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WEEKLY INVESTMENT COMMENTARY

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Rare Washington Compromise: A Modest Economic Positive

Stocks Stall, With Investors' Eyes Focused on the Fed

Last week brought some good (and surprising) news in the form of a spending deal in Washington and signs that consumer borrowing picked up. Somewhat perversely, however, investors reacted negatively in a repeat of the "good news is bad news" theme we've seen for some time, since signs of improvement have been interpreted as increasing the possibility that the Federal Reserve would begin tapering its asset-purchase programs sooner rather than later. There is some logic to this view, and we do think the odds of a December taper have gone up. That said, the more likely timeframe is early 2014, a view supported by the fact that inflation continues to remain low, allowing the Fed more latitude.

For the week, the Dow Jones Industrial Average and S&P 500 Index both fell 1.7% to 15,755 and 1,775, respectively, while the Nasdaq Composite lost 1.5% to close at 4,001. In fixed income markets, Treasury yields were flat for the week (as were prices), with the yield on the 10-year Treasury beginning and ending the week at 2.86%.

Washington Surprises With a Spending Deal

In a rare act of negotiation and bipartisanship, leaders in the House of Representatives and Senate agreed last week to fund discretionary spending for the next two years. The deal moderately increases government spending and scales back the previously planned "sequester" cuts. The increased spending will be covered by increasing some government fees and changing pension contribution plans, as well as via some vaguely defined future spending cuts.

Assuming the deal is ratified by the Senate (and we believe it will be), it will accomplish two things. First, it will mitigate fiscal drag associated with the sequester. Second, it will remove a lingering uncertainty—the possibility of another government shutdown—that had the potential to undermine both business and consumer confidence. We would view the spending deal as a modest positive, with initial estimates suggesting it may add approximately 0.2% to gross domestic product in 2014.

While any agreement is better than none, there is a lot that this deal does not tackle. It does nothing to address the debt ceiling, tax reform, long-term entitlement reform or the pending expiration of previously extended unemployment benefits. At the very least, we expect political wrangling over the debt ceiling to continue into 2014—especially as next year brings with it the backdrop of the midterm elections.

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Increased Borrowing a Positive Sign for the Economy, and for Stocks

Outside of news from Washington, last week also saw some important developments in the consumer sector of the economy. Specifically, U.S. household debt increased at a 3% annualized pace in the third quarter, the largest increase since the first quarter of 2008. Consumers' willingness to take on more debt is being driven by several factors, including a marginally better jobs market, rising household net worth and a low-interest-rate environment that makes borrowing more attractive.

Should this trend continue, we believe it could help support economic growth in 2014. Although we expect interest rates to increase next year, we are forecasting only a modest rise, and believe borrowing trends will continue to stabilize. To at least some extent, higher borrowing levels will help mitigate the impact of slow income growth and promote some increase in consumer spending. From an investment perspective, this would be a positive for stocks, but arguably a negative for bonds.

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