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Weekly Investment Commentary

Despite Uncertainty, the Bull Market Should Persevere

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Stocks Give Back Their Previous Week's Gains

Stocks struggled last week in the face of some weaker economic data (most notably, a disappointing April payrolls report). For the week, the Dow Jones Industrial Average dropped 1.4% to 13,038, the S&P 500 Index fell 2.4% to 1,369 and the Nasdaq Composite declined 3.7% to 2,956. These losses roughly corresponded to the gains that stocks had made in the previous week and, as a result, stocks are now at the lower end of the trading range that has been in effect for the last three months or so.

Economic Momentum Falters...

Recent data does appear to confirm that economic growth has softened a bit. The April labor market report was disappointing, as jobs grew a less-than-anticipated 115,000 (although the data also showed upward revisions for February and March). The unemployment rate fell slightly to 8.1%, but even that data was interpreted negatively as it suggests that some are giving up on finding employment and are dropping out of the workforce.

Not all of the data has been uniformly negative, however. The Institute for Supply Management Manufacturing Survey (which tends to be correlated with other cyclical variables) came in stronger than expected last week. Additionally, housing market data continues to suggest that housing may be slowly emerging from a multi-year quagmire. Finally, we would point to corporate earnings as a source of strength. As the first-quarter earnings season winds down, results continue to be strong. In our view, it is likely that corporations will be able to maintain their high profit margins going forward, especially since labor costs are likely to remain low.

On balance, it does not appear that the economic backdrop has changed enough in recent months to cause the Federal Reserve to alter its ultra-accommodative course. We are still not expecting the Fed to announce any sort of new quantitative easing measures, especially since core inflation remains well contained. It appears to us that the economy is still growing, but there are reasons to be concerned about its pace.

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...Although Longer-Term Outlook Has Improved

Despite these concerns, it would be a mistake to suggest that the global economy is on the brink of any sort of disaster. The world has been battling the aftermath of the credit crisis for several years now, but we do believe that conditions have improved compared to where they were in recent years.

To start, there has been a noticeable change in central bank policy over the last twelve months. One year ago many central banks were still in tightening mode (the US Fed excepted). Both the European Central Bank (ECB) and the People's Bank of China in particular were raising rates and restricting the supply of money to the global credit system, which was exacerbating ongoing debt problems. Today, the situation is quite different. Chinese authorities are working to support their economy in their efforts to engineer a soft landing. In Europe, the ECB has been on an easing campaign since late last year and recently gave some indications that an additional rate cut may be in the offing (possibly as early as June).

From a broader economic perspective, conditions are also better today than they were one year ago. At this point last year, the United States was coming off of a quarter in which growth slowed to a virtual standstill and while conditions today are certainly not great, they are at least decent. Additionally, much of the rest of the world appears to be on reasonably firm footing. The chief exception, of course, is Europe. That region is facing worse economic conditions and the financial environment remains dicey and subject to political uncertainty.

The Cyclical Bull Market Remains Intact

From a macro perspective, we believe that stocks remain well positioned relative to alternatives. The broad economic backdrop is equity-friendly, monetary policy is accommodative and valuations are not stretched.

There is a great deal of uncertainty that is acting as a headwind for the markets. In the United States, perhaps the main uncertainty is over the looming fiscal and tax issues that must be dealt with before the end of the year. Additionally, the still-developing European debt crisis has the potential to derail markets, as does the possibility for worse-than-expected economic growth. In any case, while we do expect to see markets continue to churn for the near term, we also believe that stocks will eventually be able to resume their climb.

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