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WEEKLY INVESTMENT COMMENTARY

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Fed Tapering Likely in Early 2014

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Markets Jump on Jobs News to Recover Losses

Economic news was generally positive last week, with the highlight being a strong November payrolls report. Early in the week stocks had traded down as investors continued to be concerned that positive economic data might mean the Federal Reserve would act sooner than expected in tapering its asset-purchase programs. Ironically, however, sentiment shifted on Friday. When the impressive jobs numbers came through, investors appeared to believe that the data was strong enough to show economic improvement, but not so strong that the Fed would announce tapering plans later this month.

The rally on Friday was strong enough that markets were able to recover the earlier-in-the week losses. For the week, the Dow Jones Industrial Average fell 0.4% to 16,020 (its first loss after eight weeks of gains), the S&P 500 Index was flat at 1,805 and the Nasdaq Composite edged 0.1% higher to 4,062. In fixed income markets, Treasury yields rose (as prices fell), with the yield on the 10-year Treasury climbing from 2.74% to 2.86%.

Healing Continues, but the Economy Remains Challenged

November's jobs data marked the second straight month in which over 200,000 jobs were created. We also saw a significant drop in the unemployment rate (which now stands at 7.0%). The weak spot, however, remains wage growth, with hourly earnings growing by only 2% on a year-over-year basis. So while jobs are continuing to be created, they are not growing fast enough to push up wages, a point echoed in another report that showed U.S. personal income falling by 0.1% in October. This is a point we have made in the past—anemic wage growth is a long-term structural problem, since without it, consumer spending is unlikely to improve.

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In addition to last week's labor market data, we also saw continued strength in manufacturing. The ISM Manufacturing Survey jumped to 57.3, its best level since April 2011. Additionally, new orders were also very strong, suggesting manufacturing strength is likely to continue.

To at least some extent, the strength in manufacturing can be attributed to a continued surge in automobile sales. In November, auto sales rose to a 16.3 million annualized pace, the highest level since the spring of 2007. Unfortunately, outside of automobiles, household spending levels remain depressed. According to the National Retail Federation, U.S. retail spending fell during the Thanksgiving weekend for the first time in at least seven years. Their estimate is that consumers spent $57.4 billion, a 2.9% drop from last year. This analysis matches the data seen in

the third-quarter gross domestic product report, which showed very weak levels of household consumption as well. The danger is that unless spending increases, a combination of low consumption and high inventory level suggest lower levels of production, and thus economic growth, in the coming quarter.

The bottom line of all of this is that we expect economic growth to remain modest. As such, our expectation is that while it is still possible the Fed will announce tapering of its bond purchases this month, we still feel early 2014 is a more likely timeframe.

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Gold Prices Are Likely to Remain Under Pressure

Gold prices have been falling in recent weeks, and the precious metal is now down around 15% since August. We've also been seeing recent outflows in gold funds—a noticeable contrast to last year when money was pouring in.

So what is behind the selling? First inflation is near historic lows in the United States and other developed economies are facing the prospect of outright deflation. As a result, investors are simply not focusing on investments designed to hedge against inflation, with gold being a key example. On a related point, the increase in interest rates that has occurred this year has been almost entirely driven by rising real interest rates (inflation-adjusted rates as opposed to nominal). Typically, an environment of rising real rates presents a major obstacle for gold prices. Given that we expect the current environment of low inflation and modestly rising interest rates to persist, we would retain a cautious view toward gold.

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