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Dear Valued Investor:

The European summit on October 26, the fourteenth in 21 months, finally produced a deal in a late-night negotiating session. European leaders announced a deal that was close to what had been carefully leaked over the prior weeks of deliberations and had helped the S&P 500 Index to rally off of the lows of the year. From the closing low on October 3, the Index has climbed nearly 17% in just three and a half weeks and is on pace for the largest monthly gain since 1987.

Overall, the statement confirms the view that the risk of a 2008-like financial crisis erupting in Europe, which has been the focus of global markets in recent months, has been taken off the table. However, over the long term, concerns remain about the outlook for economic growth in Europe and the ability of some peripheral countries to meet budget targets. While the statement does not clarify all the details, it does lay out the three most important aspects of the rescue package:

- **Reducing Greece's debt.** The package cuts Greece's debt burden with a 50% "haircut" on Greek bonds. Private investors, including banks, will swap their Greek bonds for those with half the face value, but higher quality given an additional 30 billion euro cushion provided against further losses.

- **A bigger buffer against bank losses.** Overall, European banks will be required to raise 106 billion euros to temporarily maintain a higher buffer against additional losses on their bond holdings. Banks will be given the opportunity to raise this capital on their own and plug any gaps with funding from their own government and the ability to tap the European Financial Stability Facility (EFSF) as a last resort.

- **Insurance against loss on European government bonds.** The EFSF will provide guarantees against the first 20–25% of losses on about one trillion euros of European government debt.

The concerns may be shifting from a crisis to a recession in Europe, as it is likely that Europe will experience a mild recession next year. However, European growth could be even weaker in light of the spending austerity and potential for less lending by the banks. The next step in a successful plan to stabilize Europe is for the European Central Bank to cut interest rates soon and reverse the two rate hikes they made earlier this year to promote growth and lending.

While the devil of the European plan remains in the details, the deal could shift investor focus to U.S. markets where economic growth and corporate profits continue to chug along. Third-quarter economic growth, as measured by gross domestic product (GDP), was recently reported at 2.5%, nearly double the pace of growth witnessed in the first two quarters of the year combined. Within the S&P 500, 75% of the companies that have reported third-quarter earnings thus far have exceeded expectations and the companies, in aggregate, are tracking to 15% year-over-year earnings growth, surpassing the 12–13% growth rate that was forecast. Given

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the current backdrop, we expect the market to remain volatile, though we do believe there is moderate upside to the S&P 500 Index between now and year-end. As always, if you have questions, I encourage you to contact your advisor.

Best regards,

Jeffrey Kleintop, CFA
Chief Market Strategist
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