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Weekly Investment Commentary

Amid Crosscurrents, the Positives Outweigh the Negatives

July 18, 2011

Markets have been highly volatile over the past several months and following a couple of weeks of gains, stocks fell again last week with the Dow Jones Industrial Average down 1.4% to 12,480, the S&P 500 Index declining 2.1% to 1,316 and the Nasdaq Composite sliding 2.5% to 2,790.

In addition to heightened levels of unease over the sovereign debt crisis in Europe and escalating noise over the debt ceiling in the United States, market volatility has been driven by uneven economic data. While we remain convinced that the economy is in a recovery mode, it is important to remember that recoveries that occur in the aftermath of financial crises tend to be bumpy and slow. The current recovery is no exception.

If we were in the midst of a "normal" recovery, real US gross domestic product growth should have averaged around 6% over the last two years given the depth of the recession. In actuality, it has averaged less than half of that. The most recent data suggest that the first half of 2011 will have expanded at a less-than-2% pace. This puts the United States at a critical juncture. Since 1960, every time year-over-year growth has fallen below 2%, the United States has entered into a recession.

Despite the flurry of weak economic data, however, we do not believe a recession is likely, and believe that the foundation for recovery remains in place. There are, in fact, a number of signs that provide reasons for optimism. Gasoline and oil prices have fallen from their highs earlier the year, the disruptions from the Japanese earthquake are fading, deleveraging trends are slowing, overall demand levels remain decent, the labor market is slowly recovering and, despite the rhetoric over deficit issues, fiscal restraint is unlikely to pose a significant drag on growth.

Although it is not our baseline view, the possibility that growth will falter in the second half of the year is a real risk. This raises the question of what policymakers would do if growth continues to disappoint. The first (and possibly only) line of defense would be for the Federal Reserve to launch another quantitative easing program. Such an outcome, however, is extremely unlikely. The Fed has downshifted its growth expectations, but not to the point that it has signaled the need for further action. Additionally, with core inflation creeping higher, the central bank is more attuned to inflation risks than it was before.

If our cautiously optimistic view is correct, we should start seeing some clearer evidence that growth is improving over the coming months. In particular, investors should be on the lookout for improved manufacturing data, declines in unemployment claims, increases in hours worked, continued positive corporate earnings results and a further pickup in bank lending. We are expecting to see all of these trends, which should help the economy regain some footing.

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Outside of US economic growth trends, a number of other factors bear close watching. As we have seen in recent weeks, the sovereign debt crisis in peripheral Europe clearly requires careful attention. Any material increase in bank funding costs, especially in core Europe, would be a serious source of concern since it would suggest that the firewall policymakers have tried to put up around the weaker European members is not holding. Additionally, while we expect to see a resolution regarding the US debt ceiling issue, the uncertainty caused by the debate has the potential to further disrupt markets. The future direction of the dollar is also unclear. On the one hand, relatively easy monetary policy in the United States and uncertainty about the domestic growth picture are both dollar-negative. Moreover, if the situation in peripheral Europe calms down, as we expect it eventually will, the euro would likely strengthen against the greenback. On the other hand, the dollar remains cheap and is likely to strengthen later this year as the domestic growth picture improves and investors start to focus on the prospect of the first Fed rate hike, which we expect sometime in the middle of next year.

Ultimately, since we expect the US economy will improve in the second half of 2011, we also expect the backdrop to become more friendly for stocks. Our bottom line view is that investors should maintain a reasonably constructive bias toward risk assets, but should also be prepared to scale back exposure if evidence of economic growth acceleration does not materialize.

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