

Weekly Investment Commentary

Will Policy Response Follow Policy Rumor?

June 18, 2012

Stocks Rise Again

The past two weeks have been better for stocks, with the major indices up in consecutive weeks for the first time in more than a month. However, investors have had to endure a seesaw of ups and downs as markets try to anticipate the next phase of sentiment. The down-market sentiment has been triggered mainly by concerns about the European financial crisis and the contagion from country to country, with the effects most visible in fixed income markets, government debt and bank stocks. Episodes of up-market sentiment reflect growing confidence that policymakers are ready to act and will do so soon.

Last week, a pivotal period just ahead of the Greek elections that could determine the next phase in attempts to stabilize the European crisis, produced positive results. The Dow Jones Industrial Average rose 1.7% to 12,767, the S&P 500 Index advanced 1.3% to 1,343 and the Nasdaq Composite inched up 0.5% to 2,873.

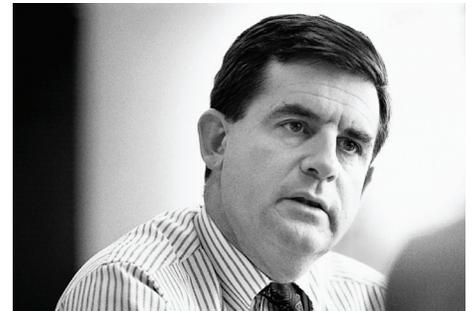
Europe Remains Stuck

Europe remains stuck in a cruel cycle of recession, a banking system in need of life support, frozen policymakers, too much debt and a downward confidence spiral. Investors and policymakers agree on one thing: Monetary stimulus by the European Central Bank (ECB) will be the most effective in stabilizing the global financial system. However, the ECB is one of the central banks that has done the least in terms of stimulus. Investors can only hope that weakening German growth, falling inflation and declining German government bond yields will dampen concerns about inflation among Germans. If so, the ECB may then have the reason and leeway to launch another round of quantitative easing (QE) with the specific aim of narrowing rising sovereign debt yields and restoring stability in the financial system.

Globally, we believe monetary policy will remain accommodative. Headline inflation this year has dropped in most major economies, and is likely to come down even more as global growth slows further. As a result, we believe central banks in the major economies will keep interest rates low for the foreseeable future.

US Economy Slow, But Steady

In the United States, economic growth slowed this spring (likely due to poor weather and the earlier spike in gasoline prices), but remains intact. Still, market chatter has again turned to talk of a new round of QE from the Federal Reserve. We are dubious



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of such a move since US Treasury yields are at new historic lows, the economy continues on a modest but reasonable growth path and even the long-ailing housing market is stabilizing.

On the policy front, a comprehensive overhaul of the US tax code is getting renewed attention in Washington, DC. The weak US economic growth, fatigue over Bush-era tax cuts, warning about the US debt outlook, pressure to reduce the world's highest corporate tax rate and worries over the January "fiscal cliff" have re-ignited pressure to get something done. While the specifics vary, the commonalities across tax reform plans under almost any November election scenario include higher taxes on capital gains and dividends, a cut in the corporate tax rate, curbs on the tax benefits of debt financing and a crackdown on overseas corporate tax avoidance schemes.

Policy Will Continue to Drive Markets

In our view, market sentiment over the next couple of weeks will likely hinge on policy developments. The outcomes will be consequential for financial markets, and may well overshadow other news. First, the implications of Sunday's Greek elections, in which voters narrowly favored a pro-Europe party, will become more apparent in terms of the impact on overall European policy. The election results will likely calm world markets to some degree and ease fears that the country will leave the eurozone, but it is still a long road for Greece. In addition, the outcome of this week's G20 meeting of nations, while not the forum to produce concrete policy actions, could set the tone for policy responses in coming months. We would expect the G20 to encourage Europe to move further toward fiscal and banking union and central banks to ease policy.

In the United States, this week's Federal Open Market Committee (FOMC) meeting will drive sentiment. Considering recent data, we believe the odds are greater that the FOMC may ease, but we remain skeptical of such a move. That said, any type of Fed balance sheet operation is likely to be supportive of equities and other risk assets. Finally, a Supreme Court ruling on the healthcare law is widely expected in the next couple of weeks, and it is clearly too close to call. Markets are at the intersection of many crosscurrents, but remain dependent on fiscal and monetary policy decisions. We will see if policy response follows policy rumor.

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