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WEEKLY INVESTMENT COMMENTARY

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Mixed Global Growth Warrants a Focus on Emerging Markets

Markets Continue to Digest January's Gains

As was the case the prior week, last week saw little price change in US financial markets as investors are apparently taking a breather to digest some mixed economic news. For the week, the Dow Jones Industrial Average fell fractionally to end the week at 13,981, while the S&P 500 Index and Nasdaq Composite each advanced 0.1% to close at 1,519 and 3,192, respectively. Fixed income markets were also little changed, with the yield on the 10-year Treasury rising very slightly to end the week at 2.01%.

US Economy Faces Near-Term Headwinds

We have been saying this for some time, but it remains true: the US economy is continuing to grow slowly, with the data vacillating between positive and negative news. The good news last week came in the form of evidence that the labor market continues to heal. On Thursday, initial jobless claims plunged to 341,000, significantly below the level of the prior week and below the one-year average. On the other hand, we also saw some weakness in other areas of the economy. January's industrial production figures showed an unexpected contraction, rising just 2% from a year earlier, the slowest pace in nearly three years.

Last week, we discussed a potential economic risk in the form of weak spending and the recent data we have seen confirms that spending has been slowing. Due primarily to the increase in payroll taxes that took effect at the beginning of the year, January's retail sales figures showed a dramatic slowdown, rising just 0.1%. Looking ahead, we expect that near-term growth (meaning the first and second quarters) will be held back by weaker consumption as consumers adjust to higher tax levels and have to wait longer than usual for their tax refunds.

Global Growth Echoes the US Trends, with China Being a Bright Spot

Outside of the United States, the trends are quite similar. Most areas of the world (developed markets in particular) are struggling through slow growth, although China has been regaining some of its old swagger. While it hardly comes as a surprise, Europe's economy continues to struggle. Even Germany, which had been one of the few bright spots in Europe, showed an economic contraction in the fourth quarter of 2012, with economic growth falling by 0.6%, its sharpest contraction since the first quarter of 2009.

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Japan is also showing signs of weakness. Investors had been expecting a modest expansion in the fourth quarter, but the data showed the economy shrank by 0.1%, the third consecutive quarter of economic contraction. While many are anticipating that monetary and fiscal stimulus will finally jump start the Japanese economy, the recent data is a useful reminder that many challenges remain.

In contrast to the weakness seen in most developed markets, China is definitely recovering from its 2012 slump. Exports are once again thriving, with January showing a 25% year-over-year gain. This growth is likely inflated by seasonal patterns, but is nonetheless a significant improvement compared to last summer when exports were essentially flat. Perhaps even more importantly, given that China is focusing on domestic spending levels, Chinese retail sales have continued to climb, with January's data showing the fastest pace of growth since early 2012.

Divergent Growth Patterns Make Emerging Markets Well Positioned

The bottom line to us is that while overall global growth is likely to be marginally better in 2013 than it was in 2012 (thanks largely to a resurgent China), investors should be prepared for ongoing fits and starts in the pace of growth. Among developed markets, we expect US growth will outpace growth in Europe and Japan, but even in this case the United States is likely to have a slow start to the year.

From an investment perspective, we would argue that the macro backdrop suggests emerging markets should outperform on a relative basis. While directly investing in emerging markets should be an important component of an investor's portfolio, we also believe investors should be aware that certain market sectors have the potential to benefit from stronger growth in emerging markets. For example, the US technology, energy and materials sectors generate a third or more of their sales from emerging markets, compared to just 16% for healthcare and less than 10% for utilities.

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