDEX RETURNS AS OF JUNE 30, 2010						
	2st Qtr	Annualized Total Returns				
	2010	2010	1-year	3-year	5-year	10-year
<b>Fixed Income</b>						
Barclays Capital Aggregate	3.5%	5.3%	9.5%	7.5%	5.5%	6.5%
Barclays Capital Municipals	3.4%	5.8%	15.9%	7.4%	5.3%	6.9%
Barclays Capital High Yield	-0.1%	4.5%	26.8%	6.5%	7.2%	7.3%
<b>Domestic Equities</b>						
S&P 500	-11.4%	-6.7%	14.4%	-9.8%	-0.8%	-1.6%
Dow Jones Industrial Avg	-9.4%	-5.0%	18.9%	-7.4%	1.7%	1.7%
Nasdaq Composite	-11.8%	-6.6%	16.0%	-5.9%	1.4%	-5.5%
S&P Mid Cap 400	-9.6%	-1.4%	24.9%	-5.9%	2.2%	5.3%
Russell 2000	-9.9%	-1.9%	21.5%	-8.6%	0.4%	3.1%
<b>Investment Styles</b>						
S&P BARRA Growth	-11.3%	-8.0%	12.6%	-6.9%	0.2%	-3.9%
S&P BARRA Value	-11.6%	-5.3%	16.4%	-12.8%	-1.9%	0.7%
<b>Foreign Equities</b>						
MSCI EAFE	-13.7%	-12.8%	6.6%	-12.8%	1.4%	0.5%
MSCI World	-12.5%	-9.5%	10.9%	-10.9%	0.7%	-0.7%
MSCI Emerging Markets	-8.3%	-6.1%	23.3%	-2.3%	12.9%	9.7%
<b>Other</b>						
DJ-AIG Commodity Index	-4.8%	-9.7%	2.6%	-9.5%	-3.8%	1.8%
S&P BMI REIT Index	-4.8%	3.6%	48.6%	-14.0%	-4.7%	3.6%

INTEREST RATES & INFLATION		
Consumer Price Inflation (CPI)	1.8%	2.0%
Money Market Yields	0.0%	0.0%
10-Year Treasury Yield	3.9%	2.9%
10-Year PA Municipal Yield	3.4%	3.8%
High Yield Corporate Bond Yield	9.1%	9.2%

MARKET VALUATIONS			
	6/30/2010	Forward	Dividend
	Price	P/E	Yield
S&P 500	1,031	12.7	2.1%
Dow Jones Industrials	9,774	12.1	2.8%
Russell 2000	609	21.4	1.4%
MSCI EAFE	1,348	12.3	3.2%

\* Total Returns Include the Reinvestment of Dividends.

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## Equity Markets

Greece, struggling under the weight of massive deficits, a large debt load, weak growth, and labor force inflexibility ignited fears of a sovereign debt contagion in the second quarter. Fortunately, the European Union (EU) and IMF pulled together a \$1 trillion aid package to address the crisis and encourage a return to normality. While effective at bringing calm, covering over debt with more loans essentially kicks the can down the road and we expect more challenges ahead for the EU and Euro currency. In fact, sovereign debt and its debilitating impacts will remain the key risk in the outlook for the world economy in the coming years, at least from our point of view.

While it is our belief that the U.S. is better positioned than either Europe or Japan, we see multiple side effects of the debt load being borne by the Developed Markets. First, growth is likely to remain sub-par. As the chart (middle right) reveals, growth rates in the U.S. have diminished as our debt burden has risen. Unemployment should remain stubbornly high, and when combined with stagnant real estate prices and the need for increased savings, the pace of consumer spending (which accounts for 71% of US economic activity) should remain modest. Further hindering growth conditions will be the need for higher taxation to deflate swollen deficits and meet loan obligations. Finally, aging populations are increasingly demanding more from government at a time when its ability to deliver has never been more tenuous. As governments try to tighten their belts and improve fiscal conditions, the monetary policy of the Federal Reserve and central banks across the developed world are likely to remain very accommodative (attempting to offset the fiscal situation), suggesting the low-rate environment should continue for the foreseeable future.

