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WEEKLY INVESTMENT COMMENTARY

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Elections and Earnings Uncertainty Weigh on Sentiment

Stocks Flat During a Storm-Shortened Week

The US stock market was closed on Monday and Tuesday last week due to the widespread flooding and power outages that affected the East Coast, and in a shortened week of trading, stocks were little changed. The Dow Jones Industrial Average declined 0.1% to 13,093, the S&P 500 Index was up 0.2% to 1,414 and the Nasdaq Composite fell 0.2% to 2,982.

While the full impact of Hurricane Sandy is still being assessed, we expect that the net result of the storm will probably be neutral from an economic growth perspective. We will certainly see a decline in economic activity in the short term, but longer-term reconstruction and rebuilding efforts will provide an economic boost.

US Elections Front and Center

This week, of course, voters in the United States are heading to the polls and the presidential election appears unusually tight. Last week's hurricane probably helps President Obama from a political perspective, since the storm diverted voter attention away from issues such as the economy and the elections horse race and gave the President a chance to appear presidential and to transmit a positive message. The other variable that came into play last week was the October labor market report. The data was slightly better than expected (nonfarm payrolls rose by a better-than-forecasted 171,000), although the unemployment rate ticked up to 7.9%. In our view, the report was probably neither strong enough nor weak enough to have any measurable impact on the election results.

As we head into the final hours of campaigning, it appears that Governor Romney is a slight favorite in terms of the popular vote and President Obama is leading in the Electoral College (which is really what counts). It is looking possible that the election results will be so close that the outcome will depend on recounts and late ballots. Should this happen, we may not know the result for several days or even weeks. In such an environment, increased uncertainty would likely be a negative for the markets. Once the results are known, attention will immediately turn to the prospects for resolving the fiscal cliff, and investors will closely analyze the winner's statements about growth and debt levels for clues as to what might come next.

In addition to the presidential election, of course, investors are also focused on Congressional elections. At this point, it looks to us like we should more-or-less see

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a continuation of the status quo. The Republicans are likely to retain control of the House of Representatives, but will likely lose between 10 and 15 seats, while the Democrats should retain control of the Senate, and will probably lose a seat or two.

Soft Earnings Do Not Presage a Bear Market

After a strong summer, stock market momentum has faded a bit in recent weeks. US stocks fell around 2% in October as the positive momentum from the launch of QE3 faded and as investors began to focus on a relatively weak outlook for earnings and profits.

Third-quarter earnings have been disappointing, and as we indicated last week, domestically oriented companies have been outperforming those with broader foreign exposures. Many investors are wondering whether the current period of earnings weakness represents the start of a more significant downturn. In our opinion, such concerns are probably overstated. True, some areas of the world are in recession, but policymakers around the globe still have a pro-growth bias, inflation risks are not significant and global growth levels remain at least decent in most areas. We believe that increased market volatility and the slump in corporate profits are part of a correction and do not signal the start of a bear market.

Looking ahead, we expect US economic growth to continue to proceed at around a 2% level. The recovery in housing is gaining traction and we may see slightly stronger levels of growth in the second half of 2013. In this environment, earnings growth should be able to recover, suggesting that stocks remain well positioned.

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