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THE WEEKLY VIEW

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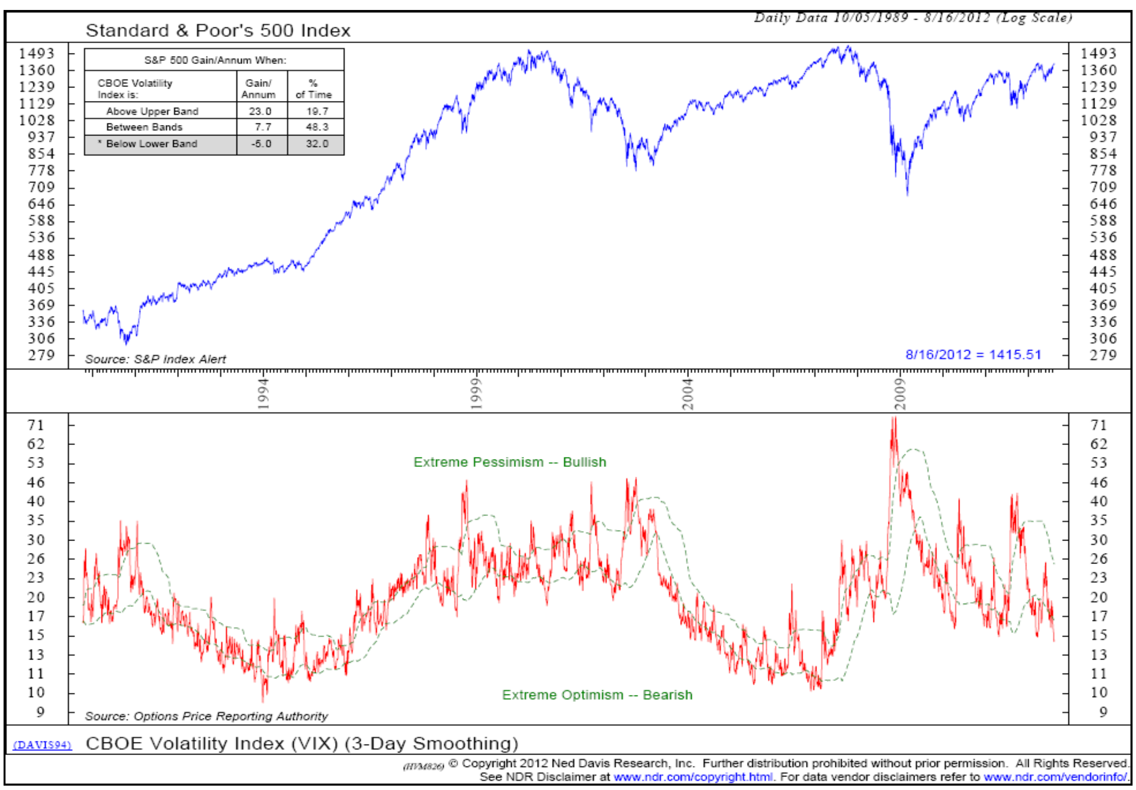
Eerily Calm Ahead of the Election Storm

Daily US stock market volatility has fallen to its lowest levels since the Lehman crisis (see chart below) as most global stock markets continue to grind higher. Medium term (6 to 12 months), we regard both the higher market levels and the lower volatility as bullish. In a world still filled with uncertainties, we regard this summer's relative calm as a sign that, despite unrelenting outflows from stock funds, stocks are climbing a "wall of worry."

Shorter term (over the next two months), we are still inclined to wait for a better entry level for the cash we are holding in our more conservative portfolios. We suspect that some of the 'eerie calmness' is because it is August and, having avoided a financial storm with strong statements of intent by ECB President Mario Draghi and recent statements of support for the euro from Angela Merkel, European markets have been moving higher as Spanish and Italian bonds yields have been moving down. Come September, we are likely to be reminded that the global economy is still slowing, Mediterranean Europe is still in a downward spiral of falling demand and high interest rates, and the German supreme court will be voting on the constitutionality of the Merkel government's proposals for greater fiscal union.

This, coupled with the heating up of the US electoral campaign, will likely bring back some volatility and, as the chart below shows, volatility at current levels suggests a modicum of caution. Finally, US equity trading volumes are also near five-year lows, which suggests to us that investors are disengaged – and by extension stocks are cheap.

