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Weekly Investment Commentary

Markets Gain Ground, but Remain Range-Bound

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Stocks Rise as Earnings Accelerate

Stocks managed to post their third consecutive week of gains, again thanks to perceived progress on the European debt crisis and signs of improving economic data. For the week, the Dow Jones Industrial Average climbed 1.4% to 11,808 and the S&P 500 Index advanced 1.1% to 1,238. In contrast, the Nasdaq Composite declined last week, falling 1.1% to 2,637.

Also boosting sentiment last week was some better-than-expected results on the earnings front. Third-quarter earnings season is now well under way, with more than one-third of companies having reported results. At this point, 62% of companies have exceeded revenue forecasts and 71% have beaten earnings estimates. As has been the case for some time, the financial sector has lagged the rest of the market.

Policymakers Grapple With European Debt Issues

The ongoing debt crisis in Europe remains the critical issue affecting global markets. This past weekend, representatives from the 27 members of the European Union met to discuss potential resolutions to the crisis and appeared to at least make some progress, promising a package by mid-week.

Policymakers are scrambling to find and implement programs that will save the euro and avoid a collapse of the European banking system. There are some similarities between the current European debt crisis and the financial crisis of 2008, and as with the situation a couple of years ago, it appears that the financial and economic pain will have to become severe enough for policymakers to take some unwanted but necessary steps to prevent widespread debt deflation. The parties are under tremendous pressure to solve the interrelated problems of Greek (and other countries') debt, weakened banks and a bailout fund in need of reinforcement. Ultimately, we believe policymakers will need to implement funding packages that are effectively open-ended in order for investors and the business sector to regain confidence in the euro and the region's banks.

Even if policymakers are able to come together on such a package, tensions could continue to escalate since any such package will not, by itself, solve Europe's debt problems. We are hopeful that policymakers will be able to stave off full-blown debt deflation, but Europe has a long way to go before balance sheets are repaired and the foundation for better growth is in place.

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US Economic and Political Uncertainty

US economic data has shown some encouraging signs in recent weeks. Retail sales figures and jobs indicators have trended to the positive, which has caused a number of economists to upgrade their forecasts for third- and fourth-quarter gross domestic product growth. The overall sense of economic uncertainty remains high, but it is looking increasingly likely that the United States will avoid a double-dip recession.

One issue that is acting as an increasing drag on economic and market sentiment is the political uncertainty and strife in the United States. There is a great deal of squabbling over the jobs-creation plans and fiscal policies in Washington, DC and the extent to which the Federal Reserve will engage in additional monetary stimulus also remains a wildcard. Time is also running out for the so-called "super committee" charged with creating a plan to rein in the federal debt. The Occupy Wall Street movement has also been gaining increased attention. It is impossible to boil that movement down to a single issue, but it is clearly a symptom of deepening social turmoil, political polarization and economic discontent in the United States.

Clearly, significant progress in Europe would help the stock market to hold a sustainable upward trend, but we also believe that continued improvements in the labor market would be a necessary ingredient.

Potential Catalysts to Break Out of the Trading Range

With the market gains in recent weeks, stocks in the United States have moved closer to the upper end of the trading range they have been in since early August (represented by 1,100 to 1,250 for the S&P 500). In the near-term, we expect that progress (or lack thereof) in addressing the European debt crisis will continue to be the main driving force behind the direction of risk assets, and given the volatility of that situation, we expect markets will continue to see some significant swings.

So what will it take for markets to break out of their trading range? Clearly, significant progress in Europe would help the stock market to hold a sustainable upward trend, but we also believe that continued improvements in the labor market would be a necessary ingredient. On the downside, we do not expect to see a major market breakdown below the 1,100 level unless the European system fails to stem the banking crisis.

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