

Investment Commentary

December 6, 2010

Equities resumed their upward move last week. While early in the week investors retreated from risk-taking, the better-than-expected European and US economic releases, as well as stronger initial retail sales news, encouraged a more aggressive approach by week's end. For the week, the Dow Jones Industrial Average rose 2.6% to 11,382, the S&P 500 Index advanced 3.0% to 1,224 and the Nasdaq Composite climbed 2.2% to 2,591.

These positive market moves belied the concerns weighing on the equity markets regarding potential contagion from the European debt crisis and heightened expectations of further monetary tightening in China. However, last week's positive market moves demonstrate an important difference compared to the environment during the height of the European debt crisis last year; at that time, the US economy was just entering a soft patch, and the markets responded poorly.

Regarding the European debt crisis, we think the consensus is shifting to support the view that this peripheral European problem will remain a local problem, and that impact outside the European area will be limited. Realistically, the problem is far from resolved and we expect to see the issue reemerge again in 2011. But, for the past week, investors were willing to look past recent European Monetary Union stress and focus on the past month's abundance of positive economic surprises. Certainly, a key risk to our generally optimistic outlook would be for financial conditions to again tighten on the back of the European debt market problems. So far, however, market indicators such as liquidity spreads have remained fairly neutral and there has been no noticeable upward pressure on either corporate bond or high yield spreads, which would indicate concern.

There were a number of economic statistic releases this past week. Highlights included the Case-Shiller Home Price Index, which fell just under 1% for the month of September, putting the year-over-year gain at just over 1% as the bottoming process in the housing market continues. Consumer confidence rose more than expected in November, which is an important factor going into the holiday shopping season. The ISM Manufacturing index for November came in above expectations, and was consistent with a 4% real GDP growth rate. In general, the data continues to support our contention that the economic recovery remains intact.

Of course, one of the most critical areas of the economy continues to be the labor market, and, unfortunately, Friday's November employment report was disappointing, with non-farm payrolls increasing only 39,000, private jobs expanding by only 50,000 and unemployment notching up to 9.8%. The only bright spot was the increase in total number of hours worked. That said, we believe that the strength in many other economic indicators shows that policy is moving the economy in the right direction. In fact, investors did find good news in the unemployment report: With the unexpectedly poor numbers,



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it seems possible that Washington might increase its focus on jobs creation. A more defined set of priorities in Washington could result in less uncertainty with respect to taxes, regulation and healthcare policies. All of this could go a long way in supporting both businesses and confidence levels and could help support real jobs growth.

On a related front, Washington is continuing to debate the potential extension of the soon-to-be expired Bush tax cuts. It is looking increasingly likely that the two sides will agree to extend all the cuts for two or three years, while also extending jobless benefits for a year. As with any good compromise, the Republicans and the Democrats would each get to claim some measure of victory should this result come to pass. At the same time, the noise surrounding the deficit commission also continued to put a focus on the report delivered by that group. While it does not seem likely that any significant action will be taken on this issue, at least discussions are continuing.

Taking a look at the markets, from a tactical standpoint, we think it is important that the correlations among asset classes have continued to fall, an indicator that investors are beginning to seek value across different investment areas rather than all herding to the same investments and limiting profit potential. Even within equities, it seems that investors are demonstrating healthy behavior by becoming discriminating and breaking out of patterns. Investors seem to be moving away from responding to increased macro risks by selling and lessened risks by buying – this is a positive development and means that value and fundamentals will play an increasing role in driving performance going forward.

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