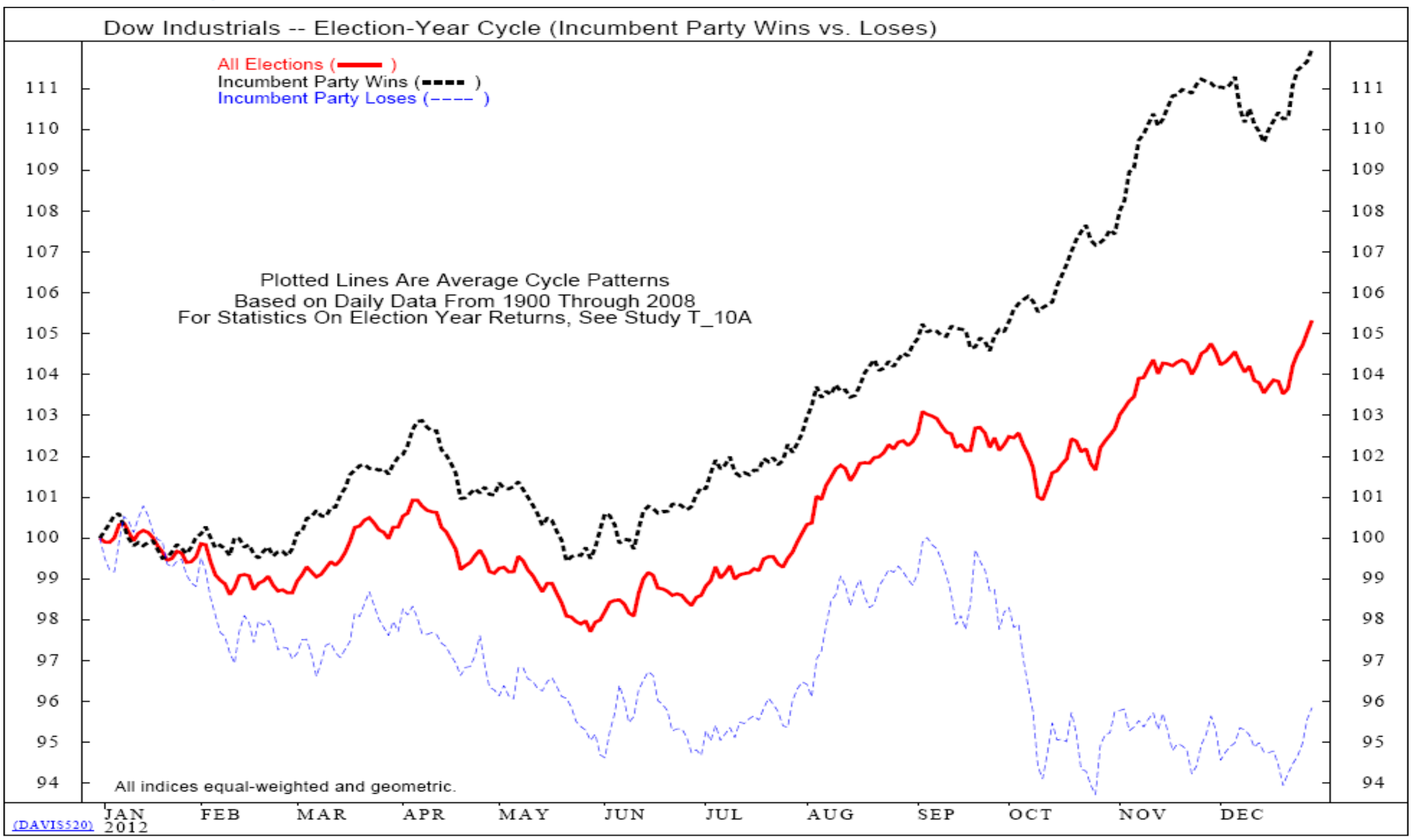


Past performance is no guarantee of future results.

The Weekly Chart, courtesy of NDR, shows election years since 1900 aggregated into a Dow Jones Industrials composite – the middle line (red) – and so far the market is following the script closely with an April high, a June low, and a strong July and August. In a typical election year, volatility picks up after Labor Day, with the market bottoming in October. History is clear in the aggregate, namely that the market performs best when the incumbent wins. Our interpretation of this data is that elections are often a referendum on the health of the economy, and since stocks reflect the economic outlook this makes intuitive sense to us. Heading into this November the candidates are currently neck and neck, and the economy is unlikely to change from 'slow growth' in the next two months, in our view.

This year's referendum seems more about how the US will choose to deal with its budget deficit – the balance between spending cuts and tax policy is now the central battleground of the campaign. It is our view that fiscal policy uncertainty – tax rates and spending plans – has been an important impediment to growth as it has caused businesses and individuals to find planning very difficult. Without weighing in on the different party ideologies, we believe that the simple process of getting past the election and opening the debate on a fiscal solution will be a positive. Investor skepticism of Washington is already so high that we see opportunity for strong markets once the election results are known and the negotiation on a solution begins. Should the parties work out a 10-year deal, we think stocks will respond positively. Only if we get a repeat of last summer's impasse would we expect a sharp sell-off. We still place a 70% probability on stocks being higher one and two years from now.

THE WEEKLY CHART: ELECTION YEARS USUALLY HAVE A STRONG SUMMER, A FALL CORRECTION, AND A STRONG FINISH



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