

## Weekly Investment Commentary

### Intense Volatility Rattles Investor Confidence

August 15, 2011

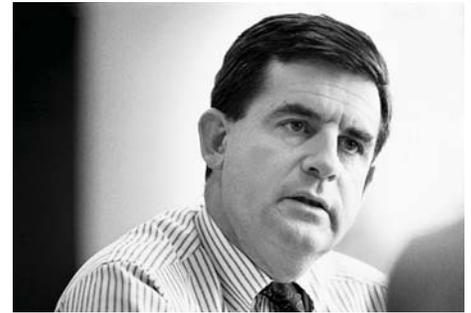
Stocks endured intense volatility last week. The Dow Jones Industrial Average experienced four consecutive daily 400-point swings for the first time in history and markets moved over 4% on each of those days, marking only the fifth time in the last century that occurred in a single week. After all was said and done for the week, the Dow dropped 1.5% to 11,269, the S&P 500 Index fell 1.7% to 1,179 and the Nasdaq Composite declined 1.0% to 2,508.

The primary catalysts for the high levels of volatility have been, of course, S&P's downgrade of US Treasuries and the ongoing sovereign debt crisis in Europe. Over the past couple of weeks, investors have been aggressively "de-risking" as they have been downgrading their outlooks for the future of global economic growth. The broad concerns about the health of the global economy are clearly understandable given that in many parts of the world fiscal stimulus has been largely exhausted and monetary policy rates are already at or near zero. Given this backdrop, many investors are deeply fearful of the possibility that declining markets could exacerbate an already-weak economy via a further weakening in confidence.

The Federal Reserve held its regularly scheduled policy meeting last week and acknowledged that the US economic recovery was "significantly slower" in the first half of 2011 than it had previously expected. Additionally, the central bank lowered its forecast for growth and indicated that it believed downside risks have grown. Given this backdrop, the Fed indicated that it planned to keep the Fed Funds target rate at its current level of between 0% and 0.25% through at least mid-2013. This statement represents a dramatic change in the Fed's stance and is the first time that it announced a specific future time frame for interest rate decisions.

There was also some positive economic news that was released last week. Initial jobless claims for the week ended August 6 fell to below 400,000 for the first time since April, a trend that reinforces our view that the softness in the labor market continues to slowly fade. Additionally, retail sales for June were revised higher and July's retail sales figures also increased.

Looking ahead, we continue to believe that the fundamental foundations for the global economy should be sufficient to keep the recovery on track, but economic growth will likely continue to be anemic. Confidence levels are extremely low and an additional influx of liquidity may be needed. The deteriorating economic conditions are making it clear that additional action by the world's major central banks may be necessary to bolster confidence and stabilize the global economy. The US Federal Reserve and the Bank of England have been discussing the possibility of additional asset purchases and the European Central Bank may also be preparing to widen its purchase list of sovereign



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bonds. Monetary policy will need to remain accommodative until well after economic growth has turned around (a fact that the US Fed clearly acknowledged with its comments last week).

For the United States, there is serious work to be done to repair the country's balance sheet. The United States has experienced a significant deterioration in finances since the late 1990s when the budget was last in surplus. There is a great deal of ongoing debate in Washington over these issues, but it looks like any real progress will have to wait until after the 2012 elections. In terms of Europe's debt issues, a comprehensive pan-European solution is needed rather than just the temporary Band-Aid approaches taken so far. Some initial progress has been made on this front, but more is needed. All of this suggests that debt issues will remain a concern for some time.

Our summary view is that we believe investors are overly pessimistic about the possibility of a renewed recession in the United States. It is important to remember that equity markets have a poor track record as acting as predictors of recessions and corporate fundamentals remain strong. Since 1950, the United States has never entered a recession with corporate balance sheets as flush with cash as they currently are — at present, nonfinancial companies are holding cash in the amount of around 11% of their balance sheets, the highest level in over 60 years. From an earnings perspective, results have also been very strong. Second-quarter results show that earnings have grown over 18% on a year-over-year basis driven by a nearly 10% rise in revenues. Corporate earnings are all but certain to surpass their mid-2007 highs before the end of this year, and yet stocks remain about 35% below where they were at that time. This backdrop underscores how inexpensive stocks are at present. This is not to say that we expect a rapid price rebound since markets are likely to continue to be driven by near-term economic and debt issues, but it does suggest that the long-term outlook for equities remains positive.

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