One of the main issues affecting global financial markets in recent weeks has been the increase in interest rates that has resulted from investor concerns over a potential change in Federal Reserve policy. Last week saw a reversal of that trend. Fed Chairman Ben Bernanke sounded a more favorable tone when he indicated that the Fed was unlikely to hike short-term rates abruptly, which resulted in a notable pullback in Treasury yields.

Going forward, we expect fixed income markets to remain volatile, but we do not believe that we will see a precipitous drop in prices and overly dramatic advance in yields. For one reason, inflation still remains tame, which means the Fed is under less pressure to move quickly.

Although several members of the Federal Reserve have clearly indicated that the central bank's longstanding easing bias presents some risks, without inflationary pressure the Fed is unlikely to quickly shift away from monetary accommodation.

For equities, our view is that as long as we do not see a significant increase in yields, stock markets can continue to advance, as we saw last week. In addition to the interest rate and inflation environment we described, we would point out that corporate balance sheets remain quite healthy and that stocks appear reasonably priced relative to their own historical valuations as well as to bonds and cash alternatives. As such, our view is that we are likely to see further equity price increases over the next six to twelve months (although the pace of gains is unlikely to match what we saw in the first half of the year).