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WEEKLY INVESTMENT COMMENTARY

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Turmoil in Ukraine Drives Up Market Risks

Geopolitical Events Rattle Investors

The events in Ukraine held markets hostage last week, and at this point it appears likely that tension and turmoil will persist as a solution to the standoff in Crimea is eluding politicians. As tension rose last week, investors generally sold off higher-risk assets such as stocks and high yield bonds and moved to safe havens, including gold, which rose by roughly $35 last week. For the week, the Dow Jones Industrial Average dropped 2.4% to 16,065, the S&P 500 Index declined 2.0% to 1,841 and the Nasdaq Composite fell 2.1% to 4,245. In fixed income markets, Treasury yields fell (as prices rose), with the yield on the 10-year Treasury dropping from 2.79% to 2.65%.

The situation in Ukraine is fast moving and highly fluid, and while we do not expect a serious escalation of violence, the prospect of mounting tension is real. Following the referendum on March 16, in which the vast majority of Crimean voters favored becoming part of Russia, many world leaders have amped up the calls for sanctions against Russia. At the same time, Russian officials have vowed to move quickly in annexing Crimea and are considering sanctions of their own. The possibility of economic sanctions being enacted is rising, and while those measures would likely have little direct effect on the U.S. economy, the risk of escalating geopolitical tensions is undermining investor confidence.

U.S. Consumer Sentiment Remains Weak

It doesn't help matters that the turmoil in Ukraine is occurring at the same time that U.S. consumer confidence is already weakening. Last week did bring some evidence that the overall economy is improving, with jobless claims falling to their lowest level since last November. But confidence remains fragile, as seen in the March reading of the University of Michigan's Consumer Confidence Index, which fell to its lowest level in four months.

Weak consumer confidence is a key reason why retail spending remains lackluster. The latest retail sales report shows a rebound in February, but also revises January's reading sharply downward. On a year-over-year basis, retail sales are growing at a pace of just 1.5%, the slowest rate we have seen since 2009.

Market Risks Appear to be Growing

Last week's market downturn does raise the question of how vulnerable stocks might be. While we continue to believe the long-term prospects for equities remain sound, we would point out that despite last week's spike, volatility across financial markets is still relatively low. Additionally, stock prices are close to their all-time

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highs, which suggests they are not factoring in a lot of bad news. As such, should the situation in Ukraine deteriorate, stocks could be vulnerable in the near term.

In particular, we remain cautious toward consumer-related companies. Both the consumer discretionary and consumer staples sectors are trailing the broader market and are in negative territory on a year-to-date basis, but they still appear expensive. The consumer discretionary sector is currently trading with a valuation of 21 times trailing earnings, the highest of any market sector. If consumer spending does not rebound in the coming months, these areas of the market are likely to continue to underperform.

In addition, depending on how the events in Ukraine unfold, there are some specific risks for Europe. Europe imports roughly 30% of its natural gas from Russia, and should any sort of economic sanctions come to fruition, Russia could decide to interrupt this supply. At this point, we are not expecting this to occur, but should significant sanctions be enacted, such actions would certainty hurt Europe's already-fragile economic recovery and would act as a drag on European stocks.

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