

Investment Commentary

July 26, 2010

US equities posted positive results last week as uncertainty continued to ease in the markets. Funding conditions in the euro's non-core countries have improved, activity out of the European economies has been better than expected, US earnings reports have been strong and we have seen the passage of the European bank stress tests. Overall, the Dow Jones Industrial Average gained 3.24% last week to close at 10,425, the S&P 500 Index advanced 3.55% to 1,103 and the Nasdaq Composite rose 4.15% to 2,269. Factoring in these results, US equity markets extended their gains for the month of July to more than 7%.

Notably, the major short-term ambiguities that kept market participants on the fence – the US banking bill, growth in China, the EU bank stress tests and European sovereign funding – have abated to some degree for the time being. The US bank bill has become law, but it will take years to gauge the impact of the more than 2,000 pages of text; China's growth has slowed to 7% or 8%, reducing the need for much further tightening; and European funding pressures have softened as non-core banks are starting to get access to the bond market and are able to borrow more in the interbank markets.

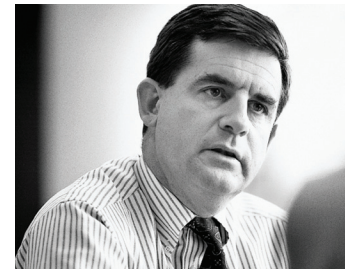
In terms of earnings, 30% of S&P 500 companies have reported their second quarter results, and the magnitude by which reporting companies exceeded analyst estimates is the fourth-highest on record. Reported earnings so far are more than 13% higher than expected on a dollar-weighted basis due to both top-line strength and continued margin improvement. The breadth of revenue results beating expectations also has been high.

Positive surprises in the data are obviously based on past information. For asset prices to rise, there has to be increases in future expectations about earnings and cash flow. In the case of the United States, we are getting a limited amount of that. While earnings are quite good, the follow-on has been to raise estimates consistent with the beat, at most, with no increase seen in the second half of the year.

Turning to politics, absent an exogenous event that radically shifts the political landscape, Democrats will likely suffer significant losses in the mid-term elections. Even if they retain majorities in both chambers, their margins likely will be so small that they will lose their governing majorities, making it unlikely that Congress will pass anything controversial next year without bipartisan support.

There is a potentially bullish shift afoot on the Bush tax cuts. Many, including us, have thought that the cuts would be extended for individuals with under \$200,000 in income, and for families with less than \$250,000. However, support is growing among some Democrats for extending the tax cuts to everyone.

The US Fed marked down its estimates for inflation and real gross domestic product for 2010 and 2011, and acknowledged that the unemployment rate may decline more slowly than previously expected. In recent testimony, Fed Chairman Ben Bernanke barely acknowledged the recent disappointment in US economic data and also downplayed the growing risk of deflation. His message is that the bar is set fairly high for more monetary stimulus.



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Our view remains that a sustained, albeit subpar, economic recovery is in the cards. We are watching the indicators carefully for signs of a more negative path for the economy. At this time, neither critical equity sectors nor credit spreads are signaling that the recovery has been derailed, which suggests to us that the cyclical recovery in corporate profits is not over. Still, the US economy continues to face significant headwinds, giving us reason to believe that the move higher in equity and other risk asset prices will likely be a long, hard grind characterized by continued volatility.

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