

## Investment Commentary

February 14, 2011

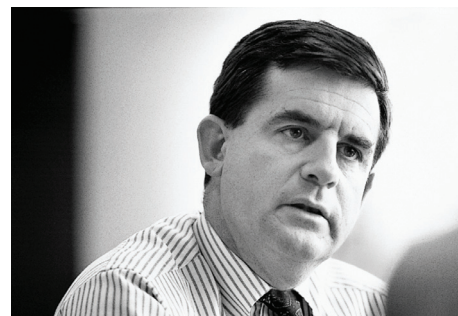
Stocks advanced yet again last week in light of rising optimism about economic growth, strong corporate earnings and a continued fading of the fears that kept many investors away from risk assets over the past couple of years. For the week, the Dow Jones Industrial Average climbed 1.5% to 12,273, the S&P 500 Index rose 1.4% to 1,329 and the Nasdaq Composite advanced 1.5% to 2,809. In our view, while the rally has been strong, it is not yet exhausted. Although a short-term correction could take place at any time, equities remain relatively inexpensive and we believe the bull market should continue.

Economic growth in the United States has continued to improve in recent weeks. Business confidence measures have moved to multi-year highs, sales levels are rising, profits are improving and business investment levels remain robust. The economy is clearly transitioning from a recovery phase to an expansion phase. The difference between the two is that the former is dependent on monetary and fiscal stimulus while the latter is based on improvements in demand from the consumer sector as well as on companies' top-line growth and growing trends in capital investment – trends that are more self-sustaining.

It is important to remember, however, that the significant long-term issues that drove the economy into recession (the fiscal crisis and resultant deleveraging) have not gone away and will still take some time to address. It is clear that the launch of QE2 in late 2010 as well as the extension of the Bush-era tax cuts (plus additional sweeteners) have helped lift near-term economic prospects, but what happens in the second half of the year and beyond remains an open question.

The murkiness of the long-term outlook combined with the fact that economic growth expectations have improved result in some additional risks. At present, expectations for 2011 economic growth have risen to around the 3.5% level, meaning that it will be an increasing challenge for data releases to result in positive surprises. It is extremely difficult at this point to make any sort of assessment as to what the economy will look like in 2012, but we expect 2012 to be a year marked by a Federal Reserve that is slowly working to normalize rates, by emerging economies that are continuing to experience faster growth levels than the rest of the world, by a political backdrop that will make President Obama eager to promote growth-friendly policies and possibly by a housing market that is able to make some contributions to economic growth levels.

One factor that we do not believe will be a significant issue in the year ahead is inflation. Rising food and energy prices have received their share of headlines, and while these factors are highly significant in emerging economies (where purchases of food and energy make up a much larger percentage of consumer spending), they are less so in the developed world. There is still a great deal of slack in the world's developed market economies (which can be seen in the labor markets), and we do not believe we need to be overly concerned about inflation.



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Given the improving economic backdrop, it should not be a surprise that we are seeing a broad asset allocation shift among investors from bonds toward equities. Some observers have suggested that the recent inflows into equity mutual funds mean that the rally in stocks may be coming to an end, but we do not share that view and continue to believe that equities are a good place for most investors to be. From a geographic perspective, we continue to believe that US stocks are very well positioned relative to alternatives. US economic growth is continuing to improve, while Japan and Europe are continuing to face some problems. Emerging markets do represent some attractive opportunities, but in some cases (such as China) growth levels are too high and inflation is becoming a problem, causing authorities to ramp up tightening efforts.

For many investors, the shift into equity markets is still in the early stages and equity valuations are hardly stretched, suggesting that the upward moves have further to run. While pullbacks and corrections will no doubt occur along the way, we believe they should be short and shallow and should be taken advantage of to add to positions.

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