Given this outlook, we prefer our Developed Market exposure to be conservative, consisting of **high quality** companies with strong balance sheets that ideally are able to produce growth independent of the slow-growth environment likely to grip the economy. Surprisingly, many of these companies trade at a discounted P/E relative to the broader market averages, while producing higher financial returns and offering higher dividend yields. Sluggish domestic conditions should favor areas with business exposure to stronger global growth, particularly in the Emerging Markets, such as a **Growth investment style**. Financials and Consumer-related sectors are faced with long-term consumer deleveraging and should be avoided.

One of the many challenges facing investors today is the fact that correlations (the extent to which investments move up and down together) remain unusually high. In evaluating the market's response to the European sovereign debt troubles in recent months, two sectors weathered the storm rather well – high quality U.S. bonds and Gold. If these troubles come to the U.S. down the road, Gold may be one of the few asset classes positioned to produce positive returns, as bond market values could likely suffer from rising interest rates and credit spreads. As the chart (Right) illustrates, Gold has historically provided excellent diversification benefits since correlations with equities are often low or negative and the yellow metal would provide some protection if either inflation or deflation forces gain the upper hand in response to policy initiatives and the structural backdrop. We feel Gold will continue to perform well longer term given our lack confidence in policymakers around the world to make the necessary and difficult changes required to address weak fiscal situations as governments are notoriously reactionary.

## DEBT IS THE KEY SECULAR RISK IN THE OUTLOOK

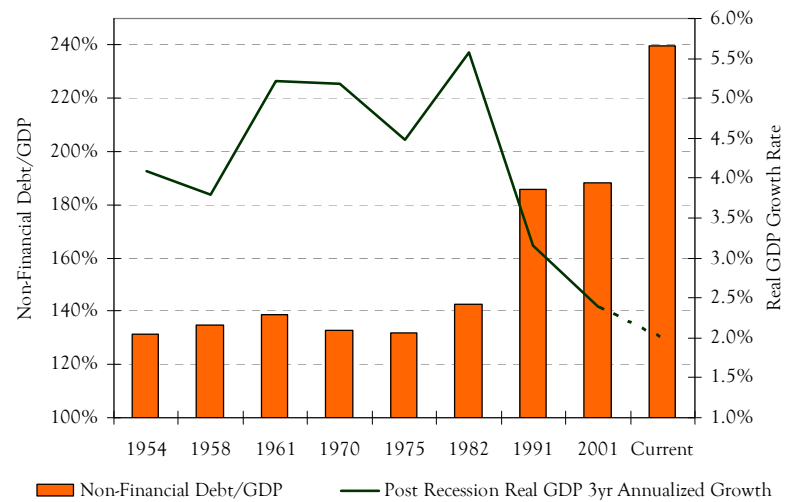
### U.S. Debt vs. the PIIGS

Country	Budget Deficit % of GDP	Government Debt % of GDP	2010 GDP Growth Est.
Portugal	9.4	76.8	0.3
Ireland	14.3	64	-1.4
Italy	5.3	115.8	0.7
Greece	13.6	115.1	-0.3
Spain	11.2	53.2	-0.8
U.S.	10.3	85.1	2.5

