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Weekly Investment Commentary

Have We Reached the End of the Rally?

April 2, 2012

Markets Rise to Cap an Exceptionally Strong Quarter

Markets moved modestly higher last week, which helped stocks to return one of the strongest first quarters in history. For the week, the Dow Jones Industrial Average climbed 1.0% to 12,212, the S&P 500 Index rose 0.8% to 1,408 and the Nasdaq Composite advanced 0.8% to 3,091. On a year-to-date basis, US stocks (as measured by the S&P 500 Index) rose by an impressive 12%, although it is important to note that the pace of growth slowed noticeably toward the end of the quarter, suggesting that the rally has been weakening.

Economy and Policy Remain Supportive

One of the primary reasons for the recent advance in stock prices, of course, has been that economic data have been surprisingly positive. Additionally, central banks around the world (including the US Federal Reserve) have remained committed to retaining exceptionally accommodative monetary policies.

There are certainly some significant downside risks that investors should remain aware of, including rising oil and gasoline prices that have been exacerbated by escalating geopolitical tensions. Additionally, we have seen some continuing progress regarding the ongoing debt crisis in Europe and while the risks of chaotic defaults seem less today than they were in the middle of 2011, political developments could trigger some setbacks.

In any case, however, we believe that the macroeconomic and policy backdrop remain broadly supportive of risk assets. In the United States, we expect the labor market to continue to improve as the year progresses and even the long-beleaguered housing market has been showing increasing signs of life. Recent comments from Fed Chairman Ben Bernanke indicate that the central bank remains concerned about economic risks and the Fed has made it very clear that its desire is to keep interest rates at historic lows for the foreseeable future. At this point, we believe that the odds for a new round of quantitative easing (i.e., QE3) remain very low given the positive trend of leading employment and economic indicators.

US Political Risk Has Grown

One wildcard that has the potential to disrupt our generally positive outlook is the US political situation. The United States faces some enormous economic, tax policy and debt-related issues that need to be resolved by the end of 2012, but it is becoming

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increasingly clear that little or no action is likely to be taken until after the November elections. There appears to be a general consensus that a lame duck session of Congress in December will become the venue for cobbling together some new economic and tax policies, but there is no guarantee that Congress will be able to act in time to write and pass legislation.

Specifically, we believe Congress needs to extend or redesign the Bush-era tax cuts that are scheduled to expire at the end of this year and reconsider the budget sequestration that calls for $600 billion over 10 years in cuts for both defense and domestic discretionary spending. Should Congress fail to act, we believe there would be significant negative effects for the US economy and financial markets. The consensus among economists is that if nothing is done, higher tax rates and sharp spending cuts would shave between 3% and 4% off the pace of US economic growth, which could trigger a high probability of a recession.

An additional issue is that the debt ceiling may need to be raised again before the end of 2012, and as we saw from the acrimonious debate surrounding this issue last year, such issues cannot be taken lightly. In recent years, Congress and the Administration have made a habit of waiting until the last possible minute to address these sorts of issues, and they certainly could do so again this year, but in any case, investors have reason to be concerned.

A Pause in the Market Rally?

Our overall view about the markets is that improvements in the global economic outlook, continued easy financial conditions and slowly improving investor risk appetites are all reasons that stock prices should continue to crawl higher.

Markets have, however, paused somewhat in their rally over the last several weeks. To a large extent, this can be attributed to the fact that prices had risen so far so quickly and we have been saying for some time that markets were overdue for a period of consolidation or correction, but it is also important to emphasize that we believe we will need to see further evidence of economic improvement for gains to continue. We continue to believe that stocks are headed higher from here and do not believe that we have seen the market highs for 2012 yet, but we would caution that the pace of gains is likely to be slower and more uneven than they were during the first quarter.

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