

Investment Commentary

August 30, 2010

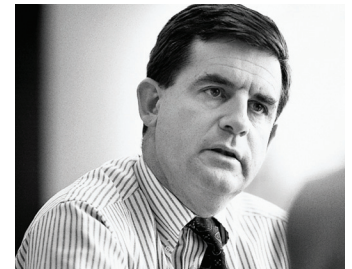
Stocks endured another down week last week, but thanks to a rally on Friday, the losses were trimmed. For the week as a whole, the Dow Jones Industrial Average lost 0.6% to 10,151, the S&P 500 Index fell 0.7% to 1,065 and the Nasdaq Composite declined 1.2% to 2,154.

There was some positive economic news last week, including initial jobless claims, which were less than expected. That number fell to 173,000 from 504,000 the prior week. Additionally, signs have been emerging that lending standards are easing somewhat. The Federal Reserve's senior loan officer opinion survey showed that overall standards have been becoming less stringent and small bank lending has been increasing – a necessary ingredient for a broadening recovery.

The economic highlight last week was a speech by Fed Chairman Ben Bernanke, who provided a fairly dovish outlook in his comments. Chairman Bernanke made it clear that more easing would be in store unless the economy improves. His statements should help ease some fears among investors who remain concerned about the possibility of a double-dip recession. His reasons for optimism included ongoing monetary policy accommodation, the improvement in consumer balance sheets, the stabilization of bank lending standards mentioned above and a general improvement in financial conditions that are becoming more supportive for growth. To be sure, there are a number of downside risks and the economy remains quite fragile. In particular, one aspect of the economy that remains troubling is the lack of business, consumer and investor confidence. On the whole, we believe that the economy is continuing to go through a deleveraging phase (particularly on the part of the consumer), but we maintain our view that the US economy is unlikely to experience a double dip and that the global economy will not slide back into recession.

To us, one of the more interesting features of the current economic and market landscape has been the continued resilience of the corporate sector in the midst of weak economic data. The growth in corporate profits and the ongoing decline in corporate credit spreads are forecasting economic strength. In fact, corporate profit margins as a percentage of GDP are near 40-year highs. During a normal economic cycle, such levels would encourage companies to spend more on capital expenditures and/or ramp up hiring plans, but most companies have remained reluctant to reduce their cash levels. We have seen some increases in capital spending, but a lower amount than would normally be expected given current profits, and, of course, private sector hiring has remained anemic. Some of this reluctance to spend can be attributed to uncertainty surrounding potential legislative and regulatory changes coming out of Washington, but we believe that we are at a point where companies will need to either accept slower growth levels or begin to put more of their capital to work.

For the past several months, stocks have been caught between the crosswinds of a range of positive and negative forces. On the bullish side, strong corporate profits, increases in merger and acquisition activity, high levels of corporate debt issuance and some renewed spending on capital expenditures show that the corporate sector remains a source of strength. Additionally, the Fed has made it clear that it will continue to do what it can to remain accommodative. Outside of the United States, economic data also continues to be somewhat stronger than expected through most of Europe and Asia.



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There are, however, a number of bearish forces that warrant mentioning as well. A lack of overall confidence has been depressing markets, which is not surprising considering that the most visible aspects of economic growth – jobs growth and the unemployment rate – have continued to be disappointing. Additionally, the housing market remains an important source of weakness. There are also the real and ongoing threats of deleveraging that have to be considered. The consumer still has some work to do on this front, and we have seen sovereign debt spreads widen in Europe recently.

The critical issue for investors remains the question of whether the economy will experience the much-dreaded double dip. We are on the optimistic side of this debate and would point out that while the recovery has been slow, we have made significant progress. On a real basis, US gross domestic product has regained 70% of what was lost during the recession and on a nominal basis, GDP has regained all of it, meaning that the United States is in a nominal expansion.

In any case, investors in US stocks can expect continued volatility ahead. The S&P 500 Index has remained in a rough trading range of between 1,020 and 1,120. We do not expect to see a dramatic breakout of this range at the current time, but do believe that as economic conditions slowly improve, the positive forces should win out.

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