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WEEKLY INVESTMENT COMMENTARY

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Look for Inflation to Remain Muted

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Stocks (Again) Make New Highs

Once again, stock markets advanced last week, getting a boost from the relatively dovish comments made by Federal Reserve chair nominee Janet Yellen at her confirmation hearing. For the week, the Dow Jones Industrial Average climbed 1.3% to 15,961 and the S&P 500 Index advanced 1.6% to 1,798, with both indices again reaching record highs. The Nasdaq Composite also advanced, rising 1.7% to 3,985. In fixed income markets, yields were little changed. The yield on the 10-year Treasury fell slightly (as prices rose), from 2.75% to 2.70%.

Inflation is Virtually Nonexistent...

In recent weeks, we have spent time discussing the still-fragile nature of the U.S. economic recovery, but we haven't focused as much on another important factor that affects the markets—inflation. Although many have been expecting the Federal Reserve's long period of easy monetary policy would trigger a rise in inflation, it has not done so. In fact, inflation remains close to historic lows in the United States and we believe this phenomenon will persist into 2014. This suggests the Fed will continue to keep short-term rates low for a prolonged period of time.

While different measures of inflation provide different readings, virtually all inflation metrics suggest that U.S. inflation is trending around 1% annually. Last week we saw import prices fall by 0.7% (they are down 2% from a year ago) and next week we'll see October's consumer price inflation reading—a number expected to be around 1%. By any measure, current readings are extremely low, even by the low-inflation standards of the last four years. This phenomenon is not confined to the U.S. Not counting food prices (which tend to be highly volatile) inflation is close to historic lows in most of the developed world as well.

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...and Should Remain so for Some Time

So why are we seeing such low inflation measures? We would point to three factors: low wage growth, excess capacity and slow credit growth. Regarding wages, the Bureau of Labor Statistics last week announced that unit labor costs actually fell at an annualized 0.6% rate in the third quarter. Given the considerable slack in the labor market, there is little reason to believe that wages will grow noticeably any time soon. At the same time, U.S. capacity utilization (a measure of how much of the country's productive capacity is being employed) is running around 78%, a depressed level and well below the historic average. On a practical basis, low capacity utilization means that we are not seeing factory bottlenecks or overstressed utilities and thus are not seeing upward pressure on prices. Finally,

while the Fed has continued to expand its balance sheet through asset purchases, banks have not been lending aggressively. With lending and credit growth slow, growth in the money supply is slow as well—another factor limiting any increases in inflation.

To be sure, none of this means that inflation will not eventually pick up. But for now, while we remain in a world of slow wage growth, excess capacity and limited credit growth, inflation will remain low. For how long? We don't expect a notable increase in inflation for at least the next year or so.

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Stay Underweight TIPS in a Low Inflation World

So assuming we remain in a low-inflation world through at least most of next year, what are the investment implications? First, while we expect the Fed will begin paring back on its asset purchase program at some point in the next several months (a process known as tapering), the central bank is likely to keep short-term interest rates pegged at zero through 2014, and potentially much longer. Low short-term rates have been one of the factors supporting stock prices, and that should remain a tailwind for companies and the economy.

Second, we don't believe investors need to increase holdings that are designed to protect against inflation, especially if those asset classes are expensive. In particular, we have a negative view toward Treasury Inflation-Protected Securities (TIPS). The absence of inflation is a key reason why TIPS have underperformed so much in 2013. On a year-to-date basis, the Barclays U.S. Aggregate Bond Index (a broad measure of fixed income) is down around 1.5%, while TIPS are off close to 7%. Despite these losses, however, we believe TIPS are still expensive. Finally, we would point out that while TIPS are a hedge against inflation, they remain vulnerable to rising real interest rates, just as nominal Treasuries are.

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