

Weekly Investment Commentary

Equity Gains Likely to Continue, But at a Slower Pace

February 27, 2012

Markets Climb to 12-Month Highs

Stock prices rose again last week, although at a more labored pace than has been the case for most of 2012. For the week, the Dow Jones Industrial Average rose 0.3% to 12,982 (and did move above the psychologically important 13,000 level a few times), the S&P 500 Index advanced 0.3% to 1,365 and the Nasdaq Composite climbed 0.4% to 2,963. With these gains, markets have reached new 12-month highs and have rallied close to 25% from their low point of October 2011.

A Quiet Week for the Economy, But Good News Nonetheless

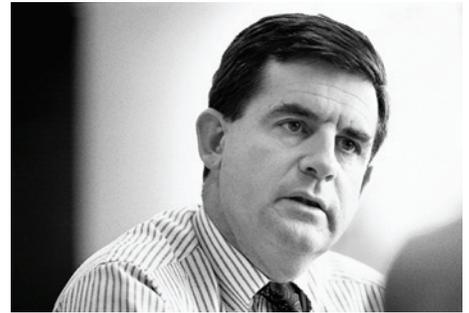
It was a relatively subdued week in terms of economic data, with the highlight perhaps being the weekly initial unemployment claims, which were unchanged (a stronger-than-expected result). This data helps confirm that improvements in the labor market have been gaining traction. This Friday we will see the February employment report and most economists are calling for a new jobs number of 200,000 or higher with a flat or perhaps slightly lower unemployment rate.

One area of the economy that has long been troubled is the residential housing sector, but this area of the economy is beginning to show some limited signs of improvement. New home sales, mortgage applications and home building levels are all showing some gains and the large inventory of unsold homes is beginning to clear. We believe the housing market remains in the midst of a multi-year bottoming process that began in 2009 and we expect that residential construction will be a modest positive contributor to growth in 2012, as it was last year.

From a global perspective, the world economy has experienced a decent start to 2012, but the ongoing recovery does have some risks and question marks. Fiscal policy remains tight in some quarters of the globe and there is still room for easing (as we saw with the Bank of Japan's recent decision to enact some new quantitative easing measures). Additionally, ongoing debt deleveraging remains a concern, as does the recent move higher in oil prices. Of course, we would also add the ongoing European debt crisis to the list of issues that could potentially disrupt the global economy's positive momentum.

Climbing Oil Prices Spark Concerns

Several of the risks that we have been discussing for some time now have ebbed over the last several months, such as the removal of the uncertainty over the US payroll tax cut extension, some additional clarity over the Greek debt restructuring and China's policy easing and likely economic soft landing. An additional risk, however, has surfaced in the form of higher oil prices. The oil price spike from early 2011 is fresh in investors' minds and the recent advance in oil prices has some wondering whether history will repeat itself. Last year's price spike came as a result of social and political unrest throughout the Middle East and in North Africa and this year escalating geopolitical tensions with Iran has been the primary culprit.



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While higher oil prices are unambiguously a negative for global economic growth and have the potential to act as a drag on equity markets, the scale of the recent increase has still been relatively modest. To put it in context, oil prices have advanced by around 20% over the last few months. In contrast, oil jumped 50% between September 2010 and March 2011. While higher oil prices bear watching, we would not consider oil a significant risk unless the price increase grows more severe.

Further Gains for Stocks?

The impressive advance we have seen in stock prices over the past several months has largely come about from a string of positive economic news and the absence of the emergence of additional downside risk. In other words, a few months ago, stocks were priced for a weaker macro environment than the one that has come to pass. So what will it take for stocks to continue to move higher? We believe we would need to see some broader improvements in economic data and/or further political progress in terms of reducing macro uncertainty.

Regarding that second point, last week's announced Greek debt restructuring deal should help reduce some uncertainty, assuming the measures are successfully implemented. There was little market response to the announced deal as it generally met investors' expectations and there is still more work to be done on this front. We expect the situation in Greece to worsen from both a fiscal and social perspective, but we also believe that the debt restructuring will move forward.

Equity risk premiums have fallen in recent months as markets have rallied and we do believe there is room for further advances. At the same time, however, we expect the pace of price appreciation to become slower and more uneven. As we have been saying for the last couple of weeks, we would not be surprised to see some sort of pullback or correction in the near term, but we also believe that stock prices will end the year higher than where they are today.

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