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WEEKLY INVESTMENT COMMENTARY

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What to Do When Growth is Too Slow

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Stocks Sink and Yields Fall on Negative Economic Data

Last week featured a series of disappointing economic results, including weak manufacturing data, a jump in new jobless claims and, most notably, a weak monthly employment report. In this environment, stocks traded erratically, and ended the week lower, with the Dow Jones Industrial Average declining 0.1% to 14,565, the S&P 500 Index falling 1.0% to 1,553 and the Nasdaq Composite dropping 1.9% to 3,203. Small cap stocks fared even worse, with the Russell 2000 Index losing nearly 3% last week. In fixed income markets, Treasury yields fell yet again (as prices rose), with the yield on the benchmark 10-year Treasury declining from 1.85% to 1.71%, close to where it started the year (just one month ago, the 10-year was yielding over 2%).

Jobs Growth (or Lack Thereof) Remains Key

For much of 2013, observers who were trying to identify potential downside risks to the markets have been focusing on issues such as the fiscal cliff and the associated drama in Washington or flare-ups in the European debt crisis. And while these issues remain important, last week demonstrates that the real risk to the markets may be something more mundane: the slow pace of the recovery. Importantly, the problem is not that the economy isn't improving; it's that it is not getting better as fast as many have come to expect.

The March employment data that was released on Friday helps tell this story. The headline number of a paltry 88,000 new jobs was a big miss (the consensus expectation was for jobs growth of 197,000). Jobs are being created, but at a slower pace than is needed to provide a jump start to the broader economy. In the first quarter of 2013, an average of 170,000 new jobs was created each month, which is in line with the average pace since the start of 2011. So while conditions are not getting any worse on the job-creation front, they are not improving either.

A deeper look at the report shows more serious problems, however. First, jobs growth is slow enough that it is not translating into higher wages. Hourly wages were flat in March and have advanced less than 2% over the past year, which is lower than the rate of inflation. In other words, many people now have less money to spend than they did a year ago on an inflation-adjusted basis. This is one of the reasons that the savings rate is falling—an unsustainable trend that is putting downward pressure on consumer spending. Secondly, the percentage of the population engaged in the workforce continues to drop, which lowers the country's overall growth potential. The March report showed that unemployment dropped slightly

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to 7.6%, which is partly a result of the fact that more unemployed people are no longer seeking work. Today, only 63.3% of the adult population is engaged in the labor force, the lowest ratio since 1979.

Investment Positioning in a Slow-Growth World

We won't see the first quarter numbers for a couple of weeks yet, but it does appear likely that the US economy will have grown faster than most anticipated for the period. We do not expect this trend to continue and believe that growth will slow in the next few months (partially as a result of the sequester spending cuts). Slower growth will have several implications for the financial markets.

First, we think equity market volatility will be higher as economic growth becomes more uneven (in the first quarter, market volatility was at its lowest level since early 2007). Second, we expect smaller cap stocks to underperform in the coming environment. It looks to us as if small cap stocks have discounted too much good news and we think this area of the market looks vulnerable, as we saw last week. In our view, the larger capitalization segments of the market look considerably more attractive. Finally, from a fixed income perspective, we still believe rates will rise this year, but as last week illustrated, that process will be uneven. While we do prefer equities, this doesn't mean investors should abandon bonds. Instead, we suggest a focus on areas of the fixed income market that offer better value than Treasuries—specifically credit sectors (such as high yield and bank loans) and municipal bonds.

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