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Expert Commentary on Today's Market

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TRICK OR TREAT

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After a tricky period of stock market volatility in July through September, investors were treated to the best October performance through Friday for the S&P 500 in 37 years. In the September 27 issue of *Leading View*, we noted the potential for positive catalysts for stocks. Two of these catalysts were better than expected near term economic growth and Europe handling the Greek situation well sooner rather than later. Both of these catalysts contributed to the strong market for stocks since October 3.

During the late summer investors became progressively concerned about the potential of a double dip in the U.S. economy. A number of economic indicators for August tended to bolster these concerns. However, as reflected in the third quarter GDP report, consumption and capital spending performed well and the economy grew 2.5%, the best quarter for 2011. Nonetheless, consumer spending growth was aided by a drawdown in savings. With employment and wages still growing modestly, it is likely that aggregate economic growth for this quarter and next will not be much better than the third quarter results and could even be less in the first quarter of 2012. Meanwhile third quarter productivity growth may be 2.5-3.0% and this prospect has already been reflected in relatively strong earnings reports, with 70% of companies that have reported beating expectations.

The bigger boost to equities has been the actions that Europe has taken to quell a crisis of confidence in financial management of sovereign debt. Agreement was reached for the banks to take a 50% haircut on their holdings of Greek debt, for the European Financial Stability Facility to leverage itself to provide 1.4 trillion Euros support for future bond issues, and for banks to raise tier 1 capital to 9% from 5% by June 2012. These measures are a positive step forward, but details are still lacking. Consequently, European credit markets did not participate in the bullish celebration by stock investors last week. We suspect that bouts of periodic volatility still lie ahead for stock markets in Europe and elsewhere.

The U.S. stock market burst out of its two month trading range last week. Strong price moves by the indices were

supported by improving breadth of stock performance and by a growing number of new highs for the past 12 months. A strong move in stock prices with the aforementioned characteristics usually does not roll over and collapse. Stock prices may pull back from their surge but should be supported by a relatively large amount of cash in investors hands. Investors are likely to have been caught flat footed by the persistence and swiftness of the recent rise in the market. Moreover, they are aware that stocks usually perform well in the November to February period. Consequently the remaining two months in this year may represent a period when pressure increases to put cash to work in order to recover any previous loss in portfolio performance. Further supporting this view is the decline in risk as represented by the stock volatility index (VIX) falling from its high in the low 40s to the mid-20s. Finally, stock valuations remain reasonable at 12x expected 2012 earnings. This valuation is below the median of 14x during the past 10 years. Nonetheless, we note that profits growth expectations for next year are coming down and consequently, many stocks may not be as cheap as they appear.

On the cautionary side, we observe that the stock market has become overbought. An overbought condition is not always a negative especially during a strong market uplift. Nonetheless it does suggest some short term consolidation of recent gains. Investor sentiment has turned more bullish from relatively bearish levels in recent weeks. Bullish readings are not yet extreme but are clearly no longer depressed. Over the next 12 months we expect that U.S. economic growth will be slow, perhaps 2 to 2.5% at best. Some quarters may be slower, some a bit more robust. This perspective setting will weigh on profits growth. Moreover, European economic growth is likely to be very slow over the next year or more. If credit spreads narrow, European equities may perform well, but if they widen, volatility will return. Europe remains a long term workout, as does the U.S.

The next potential catalyst for the U.S. market is action by the Congressional Super Committee at Thanksgiving time. We certainly hope it will not be a turkey. With the public perception of Congress quite negative already, we believe

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that positive developments may be forthcoming to bring down the budget deficit. Members of Congress are certainly cognizant of next year's election season. This should provide some motivation for producing an agreement. We suspect any agreement will contain tax reform. Failure to produce an agreement would bring a huge cut in defense spending, further aggravating the jobs picture and clouding the future for members of Congress in districts dependent upon defense spending.

Finally, while stock market leadership this month has been in value stocks and in mid-cap issues, we continue to advocate a focus on growth, especially large cap growth stocks, because of our belief that economic and profits growth will be slow in 2012. Yield will also remain a solid theme in the equities sector. Looking toward 2012 to 2013 we believe emerging markets, which declined 20% this year before a recent rebound, are beginning to look more interesting. Many of the constituent countries have raised interest rates to dampen inflation. Assuming relatively slow global growth in 2012, inflation should be contained, opening the prospect of easier monetary policies in emerging markets in 2012 and 2013. We suggest using any near term volatility to either begin to build positions in emerging markets or to add to existing holdings.

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