Investment Commentary

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AUGUST 31, 2009

The lead economic story last week was President Obama's decision to renominate Ben Bernanke for a second term as Chairman of the Federal Reserve. This decision was hardly a surprise (but it did come earlier than expected), as Mr. Bernanke has been widely credited with being the one most responsible for bringing the economy back from the brink of collapse, and his renomination was generally viewed in a favorable light. Last week's news also included some better-than-expected economic data as well as the sobering announcement that the federal deficit would be $2 trillion higher over the next 10 years compared to earlier estimates. In the equity markets, stocks moved up grudgingly for the week, with the Dow Jones Industrial Average climbing 0.4% to 9,544, the S&P 500 Index advancing 0.3% to 1,029 and the Nasdaq Composite rising 0.4% to 2,029.

Last week's economic data included the news that the Case-Shiller home price index rose for the second consecutive month in June, a significant advance since the current recession has its roots in the housing market. In labor market news, jobless claims and non-farm payroll losses have retreated from their highs, which is also a positive sign. Additionally, the US leading economic indicator series advanced in July, marking the fourth straight month of upward moves. This series has never climbed four months in a row during a recession, which is further evidence that the United States is moving into recovery. There are, of course, some negatives worth mentioning as well. Credit conditions are still far from normal, and the US consumer remains under tremendous pressure. On balance, we would reiterate our view that the recession is in the process of ending, but would caution that we are facing a sub-par recovery.

Many observers have been pointing to the extreme run-up in equity prices over the last six months as a sign that stocks may have come too far, too fast. There is a growing perception that equities have become overbought and are expensive at current valuations. Additionally, some warning signs have begun to emerge that suggest we may be facing a near-term correction, such as the breakdown in the Chinese stock market and the possibility that the world is at the forefront of a new interest rate policy tightening cycle (evidenced by Israel's recent decision to increase interest rates).

From our perspective, all of these are valid concerns, but a number of positive factors must be considered as well. There is still a tremendous amount of uninvested money on the sidelines, and with cash earning basically zero and US government bonds yielding less than 4%, higher risk assets remain a more interesting proposition. From a fundamental perspective, economic growth, corporate earnings and credit conditions are all continuing to improve, which also creates a more equity-friendly environment. We have little doubt that markets will remain volatile, but as long as policymakers remain focused on the downside economic risks, we expect the positive factors will outweigh the negatives.

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AC2720-8/2009