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Weekly Investment Commentary

Euro Risks Continue but Support for Risk Assets Is "Good Enough"

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Stocks Bounce Back on Strong Earnings

Over the past month, stocks have traded in a somewhat volatile pattern as investors have been weighing both the positives and negatives. Last week, despite some renewed flare-ups in terms of the ongoing European debt crisis, investors focused on the continued string of positive corporate earnings reports. For the week, the Dow Jones Industrial Average rose 1.5% to 13,228, the S&P 500 Index advanced 1.8% to 1,403 and the Nasdaq Composite climbed 2.3% to 3,069.

At this point in the first-quarter earnings season, nearly half of the S&P 500 companies have reported and between 70% and 80% have surpassed expectations. While this alone points to strong results, the magnitude of the positive surprises has been even more impressive. The long-term average of positive surprises is close to 3% over expectations and this quarter the average has been above 6%. The one caveat to all of this is that while earnings growth remains strong, the pace of growth compared to recent years is slower.

Economic Growth Continues to Muddle Through

Last week, the preliminary gross domestic product report for the first quarter was released and it showed that the US economy grew at a slightly-less-than-expected rate of 2.2%. While this number represents a slowdown from the fourth quarter of last year, it is consistent with our expectation that the United States will continue to grow at a slow, but positive, pace for 2012.

Early in the year, the labor market appeared to be recovering nicely, but the pace of jobs growth appears to have slackened more recently. Last week's unemployment claims data was disappointing (representing the third such week) and concerns are growing that the labor market may be faltering. On the other hand, however, we have been seeing some continued improvements in the housing market. The housing sector is a critical one for the overall economy given how closely housing is correlated with such factors as consumer net worth, employment and, most importantly, confidence levels.

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For its part, the Federal Reserve met last week and made only some minor cosmetic changes to its outlook and interest rate policy statement. The Fed has made it clear that it is focusing on supporting economic growth and intends to keep rates at an exceptionally low level for some time. The bottom line is that the US economy is likely to continue to grow at a modest pace and that interest rate policy is likely to remain accommodative, trends that should be "good enough" for risk assets.

Downside Risks Include Political Uncertainty

At this point last year, two of the major downside risks were the possibility of the European debt crisis spiraling out of control and the inability of the United States to get its fiscal house in order. Today, while these remain two factors that have investors concerned and while there are some similarities between the situations one year ago and today, there are also some important differences.

The outlook for US fiscal policy is murky. The tax and fiscal policies that are set to expire at the end of 2012 are clouded in uncertainty and it is impossible to view them outside of the lens of the 2012 elections. In our view, the most likely development would be that a lame duck session of Congress acts to make some sort of extension and/or policy compromise at the end of this year, but the exact form of that will be dictated by November's election results.

This sort of political uncertainty is not confined to the United States. In addition to the US elections, we will be seeing elections or a change of leadership in a number of countries this year, including in China, France and several countries in the Middle East. All told, countries representing about half of combined world GDP are holding elections or switching leadership this year, suggesting that anxiety and uncertainty over elections has the potential to buffet markets.

The central downside risk for the global financial markets remains the European debt crisis. The risks for investors are clear. Should European policymakers (meaning both central bankers and elected officials) take their time in addressing escalating problems, the crisis would likely worsen, which could trigger some significant disruptions in global financial markets. This was the mistake that policymakers made last year, and it does appear that at least some policymakers have learned from their mistakes. The European Central Bank has remained committed to promoting greater liquidity and while politicians have been moving more slowly, our view and our hope is that policymakers will step in to prevent another full-blown crisis from erupting and to defend their hard-fought gains.

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