

The Week

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Worth noting:

- There is concern that the government's economic stimulus is winding down, that housing is weak and that taxes seem set to rise next year. Some investors fear a double-dip recession.
- Now that the market has taken out its February 2010 low, a further period of weakness is likely, with a realistic possibility that volatility could temporarily take the S&P 500 down to a 950 level.
- We anticipated a bumpy ride in 2010, and our January Outlook report laid out the case for why the second and third quarters likely would be the weakest of the year for the economy and equities.
- We recommend that investors who hold at least 70% of their strategic target in equities make no new commitments in the near term because probabilities are rising that the market will trade lower from here.
- We reiterate our positive six- to 12-month outlook for the economy and for equities and will be looking for buying opportunities.

Current market weakness in perspective

There is fear that a double-dip recession now seems increasingly likely given that the government's economic stimulus is winding down, housing is depressed and the unemployment rate and mortgage foreclosures are stubbornly high. Media-fueled political rancor ahead of the mid-term elections and the likelihood of higher taxes next year do not help; nor does the perception that the euro zone and Chinese economies may also be weakening.

Many investors fear a new recession – a double-dip after 2008. It may be worth remembering that for people who have lived through an earthquake, the fear of a possible aftershock can wear them down until the fear feels worse than the actual earthquake. In the balance of this report, we explain how we think investors should approach the current market weakness.

We anticipated a bumpy ride in 2010, and our January Outlook report laid out the case for why the second and third quarters likely would be the weakest of the year for the economy and for equities. It takes a while to work off some of the excesses of a 13-month rally of 80 percent. Last week, the S&P 500 broke below its February 2010 low. This breakthrough occurred at an inopportune time, when many investors were already reducing positions at the end of a very weak quarter. But now that the market has taken out its February 2010 low, a further period of weakness is likely with a realistic possibility that volatility could temporarily take the S&P 500 down to a 950 level.

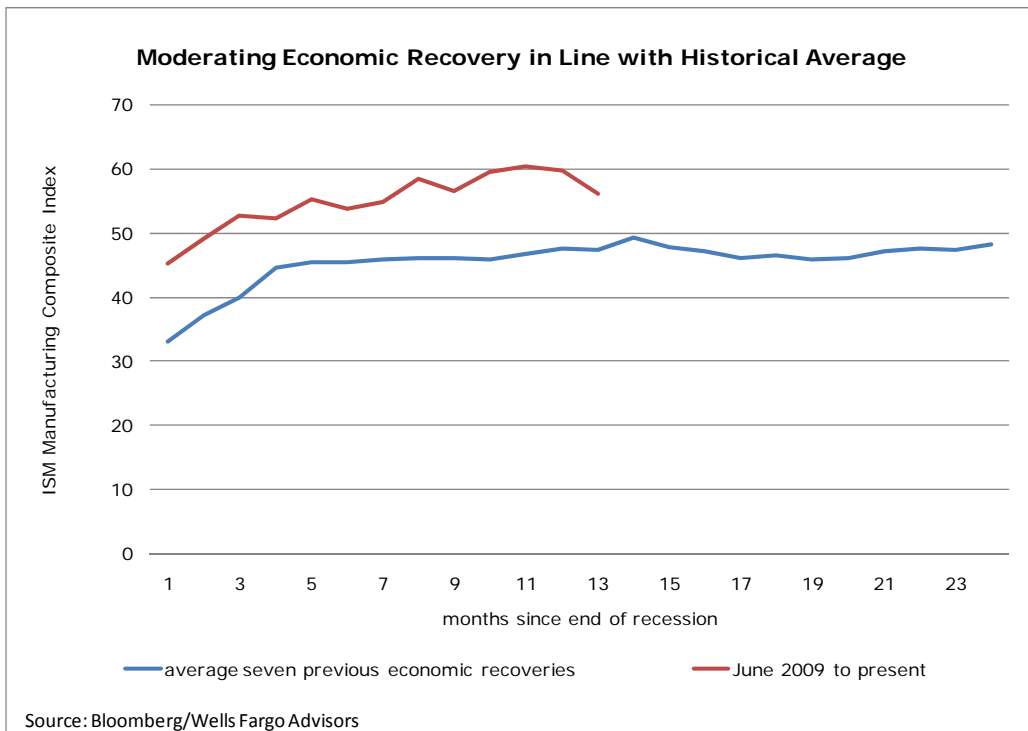
The recent market weakness does not alter the fact that the economy continues to recover. Our outlook six to 12 months ahead remains favorable. In 2008, the stock market was late to recognize the recession. Today, some market participants expect a recession despite numerous signs that the economy is growing. The current health of the economy is not nearly as dire as it

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was in 2008. Housing is the traditional leader in economic recoveries but remains depressed and lagging behind other sectors, but a number of other sectors and developments are positive for the economy:

- Monetary policy is still accommodative
- The credit markets are functioning more normally
- Companies are hiring again
- Businesses are boosting production to rebuild depleted inventories and a widespread upturn in manufacturing is in place
- Corporate profits are rising
- Consumers are spending cautiously
- Companies have resumed capital spending that was postponed during the recession
- The leading economic indicators are decelerating but still growing

The economy’s early signs of deceleration do not necessarily endanger these positive factors. Some deceleration often occurs, following an initial breakout growth after a recession, as the chart below illustrates. The chart lines depict the Institute of Supply Management (ISM) monthly index of manufacturing for the current recovery and for an average of the past seven recoveries. Values above 50 indicate manufacturing expansion, while values below 50 indicate contraction. The ISM manufacturing index is a useful proxy for the economy because it measures real-time activity in a sector that is sensitive to broad economic conditions. The line for the current recovery is still in expansion territory and is consistent with the historical pattern for a deceleration, following the initial fast pace.



Past performance is not a guarantee of future results.

In short, the dynamics of this economy suggest continued economic expansion and recovery, albeit slowed by headwinds from the housing sector. The greatest threat to the recovery likely would come from some unexpected event – such as a sharp spike in oil prices – that depresses consumer and business confidence. We continue to see the risk of a double-dip recession below 20%. If we were to see a significant shock or a reversal in the leading economic indicators, we would reconsider our view on the economic recovery.

Poor market sentiment could eventually affect the economy, but we first would have to see confidence and spending among households and businesses fall. Absent a shock or a reversal in the economic trend, we believe sentiment, not fundamentals, is driving this equity market correction.

We recommend that investors who are at least 70% invested make no new commitments in the near term because probabilities are rising that the market will trade lower from here. Others can average in during the coming months. Prices may move lower, but we will continue to look for buying opportunities, as the correction runs its course.

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