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Weekly Investment Commentary

Global Policy Remains a Critical Catalyst

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Market Messiness Persists

After a couple of weeks of declines, markets managed to recover a bit last week, although they appear to remain mired in the same sloppy trading pattern they have been in for the last month. For the week, the Dow Jones Industrial Average gained 1.4% to 13,029 and the S&P 500 Index advanced 0.6% to 1,378. In contrast, the Nasdaq Composite fell 0.4% to 3,000 due in large part to a sharp decline in Apple's stock price.

Economy and Earnings: Continued Ups and Downs

The economic backdrop continues to be mixed, but the overall trend continues to be one in which the US economy appears to be growing slowly. One interesting pattern that has emerged in recent months is that the US household sector has been picking up strength at the same time that the industrial side has been weakening a bit. While an improving household sector is critical to ensuring positive long-term growth, there are some caveats to this trend. First, some of the strength can be attributed to the fact that households have been dipping into their savings to boost spending, which is clearly not sustainable. Additionally, some of the higher levels of economic activity can be attributed to the unusually warm weather that we saw early in the year, meaning that some of the growth may have been "borrowed" from the second quarter.

Regarding corporate earnings, it is still early in the first-quarter reporting season, but so far the data has been quite good. At this point, just over 20% of companies have reported (representing about one-third of the US market capitalization) and around 80% of those have posted better-than-expected results. At this point, it seems clear that expectations for earnings growth declined too much earlier in the year.

Next Steps for Policymakers

Although the global economic and market backdrop certainly appears better than it did during the credit crisis, improvements have been slow and confidence remains shaken. Businesses, consumers and investors around the world are wary and remain on the lookout for signs of double dip recessions and market selloffs. While such attitudes are common during economic recoveries, the magnitude this time around appears well above normal.

These attitudes are hardly surprising, given that deleveraging forces remain high and the global risks of deflation are still present. In this sort of environment, the onus is falling on policymakers to provide continued assurance that they are committed to erring on the side of reflation until well after the economy has shifted into a self-sustaining expansion.

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Since late in 2011, all of the world's major central banks have clearly affirmed their resolve to sustain the economic recovery and keep interest rates low. The problem, however, is that central banks on their own cannot address all of the issues. In particular, many politicians and governments in Europe have been slower to act in helping to solve that region's debt crisis. While some of the lack of decisive action can be blamed on ongoing election campaigns it is nonetheless disappointing. Since last year, the European Central Bank has been quite aggressive in terms of attempting to promote liquidity, but the overall progress in that region has been slow and inconsistent.

Policy and Stocks Are Linked

Even a cursory look at stock market performance over the last several months shows how important global monetary and fiscal policy can be. The rally that started late last year and that persisted until about a month ago was triggered at least in part by the ECB's announcements that it would become more aggressive in terms of promoting growth and liquidity. Taking a further look back, it seems clear that the 2010 downturn in stock prices ended when the Federal Reserve announced its QE2 program and the 2011 selloff was halted by some forceful action from both the Fed and the ECB.

The world's central banks have drastically expanded their balance sheets and there is ample liquidity available. The issue is that this liquidity has been slow to move into the real economy since banks have been reluctant to lend and since private-sector credit demand has been weak. As the global economy continues to heal, however, money and credit growth is starting to improve (more so in the United States than in Europe or Japan), which is a positive sign.

Given these trends, some are wondering if the current market environment (call it what you will: a correction, a consolidation or a digestion) will require additional policy action to avoid it transitioning into something more serious. We do not believe new policy action is needed to act as a catalyst for a new leg of the bull market, but we do think we need to see a persistent commitment from all policymakers around the world to support continued economic recovery.

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