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WEEKLY INVESTMENT COMMENTARY

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Volatility Rising: Why? And How to Invest?

Stock and Bond Prices Fall Sharply

As we have been discussing in recent weeks, volatility appears to have picked up from its summer lows and investor uncertainty has been rising. While there were some positives (including confirmation that Europe's economy is finally expanding after six quarters of contraction), investor attention last week focused on escalating violence in Egypt and concerns over the likelihood that the Federal Reserve may be getting ready to scale back on its asset-purchase program.

Stocks experienced their worst weekly losses for the year last week, with the Dow Jones Industrial Average dropping 2.2% to 15,081, the S&P 500 Index declining 2.1% to 1,655 and the Nasdaq Composite sinking 1.6% to 3,602. Fixed income markets were not immune to the volatility, with Treasury yields experiencing their largest jump since June (prices move in the opposite direction of yields). The yield on the benchmark 10-year Treasury rose from 2.58% to 2.83%.

Geopolitical Risks are Rising

In addition to the human toll, the violence and political turmoil in Egypt is beginning to affect investor sentiment. The growing violence in that country is symptomatic of the rising geopolitical instability we're seeing in much of the Middle East and North Africa. While it is impossible to predict the political outcomes, one thing is clear: Over the past year, instability has led to significant disruptions in oil production and exports from Iran, Iraq, South Sudan, Libya, Nigeria and Syria. Although energy output from North America is surging, reduced supply from the Middle East and Africa helps explain why oil is one of the few commodities that has experienced price gains this year.

Fed Tapering to Start in September?

In addition to the focus on geopolitical risks, investors remain highly attuned to the timing and scope of any potential change in monetary policy. The economic data last week was mixed (and included some weak industrial production and manufacturing readings), but investors focused on one number in particular—the weekly initial jobless claims report, which was stronger than expected.

The reason this number had such an outsized influence on investor psychology is that the Federal Reserve has been vocal that it is highly focused on labor market conditions. Fed officials have been fairly consistent in saying that if the labor market continues to improve at the current pace (about 190,000 new jobs monthly), the Fed is likely to start to reduce its asset purchases (aka "taper") this fall, probably at its next meeting in mid-September. With that in mind, the key number to watch

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will be the August employment report due on September 6. If jobs growth in August matches the recent pace, the central bank is likely to start slowing the rate of its bond purchases next month.

Consider Trimming Exposures to Vulnerable Areas of the Market

So what does all of this mean for investors? First, we would argue that volatility is likely to continue to increase. Equity valuations are reasonable, but complacency appears high and headline risks are growing. In addition to the Fed's tapering decision, investors will be contending with another potential budget battle in Washington in the near future. The bottom line is that in this environment, we believe investors should consider reducing exposures to those areas of the stock market with stretched valuations and to assets that are vulnerable to rising real interest rates.

The first category would include US small-cap stocks and the consumer discretionary sector. For the second category, we would list long-dated Treasuries, TIPS, and areas of the stock market that are considered bond-market proxies, such as the utilities sector.

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