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Weekly Investment Commentary

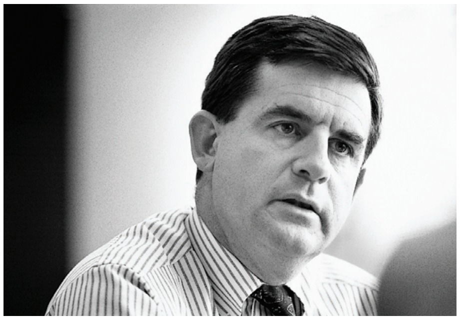
Economic Recovery Poised to Improve

September 6, 2011

Weak Jobs Data Hurts Stocks

Despite a sharp pullback last Friday that was triggered by a weaker-than-expected employment report, stocks were down only slightly last week. The Dow Jones Industrial Average fell 0.4% to 11,240, the S&P 500 Index declined 0.2% to 1,174 and the Nasdaq Composite managed to post a fractional gain to 2,480.

The August employment report showed that jobs growth was net zero for the month and the report also showed a downward revision to July's data. At the same time, the unemployment rate was unchanged at 9.1%. Stagnation in payrolls growth is an ominous sign and August marks the fourth consecutive month in which we have seen jobs growth of below 100,000. Growth in the labor market remains one of the most important economic indicators at this point in the recovery cycle, so it is understandable why the recent weakness has caused so much concern. Despite the negative tenor of recent data, however, we are expecting to see improvements in jobs growth in the months ahead. The degree to which the labor market improves will be a key factor in the direction for financial markets.



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Economic Conditions Stronger Than a Few Years Ago

Our summary view of the economy is that the United States will avoid a deep slump, but it remains an open question as to whether growth is modestly positive or if the US flirts with a recession. In any case, however, we do not expect to see a period of economic weakness that is anything like what we saw in 2007 and 2008. Unlike then, the US financial system is much better capitalized, the housing market is no longer overvalued and there is some demand in the cyclical parts of the economy. Additionally, we would point out that while temporary factors from the first half of 2011 (including the spike in energy prices and the natural disasters in Japan) cannot completely explain the downturn in economic data, they are at least somewhat responsible.

Significant Downside Risks Remain

At the same time, however, it is important to point out that there are several important catalysts that would normally be present at this point in the economic recovery cycle that are absent this time around. Chiefly, the Federal Reserve is not cutting interest rates and the government is not pumping up demand through stimulus measures. Additionally, there are several downside risks to the economic outlook. Domestically, the biggest of these is that policymakers tighten fiscal policy too aggressively, which could lead to a more intense and protracted slowdown. Outside of the United States, Europe's structural problems pose a significant risk, which perhaps represents the most serious concern facing the global economy.

European policymakers have yet to come to an agreement over how to address the ongoing sovereign debt crisis and in some ways appear to be dragging their feet. Neither Europe's political leaders nor the European Central Bank have provided an open-ended commitment that would limit contagion risk, let alone put an end to the crisis itself. As such, the situation in Europe remains a significant source of vulnerability for both the global economy and financial markets.

Outlook Is Mixed, But Skewed Toward the Positive

The outlook for economic growth is highly uncertain at this point. In addition to the factors we have already discussed, last week also saw a decline in manufacturing levels for August, but as with our outlook for employment, this is an area in which we expect to see improvements in the months ahead.

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One area of the economy that has not garnered its fair share of attention has been growth in the supply of money, a leading indicator of economic growth. Money growth has turned sharply higher recently, which has the potential to change the dynamics of both the economy and the stock market. The lag is unpredictable, but we believe that money supply growth will provide support for both in the months ahead.

An additional area of strength we would point to would be corporate earnings. As the first half of the year showed, economic growth does not have to be robust for earnings to be strong, and we expect earnings growth to remain reasonably healthy. One of the key drivers of earnings is capital expenditures, which have remained strong. We expect companies are likely to continue to spend on equipment and software, which should act as a positive for the broader economy. A great deal of uncertainty remains, but we think it is reasonable to expect that earnings growth can continue to be in the mid to high single digits in the months ahead.

On balance, we continue to believe that the US economy will muddle through with weak, but positive growth over the coming quarters with the most likely outcome being economic growth averaging somewhere around the 2% range.

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