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WEEKLY INVESTMENT COMMENTARY

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Markets Upbeat, But Some Economic Pieces Missing

Stocks Advance, With the S&P 500 Closing in on a New High

Once again, stocks advanced last week, thanks in large part to upside surprises in the economic data. For the week, the Dow Jones Industrial Average increased 0.8% to 14,514, hitting several new highs along the way. The S&P 500 Index also advanced, rising 0.6% to 1,560. That index nearly reached its all-time high of 1,565, but lost some steam on Friday. For its part, the Nasdaq Composite edged up 0.1% to 3,249. In fixed income markets, Treasury yields remained range-bound, with the benchmark 10-year yield declining a few basis points to end the week at 1.99%.

Economy Shrugs Off Higher Tax Rates

Outside of a disappointing consumer confidence number that was reported last week, virtually all of the data has been coming in at a better-than-expected rate. Looking ahead, we still expect the economy to hit a modest speed bump in the second quarter given the spending cuts associated with the sequester. For now, however, the evidence suggests that the economy is picking up momentum.

Last week, we saw some evidence that the manufacturing sector is continuing to improve, with industrial production rates and factory capacity levels both moving higher. Additionally, February's retail sales figures were released last week and showed a 1.1% increase, double what consensus expectations had forecasted. This increase is particularly noticeable, since it comes on the heels of higher marginal tax rates for the wealthy and higher payroll taxes for everyone. Despite the fears of many that the higher taxes that went into effect in January might put a damper on economic growth in general and on consumer spending in particular, so far, the economy has been able to weather the impact.

To some extent, the resilience of the consumer can be attributed to improvements in the labor market: with more people working, it is hardly surprising that more people are spending. But there is also another factor at work: a declining savings rate. After the financial crisis, many were predicting a long-term increase in the savings rate. Although we did see a brief spike in savings rates in 2008, they have since been grinding lower, with January's personal savings rate plunging to 2.4%, the lowest level since late 2007. Reductions in savings do provide a boost to near-term spending levels, but falling savings also clearly presents some risks since it is an unsustainable trend.

What to Watch: Personal Income Growth

One critical component that still appears to be missing from the economy is personal income growth. With the labor market showing signs of improvement,

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we theoretically should be seeing improvements in this area, but so far the evidence has been mixed. The latest data, from January, showed that real disposable income rose by only 0.6%, the slowest rate of growth since February 2011. February's data is scheduled to be released on March 29, and will bear close watching. We should eventually see some stronger upward pressure on income levels, but there is still quite a bit of slack in the labor market, which means that wages are unlikely to rise quickly. Until unemployment falls further, this process is likely to be a slow one.

So for now, income growth remains the key missing ingredient in the economic recovery. If income does start to rise, the economy should convert to a self-sustaining growth trajectory. On the other hand, if income growth remains muted, it would suggest that spending levels (and the broader economy) will remain vulnerable.

From an investment perspective, with consumer spending still on shaky ground, we remain cautious on consumer-oriented sectors of the stock market. Instead, we would suggest a focus on sectors such as energy, where attractive valuations offer some support.

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