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WEEKLY INVESTMENT COMMENTARY

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No Fed Tapering: Why? And What Impact Will it Have on the Markets?

Fed Surprise Drives Markets Higher

In a widely watched decision, last Wednesday the Federal Reserve surprised the markets by declining to begin backing off (tapering) its asset-purchase program. Most observers (us included) were expecting the central bank to begin a modest pullback in the pace of purchases, so the Fed's decision to stand pat took many by surprise.

Stocks responded positively to the news, shooting up to new highs in the aftermath of the Fed's decision before falling back as the week drew to a close. For the week, the Dow Jones Industrial Average gained 0.5% to 15,451, the S&P 500 Index advanced 1.3% to 1,709 and the Nasdaq Composite rose 1.4% to 3,774. In fixed income markets, Treasury yields fell sharply on the Fed's comments (as prices correspondingly rose). For the week, the yield on the 10-year Treasury dropped from 2.89% to 2.73%.

A Still-Weak Economy Keeps the Fed On Hold

Although the Fed's decision not to taper at this time took us by surprise, the Fed's inaction does confirm our central thesis that the recovery remains soft and that interest rates are likely to remain range-bound through the end of the year.

By failing to taper, the Fed signaled that it believes there are still lingering questions regarding the strength of the US recovery. The central bank remains focused on the fact that while the labor market is improving, it is doing so at an uneven pace. The Fed also pointed to the fact that more and more Americans have been dropping out of the labor force. In addition, the Fed is particularly concerned about the resilience of the housing recovery in the face of rising interest rates. This is an issue we have been discussing recently: if rates climb too far too quickly, it would imperil the housing market recovery. This concern was reinforced by some weaker-than-expected housing starts and housing permits data last week. Finally, the Fed's decision also serves as a tacit acknowledgement that the political backdrop could contribute to market risk, as Fed Chairman Ben Bernanke cited the potential for volatility around the upcoming debt ceiling and budget battles.

Investment Implications: Stick with Stocks and Credit Sectors

From an investment perspective, the Fed's actions and statements confirm many of our asset allocation views, but does temper a few. Most broadly, a slower approach to easing off on monetary stimulus adds support to our view that



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investors should be overweighting equities, should have exposure to emerging markets and should be focusing on credit sectors within fixed income markets. As we discussed last week, an environment in which rates are relatively well contained would be supportive of high yield bonds—an asset class that rallied strongly following the announcement.

In terms of some changes to our views, the most significant is that a few interest rate-sensitive asset classes—such as utilities stocks and gold—may get a temporary reprieve. We would still advocate underweights to these asset classes, but acknowledge that while real interest rates are likely to rise over the long-term (a negative for these areas of the market), the increase will not be as quick as many feared.

A slower approach to easing off on monetary stimulus adds support to our view that investors should be overweighting equities, should have exposure to emerging markets and should be focusing on credit sectors within fixed income markets.

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