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WEEKLY INVESTMENT COMMENTARY

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Watching for Cliff to Fade, Jobs to Appear

Stocks Edge Higher as Fiscal Cliff Focus Intensifies

Investors remain intensely focused on the fiscal cliff, sizing up every utterance out of Washington, DC for clues as to what the end game might be. Stocks spent most of last week seesawing based on how the mood in Washington changed, but did manage to close slightly higher than where they began. For the week, the Dow Jones Industrial Average inched up 0.1% to 13,025, the S&P 500 Index rose 0.5% to 1,416 and the Nasdaq Composite advanced 1.5% to 3,010.

Cliff Closure Remains Elusive

For better or for worse, we expect markets to stay in the same sort of volatile, short-term back-and-forth environment until a deal is reached on the fiscal cliff, and, unfortunately, last week brought little in the way of any real progress.

President Obama did propose a new package of tax increases and modest long-term cuts in entitlement spending, but the proposal was quickly rejected by Republicans. In their view, the President's plan was too heavy on tax increases, too light on spending cuts and required Congress to relinquish too much control over the debt ceiling. One relatively bright spot in the news last week was a signal from the White House that it may be more flexible than previously indicated on the topic of how much tax rates would have to increase for higher-income earners. Specifically, White House negotiators appeared to suggest they would be satisfied with some sort of middle ground between where rates were during the Clinton era and where they were after the Bush-era cuts. This suggestion does create a possible opening for compromise, but for now, a deal remains elusive.

At this point, the main question regarding the cliff is at what point investors should expect to see meaningful progress. While the "official" deadline for coming to a resolution is the end of the year, we think a more practical target is before Christmas since most lawmakers will be leaving town before the holiday. In addition, with roughly 80 Representatives and Senators not returning to Washington next year, if a deal is not reached before December 25, it is hard to imagine anything substantive happening in the last week of the year. With only three weeks until Christmas, we think all parties need to start looking for room to compromise if a deal is going to be reached.

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Slow Jobs Growth Suggests Fed's Stance Won't Change

An additional topic on which many investors are focused is the outlook for interest rates in the months ahead. The Federal Reserve has been clear in its intentions to keep interest rates at the near-zero level for the next few years, but many are wondering how long the central bank plans to continue supporting the economy through other easing measures. It is important to remember that the Fed has a dual mandate—maintaining price stability and maximizing employment. Since the Federal Reserve is not particularly worried about inflation, changes in the direction of the labor market are likely to be the key driver for the future of monetary policy.

From a practical perspective, this means the Fed will closely watch the unemployment rate and would likely adjust its policy stance as unemployment drops. So what are the specific signposts investors should be watching for? The first is some signal that the Fed is ready to halt its asset purchase programs. We would expect that to occur when unemployment falls to somewhere between 7% and 7.25%. The second signpost would be the point at which the Fed would actually start raising interest rates. Our view is that unemployment would have to fall to around 6.5% before that happens.

Neither of these signposts appears to be on the immediate horizon. Given the speed at which jobs are being created, we would not expect the Fed's asset purchase program to conclude until the end of next year, at the earliest, and it is likely to be even longer before we see interest rates climb.

Absent a much more robust rate of jobs growth (meaning between 200,000 and 250,000 per month), the Fed will likely retain its current bias, meaning investors will be faced with a continued environment of low interest rates. This suggests investors will continue to struggle to find yield in their portfolios. Rather than looking for yield by taking on more interest-rate risk in the form of longer-dated bonds, we would suggest investors emphasize investments such as dividend-paying equities and credit-related fixed income.

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