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Weekly Investment Commentary

Federal Reserve Actions Help the Rally to Continue

September 17, 2012

Market Gains Accelerate on Fed Easing Plans

The headline news last week was the US Federal Reserve's announcement of a new round of quantitative easing in which the central bank plans to purchase $40 billion of mortgage-backed securities on a monthly basis (without a predetermined end date). The Fed also pushed back the timeframe on how long it will maintain its current zero-interest-rate policy, indicating that the current level of rates should be in effect through the middle of 2015.

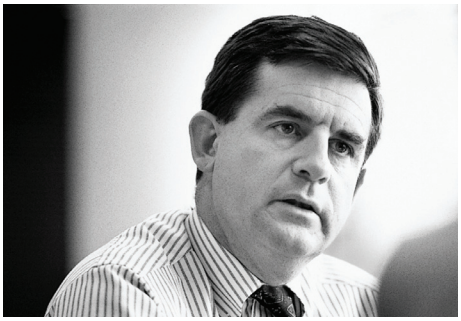
While the fact that the Fed announced new easing plans was not unexpected, the aggressiveness of the plan and its open-ended commitment came as a positive surprise to observers. Equity markets jumped on the news, with the Dow Jones Industrial Average climbing 2.2% to 13,593, the S&P 500 Index rising 1.9% to 1,465 and the Nasdaq Composite advancing 1.5% to 3,183 for the week. In contrast to market action following previous Fed easing announcements, last week also saw a significant selloff in bonds and an increase in inflationary expectations.

Political (and Other) Risks Bear Watching

The pending US "fiscal cliff" has been much in the news lately and its ultimate resolution is far from certain. We still hold out hope that there is a better-than-average chance that Congress can come to some sort of agreement during a last-minute lame duck session post the November elections to soften or delay some of the scheduled provisions. For this to happen, the Democrats would have to accept some sort of extension of the scheduled tax cuts and the Republicans would need to agree to delay some spending cuts. Should the parties not be able to come together on some sort of deal, the political environment could become more difficult in 2013.

In addition to politics, investors are also retaining focus on US economic fundamentals. Data continues to be mixed, with housing and retail sales trending down a bit last week and industrial production looking a bit better. We are still maintaining our view that US growth should trend around the 2% level for the time being.

Outside of the United States, we would note that concerns over the European debt crisis continue to percolate. The European Central Bank has committed to using its balance sheet to support the euro, but downside risks for the region remain. Growth is slow, the banking system is troubled and policymakers still need to chart a path



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forward for greater fiscal policy integration. Additionally, turmoil in the Middle East and elsewhere has been heating up. In addition to the violent protests occurring at US embassies, concerns are growing over Iran's uranium enrichment programs. The possibility of a unilateral Israeli strike on Iran is a worrisome one and would have unforeseen effects on the global economy and financial markets.

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Signposts for a Continuation of the Bull Market

Although volatility has not gone away and downside risks have remained in the forefront over the past several months, stocks have continued to perform extremely well. On a year-to-date basis, stocks are up around 18% in the United States and even higher in other markets. With 20/20 hindsight, it appears that valuations were overly depressed at the beginning of the year and that confidence in policymakers to address Europe's problems was too low. Additionally, it seems that many investors were positioned too defensively and had some catching up to do.

Looking ahead, there are some signposts investors should be looking for to determine whether or not the current up-leg in risk assets can continue. First, we will need to see some indications that aggressive monetary policy is working. That is, we'll need to see some improvements in economic growth statistics. We also would need to see the European Central Bank continue its policy support. There is still a great deal of room for policy error and the work of Europe's politicians and policymakers is far from over. Additionally, we would look for clearer signs of a soft economic landing in China. These developments are all certainly possible and given that valuations are not extended, markets do have room to make further gains.

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