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Weekly Investment Commentary

What Will it Take for the Rally to Continue?

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Bob Doll is a Senior Advisor to BlackRock®, a premier provider of global investment management, risk management and advisory services. Mr. Doll also formerly served as Chief Equity Strategist for Fundamental Equities and Lead Portfolio Manager of BlackRock's Large Cap Series Funds. Prior to joining the firm, Mr. Doll was President and Chief Investment Officer of Merrill Lynch Investment Managers.

Stocks Advance During a Quiet Week

In a relatively low-volume week of trading, stocks managed to post some gains yet again, continuing the rally that has been in place since early June. For the week, the Dow Jones Industrial Average climbed 0.5% to 13,275, the S&P 500 Index advanced 0.9% to 1,418 and the Nasdaq Composite rose 1.8% to 3,076.

Is the US Economy Moving Past its Soft Patch?

One of the factors underlying the upturn in stock prices over the past couple of months has been a modestly improving trend in US economic data. Last week, retail sales advanced 0.8%, well ahead of expectations. This was the first increase in four months, which suggests that while households remain generally cautious, spending levels are beginning to tick higher. We also saw a slight increase in unemployment claims last week, but the longer-term trend on this front has been positive. The August employment data will be released in a couple of weeks and the recent improvements in unemployment claims should bode well for those figures. Additionally, as we have pointed out before, the US housing market has been showing signs of recovery and while we expect that segment of the economy to recover slowly, we do believe that housing has turned a corner.

The United States is hardly growing at a robust pace, but we are hopeful that the economic soft patch that began in the second quarter is in the process of ending. Our view is that the ongoing and halting recovery should be sustained, provided that we are able to avoid large negative shocks. The two most obvious candidates to derail the current growth trajectory are, of course, financial contagion from Europe and the US "fiscal cliff."

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With recent economic data being better than expected, the next steps for the Federal Reserve look unclear. The Fed has been clear that additional easing measures would be contingent on the direction of the data, so at this point the odds of additional easing measures appear to be somewhat reduced. A new round of easing (i.e., QE3) is hardly off of the table, but should economic growth continue to improve its likelihood would diminish.

Are the Downside Risks Priced In?

Historically, August tends to be a quiet month for the markets, but there have been some significant exceptions. Last year, for example, saw heightened levels of volatility sparked by the Standard & Poor's decision to downgrade the rating of US debt in the midst of a political crisis. This year, there are also some undercurrents that could have the potential to cause some disruption in the markets. The European Central Bank's bond buying program has been greeted with relative quiet, but that could change quickly. Food prices have been rising, which could cause political instability, particularly in emerging markets. China is in the midst of a leadership change that could have a number of unforeseen consequences. And, of course, the US political backdrop and the related fiscal crisis has the potential to spark higher levels of uncertainty. We have been relatively constructive toward the markets for some time, but we acknowledge that these risks plus the fact that the rally has come so far so quickly could mean that stocks are poised for a pullback.

None of these risks rule out a continued rally in stocks and other risk assets, but we do believe that a longer-term continuation of the pro-risk trend would require some fundamental support, perhaps both from improved economic activity and from fading fiscal event risks. In any case, we also believe that stocks have priced in at least some probability of a worsening fiscal backdrop and that valuations already reflect some of the risks, suggesting that stocks could be poised for further upside.

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