

# The Week

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## **Worth noting**

- Earlier this spring, investors were worried about a financial crisis in Europe because of Greece's sovereign debt problems.
- More recently, concerns about Europe have lessened, and investors are now increasingly worried about the U.S. economy.
- The dollar has started to decline and the credit markets are signaling that the U.S. economy is slowing down.
- This shift in investor sentiment could add to volatility in several markets, including equities, in coming months, as a result, we have slightly reduced our tactical recommendation to equities.

## **Concerns shift from Europe to U.S.**

When driving a car, your focus of attention shifts back and forth between the distant horizon and the road immediately ahead. Experienced drivers do this naturally, but this can be a challenge for new drivers. Looking off into the distance allows you to see where the road may be turning. But, you also need to keep your eyes on the road in front of you so you don't hit a pot hole. Successful investing often requires the same shift in focus. In last week's report, we talked about looking to the distant horizon and discussed our new capital market assumptions and strategic asset allocations. This week's report will shift back to the near term to address the more immediate road hazards.

Investor concerns change all the time, much like road conditions. One stretch of road will be smooth and straight while the next mile will be bumpy. Investors concerns can change just as easily. This spring, investors were worried that the euro was no longer a viable currency. Now the euro is strengthening and the dollar is weakening instead. Such market action can tell us a lot about road conditions and near-term investment risks.

When investors were worried about Greece's debt problems a few months ago, they shifted funds from more risky Greek debt to the more conservative German government debt. This pushed German yields down to new lows for this year. However, it is important to see how other bond markets moved at the same time. That's because the spread between the 10-year German government bond yield and the 10-year U.S. government bond yield can be an important indicator of economic performance in the two countries.

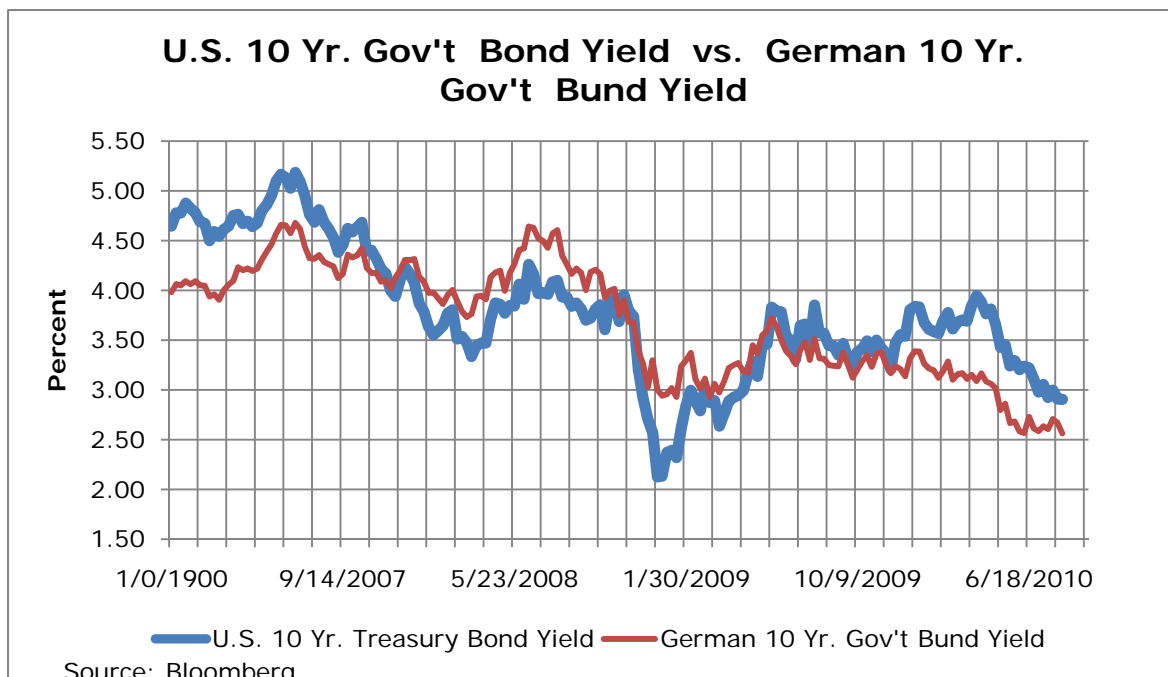
When U.S. government bond yields rise relative to German yields, this is often a sign that investors believe the U.S. economy is stronger than the German economy. Alternatively, when U.S. government yields decline relative to German yields, this is a sign that investors believe the U.S. economy is weakening relative to the German economy. During the past two months, as the European crisis appears to have stabilized and U.S. economic data has softened, the yield spread between the U.S. and German bonds has narrowed. In other words, 10-year U.S. government bond yields have declined more than similar German yields declined. This is an important signal that many investors are worried that the U.S. economy is weakening. We are also concerned that the recent slide in the U.S. dollar signals a weaker U.S. economy. Moreover, September and October are often a seasonally weak period for the stock market.

However, the U.S. stock market has moved higher during the past month, suggesting other investors think that the economy may be getting better. This divergence in market action suggests an increasing risk of market volatility in the months ahead, as one or another of these two views proves to be wrong and the other right.

We continue to believe that the equity markets will be volatile this year, after the big, 80% rally in the S&P 500 from March 2009 through April 2010. At the same time, our 2010 year-end target for the S&P 500 from our equity strategy team remains 1100-1140. Between now and the end of the year, we believe that market volatility could push equity prices lower before recovering to our target area.

Therefore, we believe there is increasing downside risk or hazardous road conditions in equities the months ahead. This could create buying opportunities for long-term investors at that time. In the meantime, short-term investors who are over-weight equities may wish to lighten positions. We recently reduced our tactical tilt and are now recommending a slight under-weight to U.S. large-cap equities. If you are overweight relative to this position, short-term investors may want to reduce their exposure to the equity markets.

In summary, several market indicators, including the declining value of the dollar and the narrowing of the spread between U.S. and German bond yields, suggest investors are increasingly concerned about the slowdown in the U.S. economy. However, the stock market has rallied because positive earnings reports have offset negative economic news. We believe this divergence creates downside risk in equities, especially heading into the seasonally weak September-October period. Therefore, we have reduced our tactical asset allocation to a slight underweight in U.S. large-cap stocks.



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