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WEEKLY INVESTMENT COMMENTARY

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Trending Still: Low Inflation, High Volatility and M&A Activity

Markets Fluctuate, But End the Week Flat

Following a couple weeks of gains, markets took a breather last week. Although there was quite a bit of back-and-forth movement as investors reacted to some mixed economic data and earnings reports, stocks ended the week pretty much where they began. The Dow Jones Industrial Average dropped 0.3% to 16,103, the S&P 500 Index declined 0.1% to 1,836, and the Nasdaq Composite rose 0.5% to 4,263. Fixed income markets were also mostly unchanged for the week, with the yield on the 10-year Treasury falling marginally from 2.74% to 2.73%.

Low Inflation Gives the Fed Breathing Room

One of the most noted bits of economic data released last week was January's Consumer Price Index reading. The data showed inflation remains well contained, with both the headline and core numbers coming in at only 1.6% on a year-over-year basis. We would point to two primary factors keeping inflation both lower and less volatile than it has been in the past. First, companies are unwilling or unable to raise prices in an environment where sluggish wage growth has consumers struggling. Second, rising U.S. oil production has helped to dampen the usual volatility in oil prices. Although oil prices are higher today than they were a decade ago, increased production in the United States has translated into less volatility in energy-related inflation.

Low and less volatile inflation is good for the economy and for financial markets, since it means the Federal Reserve is under no immediate pressure to raise interest rates. We do expect the central bank to continue its tapering program, which will make monetary conditions marginally less accommodative, but we anticipate the Fed will keep rates near zero through 2014 and into 2015. Low short-term rates provide the dual benefit of supporting equity valuations and also helping to keep long-term Treasury rates from rising too aggressively.

Equity Volatility Is Returning to Its Long-Term Average

While inflation volatility is down, the opposite is true in equity markets. The VIX Index, a measure of U.S. stock market volatility, has fallen a bit since it spiked in early February, but is higher than it was at the start of the year.

Given the prevailing economic uncertainty, the likelihood of continued Fed tapering and a still-fragile environment in emerging markets, we expect the relatively higher levels of equity market volatility to persist. To be clear, we are not forecasting unusually high levels of volatility; rather, we anticipate volatility will continue to rise from what have been unusually low levels. Specifically, we expect the VIX to

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head from its current level of just under 15 back toward its long-term average of around 20.

Merger and Acquisition Activity Continues to Accelerate

Another notable trend we'll point to this week is the rising levels of corporate deal activity. The Time Warner/Comcast deal announced earlier this month was followed last week by 2014's largest deal yet when Actavis agreed to acquire rival pharmaceutical company Forest Labs for $25 billion. Last week also brought news that Facebook would be acquiring the maker of the popular chat app WhatsApp.

This increase in M&A activity should not come as a surprise. With slow economic growth and fewer opportunities for companies to grow their businesses organically, it makes sense for companies to deploy cash or to leverage rich stock valuations to essentially "buy growth." The increase in M&A activity also may be a precursor to another potential change in corporate behavior: rising capital spending. In general, we would say higher levels of deal activity (and possibly higher spending levels) are positives, since they tend to act as tailwinds for equity markets.

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