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Weekly Investment Commentary

The End of QE2 Should Be a Non-Event for Investors

May 16, 2011

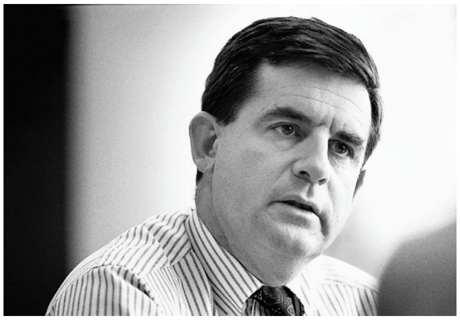
Stock markets were flat-to-down last week as economic data continued to be mixed. For the week, the Dow Jones Industrial Average lost 0.3% to 12,596 and the S&P 500 Index dropped 0.2% to 1,338. In contrast, the Nasdaq Composite was up fractionally to 2,828. In other markets, commodity prices continued to fall and the US dollar moved higher. While we do not believe that the long-term secular uptrend in commodity prices has ended, we do think that the cooling effect could be in place for some time, which will hopefully be a positive for both economic growth and stocks.

Data suggests that the global economy has slowed recently, but we believe that it is still in the midst of transitioning from recovery to self-sustaining expansion. Although several forward-looking indicators have worsened, this should not be a surprise since periodic setbacks are part of any economic recovery. Additionally, we would argue that at least some of the recent weakness in growth levels can be attributed to temporary factors (including bad weather).

On balance, however, the economic positives outweigh the negatives. As last month's employment report showed, the labor market is certainly healing and we have also started to see an uptick in household debt levels for the first time in quite a while, which (along with an easing in lending standards) helps support our view that the economy is shifting into a self-sustaining mode. The reduction in energy prices that has occurred in recent weeks should also ease some of the concerns over inflation, which, in turn, should reduce the odds that we'll see further tightening among the world's central banks.

Weaker growth levels appear to have brought about some selling pressure in risk assets as investors seem to be preparing for tighter monetary policies and the end of the US Federal Reserve's QE2 bond-purchase program. The impact of the pending end of the QE2 program is among the most talked about topics among investors. Despite the widespread concern that the end of the Fed's program could derail the recovery and send markets into a significant correction, we think the impact will be minimal. There are significant differences between conditions today and when the Fed ended its first round of quantitative easing in the summer of 2010. Lending standards have eased noticeably since that time and business and consumer loan markets have been growing. Additionally, in contrast to the time when QE1 came to an end and money growth was flat to negative, it is accelerating at present. This backdrop, combined with a general environment of better and more self-sustaining economic growth suggests to us that the end of QE2 should essentially be a non-event.

An additional issue that has some investors worried is the ongoing debate over the US federal deficit and what will happen with the debt ceiling. There is a great deal of political theater associated with these debates in Washington, which help to highlight the uncertainty and potential risks, but we think there is little to no chance that the United States would default on its debt. The actual resolution over the debt ceiling issue will likely be messy but should result in some sort of compromise in which Democrats are



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forced to cut more spending than they want to and in which Republicans will have to make some concessions as well. The arguments over deficits and spending levels will certainly not end with the debt ceiling debate and investors should expect these issues to dominate the political conversation in the run up to the 2012 elections.

Equity markets have held up pretty well in recent weeks in the face of some weaker economic data and we do not believe there is significant downside risk in the markets. Valuations remain attractive, with stocks trading at price-to-earnings ratios of around 14X compared to 2011 earnings estimates and less than 13X compared to 2012 estimates. With corporate earnings continuing to grow, we believe these ratios help make stocks an attractive long-term investment when compared to bonds or cash. We would caution, however, that given the current economic rough patch, stocks are likely to endure some additional sideways action for now.

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