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WEEKLY INVESTMENT COMMENTARY

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Volatility Prompts a More Cautious View Toward Emerging Markets

Market Selloff Continues

The sharp decline in equity markets endured for a second week, with investors again reacting to tension in emerging markets (EMs) and mixed U.S. economic data by seeking out safe-haven assets. For the week, the Dow Jones Industrial Average declined 1.1% to 15,698, the S&P 500 Index dropped 0.4% to 1,782 and the Nasdaq Composite fell 0.6% to 4,103. Factoring in these losses, U.S. stocks lost close to 4% in the first month of the year. Action in fixed income markets also echoed the previous week, with Treasury yields falling (and prices correspondingly rising). For the week, the yield on the 10-year Treasury dropped from 2.86% to 2.64%.

Turmoil Causes Investors to Flee Emerging Market Stocks

Amid continued downward pressure on their currencies, several emerging market countries raised their benchmark interest rates last week in an effort to provide support. Most notably, the Turkish central bank increased rates from 7.75% to 12%, a much more aggressive move than expected. Central bankers in India and South Africa also raised rates, but in a much less dramatic fashion.

Although emerging market equities are inexpensive (they trade at a 40% discount to developed market stocks), investors continue to view the asset class as risky and are selling down their exposures at a rapid clip. Last week brought the 14th consecutive week of outflows from EM funds and also marked the single-largest weekly outflow since August 2010. Looking ahead, we expect the combination of U.S. Federal Reserve tapering (which reduces overall global liquidity) and high debt levels in many EM countries will keep volatility high. While we do see good long-term value in emerging markets, near-term volatility suggests a more cautious stance is warranted in the shorter-term. As such, we would still be cautious about adding new positions to EM equities.

Without Wage Growth, the U.S. Economy to Remain Shaky

Although investor attention has been focused on emerging markets, certain news from the U.S. also has contributed to souring sentiment. Following a period during which economic data mostly surprised to the upside, the tone has become more mixed in recent weeks.

On the positive side, the U.S. economy ended 2013 on a strong note, with gross domestic product growing at an annualized rate of 3.2% in the fourth quarter. Other reports, however, are painting a more negative picture. Durable goods orders plunged 4.3% in December and November's figures were revised sharply lower. More troubling was December's personal consumption and income data, which

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showed that although consumers continued to spend, that spending came alongside a lower savings rate (that rate fell to an 11-month low of 3.9%). At the same time, wage growth remains elusive. Disposable income was flat in December and is up only 2.3% on a year-over-year basis, the slowest rate of growth since 2010.

The takeaway from all of this is that while consumer spending is still rising, that spending is coming from savings rather than from increases in wages and income—an unsustainable trend. Unless the pace of wage growth accelerates, spending will eventually slow, which would act as a drag on the broader economy. From an investment perspective, we would suggest this backdrop justifies a negative view toward consumer-related stocks.

Equity markets will need to rely more on fundamentals and less on Fed policy to continue to make gains.

Fed Tapering Is Removing a Pillar of Support

In addition to the aforementioned hiccups, investors also are digesting the details from last week's Fed meeting. As expected, the Fed announced it would reduce the size of its monthly asset purchases by an additional $10 billion (from $75 billion in January to $65 billion), continuing the tapering process it began last month. In our view, the central bank's quantitative easing program was effective in helping to stabilize financial markets, but it did not accomplish its stated goal of strengthening the labor market.

The Fed's actions were not unexpected and represent a step in the direction of less-easy monetary policy. Although policy is by no means tight, and the Fed is committed to keeping short-term rates near zero for the foreseeable future, tapering does mean that Fed policy is less of a tailwind for stocks than it was in past years. As such, equity markets will need to rely more on fundamentals and less on Fed policy to continue to make gains.

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