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Perspectives on Japan, Libya and Beyond

We are relieved to hear of progress in dealing with Japan's nuclear crisis and continue to track events there carefully. Meanwhile, the sentiment of global political uncertainty grows stronger with the allied intervention in Libya and the prolonged crisis conditions in the Persian Gulf. Still, while we recognize that there will be near and mid-term shocks to the system, we believe that these factors are unlikely to derail the current economic expansion. Japan is no longer a key driver of global growth, and Libya has already curtailed oil production. Other risks remain, including unrest in Bahrain, food and commodity inflation and sovereign debt.

All of us are watching closely as the impacts of the Japanese earthquake, tsunami and associated nuclear emergency continue to emerge. Over the weekend, we were relieved to hear of progress in efforts to stabilize reactors at the Fukushima Daiichi nuclear power plant. However, many challenges remain. Our thoughts are with the people of Japan at this difficult time.

Further complicating the global picture, the crisis in Libya intensified late last week as the United Nations Security Council passed a resolution authorizing the use of force in the North African nation. On Saturday and Sunday, allied air forces attacked Muammar el-Quaddafi's military, but Libya's leader remained defiant, suggesting that resolution of the conflict could take time. Meanwhile, continued unrest in Bahrain—the small island neighbor of Saudi Arabia—continued to exacerbate worries about the region as a whole.

From an investment perspective, we continue to assess the overall impact of these events. The markets were extremely volatile last week. Risk aversion was widespread as equity markets declined broadly and many investors moved to lower-risk assets such as U.S. Treasuries.

Although circumstances remain fluid, we can make a number of broad observations regarding their potential implications for the markets and economy:

U.S. Economic Backdrop. The U.S. continues to show evidence that its economy is on a firm footing—and less reliant on the support of government stimulus. S&P 500 corporate profits are likely to reach record levels this year, contributing to more M&A activity and, potentially, further corporate dividend increases. Assuming they do not worsen materially, we believe the Japan tragedy and Mideast unrest appear unlikely to derail that expansion.

Limited Economic Impact. Although still a major economy, Japan is primarily an exporter with limited influence on world economic growth. A temporary drop in demand there may actually alleviate inflationary pressures in emerging markets in the short term—helping ease a key economic worry.

Supply Chain Disruption. The key business concern regarding Japan remains the disruption of global supply chains. Japan produces a number of high-end products that are sensitive to environmental disruption. Reduced electricity generation, rolling blackouts, and damaged infrastructure are clearly challenges, but the extent of their impact is yet to be determined.

Oil Worries. In our opinion, the military intervention in Libya has few implications for energy production; most oil activity in Libya had already ceased, and Saudi Arabia and other producers appear able to make up for reduced supply. A temporary drop in demand from Japan could also ease any supply/demand imbalance reflected in pricing. Still, additional negative developments in the Mideast could heighten worries and raise oil prices, especially at a time of limited spare capacity—something that could, in turn, affect economic growth, earnings and capital markets.

Nuclear Energy. As most observers agree, the Japan disaster has dealt a major blow to the use of nuclear energy. China has already reportedly backed off its nuclear expansion plans, and political opposition is likely to increase elsewhere. As a result, natural gas may gain favor, and coal—a longtime villain for environmental groups—will likely remain a key energy source for some time.

Currency. After the earthquake, the yen appreciated sharply, in line with historical investor reactions during times of uncertainty. In reaction, the G-7 nations intervened in the currency markets, seeking to limit volatility in the value of the yen—measures which, by the end of last week, brought the U.S. dollar and yen back to their pre-disaster pricing relationship. In general, our FX team believes that currency markets and the yen in particular are likely to stabilize.

Overall, discerning the actual impacts of events in Japan will take time; meanwhile, the developments in the Mideast are unpredictable and will bear close observation. Other concerns, including the challenge of sovereign debt levels, food and commodity price inflation, and the still-stagnant U.S. housing market, may influence the economy—and markets—moving forward. Uncertainty may lead to further price volatility. As always, our portfolio managers continue to assess the market environment and their investment holdings as we strive to help our clients achieve their unique investment objectives.

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