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THE WEEKLYVIEW

Earnings and Election Masking Positive US Economic Data

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While investors continue to focus on big-picture headline risks – earnings, the election, the US fiscal cliff, Europe's ongoing financial crisis and recession, and China's growth slowdown – they may be missing some positive economic developments in the US that help explain stocks' robust performance since June.

We believe that policy uncertainty in the US is dampening economic activity as businesses await resolution of the election and the impending fiscal cliff. Thus, several bellwether stocks posted disappointing earnings, prompting a sharp sell-off on Friday. Despite these earnings disappointments, we are reassured that the S&P 500 found support at 1430, fairly close to our expected initial support level at 1428. We continue to believe US stocks are in a cyclical bull market – the S&P 500's primary trend is rising, the Fed and nearly every other central bank in the world is accommodative, and crowd sentiment is not at an optimistic extreme. Since the beginning of June, the S&P 500 is up more than 12%, rising at a 38% annualized rate, which we believe is unsustainable. After such a powerful rally, Friday's pullback to 1428 represents a minimum retracement. A further pullback to 1400 is possible and a correction all the way to 1370 would still be consistent with our belief in a cyclical bull market. (See last week's *Weekly View* for details on our expected support levels.)

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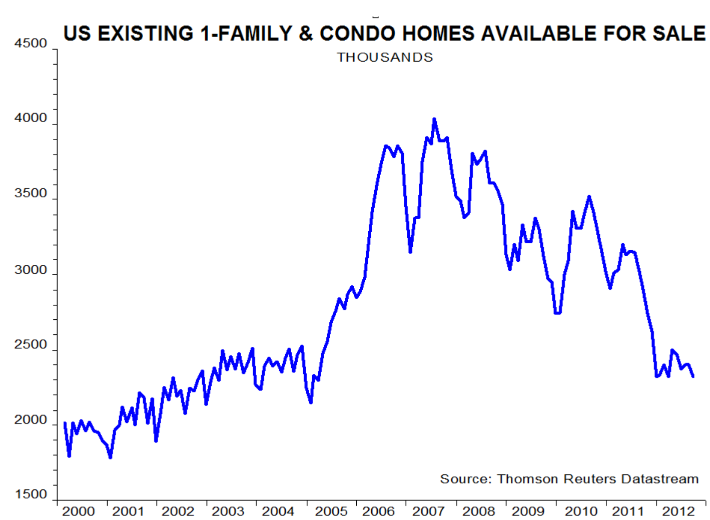
US economic conditions continue to improve, aided by the Federal Reserve, providing hope for an earnings reacceleration in 2013. The housing market is perhaps showing the clearest evidence of recovery. Record low mortgage rates are encouraging the highest refinancing activity since 2009. Housing starts were up 15% month-to-month in September to an 872,000 annual rate, the highest in four years (albeit from an extremely low base). The inventory overhang of existing homes for sale has been largely worked through — as the chart shows, existing home inventory has fallen 20% from last year. At current sales rates, existing inventories represent 5.9 months of supply (around 6 is considered normal and it was as high as 12 in 2010).