Source: Ned Davis Research

## DEBT LEVELS VS. RATE OF ECONOMIC GROWTH

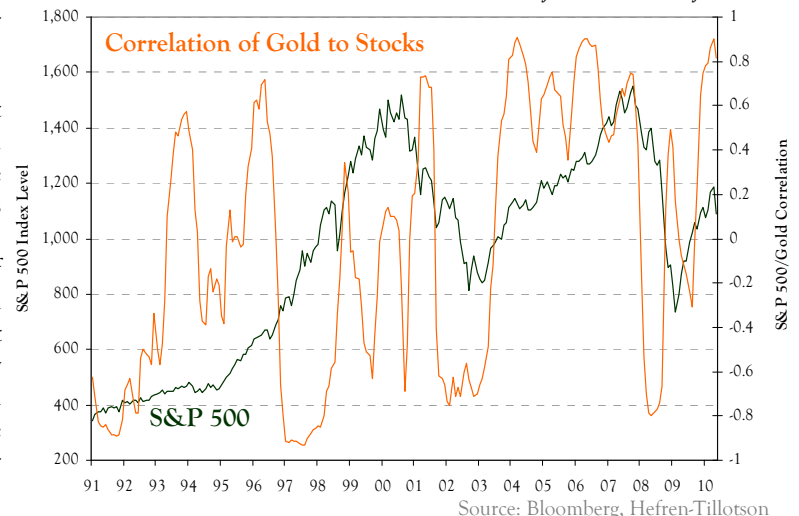
### Record Debt = Weak Growth Outlook



Source: Bloomberg, Hefren-Tillotson

## GOLD PROVIDES A HEDGE AGAINST SOVEREIGN DEBT RISKS

### Low Correlation to Stocks Provide Diversification Benefits



Source: Bloomberg, Hefren-Tillotson

Note – the use of Gold is primarily recommended for discretionary accounts where client positions can be sold quickly when prices eventually turn south.

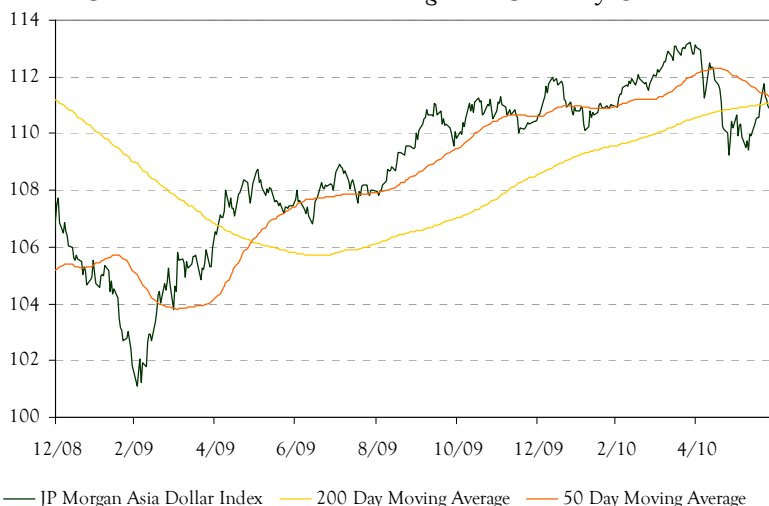
## Fixed Income Markets

In an interest rate environment where 10-year Treasuries are yielding only 2.9%, it is difficult to find much attractive across the fixed income markets. The low level of low interest rates, combined with credit spreads that approximate longer-term averages in most sectors, suggest the total return potential of the bond market is modest. Nevertheless, the asset class still provides two important features, cash flow and diversification benefits. We still favor Investment Grade Corporates and Municipals (ahead of a higher tax rates), but selectivity is important in both areas.

