

Investment Commentary

JUNE 15, 2009

Some improved economic data helped stocks move higher yet again last week. In one of the least volatile trading weeks in some time, the Dow Jones Industrial Average climbed 0.4% to 8,799, the S&P 500 Index rose 0.7% to 946 and the Nasdaq Composite gained 0.5% to close at 1,859.

While it would be premature to suggest that the economy has stabilized, recent data have shown signs of improvement. The pace of job losses has moderated, manufacturing activity has picked up and productivity measures have been trending higher, which is good news for corporate profits, inflation and overall growth. Even the housing market has been showing signs of life as both new and existing home sales increased in recent readings. As economic conditions have started to improve, there has been a corresponding increase in expectations that the Federal Reserve will begin to increase interest rates. In our opinion, such expectations are premature. While it is true that some areas of the economy have begun to recover, these improvements are starting from deep recessionary levels and, in our opinion, the current environment is still more deflationary than inflationary. The outlook for corporate earnings remains uncertain, many companies are still struggling with the possibility of bankruptcy and we anticipate at least several more months of job losses. As a result, we expect the Fed will remain on hold until clearer evidence of an economic recovery emerges.

In many ways, financial markets have been following the typical pattern associated with economic recoveries. The stock market has been rising, with those sectors that underperformed the most during the downturn now leading the pack. Credit spreads have been tightening, government bond yields have been rising and commodity prices have advanced. One unusual aspect of the current advance in equity prices, however, is that the rally has been remarkably smooth and fast. As a result, we would argue that there is a high likelihood of some profit-taking and some sort of near-term correction that would allow the market to catch its breath before moving noticeably higher.

In addition to the belief that we may be overdue for a pullback, there are some other risks that we think are worth mentioning. High deficit levels are a concern and we expect that higher tax levels are almost certainly forthcoming. The rise in oil prices and the weakness of the dollar also bear watching. From a technical perspective, we would also point out that the pace of increase has slowed in recent weeks and that volume has diminished, which suggests that momentum is waning. On balance, we expect that stocks will continue to grind higher over the course of 2009, but not without some fits and starts along the way. At the beginning of the year, one of our predictions was that stocks would experience double-digit gains in 2009. From this vantage point, we continue to believe that this prediction will come true for the S&P 500 and for most other equity markets around the world.

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