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Weekly Investment Commentary

Positive Signs Exist, but Europe and Policy Are Unclear

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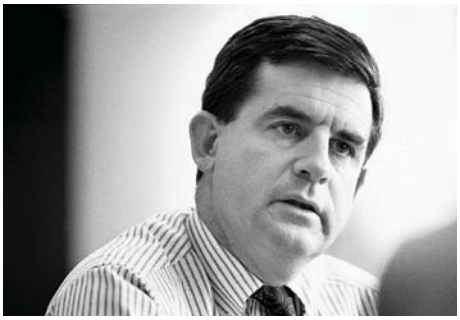

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Markets Rebound

The yo-yo trading pattern continued last week, with markets rebounding somewhat from the previous week's declines. Investor sentiment benefited from some better-than-expected economic data (including the September payrolls report) and a sense that European policymakers were making some progress on moves to recapitalize the banking system. For the week, the Dow Jones Industrial Average rose 1.7% to 11,103, the S&P 500 Index climbed 2.1% to 1,155 and the Nasdaq Composite advanced 2.7% to 2,479.

Improved Data for the US Economy

Although the US economy is still quite troubled, last week's data was generally stronger than expected. Data from the auto industry, the construction sector and manufacturing all showed signs of improvement and, importantly, so too did the labor market. Initial jobless claims had risen during August and September, but have since come back down closer to those levels seen during July, which helps suggest that the economy has been going through a rough patch rather than entering into recession. Friday's employment report was also somewhat reassuring, with jobs from the private sector rising by 137,000 for a net total of 103,000 new jobs in September. The report also showed modest upward revisions for August and July as well as an increase in average hours worked. The unemployment level was unchanged at 9.1%, a still uncomfortably high figure.

One area of the economy that remains a significant source of weakness is the housing market. Housing starts bottomed in early 2009 and today's level is only barely above that bottom. There is a great deal of excess inventory in the housing market, which is creating a structural problem of forcing too much wealth to be tied up in unproductive real estate.

Policy Options for Europe

In contrast to the United States, it now seems to be an almost foregone conclusion that Europe is headed for a recession as that region's economy has been dragged down by the debt crisis. Policymakers still have a great deal of work to do to avoid an even larger disaster than what is already being faced. They do have a number of options, including enacting short-term fiscal stimulus measures, further increasing the funding of the European Financial Stability Facility, moves to more aggressively recapitalize the banking industry and a lowering of interest rates by the European Central Bank (ECB). It is unlikely that all of these measures will be enacted, but some sort of combination could, at a minimum, buy some time.

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would need to be done in conjunction with fiscal reforms in debt-laden countries to correct their broader structural problems. This is, of course, easier said than done, but as we have been suggesting for some time, the earlier policymakers act, the less expensive such actions will be in the long-term.

Stock Valuations Unclear

For the past couple of months, equity markets have been largely driven by the macro concerns of the European debt crisis and the weakness of the US economy. Stock fundamentals, however, have remained solid, particularly in terms of earnings. We are currently at the beginning of the third-quarter earnings season, and expectations are running high for yet another strong quarter. Corporate earnings guidance for the future is likely to be mixed, but another good quarter of results would show yet again that companies have been able to manage well in the face of all of the macro uncertainty.

It is difficult to assess value in the current environment. If the European debt crisis were to suddenly disappear, stocks would appear very cheap (some would say dirt cheap), but of course the uncertainty over the debt crisis remains the critical wildcard. From a technical perspective, over the past couple of weeks the S&P 500 tested the 1,100 low it reached in August and while that level was briefly pierced from a price perspective, stocks rebounded quickly which perhaps makes the 1,100 level a stronger floor. This is not to say that that level will not be tested again, but we do believe it is a good sign.

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