From an opportunistic standpoint, we see particularly appealing value in the Asian Fixed Income markets. When investing in foreign bonds, currency movements can drive most of the total returns. By our estimates, Asian currencies are between 30-60% undervalued relative to the U.S. dollar on a Purchasing Power Parity basis, suggesting substantial upside potential. As Asian countries continue to grow in economic prominence and gain a greater share of the world economy, currencies should appreciate due to increased investment and capital flows to the region. One factor likely to spark regional currency gains in 2010 is China's recent decision to remove the Renminbi's peg to the U.S. dollar. We expect the Chinese to permit only gradual appreciation (est. 5-8% appreciation per year), but the decision should begin to unlock trapped valued across the Asian currency spectrum. Finally, there appear few signs the Fed will be raising short-term interest rates anytime soon amidst an environment of 10% unemployment, minimal inflation pressure, and ongoing questions about the sustainability of the economic expansion. Low short-term rates in the U.S. and other Developed Markets should be an additional driver of long-term Asian currency gains. From a diversification standpoint, the Asia Fixed Income markets provided decent diversification benefits during the 2008 credit crisis, holding up much better than many areas of the fixed income markets. In the past, the key risk facing Developed Market bond investors was interest rate risk, whereas Emerging Market bond investors (including those in Asia) faced primarily credit risk. Given the sovereign debt challenges discussed herein and the strong growth in Emerging Markets, this old relationship appears to be reversing to where the credit risks lie as much or more in the Developed world.

### RISING CURRENCIES TO DRIVE ASIAN BOND RETURNS

*China Revaluation to Fuel Regional Currency Gains*



Source: Bloomberg, Hefren-Tillotson

## International Markets

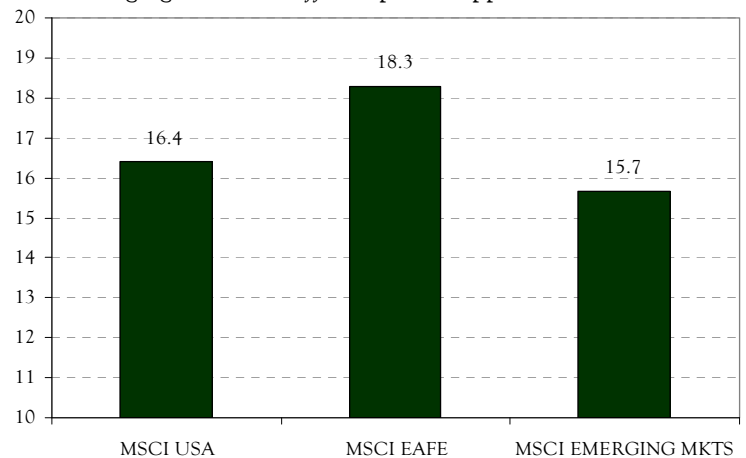
A "barbell approach" combining opportunistic Emerging Markets exposure with conservative Developed Markets exposure is at the core of our equity allocations today. We have been strong proponents of Emerging Markets exposure, particularly following the sharp sell-off stemming from the 2008 credit crisis. Our thesis for overweighting this asset class can be summarized as follows:

1. Emerging Markets offer superior economic growth potential over the next decade, in our view, which will be increasingly driven by domestic consumption and less by exports to the Developed world. Already Emerging Markets account for 31% of global GDP, up from 22% in 1998 (U.S. share of world GDP = 25%).
2. Valuations remain at a 10-15% discount to Developed Markets as illustrated in the chart below. Attractive valuations, combined with stronger growth potential, form the basis of superior appreciation potential.
3. As outlined in the previous section, currencies are appreciating relative to the U.S. dollar, boosting the returns of U.S. investors.
4. Demographic profiles are significantly better. The percentage of the population over age 65 is significantly lower in Emerging Markets (e.g. China = 8.4%, India = 5.6%) than those in Developed Markets (e.g. U.S. = 13.1%, Japan 23%, Europe 18%). Emerging Market members of the G20 account for 54% of the world's population versus only 11% for the G7. Younger populations have a propensity for economic vitality and growth, as well as, equity investments. On the other hand, older populations generally bias toward risk aversion, saving, fixed income, and government services.
5. Technical trends for these markets remain very strong and have been in a persistent phase of leadership since around 2002.

