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WEEKLY INVESTMENT COMMENTARY

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US Economy Should be "Good Enough" for Stocks

Stocks Again Reach New Records

Thanks in large part to a better-than-expected April employment report, stocks once again rose last week and reached new highs. The Dow Jones Industrial Average moved above the 15,000 level for the first time before closing the week at 14,973 (up 1.8%). At the same time, the S&P 500 Index rose 2.0% to 1,614 and the Nasdaq Composite advanced 3.0% to 3,378. In fixed income markets, Treasury yields continued to slip early in the week (as prices rose) before jumping higher on Friday. For the week, the yield on the 10-year rose from 1.66%to 1.74%.

Slow (but Positive) Economic Growth Should Help Equity Markets

Last week's labor market report surpassed expectations, with the data showing 165,000 new jobs being created last month (a pace largely consistent with the rate of jobs growth over the past two years). The report also included an upward revision to jobs growth numbers from March and February and showed that the unemployment level fell to 7.5%, its lowest level since late 2008. The one negative included in the report was a factor we have been highlighting for some time: still-tepid wage growth. Because so many Americans are still unemployed or underemployed, wages are rising at a painfully slow rate—up just 1.9% in April, a pace that is barely keeping up with inflation. Overall, the report was consistent with our view that both the labor market and the broader US economy are slowly healing, and it was clearly a relief for those concerned about another "springtime swoon" in the economic data.

As last week's market action suggested, slow, but positive, economic growth can create a friendly environment for stocks. First, we would point out that economic growth is just about fast enough to provide support for top-line corporate earnings, while slow growth is keeping costs contained. Second, given that unemployment is still uncomfortably high, the Federal Reserve is likely to keep monetary conditions accommodative and interest rates low, an environment that should be conducive to higher stock prices.

While stocks are continuing to advance, the composition of the rally has started to change. Large- and mega-cap stocks are now outperforming smaller-caps, a trend we expect will continue. Additionally, some of the more expensive defensive sectors of the market (such as the utilities sector) are underperforming, while the technology sector has experienced better results and still looks inexpensive.

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Europe Remains Behind the Curve

As we indicated, one of the reasons US stocks have been performing so well recently is that the Federal Reserve remains extremely aggressive in terms of its easing programs (the same can be said about Japanese stocks and the Bank of Japan). In other words, both the Fed and BOJ are expanding their balance sheets as they continue to purchase assets through their quantitative easing programs. In contrast, the European Central Bank has been shrinking its balance sheet, despite the ongoing recession in Europe, and European monetary policy is arguably tighter today than it was last summer.

Last week, the ECB attempted to address this issue by cutting interest rates to 0.5%, a record low. Unfortunately, we would say this action was too little, too late. A small cut in interest rates is unlikely to have much of an impact on the European economy, especially since European banks remain troubled and are still reluctant to lend. In our view, it is hard to envision a turnaround in the European economy. The European Commission seems to share this opinion, as it just lowered its expected growth rate for Europe in 2013 and expects the region to remain in a recession. Additionally, the commission is expecting European unemployment to climb to a record of over 12% this year.

From an investment perspective, we would say that there are some isolated opportunities in European stocks (particularly in Northern Europe). However, until we see a more aggressive policy response, we would advocate remaining cautious toward European equities.

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