

Martone Capital Management: Weekly Investment Commentary (8/14/2012)

Although investor attention seems focused on a number of well-known downside risks (including the European debt crisis, hesitant US economic growth and the pending US fiscal cliff), stocks have continued to climb higher and last week notched their fifth consecutive week of gains.

For the past several months, we have described the US economy as being in the midst of a soft patch, and while that characterization remains accurate, it does appear as if economic growth has improved slightly. The surprisingly strong July payrolls data we saw two weeks ago was joined last week by another decline in weekly unemployment claims as well as by an increase in June exports and a drop in June inventories. The housing market has also been the source of some positive news lately. The long-term supply/demand imbalance has seen some signs of improvement, which has helped cause a rise in construction and has helped to create a floor for home prices. Housing data is improving, but the recovery in this sector of the economy will almost certainly be slow due to challenging credit conditions and the overhang of depressed properties.

While the United States is hardly in the midst of an economic boom, the recent trend of modestly better data should help assuage fears that a renewed recession may be around the corner. By any measure, growth levels remain modest, implying that the Federal Reserve may still elect to take some action in terms of launching additional quantitative easing measures. Whether or not the central bank does so at its September policy meeting remains an open question. Should we see a pullback in jobs growth in August, or should long-term inflation expectations come down, the data could tip the Fed toward taking more action.

Questions about policy, of course, extend far beyond the United States. One of the main factors behind the improved stock performance we have seen in recent weeks has been European Central Bank President Mario Draghi's promises of open-ended support for the euro. Attention is now turning to the question of whether or not eurozone policymakers and politicians will be able to follow through on President Draghi's commitments to stabilize the bond markets and help lift depressed economic sentiment. Should they fail to do so, we would likely see renewed levels of market turmoil and potentially a deeper recession in the peripheral eurozone economies.

Returning to the United States, there are also a number of political questions that will have an impact on financial markets. The recent agreement reached by Congress to pass a six-month continuing budget resolution will at least prevent the threat of a government shutdown occurring before the November elections, but there has still been no visible progress in terms of resolving the upcoming fiscal cliff. Like most observers, we are not expecting to see any action on this front until after the elections and we believe that mounting uncertainty will be a negative for the economy and for investor confidence.

Thanks largely to hopes over additional policy action, stocks managed to survive a relatively weak second-quarter earnings season. There is some question as to whether or not the recent earnings softness will prevent stocks from making additional gains, but we have confidence in the longevity of the business cycle. Looking ahead, our view is that the positives of easy monetary policy around the world, modest growth and a still-high equity risk premium should outweigh the negatives. Volatility is likely to remain high and equities may be poised for some sort of correction given their multi-week climb, but we expect stocks to continue to grind higher in the months ahead.