

Martone Capital Management: Weekly Investment Commentary (6/4/2012)

For some time, we have been suggesting that the US economy had been holding up relatively well compared to the rest of the world. While we are not changing that view, last week's data (particularly May's employment report) provided a negative jolt and pushed stock prices down sharply.

Our summary view of the US economy is that while the United States appears to have entered another slowdown phase with the data growing more disappointing in recent weeks, the case for a renewed recession still looks flimsy. The highlight (or, rather, lowlight) last week was the monthly employment report. The data showed that far-fewer-than-expected 69,000 new jobs were created in May and that the unemployment rate ticked higher for the first time in many months, moving up to 8.2%. The data also pointed to some notable downward revisions in prior months.

Clearly, weakening jobs growth combined with other factors such as the decline in equity and commodity prices have made many investors more skittish. Just as we cautioned last summer not to grow overly concerned about the prospects of a double-dip recession and just as we suggested not growing too complacent earlier this year in the face of stronger growth, however, we would also suggest that attitudes may be overly amplifying the negatives right now. For some time, we have been in the midst of a start, stop, muddle-through pattern of growth and we continue to believe that the United States will be growing by around 2% or 2.5% for the time being.

The reality is that today the macroeconomic backdrop is stronger than it was during the growth scares of 2010 and 2011. For one, the global policy easing cycle is in full force now, with the world's major central banks much more responsive to deflationary concerns than they were in the past. Additionally, we are starting to see improvements in the US housing market (an important distinction compared to where we were in the past) and the inflation picture also appears milder. We would also suggest that the current period of weakness is, at least to some extent, attributable to the mild winter in the United States that, in effect, "borrowed" some growth from the spring.

We continue to believe that the main drag on global financial markets is not weak US economic growth, but the ongoing problems in Europe. Concerns about the stability of the eurozone and the threats of possible debt contagion have pushed down yields on such safe-haven assets as US, German and UK

government bonds to the point that they all now have negative yields in real (i.e., inflation-adjusted) terms. Clearly, investors who have flocked to these asset classes are exhibiting the height of risk aversion as they are more concerned about perceived "safety" than they are about looking for any sort of returns.

The next steps for the eurozone remain unclear, but as we argued last week, we believe there are still some options for the European Central Bank and other policymakers in terms of further recapitalizing the banking system, accelerating current bond-purchase programs and taking steps to limit potential contagion. We have been saying for some time that the longer policymakers take to act, the more expensive it will be in the long term, but the political realities in Europe are making it difficult to take decisive action.

Despite the risks, our view is that Europe's debt woes should remain moderately well contained. At present, we believe that the downside risks are already reflected in global asset prices, suggesting there is room for a recovery in risk assets should conditions stabilize or improve.

It has been the case for several years now, but the fact remains that the financial markets remain highly dependent on global monetary and fiscal policies. The world's central banks have been aggressively combatting deflation and slower growth, but it remains an open question as to whether or not the world is ready to shift into a self-reinforcing economic expansion. Given this backdrop, it is understandable that investors are highly nervous and are attuned to any sign of negative news. From our perspective, it would be a severe overreaction to forecast a global recession/deflation view and turn negative on risk assets, but there is no question that some repair work still needs to take place.