The case for Emerging Markets is increasingly well known, but has yet to hit an extreme commonly associated with major turning points in performance. As a result, we expect the Emerging Markets leadership to remain intact and be a key driver of global equity returns in the coming years. The key risks for these markets are rising inflation stemming from strong growth conditions and the eventual possibility

### GLOBAL EQUITY P/E LEVELS

*Emerging Markets Offer Superior Appreciation Potential*



Source: Bloomberg, Hefren-Tillotson

## Strategy Highlights

The following provides a summary of our investment strategy and outlook:

### Economy:

- Expect a sluggish domestic expansion restrained in part by record debt levels.
- Inflation should remain low in 2010, but long-term risks are to upside.
- The Federal Reserve should keep short-term rates low for the foreseeable future.

### Fixed Income:

- Higher taxes will be needed to support swollen deficits, record debt, and our large entitlement programs, thus favoring Investment Grade and High Yield Municipal bonds.
- Corporate bonds should be favored over domestic government debt, but the pace of outperformance should moderate.
- Returns from the High Yield sector should also moderate and be driven predominately by current income.
- Foreign bonds exposed to Asian and Commodity-based currencies should outperform.

### Equities:

- A “barbell approach” combining opportunistic Emerging Markets exposure with conservative Developed Markets exposure is at the core of our equity allocations today. We expect Emerging Markets to continue their secular economic and market leadership as the U.S. and other Developed Markets struggle with sub-par growth prospects and deleveraging.
- Sluggish domestic conditions should favor high quality companies and those with business exposure to stronger global growth such as a Growth investment style and sectors including Technology, Energy, Materials, and Industrials. Financials and Consumer-related sectors are faced with long-term consumer deleveraging and should be avoided.
- Select areas of Health Care should benefit from recent legislation, which removed uncertainty from the sector’s outlook.
- The secular bear markets in the U.S. and other developed equity markets may not have reached an end, arguing against the use of indexing strategies and warranting conservative expected returns.
- International Small Caps continue to offer good value and should benefit from the ongoing global economic expansion.

### Other:

- The secular bull market in Commodities and Gold should remain intact, driven by supply constraints, continued demand growth in emerging economies, and dollar weakness against Asian and commodity-based currencies.
- Real Estate conditions have stabilized, but the sector is likely to struggle with post-bubble influences and deliver only modest returns.

## Of Interest

### The Corporate Sector - A Positive Being Overlooked

With so many of the headlines today highlighting negative attributes of the economy and markets, it is easy to get discouraged or scared. While we are not minimizing the importance or impact of developments like the sovereign debt troubles or other structural challenges, there are two sides of every story. The corporate sector is a clear bright spot. S&P 500 earnings growth is expected to reach 16.5% in 2010. During the first quarter’s reporting season, 76% of companies reported a positive earnings surprise with year-over-year growth of 52%. Cash as a percentage of non-financial corporate balance sheets is at record highs, providing substantial financial flexibility.

### Europe – The Good, the Bad, and the Ugly

European equities have borne the brunt of the recent market correction, falling 15% from mid-April through the end of May. Europe faces considerable structural challenges in the years ahead, ranging from inflexible labor markets, high regulation, poor demographics, heavy debt burdens and swollen deficits to the basic structural of the Euro single currency and European Central Bank mandates. While there are many things not to like, there is clear value in the region’s large exporters/multinationals. Managers capable of gaining exposure to such companies while hedging away Euro currency exposure should do quite well relative to broader equity indices.

### Sources of Reliable Diversification

Abraham Lincoln once said “I don't think much of a man who is not wiser today than he was yesterday”. Since wisdom is the application of knowledge gained, our challenge is not only to be in constant pursuit of knowledge, but then to apply it. We have spent considerable time studying the 2008 bear market and economic downturn, our strategies, and the brief shortfalls of diversification during the Autumn of that year. We have recently incorporated Gold into discretionary portfolios to proactively hedge against new sovereign debt risks and are considering adding a tactical manager capable of taking short positions. We have found few managers capable of doing this effectively and consistently over time, but those able to have produced reliable diversification benefits. At a time when correlations remain abnormally high, these steps should provide added diversification benefits and downside protection to portfolios, complementing traditional fixed income positions.

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