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WEEKLY INVESTMENT COMMENTARY

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Investment Ideas for a Two-Speed Economy

Stocks Edge Higher During a Quiet Week

Equity markets continued to rise in the early part of last week, again hitting new highs, before declining slightly on renewed uncertainty regarding the timing and scope of the U.S. Federal Reserve's plans to taper its asset purchase program. By the end of the week, markets were able to hold onto modest gains, with the Dow Jones Industrial Average climbing 0.3% to 15,615 and the S&P 500® Index rising 0.1% to 1,761. In contrast, the Nasdaq Composite fell 0.5% to 3,922. In fixed income markets, Treasury yields rose slightly (as prices correspondingly fell) from 2.51% to 2.62%.

Entering a Two-Speed Economy

Recently, we've been talking quite a bit about the slow-growth nature of the U.S. and global economies. A closer look at the data reveals an emerging divergence between different areas of the economy. Specifically, the U.S. economy appears to be growing at two speeds—manufacturing is expanding, while the labor market and household spending remains subdued.

Last week's data helps illustrate this trend. On the positive side, all the manufacturing data (including the ISM National Survey and the regional surveys) came in much stronger than expected, with new orders data looking particularly solid. On the negative side, jobs growth (and by extension consumption) remained weak. We're still awaiting the October jobs report, but last week's ADP employment survey showed only 130,000 new jobs created for last month, which was well below expectations. Anemic jobs growth continues to hamper confidence levels and is negatively affecting retail sales.

This phenomenon is not isolated to the United States. In China, growth rebounded nicely in the second quarter, but continues to be led by investment and infrastructure spending rather than consumer spending. We're seeing some similar trends in Europe. In Spain, for example, the economy is growing modestly, but is being led by exports while unemployment remains close to record levels.

Ultimately, this divergence is not sustainable and needs to be solved. Either the global and U.S. economic recoveries will broaden and we'll begin seeing improvements in the pace of jobs growth and consumer spending, or the rebound in manufacturing will level out as inventory levels start to climb too high. In our view, we continue to believe we will see a very modest improvement in the pace of economic growth in 2014.

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Treasuries Continue to Appear Unattractive

At current levels, we simply do not believe that Treasuries look attractive and expect yields to remain range-bound at least for the short-term. There has been some downward pressure on yields thanks to some disappointing economic data. However, with manufacturing data still strong and with a Fed that appears determined to slow the pace of its asset purchases by early 2014, there is a limit to how low bond yields are likely to go. At the same time, we expect any rise in rates to be measured.

Cyclical Stocks Look Appealing

Within equities, we believe that the rebound in manufacturing supports overweight positions in cyclical stocks. In general, cyclical companies are cheaper than defensive ones and they also stand to benefit more from any improvements to the global economy. It's worth pointing out that even during the relatively weak growth of the last three months, U.S. cyclical companies have gained approximately 4.5%, roughly double the pace of more defensive sectors. In particular, we would emphasize the global information technology and energy sectors, as well as U.S. manufacturers (such as chemical companies) that benefit from lower energy costs.

We believe that the rebound in manufacturing supports overweight positions in cyclical stocks.

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