WEEKLY INVESTMENT COMMENTARY

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Sector Outlook: Utilities Looking a Bit Better, Consumer Discretionary Under Pressure

Mixed Earnings News Prompts Only Modest Market Movement

Stocks drifted both higher and lower last week as investors focused on a rash of year-end corporate results, some good and some bad. Outside of December's retail sales results (which we discuss in detail below), it was a relatively quiet week for economic data. Although stocks did reach new record highs in the middle of the week, markets ultimately ended mixed, with the Dow Jones Industrial Average climbing 0.1% to 16,458, the S&P 500 Index declining 0.2% to 1,838 and the Nasdaq Composite advancing 0.6% to 4,197. Fixed income markets were also relatively muted, with the yield on the 10-year Treasury falling slightly from 2.86% to 2.82%.

Utility Stocks Are Looking Less Dangerous

For the past two years, the utilities sector has been one of our least favorite areas of the market. During that time, the sector has lagged the performance of the broader market by approximately 18%. This underperformance has chiefly been a function of two factors: the sector's sensitivity to rising rates and high valuations. However, we do see the prospects for utilities improving modestly, for a couple of reasons:

First, while we expect long-term interest rates will continue to rise, we believe further increases will be modest. Since the utilities sector is often seen as a proxy for the bond market, the rates backdrop is important to that sector. We've discussed before that shorter-duration assets (meaning bonds with maturities in the 2- to 5-year range) are likely be the most vulnerable part of the bond market in 2014. In contrast, longer-duration areas of the market have already seen an increase in interest rates and we expect any further upward rate action in that area to be less severe than was the case in 2013. A more stable long-term rate environment should take some of the pressure off of longer-duration areas of the fixed income market, and off of utilities stocks.

Second, we would argue that utilities stocks are no longer as overvalued as they have been for most of the past two years. Utilities companies typically pay a relatively high dividend rate, and with investors desperately searching for income, the sector captured significant inflows. As a result, valuations for utilities stocks had become inflated. Today, while the sector still looks expensive relative to its long-term average, valuations have fallen, and given utilities' underperformance, the sector now trades at a discount to the broader market. Specifically, valuations for the utilities sector have contracted by around 10% since last April, and large-cap utilities companies now trade at a 10% discount to the broader market (versus a 5% premium in the middle of 2012).

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There are other defensive areas of the market that offer more value (notably healthcare), but the bottom line is that we would no longer be as cautious toward utilities as we once were. From a portfolio construction perspective, we would move our view of utilities from an "underweight" to a "neutral" stance.

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Consumer Discretionary Stocks Still Warrant Caution

One theme we have been noting for some time is that while the broad economy is showing signs of improvement, the consumer segment remains under pressure.

We saw confirmation of this trend in the December retail sales figures released last week. Although December's results were a bit better than expected, the prior month's numbers were revised sharply lower. On an annual basis, retail sales are growing by 4.1%, which is below the long-term average. Additionally, much of last year's gains in sales were driven by the outsized influence of the auto sector. Stripping out the food and auto sectors shows that the average monthly gain in sales for 2013 was a paltry 0.3%, a slower pace than the post-recession average.

We would also point out that retail sales were relatively weak during the 2013 holiday season. Sales rose only 3.8% during this time, missing forecasts. While the weakness was most evident in mass market retailers, many specialty retail companies also saw disappointing results.

All of this leads us to a wary view on the consumer discretionary sector. Valuations for this area of the market look stretched, and with consumer spending still under pressure, the sector overall looks vulnerable.

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