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Weekly Investment Commentary

Labor Trends Signal Economic Shift to Self-Sustaining Mode

April 4, 2011

Although markets contended with some downside risks last week, including higher commodity prices and ongoing debt issues in Europe, stocks managed to post further gains as they continued to bounce back from their recent market correction. For the week, the Dow Jones Industrial Average rose 1.3% to 12,377, the S&P 500 Index advanced 1.4% to 1,332 and the Nasdaq Composite climbed 1.7% to 2,790.

In economic news, one of the highlights last week was the March employment report that was released on Friday. For some time now, leading labor market indicators, including jobless claims, profit trends and lending standards have been pointing in a positive direction, and we are finally also seeing impressive growth figures in private sector jobs creation. The March report showed that payrolls were up 216,000 for the month and also indicated that the two previous months showed upward revisions. Additionally, the unemployment figure dropped again, to 8.8%. This report, combined with recent strong manufacturing data, suggests to us that the economic recovery remains on track and, more importantly, that jobs growth is finally gaining enough traction to help shift the economy into a self-sustaining mode.

Although we continue to have a generally optimistic view of the economic and markets backdrop, we would be remiss if we did not highlight some of the risks that are present. One issue that has been prominent in the headlines is the threat of a government shutdown. The latest continuing resolution expires this Friday and although signs are pointing to a growing likelihood of some sort of budget agreement, the potential uncertainty of the situation remains a potential negative. Additionally, investors need to be aware that even if the budget for the current fiscal year can finally be agreed upon, negotiations are already beginning for the 2012 fiscal year, which begins on October 1, 2011, meaning that this question of budget impasses is not likely to fade completely.

Also, some investors are concerned about what will happen when the current Federal Reserve asset purchase program (QE2) is completed on June 30, believing that the end of the Treasury purchases will result in a negative shock for stocks. In our view, such concerns are likely overdone. We have been through a similar situation before, when the Fed eased up on its purchase of mortgage securities, and the markets managed the transition without a serious problem. We are not expecting to see significant negative effects on stocks from the end of QE2.

Additionally, we would highlight the potential risk of escalating weakness in the housing market. The recent downtrend in home prices does raise some concerns, and should this slide continue it would threaten the improvements we have seen in consumer confidence and could cause renewed issues for the banking system. As with the rise in oil prices, the housing market remains a key area to watch in terms of potential threats to our cautiously optimistic outlook.

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Although stock prices have now doubled since their secular low in March 2009, we continue to believe that the macro backdrop remains conducive to further gains in equities. The Federal Reserve remains accommodative even though the economy is gaining traction and core inflation remains well contained despite higher food and energy prices. Economic improvements are continuing (and, as mentioned above, the accelerating recovery in the labor market is particularly encouraging), and corporate earnings remain a source of strength. Although gains may be modest compared to the frenetic pace of the last six months, we continue to believe that equities remain an attractive investment choice.

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