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WEEKLY INVESTMENT COMMENTARY

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Investors Look Past Weak Growth to Push Stocks to New Records

Stocks Return to Their Winning Ways

The preponderance of the economic data is pointing to a significant slowdown in growth compared to what we saw late last year, but investors looked past the weak data and bid stocks higher. It appears most remain optimistic that the Federal Reserve will keep policy accommodative, and there also seems to be a belief that growth will improve when the weather does also. For the week, the Dow Jones Industrial Average climbed 1.4% to 16,321, the S&P 500 Index rose 1.3% to 1,859 (another record high) and the Nasdaq Composite advanced 1.1% to 4,308. In fixed income markets, Treasury yields fell slightly (as prices rose), with the yield on the 10-year Treasury dropping from 2.73% to 2.65%.

Growth Is Slowing, But Housing Is Becoming a Bright Spot

Last week brought continued evidence that economic activity is decelerating. Fourth-quarter gross domestic product growth was revised sharply downward, from an originally reported 3.2% to 2.4%. Even more troubling was the fact that personal consumption, a significant driver of overall growth, was also revised to a lower-than-expected 2.6% rate.

Data pointing to more recent economic activity also has been disappointing. Durable goods orders fell 1.0% in January, and while this was a bit better than economists had expected, it followed an even more significant drop in December. This now marks the first time since 2011 that we have seen a drop in durable goods for two consecutive months.

Additionally, and most importantly for future growth, the Chicago Fed National Activity Index (CFNAI) fell to a six-month low. Historically, we have found the CFNAI to be one of the best forward indicators of the pace of growth. At its current level, that index is suggesting first-quarter growth will come in at around 2.1%, which would represent a further deceleration from last quarter.

All of that said, a few areas of the economy are holding up relatively well. Chief among them is housing, which is being helped by still-low interest rates. The yield on the 10-year Treasury has been stuck around the 2.70% level, and mortgage rates have fallen again, with the average 30-year fixed rate holding at just under 4.5%. This backdrop is lending strength to the housing market. Sales of new single-family homes rose 9.6% in January to a seasonally adjusted annual rate of 468,000, the highest level we have seen since the summer of 2008.

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Are Valuations Becoming Too Rich in Some Asset Classes?

Despite the weakness in economic growth, investors have been bidding up stock prices, causing valuations for U.S. equities to climb. U.S. large-cap stocks are now trading at over 17x trailing earnings, close to the multi-year highs we saw late last year. Similar trends are evident in high yield bonds. The yield spread between U.S. high yield bonds and Treasuries has been tightening in recent weeks, meaning investors are willing to accept increasingly smaller yield premiums to take on additional risk.

These market movements suggest to us that investors are making an implicit bet that the recent trend of weaker growth is a temporary one, and that an acceleration will emerge in the coming months. This is not an unreasonable expectation, but if the economic data does not begin to improve, then stocks and other higher-risk assets may become more vulnerable.

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