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WEEKLY INVESTMENT COMMENTARY

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The Central Bank Divide

Stocks Rally on Stronger Data

U.S. stocks continued to climb higher last week following better-than-expected economic data. For the week, the Dow Jones Industrial Average was up 1.35% to 16,924, the S&P 500 Index rose 1.53% to 1,949, and the tech-heavy Nasdaq Composite Index climbed 1.73% to 4,321. Meanwhile, the yield on the 10-year Treasury rose from 2.46% to 2.59%, as its price correspondingly fell.

Stronger economic data leads to a proverbial "good news/bad news" dilemma. The good news is that a stronger economy is supportive of stocks. The downside is that the Fed will move to normalize interest-rate markets, perhaps earlier than some expect. At the very least, that will put additional pressure on bonds. Interestingly, the opposite scenario is unfolding elsewhere, with more aggressive central bank actions in Europe and Japan. In short, we are seeing signs of a "central bank divide" with potential ramifications for U.S. investors.

Slow, But Real Progress on the Jobs Front

Equity markets once again touched new record highs last week, supported by labor market and manufacturing reports that confirmed the U.S. economy has recovered from its weather-induced slowdown.

In the United States, both the ISM manufacturing and non-manufacturing surveys came in better than expected and the labor department announced that fewer Americans filed applications for unemployment benefits over the past month than at any time in the last seven years.

Most importantly, Friday's non-farm payroll report was solid, with 217,000 net new jobs in May. After a slump in early 2014, job growth is back to around 190,000 a month on average. This is hardly spectacular, but it does represent a significant improvement from earlier in the year.

In addition, there was more good news with hourly wages ticking higher last month after stagnating in April. To be sure, wage growth is still barely keeping up with inflation, but at the very least it is remaining stable rather than sliding. Overall, the report suggests the U.S. labor market continues to make slow, but real progress, although the plight of the long-term unemployed shows little improvement.

The bottom line: Stocks have benefited from generally stronger economic data, and that should support earnings growth in the second half of the year, even with interest rates on the rise.

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But a key question now for investors is how the Federal Reserve (Fed) will react to improving economic data as it continues to taper its asset purchase program. Our take: The Fed may move to normalize interest-rate markets earlier than some expect, although Friday's data on its own is not enough to change the path of monetary policy expectations.

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Aggressive Actions in Europe and Japan

Elsewhere the story is different. While the Fed is likely to moderate its monetary accommodation and start raising rates by next year, other central banks are moving in the opposite direction. Last week, the European Central Bank (ECB) further eased monetary policy. Included in its actions was a move to push short-term deposit rates into negative territory, the first time a major central bank has attempted this. At the same time, the Bank of Japan (BoJ) is likely to continue its very aggressive asset purchase program through 2016.

For markets and investors, this "central bank divide" has at least three implications. First, global interest rates are likely to stay low and liquidity high for the remainder of the year, even as the Fed pulls back. Second, the dollar is likely to strengthen if the Fed is less accommodative while other central banks are maintaining very easy monetary policy. Finally, lots of liquidity from the ECB and the BoJ will help support international equity markets. This was already evident in Japan, which closed at a three -month high last week.

In short, we've been saying for some time that we have a positive view of European and Japanese stocks and U.S. investors should consider increasing their holdings of both. To us, the latest developments only support that case.

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