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Weekly Investment Commentary

Uncertainty Remains, but so too Does Opportunity

September 19, 2011

Stocks Rebound Sharply

High levels of market volatility continued last week as the "risk on/risk off" trading pattern continued. Last week was a "risk on" one, with stocks moving sharply higher. For the week, the Dow Jones Industrial Average climbed 4.7% to 11,509, the S&P 500 Index advanced 5.4% to 1,216 and the Nasdaq Composite rose 6.25% to 2,622.

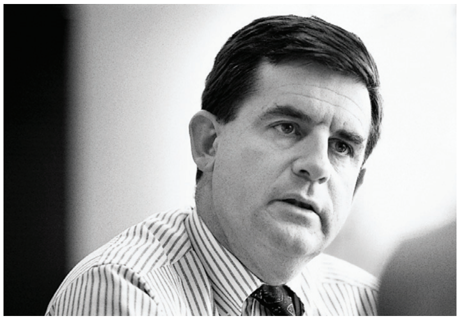
The overall environment continues to be dominated by high degrees of uncertainty, low conviction and heightened fears of a double-dip recession and policy missteps. Nevertheless, we believe that the current uncertainty creates investment opportunities — particularly for those who are able to bear the short-term risks.

European Risks Continue to Dominate

We have been saying for some time that the key risk for the world's economy and financial markets is the deteriorating situation in Europe. There has been much discussion about potential solutions among policymakers, but unfortunately little real action. Last week, many of the world's central banks, including the European Central Bank, the US Federal Reserve, the Bank of Japan and the Bank of England announced coordinated actions that are aimed at easing pressure on European banks. In addition, European governments are engaging in talks about creating additional programs that may help the debt crisis, but significant action has yet to occur.

The actions that have been taken by Europe's policymakers to date have been somewhat sporadic and not highly coordinated. Theoretically, Germany could step in and take on a larger role in attempting to stabilize the situation, but that is a difficult political prospect given that many German citizens are against what they perceive to be handouts to economically weaker parts of Europe. For its part, the European Central Bank could also play a larger role by expanding its commitment to purchasing troubled debt (i.e., launching a new quantitative easing program), but that is also unlikely to occur in the immediate future.

Ultimately, we do believe that the parties will come to some sort of resolution since, over the long-term, the costs of keeping the eurozone intact would be less than letting it dissolve, but the complex political backdrop makes it difficult to predict exactly what the solutions might be. Regarding the specific issue of a potential Greek debt default, we believe that the markets have already priced in a high likelihood of such an event occurring, meaning that if any sort of default is conducted in an organized manner it might not have an oversized impact on financial markets.



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US Equities Remain Well Positioned

In contrast to Europe, the United States economy remains in reasonably good health. The United States does, of course, have its own sovereign debt issues to deal with and the future state of the federal deficit is an obvious source of concern. The difference between the United States and Europe is that the United States has the ability to solve its own fiscal problems, even if coming to an agreement about how to do so is a significant challenge.

Given this backdrop, it's hardly surprising that US stocks have been outperforming on a relative basis over the past couple of months. Before last week's rebound, European equities have fallen 32% from their highs compared to an 18% decline for US markets and we continue to believe that US stocks also remain relatively attractive going forward. The US banking system has continued to heal since the credit crisis at a faster pace than in most parts of the developed world. Corporate earnings have also been expanding and we believe valuations for stocks are quite attractive. Additionally, the Fed is poised to remain accommodative for quite some time and we expect the central bank to announce a shift in its balance sheet management to promote investments in higher-risk assets (the so-called "operation twist").

We have been arguing, and continue to argue, that stocks will remain in a trading range of between 1,100 and 1,250 for the S&P 500 unless and until additional clarity emerges. While we expect to see volatility continue in the near-term, the longer-term outlook for US stocks remains a bright one.

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