WEEKLY INVESTMENT COMMENTARY

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Fourth Quarter Looks Promising, but Washington Remains a Wildcard

Markets Trade Unevenly Amid an Uncertain Political Backdrop

With the government shutdown persisting, markets remained highly attuned to the latest news and rumors coming from Washington, D.C., and traded somewhat erratically last week. For the week, the Dow Jones Industrial Average lost 1.2% to 15,072, the S&P 500 Index was flat at 1,690 and the Nasdaq Composite advanced 0.7% to 3,807. Fixed income markets were little changed, with the yield on the 10-year Treasury moving from 2.63% to 2.64% (prices move in the opposite direction of yields).

The Third Quarter: What We Got Right and Wrong

Now that the last quarter of the year has begun, it seems a good opportunity to take a look back over the past three months to see what calls we got correct, and which we missed. From an economic perspective, the third quarter largely played out as we expected, with the U.S. exhibiting positive but uninspiring growth. The key positive theme in the United States remains a continued resurgence in manufacturing. This, however, has been tempered by lingering weakness in the jobs market and in consumer spending. The big surprise, of course, was the Federal Reserve's decision to hold off on tapering its asset purchase program. Real interest rates rose during the third quarter, but overall economic growth remained soft and inflation stayed low.

From a markets perspective, while fears over Fed tapering and some uneven economic data hurt stocks earlier in the quarter, September was a surprisingly strong month for equities. The Fed's decision to keep its quantitative easing program going, combined with a moderating of tensions in Syria, helped stocks to easily outperform bonds for the third quarter (as we had forecasted). Three other market themes were evident, each of which was also consistent with our forecasts: cyclical stocks outperformed defensive stocks (with utilities stocks performing particularly poorly); the equity market rally broadened to include international stocks and emerging markets, which outperformed the U.S.; and fixed income credit sectors outperformed Treasuries.

So where did we miss? First, we continue to be surprised by the strength in the consumer discretionary sector. Despite a mediocre jobs market, retailers and other consumer discretionary stocks continued to outperform. Another call we got wrong has to do with market capitalization. Although we continue to have a preference for large and mega-cap stocks, small caps outperformed in the third quarter.

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As the fourth quarter unfolds, we continue to believe that stocks can move higher.

Stick with Stocks and Credit Sectors, but Beware of Political Risks

As the fourth quarter unfolds, we continue to believe that stocks can move higher. In particular, investors may want to consider taking on a bit more cyclical exposure, particularly those investors who are harvesting tax losses and are looking for new places to invest. Additionally, despite their recent strength, we would suggest caution toward consumer-oriented companies. These sectors of the market appear expensive and are highly exposed to continued softness in the labor market. Finally, we continue to believe that fixed income credit sectors (such as high yield and bank loans) look more attractive than Treasuries.

What are the risks to our views? The most pressing is the political drama from Washington. Left to its own devices, we would expect to see some modest improvements in the U.S. economy in the last quarter of 2013 and into early 2014, which would support the views we outlined above. However, the political dysfunction in Washington has the potential to undermine business and consumer confidence, which would act as a drag on the economy.

Looking ahead, we still expect that a deal on the debt ceiling will be reached in time, but given the prevailing level of acrimony, it is hard to imagine a comprehensive, long-lasting solution. Instead, it seems more likely that the best Washington will manage will be some sort of temporary patch that keeps the drama going. As such, political uncertainty is likely to remain high, pushing market volatility higher than it would otherwise be.

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