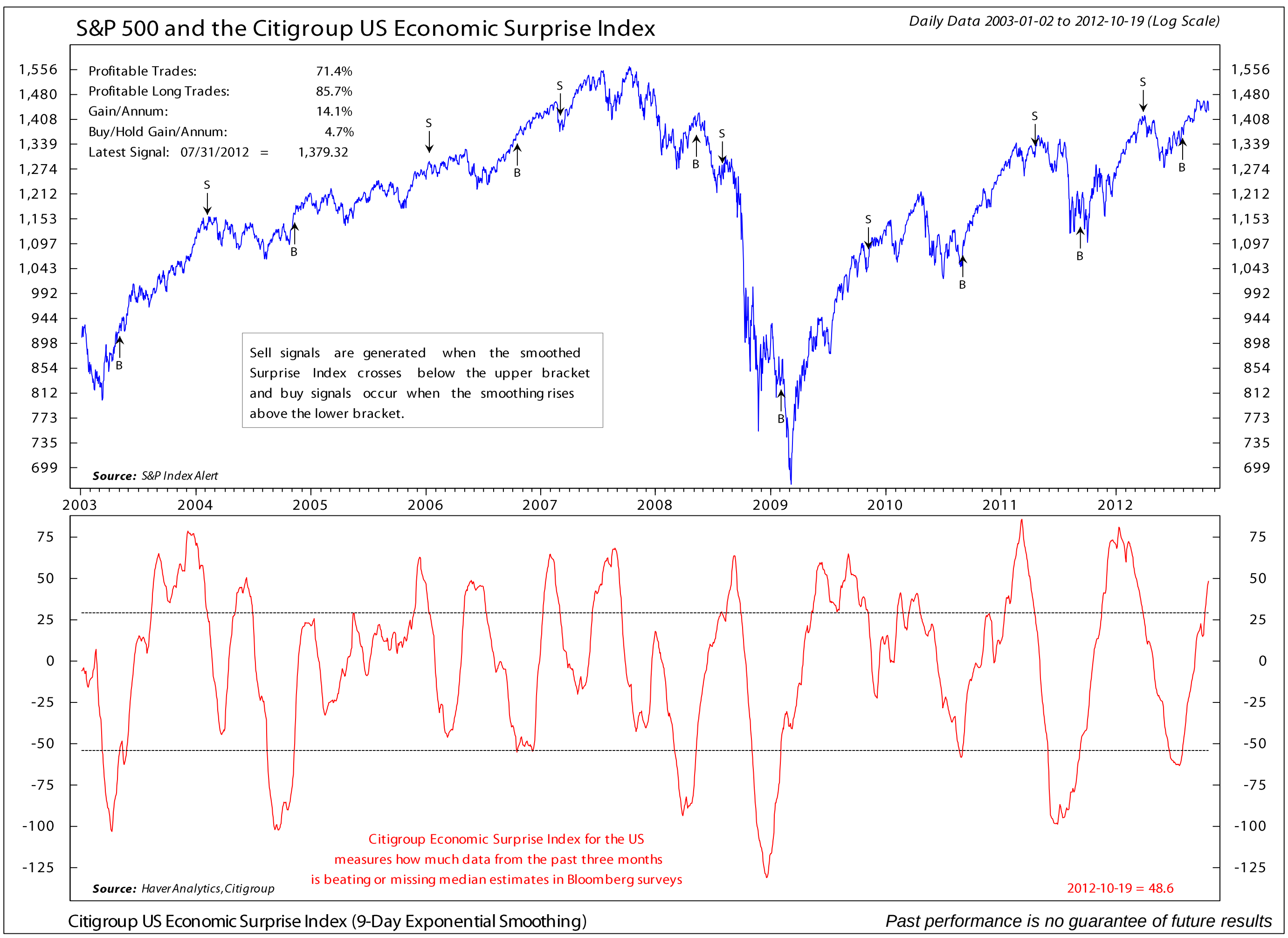
The Citigroup Economic Surprise Index (see Weekly Chart) highlights the improvement in fundamental economic data that helps explain the S&P 500's sharp gains since June, which has pushed it to a five-year high in spite of ongoing investor worries.

Despite earnings disappointments early in the third-quarter reporting season, we are reassured that the S&P 500 found support at 1430 last week, close to our expected first level of market support at 1428.

ISI Group points out that existing house prices are up 16% on an annualized basis over the past eight months (reflecting a boost in higher-end home sales), which has a positive effect on consumer confidence, net worth, and banks, and helps prompt 'fence sitters' to move, further lifting existing and new home sales. Although distressed properties — still about a quarter of all existing home sales; last year was around a third — are likely to keep home prices from rising too much, the fundamentals of household formation, income growth, and rental yields remain positive enough to keep the housing recovery on track, in our view.

The Citigroup Economic Surprise Index (CESI, bottom panel in the chart below) reflects the improvement in overall economic conditions, especially against the perspective of market expectations. Ned Davis Research describes it thusly: "The Citigroup Economic Surprise Index for the U.S. measures how much data from the past three months is beating or missing the median estimates in Bloomberg surveys." Better-than-expected results in a number of major economic releases over the past few months — such as in housing, employment, retail sales, vehicle sales, consumer confidence, purchasing manager indexes and industrial production — has turned the CESI sharply positive. Using our own studies of this index, current levels suggest further upside for stocks over the next few months, but as with any sentiment index: 'beware the crowd at extremes'. Furthermore, the Eurozone version of the CESI recently turned positive after being deeply negative during the summer, which we think supports our decision to move to neutral from underweight Europe in our portfolios. The CESI's highlight the relative improvement in fundamental economic data that helps explain the S&P 500's sharp gains since June, which has pushed it to a five-year high in spite of ongoing investor worries.

THE WEEKLY CHART: POSITIVE ECONOMIC SURPRISES SUPPORT FURTHER STOCK GAINS



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