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Weekly Investment Commentary

Investors Look Forward to More Policy Help

June 11, 2012

Stocks Bounce on Easing Hopes

Following a significant slide the week before, stocks bounced back last week, primarily due to a growing sense that policymakers in Europe and the United States may be ready to engage in further easing measures. The increasing stress in Europe has put additional pressure on the European Central Bank (ECB) and on other policymakers to take stronger action, and, indeed, over the weekend European finance ministers announced a new plan to recapitalize the Spanish banking sector. In the United States, the recent trend of weaker economic data has also caused some to believe that the Federal Reserve would engage in additional easing measures, although we are not yet convinced that will happen.

In any case, the possibility of new action was enough to push stocks higher, with the Dow Jones Industrial Average jumping 3.6% to 12,554, the S&P 500 Index rising 3.7% to 1,325 and the Nasdaq Composite advancing 4.0% to 2,858.

European Policymakers Set to Take Action

The news over the weekend regarding the aid package for Spanish banks was sketchy on details and much still needs to be debated and decided, but the formation of the package is clearly a positive step in that it shows that European policymakers remain committed to combatting the debt crisis.

The ECB met last week and while it elected to keep rates on hold, bankers did signal a willingness to intervene at some point in the future should conditions continue to deteriorate. The exact next steps that the ECB will take are unclear, but possibilities include further rate cuts and/or additional bond purchases. Of these, we believe that interest rate cuts are quite likely, and we may see more than one reduction in rates over the coming months. In our view, there is less of a possibility that the ECB will engage in a renewed bond purchase program, particularly since the European Central Bank has been indicating that it would like to see politicians and governments step in and take on more responsibility.

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US Outlook Remains Stable

Although we expect the European economy to remain weak and troubled by ongoing debt problems, we continue to believe that the US economic backdrop remains fairly benign. The recent employment report for May certainly spooked investors and reinforced the notion that the United States has entered into an economic soft patch. Additionally, from a political perspective, the labor market news virtually assures that President Obama will remain on the defensive on the economy and puts greater pressure on the President and Congress to address the looming "fiscal cliff." It would be a mistake, however, to place too much emphasis on May's report. The housing market is continuing to heal, the corporate sector remains a bright spot, inflation is low, policy is easy and we expect lower energy prices should provide a lift to household spending data over the summer.

From a policy perspective, we would acknowledge that weaker economic data does increase the odds of the Fed taking some sort of additional action, but we would peg the odds at somewhere around 50/50. For his part, Fed Chairman Ben Bernanke testified before Congress last week and appeared, at best, lukewarm toward the prospect of the Fed engaging in new easing measures.

Markets Primed for a Rebound?

The sense that policymakers may provide more assistance was enough to reverse the market correction, at least for one week. The backdrop does remain fragile, however, and investors could quickly enter panic mode if additional policy help does not materialize (particularly in Europe). Should European policymakers continue to take similar steps as we saw over the weekend, investors would likely grow more confident.

In the United States, we believe the current economic angst is misplaced, although uncertainty over the fiscal cliff issues will help ensure that markets remain turbulent. Our view is that some sort of compromise should materialize, which should help the US economy remain on stable footing. From a fundamental perspective, valuations are attractive, corporate earnings remain solid and technical indicators suggest that markets may be poised for the next "risk on" phase. In all, we believe that the cyclical bull market for stocks remains intact, but the next up leg will likely not occur until we see more policy response.

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