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Weekly Investment Commentary

Markets Vacillate Between Weaker Data and Hopes for Policy

June 25, 2012

Stocks Sink on Lukewarm Policy Action

Last week was a modestly negative one for stocks as investors continued to focus on a trend of weakening economic data. Additionally, many were disappointed by what was perceived to be a less-than-robust response from the Federal Reserve following its policy meeting last week. For the week, the Dow Jones Industrial Average lost 1.0% to 12,640 and the S&P 500 Index declined 0.6% to 1,335. The Nasdaq Composite bucked the trend and advanced 0.7% to 2,892.

Extending "Operation Twist"

Last week, at the Fed's much-anticipated June policy meeting, the central bank announced that it would be extending its Operation Twist program in which the Fed purchases longer-dated Treasuries and sells short-term Treasury bills as part of its effort to reduce long-term rates. Many observers were expecting and hoping for more aggressive action from the Fed and were anticipating the launch of a new quantitative easing program, so the news was largely treated as a disappointment.

The Federal Reserve, however, did leave the door open to the possibility of additional action at some point in the future. It is also important to remember that the Fed has already done quite a bit, both in terms of quantitative easing measures and extending the timeframe for which it intends to maintain the current zero-rate policy. In any case, the reality is that while the Fed clearly has a bias toward easing there is only so much that additional policy can do—as such, the US economy will have to continue its slow exit from the problems it has faced for the last several years.

Policy Hopes in Europe

Across the Atlantic, the conversation about Europe is also one that is dominated by discussions of policy. The current focus is on the upcoming European Union summit to be held in Rome. The hope is at that summit we will see some further agreement that would push the monetary union toward a closer political and fiscal union. Should that occur, it would be good news for risk assets in general and for euro-related risk assets in particular. As has been the case since the debt crisis began, however, there are no quick fixes and perhaps the best we can expect would be to see a set of agreements that buys policymakers more time.

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Positives Should (Ultimately) Win Out

At this point, the economic, market and policy risks appear skewed toward the downside, but we believe it would be a mistake to overlook the number of positive forces that are also present. First, while the US economy does appear to be in the midst of a soft patch, the economy is still growing and should continue to churn along at a modestly positive pace. Importantly, several leading indicators are pointing in the right direction. Housing permits, which are one of the strongest indicators of future economic activity, appear to be in an improvement period. The commercial banking system is also continuing to heal, which is supporting domestic nonfinancial profits, another important economic bellwether. Additionally, we would point out that the concerns over higher oil and energy prices evident earlier this spring have faded, and we should see a drop in core inflation readings later this year.

From a corporate perspective, we would emphasize that most corporations remain in strong shape. Balance sheets are very healthy and cash levels remain high. Companies have been reluctant to spend their cash, but we do expect to see higher levels of spending once the future direction of policy becomes clearer.

Outside of the United States, the situation in Europe obviously remains troubling, but we continue to believe that the debt crisis will remain contained. The slowdown in China has also long been a source of concern, but we have no expectation that China will experience a hard landing and expect the country to remain an important source of global economic growth.

At present, investors are faced with a high degree of uncertainty and are continuing to approach the markets cautiously. Markets have been seesawing amid the crosscurrents of macro risks and hopes for new (or at least more clear) policy direction. The war between the two will be long and hard fought, but our guess is that the next battle should be won by the policymakers. In our view, the positive forces will eventually win out, but we recognize that risks remain high and that policy needs to become more clear before risk assets can resume a stronger uptrend.

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