

Weekly Investment Commentary

Investors Should Look Past Near-Term Risks

June 20, 2011

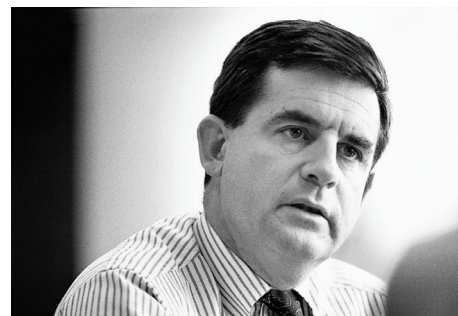
US equity averages were flat to mixed last week as investor conviction remains low. For the week, the Dow Jones Industrial Average posted a modest 0.4% gain to 12,004, the S&P 500 was up fractionally to 1,272 and the Nasdaq Composite fell 1.0% to 2,616.

Uncertainty levels remain high and investors are struggling with a myriad of economic issues. Because clarity levels and conviction are both low, investment sentiment and volatility swings have been magnified in recent weeks. From our perspective, we believe there are a number of issues that warrant concern, but we believe investors should look past the near-term risks and view the current weakness as a potential buying opportunity.

First, on the economic front, the US economy is faced with some significant structural headwinds that have made for a sluggish recovery. Despite the more negative tone of economic data over the past couple of months, we do not believe we are in the midst of anything more serious than a rough patch occurring in the middle of a sustained recovery. As such, we are optimistic that we will see a reacceleration in growth in the second half of 2011. Global industrial activity appears poised for a rebound, consumer spending levels have remained resilient, household savings rates have been climbing, banks continue to ease lending standards and corporate confidence levels remain high. The labor market experienced a downturn in May, but we believe the longer-term trend in jobs growth should remain positive. Overall, we think a pickup in economic growth in the second half of the year is likely and we are expecting to see gross domestic product growth of around 3% for the last six months of 2011.

An additional issue that has investors concerned is the current state of monetary policy. We have been commenting extensively on why the pending end of the Federal Reserve's quantitative easing program (QE2) should essentially be a non-event for investors, but questions do remain about what the Fed's next steps will be. Given the recent weakness in economic data, some investors are awaiting signals for the launch of QE3, but we think there is little likelihood of that occurring. Quantitative easing programs are (by definition) inflationary, and since inflation risks are rising, the Fed will be reluctant to add to inflationary pressures. Additionally, the political backdrop is not one in which further quantitative easing measures would be welcome. As a result, we believe there would have to be a clear risk of the United States re-entering a recessionary and deflationary spiral before the Fed would contemplate a QE3 program — an environment we do not believe is likely.

Outside of the United States, investors are again focusing on European debt issues, particularly the debt crisis in Greece. Policymakers are struggling to reach a long-term agreement that will resolve the crisis without risking further contagion. There has been some talk that a policy of deliberately engineering higher inflation levels could ease debt burdens, but we think that such an approach could have disastrous consequences.



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Despite a widespread perception that higher inflation reduces public debt burdens, we believe that such an environment would increase net new borrowing costs, making it more expensive to finance deficits and refinance maturing debt. Looking ahead, we expect the European Union and the International Monetary Fund to continue to provide support for Greece. Ultimately, the best resolution would be a combination of sustained economic growth and fiscal austerity. Engineering such an environment is, of course, monumentally difficult, meaning that risks related to sovereign debt crises will not disappear any time soon.

For investors, there is certainly no shortage of things to worry about, an environment that has caused stocks to move in a corrective or sideways pattern for close to two months. We do expect investor anxiety and market volatility levels to remain elevated for the time being. At some point, we expect stock valuations will settle at a level where investors feel adequately compensated for the downside risks facing the market. We are retaining a constructive view toward the economy and the markets and we suspect such a valuation level is not too far away. As such, we continue to recommend that investors view the current period of weakness as an opportunity to take on additional risk.

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