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WEEKLY INVESTMENT COMMENTARY

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With Stocks Surging, Some Caution is Warranted

Stocks Power to New Highs

Fueled in large part by some better-than-expected economic data (including the February jobs report), stock markets again posted gains as investors shrugged off any bad news associated with the sequester and focused on the positives. As was widely reported, the Dow Jones Industrial Average reached a new all-time high last week, closing at 14,397, up 2.2% for the week. Other indices saw similar gains, with the S&P 500 Index rising 2.2% to 1,551 (still below its record high of 1,565) and the Nasdaq Composite advancing 2.4% to 3.244. In fixed income markets, the benchmark 10-year US Treasury yield advanced (as prices correspondingly fell), rising from 1.84% to 2.06%.

In addition to improving economic data, stocks have also been benefitting from improving investor sentiment. Last week marked the fifteenth consecutive week in which we witnessed flows into equity funds. Significantly, these flows do not appear to be coming at the expense of bond funds (which continue to experience inflows), but rather from cash holdings. Although the pace of flows into stocks has been slowing in recent weeks, it does seem clear that many investors are finally putting some money to work and are moving off of the sidelines. In our view, this trend has the potential to continue, which could help stocks to continue to post gains.

Jobs Growth Confirms the Ongoing US Recovery

The economic highlight from last week was February's jobs report, which showed that the country added 236,000 new jobs last month, gains that helped push the unemployment rate down to 7.7%, the lowest rate since 2008. The bottom line is that the labor market report confirmed that the US economy is continuing to improve and is demonstrating surprising resilience in the face of higher taxes.

For the bears out there, there were a few data points associated with the report that could temper enthusiasm. First, the report did show a substantial downward revision to January's job growth numbers. Secondly, hourly earnings remain relatively stagnant, growing just over 2%, which is barely keeping pace with inflation. This suggests that while new jobs are being created, they are not being created at a fast enough pace to push up wages. Additionally (and perhaps most importantly), the labor force participation rate, which measures what percentage of an economy's potential labor pool is actively working or looking for a job, fell to 63.5%, the lowest level since August 2012. While this alone is unlikely to cause any near-term issues, a falling participation rate does have the potential to slow the broader economy's rate of growth.

Russ Koesterich, Managing Director, is BlackRock's Global Chief Investment Strategist, as well as Global Chief Investment Strategist for BlackRock's iShares business. Mr. Koesterich was previously Global Head of Investment Strategy for active equities and a senior portfolio manager in the US Market Neutral Group. Prior to joining the firm in 2005, he was Chief North American Strategist for State Street Bank.

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Notwithstanding some of these potential negatives, we believe the report was a good one and shows that the labor market continues to heal. Other data (including manufacturing reports) has also been pointing to some good news and we do believe that the US economy is improving. As we mentioned last week, the sequester is likely to act as a drag on the economy in the coming months, but the recent data confirms that the United States can probably withstand the hit.

In particular, we think US mega caps look particularly attractive and offer compelling valuations and high profitability.

Warning Signs Ahead? Stick with Mega Caps

Stocks have been experiencing a strong run and the magnitude of recent gains is causing some indicators to flash yellow. After spiking a couple of weeks ago, volatility measures have fallen again, suggesting that some investors are becoming complacent. Additionally, corporate earnings growth has not been keeping pace with price gains, which means that valuations are slightly less attractive than they were a few months ago (although we still think stock valuations are cheap relative to bonds and cash).

While none of this means that the rally is over, it does suggest that investors should become more selective as they look at potential investment opportunities. We would advocate emphasizing those areas of the market where fundamentals have kept pace with the broader rally. In particular, we think US mega caps look particularly attractive and offer compelling valuations and high profitability. In contrast, we think small cap stocks are looking relatively expensive. Small caps have outperformed other market segments on a year-to-date basis and we do not believe their fundamentals are as attractive as larger companies. As such, this may be a good time to take some profits from that areas of the market and reallocate to segments that are more compelling.

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