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WEEKLY INVESTMENT COMMENTARY

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Surprise! Could Rates Rise Sooner Than Expected?

Market Upturn Resumes as Investors Focus on the Positive

The market-related headlines last week were dominated by the ongoing turmoil in Ukraine and comments from Federal Reserve Chairwoman Janet Yellen that appeared to indicate the Fed might begin raising rates earlier than anticipated. Investors shrugged off the seemingly negative news, however, and pushed stock prices higher. For the week, the Dow Jones Industrial Average advanced 1.5% to 16,302, the S&P 500 Index climbed 1.4% to 1,866 and the Nasdaq Composite rose 0.7% to 4,276. In fixed income markets, Treasury yields advanced a bit (as prices fell), with the yield on the 10-year Treasury rising from 2.65% to 2.74%.

Investor Anxiety Over Ukraine Diminishes

Just two weeks ago, market sentiment was dominated by mounting tensions between Russia and Ukraine over the disputed region of Crimea. Last week, however, investors largely turned their attention elsewhere, even as Russia has now effectively annexed Crimea. While the endgame remains uncertain, investors appeared to find relief in the fact that sanctions against Russia have been relatively modest and have yet to be met with any serious Russian response. As we indicated last week, this situation bears close watching, and if the rhetoric over potential sanctions turns into additional action, it would likely prompt additional market volatility and put downward pressure on stocks.

Fed's Views Evolving Along With the Economy?

Last week brought additional evidence that the soft economic data we saw in January and February could, at least in part, be attributed to the severe winter weather. Consumer spending remains troubled, but manufacturing activity and construction are recovering from their winter weakness. The latest readings show that U.S. industrial production rose more than expected, capacity utilization increased and new building permits surged.

Given the improving tone of the economic data, it came as no surprise last week when the Fed announced it would taper its asset purchase programs by an additional $10 billion. What did come as a surprise was Ms. Yellen's estimation that the Fed may begin hiking short-term interest rates six months after the current quantitative easing program winds down. If the Fed follows through, and continues its current pace of tapering, this could mean rate hikes in the spring of 2015, earlier than the markets had previously forecasted.

At the same time, the Fed's forecasts for economic growth appeared more optimistic than they were previously, and included a revised view toward the labor

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market. Specifically, it appears the central bankers may be starting to adopt the view that the chronically low labor force participation rate (meaning those working or looking for work) could remain low for an extended period. They attribute this to long-term structural issues, such as technological advancement and a growing gap between workers' current skills and those needed to perform increasingly specialized jobs. If the problems in the labor market are, in fact, structural in nature, that would suggest there may be less "slack" in the workforce than previously thought. In turn, this would mean any marginal increase in demand for labor could push wages and inflation higher. At this point, there are few (if any) signs that this dynamic is occurring, yet it does indicate an important shift in the Fed's thinking. It also explains why the central bank may be inclined to increase rates sooner than previously expected.

The short and intermediate portions of the Treasury market (Treasury bonds with durations of three to seven years—the area often called the "belly" of the yield curve) could be particularly vulnerable to increased volatility.

What Higher Rates Mean for Markets

So if the Fed were to raise rates earlier than previously thought, what would that mean for financial markets? First, it would likely mean a stronger U.S. dollar (particularly since Japanese monetary policy remains on an aggressive easing path and the European Central Bank may be forced to adopt an easier policy to combat persistent deflationary pressure). The dollar did rally sharply last week as a result of such expectations.

Second, echoing a point we have been making for the past several months, the short and intermediate portions of the Treasury market (Treasury bonds with durations of three to seven years—the area often called the "belly" of the yield curve) could be particularly vulnerable to increased volatility, and are the areas most likely to be hurt by an increase in rates.

Finally, in an environment characterized by a strengthening dollar and rising real (inflation-adjusted) rates, gold prices are likely to come under pressure. So far this year, gold has rallied due to an unexpected drop in interest rates, but that trend could be set to change. We may have already started to see that shift, with gold prices pulling back last week from a six-month high.

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