

Weekly Investment Commentary

Risks Remain High, but May Be Receding

November 7, 2011

Volatility Rises Over Greek Surprise

Market action last week was dominated by the early in the week announcement from Greek Prime Minister George Papandreou that he would call for a referendum to allow Greek citizens to vote on whether or not the country would accept the previously announced bailout package in exchange for additional austerity measures. This surprise announcement called into question the stability of the eurozone, renewed risks of a chaotic default of Greek debt and caused risk assets (including stocks) to sink sharply. After it became clear that this decision was politically untenable, the probability of such a referendum faded and markets managed to stage a recovery. For the week as a whole, however, stocks were down, with the Dow Jones Industrial Average falling 2.0% to 11,983, the S&P 500 Index declining 2.5% to 1,253 and the Nasdaq Composite dropping 1.9% to 2,686.

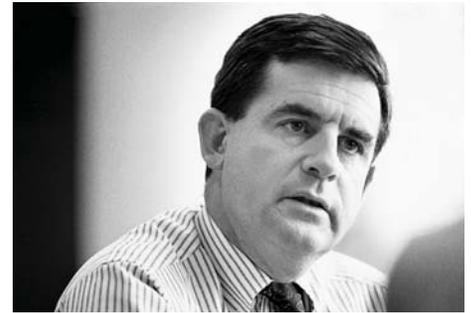
In related European policy news, the European Central Bank (ECB) announced last week that it would lower rates from 1.50% to 1.25%. While we recognize that this is a positive step in terms of promoting a more growth-friendly environment, it only partially unwinds the two ill-timed rate hikes imposed by the ECB earlier in the year.

More Moves From the Fed on the Horizon?

The US Federal Reserve met last week and, as part of its decision to keep rates on hold, also announced that it had lowered its economic growth forecast for the country for the next couple of years. While some viewed this downgrade as a surprise, our view is that the Fed was merely catching up with consensus forecasts that had previously taken a dimmer view of the US economy.

Given the Fed's comments, it appears the central bank may be paving the way for an additional round of quantitative easing (i.e., a QE3 program). The Fed has been extremely active in recent years and while the central bank's programs may have prevented a more serious economic disaster, it has failed to deliver the sort of decent economic growth and sharply decreasing unemployment that is typical during the early stages of economic recoveries. To a large extent, this is due to the fact that consumers are still in a deleveraging stage and overall confidence levels remain depressed, which is preventing businesses from hiring.

In any case, we do not think the Fed is quite ready yet to enact QE3, but should we see some sort of combination of further chaos in Europe, inflation levels receding further and economic growth deteriorating, the likelihood would grow. On the economic front, last week saw the release of the October payrolls report. Gains were slightly weaker than expected (up 80,000), but the data also showed that gains in August and September were revised up sharply and that unemployment fell very slightly, from 9.1% to 9.0%.



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Market Risks Appear to Be Fading

Notwithstanding last week's decline, markets have accelerated sharply since early October, and it is worth taking a step back to consider what has changed over the past month. Several weeks ago, investors were facing the dual threats of the inability of European policymakers to solve the debt crisis and what seemed to be a growing likelihood of a double-dip recession in the United States. Given that backdrop, equity risk premiums had moved sharply higher. Today, while the environment can hardly be called great, these risks seem less severe than they previously were, which has allowed the risk premiums to recede somewhat.

In Europe, the odds are growing that policymakers will be able to contain the debt crisis and engineer some sort of stable and organized default of Greek debt. Additionally, the ECB has transitioned to an easing bias, which should provide at least some help for the overall economy. In the United States, risks of a renewed recession have been fading and while growth levels are certainly not robust, the economy does appear to be poised to continue to deliver modestly positive levels of growth. The debt crisis and ongoing economic uncertainty are likely to remain headwinds for stocks for some time, but it does appear to us that markets have moved past the period of greatest risk.

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