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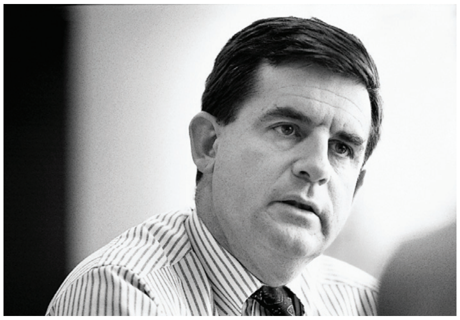
# Investment Commentary

February 22, 2011



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Last week was yet another positive one for risk assets and for stocks in particular, with the Dow Jones Industrial Average and S&P 500 Index both climbing 1.0% to 12,391 and 1,343, respectively, and the Nasdaq Composite advancing 0.9% to 2,834. The near non-stop rally is causing some investors to wonder how long it can last. Certainly, there are some risks to worry about, including the over-indebted nature of many governments, lingering credit issues from the financial crisis, inflation in emerging markets and political upheaval caused in part by rising food prices. While these factors all have the potential to disrupt markets, in our view risk assets continue to look attractive.

From an economic perspective, most indicators have been beating expectations on a steady basis over the past six months. This trend was largely due to the fact that in the middle of last year, markets had begun to price in a strong likelihood of a double-dip recession. This, of course, did not happen. At this point, most investors are acknowledging that the outlook has turned much less ominous, but no one is suggesting that all of the risks have completely gone away. From our perspective, the future course of the economy will be highly dependent on the employment conditions. Should employment growth accelerate (as we believe it will) it should go a long way in terms of making the economic recovery and expansion self-sustainable.

As the economy continues to improve, concerns over inflation have repeatedly surfaced. In the United States, data showed that the Consumer Price Index rose by a higher-than-expected 0.4% in January and while most of that advance came as a result of higher food and energy prices, core inflation also increased more than was expected (including upward price movements in apparel, air transportation and rent). In our view, inflation remains in the midst of a long-term bottoming process. Eventually, we should see higher inflation levels, but we are not expecting inflation to become a serious concern in the developed world. Unlike emerging markets, inflation in most developed economies is driven much less by commodity prices and much more by labor costs. Given current high levels of unemployment in the United States, we do not believe higher inflation levels are imminent.

On the other hand, inflation is clearly a pressing concern in emerging economies. Part of this has to do with economic growth trends over the last several years. The global recession hit the developed world the hardest and caused excess economic capacity and weaker demand levels – these trends are still evident in the developed world and are helping to hold inflation in check. Emerging nations, however, continued to grow during the global recession and are now getting an additional growth jolt as the global recovery gains traction. As a result, many emerging markets (including China) are in the midst of a tightening cycle. At present, emerging market policy tightening appears to be depressing stock prices in those markets, but economic growth levels continue to be strong, suggesting that further tightening is likely.

In addition to potential inflation risks, many investors are keeping a close eye on the political developments throughout the Middle East and Northern Africa, where populist uprisings are spreading. The end result of all of these developments remains a wildcard (both in terms of the political implications as well as the economic and market implications), but as of now, the impact has remained localized.

For now, the rally in risk assets appears set to continue, although we anticipate disruptions along the way. Many investors are in the process of purchasing equities and other risk assets largely because the alternatives (government bonds and cash) are so unappealing. The bearish view of the current rally is that it is liquidity-driven and based on artificial propping-up by overly easy monetary and fiscal policy support. While we agree that the stimulus from the Federal Reserve and other policy makers has been an important pillar in helping to restore economic growth and drive risk asset prices higher, we also believe that the economy is transitioning into a self-sustaining expansion. In our opinion, this environment of improving growth, low inflation and a supportive policy backdrop continues to represent a "sweet spot" for risk assets.

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