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WEEKLY INVESTMENT COMMENTARY

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Budget and Debt Ceiling Drama Goes to the Brink

Washington Drama Continues to Drive Volatility

Markets last week were knocked around by the news and rumors coming from Washington, D.C. regarding when and whether there would be a resolution to the government shutdown and an extension of the debt ceiling. Early in the week, pessimism reigned and stocks experienced a sharp downturn, but by the end of the week, when it appeared the outlines of a potential deal were forming, markets rallied. For the week as a whole, stocks advanced, with the Dow Jones Industrial Average gaining 1.1% to 15,237 and the S&P 500 Index climbing 0.8% to 1,703. The Nasdaq Composite, however, lost ground and was off 0.4% to 3,791. In fixed income markets, Treasury yields rose slightly (as prices correspondingly fell), with the yield on the 10-year Treasury rising from 2.64% to 2.69%.

A Short-Term Resolution Still Looks Possible

By the end of last week, it was starting to look like a deal was coming into focus that would have consisted of a temporary extension of the debt ceiling and potentially a short-term continuing resolution that would have reopened the government. Over the weekend and into Monday morning, however, that deal failed to gain much traction and Congress and the Obama administration were still clashing over a variety of proposals and counter-proposals.

At this point, we are still reasonably optimistic that some sort of patchwork deal will go through that will at least temporarily extend the debt ceiling on or around the October 17 deadline that has been cited by the Treasury Department. Any such deal, however, is likely to be limited and piecemeal. In the near-term, any budget agreement would be viewed as a positive, but if the best Washington can do is a series of short-term extensions, there will be an economic price to be paid. Ongoing and elevated levels of political uncertainty will spark higher levels of market volatility, act as a drag on business and consumer confidence and will negatively impact economic growth.

Negative Budget Battle Effects are Already Being Felt

We are already seeing some signs that lower levels of confidence are affecting spending levels for the worse. Last Friday, the University of Michigan's index of consumer sentiment was released, with the index falling to 75.2, its lowest level since January. The survey indicated that the government shutdown is causing consumers to be more pessimistic about the state of the economy, and in general, lower confidence leads to lower spending—a negative for economic growth.

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Additionally, the ongoing uncertainty is having an effect on investor sentiment toward U.S. stocks. Although equities did rebound late last week, mutual fund flows continue to show that investors are moving away from the U.S. In a trend that now has existed for a few weeks, investors are pulling money out of U.S. funds and moving into Europe and other regions. This stands in marked contrast to the dominant trend that existed for the first half of the year when the United States was the preferred (and often the only) destination for investors. Clearly, in light of rising political uncertainty, investors are rethinking their strategies.

Economic and Market Implications: Slower Growth, Delayed Tapering and a Focus on International Stocks

From an economic and markets perspective, we would highlight three implications for investors. First, while the United States is unlikely to slip back into a recession, growth will be slower than it otherwise would be. Were it not for all of the political turmoil, we would expect the U.S. would be able to grow by somewhere between 2.5% and 3% in the fourth quarter. Given the drama in Washington, we would peg 2% as a more likely number.

Second, in what may be a silver lining, the Federal Reserve will probably adopt a slower pace to tapering (plans to ease off on its asset-purchase programs).The economic uncertainty caused by the political rancor, combined with the delays in economic data releases due to the government shutdown, is likely to push back the Fed's policy-making decisions.

Finally, we believe the prevailing environment should be a reason for investors (particularly those who are overweight in U.S. stocks) to move more of their assets into international equities. International stocks are less expensive than U.S. markets (and thus offer more value), and it is becoming increasingly clear that the U.S. is no longer the only safe haven in the global markets.

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