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Expert Commentary on Today's Market

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A MIXED OUTLOOK

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While a down month for equities, November closed strongly. The S&P 500 climbed over 7% in the last week of November. European markets also rose over 7% and Asian bourses climbed more than 8%. Much of these gains came after further signs of growth in the U.S. economy and the announcement of a significant swap arrangement by key central banks in an effort to lower the borrowing costs for European commercial bankers.

In the week ahead, attention will be focused once again on Europe. Representatives of the member nations of the European Union meet Friday. In advance of their gathering, the Italian government has agreed to a fiscal program, subject to Parliament approval, to raise taxes and cut expenditures in an effort to manage future borrowing needs. Meanwhile, Germany felt a touch of contagion recently when a bond offering failed to attract strong demand. With the exception of Germany, sovereign bond yields remain elevated in much of Europe and bankers continue to be stingy lenders.

Germany is pushing for fiscal union to complement the existing monetary union in the EU. Fiscal union would bring a degree of fiscal discipline. If the EU were to agree to a greater fiscal union, then the European Central Bank may follow a more aggressive policy of using its balance sheet to buy sovereign debt. It is also possible that euro zone central bankers might lend money to the International Monetary Fund which, in turn, would offer credit to sovereigns having difficulty meeting their debt obligations. Without such loans, the IMF does not have sufficient funds to meet the expected needs by a number of countries.

It is likely that additional progress will be made Friday by the EU to deal with its financial challenges. Nonetheless, we do not expect a complete solution to be produced this week. Hopefully, actions will reflect progress on producing a more manageable outcome. Realistically, the EU will likely be working on improving its financial health for some time into the future.

The U.S. stock market has been buoyed recently by signs of

better than expected growth. Leading indicators are rising, November same store retail sales rose more than 3%, and the market for private sector jobs has grown nicely since August. Some of the growth from the economy is coming from the manufacturing sector. This is significant because major countries outside the U.S. are experiencing weakening manufacturing. While U.S. economic growth is probably running at a 2.5% annual rate currently, most other major economies are growing at a slower rate. For the moment, the situation favors investment in the U.S.

Nonetheless, the stock market discounts the future despite its high volatility during shorter intervals of time. At this time, it is likely that the U.S. will grow 1.5–2.0% in 2012. However, the risks of growth are on the downside. European and other economies may be a greater drag on U.S. growth than now expected. Moreover, a political election year carries a number of uncertainties which might constrain activity. All of this assumes no new shocks to economies and markets.

U.S. equities, especially those of high growth companies, remain reasonably valued at about 11x 2012 estimated earnings on a company by company basis. Profits growth, which may increase in the low teens for 2011, is likely to be virtually flat in 2012. A number of multinational companies are expected to be impacted by slowing global demand growth. Some of this prospect may be reflected in current stock prices, but unfortunately, we will not know until sometime in the first half of 2012 what the impact will be.

At this time each year, investors look for a Santa Claus rally as the holiday season nears. We believe that for the Santa Claus rally to occur the stock market will either have to sell off or move decisively higher through the 200 day moving average which defines the trend of the market. Currently, the S&P 500 is just below the 200 day moving average. A breakthrough of the 200 day and then the October high on rising volume and expanding breadth would be positive for potential follow through. Overall, we expect a trading market with a low point to point return to characterize 2012 as it did in 2011.

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Given this outlook, we continue to believe that growth stocks and yield issues will produce favorable returns as they have in 2011. High grade corporate and municipal bonds continue to have an appeal. Emerging market equities and debt should perform better over the next 12-18 months, as monetary policies ease.

To our readers, we extend greetings of the season and wish all a healthy and prosperous New Year.

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