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Weekly Investment Commentary

Looking Past Weak Data; Awaiting Policy Responses

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Markets Bounce on Policy Hopes

Although last week featured some lackluster economic and earnings news, investors continued to focus their attention on the growing possibility of additional monetary policy action, particularly from Europe. For the week, the Dow Jones Industrial Average climbed 2.0% to 13,075, the S&P 500 Index advanced 1.7% to 1,385 and the Nasdaq Composite rose 1.1% to 2,958.

A Soft US Economy and Earnings Backdrop

The headline US economic data last week was the second quarter gross domestic product report, which showed that the US economy grew at a 1.5% rate. The findings were more-or-less in line with consensus estimates and confirmed the prevailing view that economic growth has been in the midst of a soft patch. For some time, our view has been that the US economy would be growing somewhere around the 2% level in 2012, and the data does little to change our forecast. At its present trajectory, the United States is growing at a slightly-below-potential rate, suggesting that the case for additional policy stimulus is not clear cut.

Not surprisingly, given the modest economic backdrop, the corporate earnings environment in the second quarter has also been somewhat stagnant. At this point, it appears that a high number of companies will have fallen short of growth expectations for the first time in quite a number of quarters. Forward guidance has also been relatively weak, suggesting that these negative trends may persist into the future. Corporate managements have been reluctant to spend the high levels of cash on their balance sheets given the high degree of policy uncertainty, both in the United States and in Europe. The one silver lining to corporate and economic weakness and uncertainty is that the risks already appear to be priced in to the equity markets.

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Looking for Policy Help

This week, both the European Central Bank (ECB) and the US Federal Reserve will be holding policy meetings. We are not expecting any real news from the US Fed at this point. While the possibilities of a new round of quantitative easing may be growing, we do not believe the Fed is quite ready to commit.

In contrast, indications are that the ECB will be announcing a renewed round of peripheral bond purchases as part of its efforts to address the ongoing sovereign

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debt crisis. In public comments last week, ECB President Mario Draghi strongly suggested that such action was likely as the bank is very focused on combatting speculative pressures on Spanish and Italian bonds.

In our view, the current up-cycle, both in terms of the economic recovery and in terms of equity prices, remains intact.

Backdrop Remains Equity Friendly

As we saw last week, investors remain focused more on macro trends and issues than on market fundamentals. In particular, investors' ability to shrug off a period of earnings weakness as they focus on additional policy help suggests that the current equity bull market still has some legs.

In our view, the current up-cycle, both in terms of the economic recovery and in terms of equity prices, remains intact. For some time now, we have been calling for an environment of modest economic and earnings growth (but, importantly, not a recession in the United States). We have also been suggesting that continued monetary easing around the world would be likely. Such a backdrop suggests that the "muddle through" economy and "grind higher" equity environment should continue.

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