

Investment Commentary

January 24, 2011

For the week, the Dow Jones Industrial Average rose 0.72% to 11,872, the S&P 500 Index declined 0.76% to 1,283 and the Nasdaq Composite declined 2.39% to 2,690. While most other averages declined, this week marked the eighth week of gains by the Dow, which has risen 7% over that span.

A number of technical factors came into play over the past week to interrupt the broader equity rally, although issues related to sovereign debt in Europe account for some fundamental causes as well. In this context, we believe that there are a number of near-term catalysts for potential market correction: strongly bullish sentiment, peripheral country issues in Europe, commodity inflation that could cause further policy tightening in emerging markets, the need to raise the US debt ceiling and bad weather in areas of the United States that could cause a slowdown in the economic recovery. However, looking beyond these technical issues, we believe there is no reason to change our constructive view regarding the recovery and trajectory of the markets. Growth indicators remain good and are being reinforced by the fourth quarter reporting season, and evidence of flows out of fixed income and into equities should provide a positive supply/demand backdrop.

Last week, initial jobless claims moved lower by 41,000 (based on the revised number) to 404,000 (much better than the expected level of 425,000), undoing most of the prior week's increase. In addition, December month-over-month home sales rose 13.2%, offering another sign that the economy continues to heal. Fourth-quarter earnings reports continue to beat expectations, though not as much as in previous quarters. The best earnings performances have been in technology and materials, while more mixed reports have come from some of the financial and consumer sectors. The market has rewarded fourth-quarter "earnings beats" in particular when those results are accompanied by top line revenue gains. Companies that have been only cost-cutting have not had their stocks go up. The focus on top line performance is increasingly important, as investors are skeptical of the ability of margins to move higher.

The Federal Reserve released its Summary of Commentary on Current Economic Conditions (known as the "Beige Book") last week, pointing to continued improvement in overall US economic conditions. Generally better conditions were reported in manufacturing sectors, with strong new orders the main contributor. Another bright spot was the retail sector, which enjoyed a better holiday season in terms of sales than last year. Even auto sales remained upbeat. The labor market appears to be strengthening in most regions, an encouraging sign that payroll figures will start picking up. However, the Beige Book also confirmed that there were few positive signs in the housing area.

A number of factors bear close watching for investors, including the potential for additional Chinese policy tightening, ongoing weakness in the housing market and ongoing European sovereign debt issues. The overall strength of the economy, however, suggests to us that



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a repeat of the environment of fear that surfaced last year when the Greek sovereign debt problem developed is unlikely. We continue to believe the most important operating assumption for investors is that central bankers and policymakers will do all they can to keep deflation off the table as part of their continued attempts to stimulate the economy. The main goal will be to spur job growth, and there is little worry about the long-term impact of inflation. We believe the strength in profit margins coupled with a less-hostile regulatory posture by Washington, D.C., should spur increased confidence, which should lead to a pickup in employment. With continued progress along this trajectory, we believe we will move into a more virtuous and self-fulfilling economic cycle.

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