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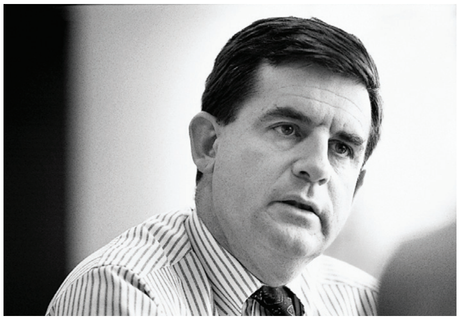
Weekly Investment Commentary

Despite Escalating Risks, Global Recovery Remains Intact

March 14, 2011



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Risk assets experienced a setback last week in the face of rising tensions in Libya and the Middle East. Additionally, the massive earthquake that hit Japan on Friday resulted in a sharp downturn in Japanese equities on Monday and increased the sense of investor unease. For the week, the Dow Jones Industrial Average lost 1.0% to 12,044, the S&P 500 Index declined 1.3% to 1,304 and the Nasdaq Composite fell 2.5% to 2,716.

The human costs of the earthquake in Japan are obviously foremost in everyone's mind at this time, but the potential economic and market implications are also being weighed by investors. In the short term, the earthquake and resulting turmoil add to global market risks and will almost certainly depress the Japanese economy. It is still too early to definitively assess the potential long-term results (particularly as it relates to the problems facing some of Japan's nuclear reactors), but we will point out that disasters, natural or otherwise, usually have only a temporary economic impact unless there is a sizeable and permanent policy response. The struggling Japanese economy has a great deal of excess capacity, and it is possible that Japanese officials will use this occasion to undertake some desperately needed structural reforms to make the country's economy more competitive.

The ongoing turmoil in Libya and the Middle East has continued to weigh on markets and the resulting oil price spike at a minimum reduces some of the upside potential for global economic growth and adds to potential volatility in the financial markets. At this point, most market observers are viewing higher oil prices as a temporary condition, but if prices stay where they are for longer than expected, or move noticeably higher, global GDP growth forecasts will be negatively impacted. One of the main questions investors are asking is whether we will see some sort of political crisis in Saudi Arabia. The Kingdom of Saudi Arabia has relatively strong economic and political fundamentals when compared to its neighbors, and at present most view the risks of political unrest in that country as low. In any case, however, as long as anxiety over the Middle East remains high, so will investor uncertainty.

Regarding the US economy, we do not believe oil prices have advanced to the point that they will derail the economic recovery. In our analysis, it would take another $20 to $30 a barrel increase before that would happen. Geopolitical risks are, of course, impossible to predict and oil markets are notoriously volatile, but we are not expecting prices to climb that high. Barring further cuts to oil supplies and/or significant oil price increases, we still believe that a 3% real GDP growth figure for 2011 makes sense. Demand levels remain strong in the United States, and monetary policy remains growth-friendly. Recent data has continued to show that the economy is improving. Last week, for example, February retail sales figures were released and showed that higher energy prices have not stopped consumers from spending.

The US economy has now experienced six consecutive quarters of positive growth since the recession officially ended in the middle of 2009. Growth now appears to be settling into a trend-level pace for 2011. Manufacturing levels have been experiencing strength, and although the labor market remains troubled, that also is improving. The US consumer sector has been repairing itself to some degree, but still has further to go. Since the recession ended, consumer spending has accounted for only 55% of US GDP growth, well below its historic average of 70%.

From a markets perspective, global equities have corrected somewhat amidst rising oil prices and escalating geopolitical risks. However, outside of region-specific downturns in the Middle East (and more recently in Japan), downturns have been relatively modest. The turmoil in the Middle East is unlikely to be resolved quickly or easily, meaning that oil market volatility is likely to remain high. Economic fundamentals, however, remain sound. Investors have ample cash to put to work and are still underweight equities. Our base forecast remains that the markets should continue to move in an upward direction over the long term, but we may need to see some additional clarity on the geopolitical front before that can occur.

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