

Weekly Investment Commentary

Disappointing Data Should Be Temporary, But Ultimately All Depends On Jobs

June 6, 2011

A stream of increasingly disappointing economic data helped accelerate the multi-week correction in stocks. Last week, the Dow Jones Industrial Average lost 2.3% to 12,151, the S&P 500 Index declined 2.3% to 1,300 and the Nasdaq Composite fell 2.3% to 2,733.

The most recent high-profile evidence pointing to a slowdown in growth came in Friday's jobs report for May. For the month, total nonfarm payrolls grew at a much lower-than-expected 54,000 (consensus expectations were for over 150,000). Additionally, the unemployment rate unexpectedly rose to 9.1%. In retrospect, a disappointing data set should not have been that surprising given the weaker data we have seen over the past month. There has clearly been a soft patch in economic performance this spring, and as such, the employment growth rate is slowing rather than accelerating. In addition to the weak labor market report, the ISM Manufacturing Index for May dropped sharply and weekly jobless claims have become more elevated.

The news has been bad enough recently that the term "double dip recession," which had been banished to the sidelines, has again begun to appear in the financial press and in investors' conversations. Additionally, some have been discussing the prospects for an additional round of Federal Reserve-engineered stimulus. From our perspective, neither of these possibilities has much real chance of occurring. We recognize that the US economy has hit a rough patch, and we remain concerned about the potential fallout effects from the slowdown in China and from ongoing debt problems in Europe, but we believe the preponderance of the evidence suggests that the United States economy will continue to grow at least at a modest pace.

In our opinion, the current slowdown in economic growth can be attributed to a number of different factors, some of which will be temporary. First, we believe we are still seeing the lagged effects of the spike in energy prices that occurred earlier in the year as a result of supply disruptions and escalating geopolitical risks. Additionally, production problems caused by the earthquake in Japan have had some negative effects on the global economy. In the United States, a rash of poor weather, including some terrible floods and tornadoes, have contributed to a short-term slowdown in growth levels. All of these factors, however, have not been enough to cause a break in economic growth. For that to occur, we believe we would need to see a material weakening in liquidity, lending rates and the health of the overall credit market, events that do not appear to be on the horizon.

Regarding the role of the Fed and the possibility of another round of quantitative easing, we expect the central bank to maintain its current policies for now. The US Fed is one of the few major central banks in the world that has yet to signal a shift to a tighter monetary stance, and given the recent string of weaker economic data, we do not believe that will change any time soon. At the same time, we do not believe the Fed will be launching additional easing measures once its current bond-purchase program winds down at the



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end of this month. As we have been discussing in recent weeks, the QE2 program was effective in terms of helping shift the economy from a deflationary to an inflationary mode and it also helped raise asset prices by prompting investors to take on more risk. At this point, however, the Fed will be content to allow that program to end. In other words, once QE2 ends, we are not expecting to see a QE3.

An additional item that has been in the news lately has been the ongoing debate over the US deficit and what will happen with the debt ceiling. As we have said before, the discussion over the debt ceiling has to be viewed through the lens of political theater, and we expect that the debate is likely to go to the 11th (if not the 12th or 13th) hour. We do believe that the debt ceiling will ultimately be raised as part of a broader agreement to cut spending by at least \$1 trillion over the next 10 years. We are likely to see some cuts in defense spending, a cap on discretionary spending levels and some sort of budget process reform that would force Congress to reach certain debt targets. We also may see some cuts to second-tier entitlement programs, but we doubt there will be meaningful changes made to Medicare, Medicaid or Social Security.

Looking ahead, the economic forecast will be largely dependent on the state of the jobs market. A significant acceleration or deceleration in the pace of jobs growth has the potential to change almost everything. While we do acknowledge the downside risks, we believe that trends in corporate earnings and profits suggest that the pace of jobs growth should pick up in the second half of 2011, which would help keep economic growth on track.

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