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WEEKLY INVESTMENT COMMENTARY

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The Fed's Easy Money Policy Should Remain a Tailwind for Stocks

Stocks Continue to Hit New Records

Although economic data continues to be mixed, investors have been focusing on solid corporate earnings reports and have been taking solace in the fact that the Federal Reserve appears set to keep rates low for quite some time. As a result, markets moved higher, with major indices once again reaching new records. For the week, the Dow Jones Industrial Average climbed 0.7% to 16,064, the S&P 500 Index advanced 0.4% to 1,804 and the Nasdaq Composite rose 0.1% to 3,991. In fixed income markets, Treasury yields moved slightly higher (as prices fell), with the 10-year Treasury yield rising from 2.70% to 2.75%.

Economic Story Remains the Same: Slow, but Positive Growth

The economic data shows that while it may be doing so grudgingly, the economy is growing. Taking a look at the critically important labor market as an example, last week's initial unemployment claims numbers showed a 21,000 drop, effectively bringing claims back to their pre-government-shutdown levels. But while the unemployment rate has dropped and initial unemployment claims are falling, other labor market metrics look less healthy. First, the drop in the unemployment rate can be largely attributed to the fact that more and more people have stopped looking for work. Second, many of the new jobs are part-time, leaving the underemployment rate high. Finally, despite some acceleration in job creation, wage growth remains well below trend.

We also saw October's retail sales figures last week, and while they were stronger than expected, much of the gains were concentrated in auto sales. Outside of food and autos, retail sales were up only fractionally. A similar pattern exists outside of the United States. In Europe, for example, Germany is showing signs of economic improvement (with business confidence hitting an 18-month high), but other areas, such as France, are continuing to struggle.

Modest Growth and Low Inflation Gives the Fed Room to Maneuver

As we discussed recently, sluggish growth has been matched with almost nonexistent inflation. Last week's data helped confirm this trend, with U.S. consumer and producer price inflation decelerating to 1.0% and 0.3%, respectively. By these measures, inflation in the United States is now at a four-year low.

The upside to weak growth and low inflation is that the Federal Reserve has significant latitude in determining how they adjust monetary policy. While it is still possible that the Fed will announce its long-awaited and long-expected move to begin tapering its asset-purchase programs as soon as next month, the central bank will



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be able to maintain its easy money policies by other means. In particular, there are no signs that the Fed plans to raise short-term interest rates (which have been locked at near zero since December 2008) any time soon. Additionally, the Fed seems determined to provide clear forward guidance on the direction of rates and wants to avoid a repeat of what occurred in the spring when the markets misinterpreted a discussion of tapering as a prelude to higher rates.

The Outlook for Stocks Remains Strong, but Signs of Profit-Taking are Emerging

Fed policy should continue to provide a tailwind for stocks and we continue to have a positive view toward equities. As such, we believe investors should continue to overweight stocks in their portfolios.

Although stocks have been hitting record highs, flows into stock funds have moderated a bit in recent weeks. We have also begun to see some outflows in higher-risk areas of the market, such as from emerging markets funds. These moves suggest that the magnitude of the recent rally has prompted some investors to engage in selling and profit-taking. We think these moves make sense, and would even go so far as to suggest trimming exposures to areas of the market that appear somewhat extended. These would include U.S. small caps and some of the more speculative parts of the tech sector, such as software services and social media companies (but, importantly, we would continue to advocate an overweight to the technology sector as a whole).

We believe investors should continue to overweight stocks in their portfolios.

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