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Mid-Month Market Cycle Monitor

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Politics, Earnings, and Confidence

The path of the business cycle follows a regular pattern. However, the timing, extent, and duration of each cycle can vary widely.

Last month we warned of a **higher level of political risk.** The past four weeks has indeed seen politics affecting the financial markets.

In Europe, as we await the ratification of the European Financial Stability Fund (EFSF) by the 27 member states (16 nations) of the European Union, the German Central Bank indicated that it would not purchase Spanish or Italian bonds which led to renewed fears of a contagion of Sovereign defaults. The European Central Bank (ECB) stepped up on the following day, purchasing Spanish and Italian bonds to shore up the Euro zone financial system.

In the U.S., brinkmanship partisan politics undermined confidence to the degree that even though a last hour deal resulted in the raising of the debt ceiling averting a potential default, the terms of the deal along with the current state of the political process led **S&P** to **downgrade the U.S. credit rating to below AAA.**

The **U.S. downgrade rekindled fears of European defaults** as market participants considered the potential for and the ramifications of a downgrade of France's credit rating despite affirmation of France's AAA rating by all three rating agencies.

Meanwhile, in an effort to further support an anemic economy, the **Federal Reserve pledged to keep short-term interest rates at low levels until 2013** (despite three dissenting votes to do so).

We are currently awaiting the details of a meeting between French President Sarkozy and German Chancellor Merkel on greater Euro zone coordination.

Given the Federal Reserve's commitment to low interest rates and the moderating price of oil, we now consider **crisis politics** and the resulting **decline in confidence** as the primary exogenous events that **could derail the economic recovery**.

An **expanding economy,** supported by **low interest rates**, with **low inflation** and **improving corporate profits** all provide **a favorable environment for stocks.** While domestic economic growth may be lower than we would prefer, recently reported corporate earnings have been mostly encouraging. Of the 459 S&P 500 companies who have reported, 71% have beaten expectations, 9% were in line, and 20% reported lower than expected earnings.

At this juncture, while the **most probable scenario** is for a continuation of **sluggish economic growth**, the **risk of a double dip recession has increased** given the recent weaker than expected economic data coupled with the potential for political policy mistakes and deteriorating confidence.

For those of you who are **willing to accept the near-term risks** in expectation of the eventual resumption of global growth, we are using the recent volatility in stock prices as an **opportunity to swap** out of some stocks that have not been meeting expectations into other stocks that have been reporting stronger fundamental results.

For those of you who have a **lower tolerance for risk**, we are **reducing** your allocation of **stocks in favor of cash** to preserve capital should a political mishap result in a double dip recession.

As always, please feel free to contact us for any reason.

ASSET MIX: We are **underweighting bonds.** We are **either maintaining or reducing** the allocation to equities depending upon your equity strategy and personal risk tolerance.

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