Martone Capital Management: Weekly Investment Commentary (9/26/2012)

Following two weeks of impressive gains sparked by policy easing actions taken by the European Central Bank (ECB) and the US Federal Reserve, markets were little changed last week as investors appeared to take some time to digest the latest rise in prices.

The last few weeks have been highly eventful in terms of central bank action. The Fed's decision to engage in a new round of quantitative easing is particularly striking for two reasons. The first is that the Fed has linked its mortgage-backed bond purchases to an attempt to reduce the unemployment rate, which is unprecedented in its specificity. As such, the Fed has left itself some room to increase its planned purchases if unemployment does not move down noticeably. Secondly, it is important to note that the Fed took these steps despite the fact that inflationary expectations have been starting to move higher, suggesting that the central bank is willing to risk higher inflation levels in exchange for a jolt to economic growth.

To be sure, the US economy is still weak and remains dependent on policy help, but we have seen the data turn modestly more positive. Bank lending standards have been easing, demand for credit is expanding and borrowing rates are up. After a long and painful downturn, the housing market is also showing signs of life. It seems to us as if the tremendous amount of liquidity the Fed has injected into the system is finally leaking into the real economy.

Looking ahead, however, it's worth asking what it will take for a sustained bull market phase in risk assets to continue. In our view, there would be several preconditions. The first is that European policymakers and the ECB must remain committed to protecting that region's sovereign bond market and financial system. Recent actions in Europe suggest that they will do so, but there is ample room for policy error. In the United States, we believe we would need to see some progress in terms of tackling the fiscal cliff issues and creating a longer-term plan for fiscal stability. Additionally, investors would need to be assured that China is undergoing a soft landing and the world would also need to avoid any sort of geopolitical incident that could cause a spike in oil prices.

Overall - we would argue that while a consolidation of the gains we have seen in the last few months could happen at any time, we expect that stocks

should continue to outperform Treasuries and cash over the next twelve months.