Martone Capital Management: Weekly Investment Commentary (2/26/2013)

For much of 2013, stock markets either have been moving up strongly or have been relatively quiet. That trend changed last week, with stocks dropping sharply in the middle of the week. The catalysts for the selloff appeared to be concerns (triggered by the release of the latest Fed minutes) over how long the Federal Reserve would remain engaged in its asset-purchase program as well as additional evidence that higher taxes are dragging down growth.

Although the market volatility was mild by the standards of the last five years, last week was the most volatile the markets have been since late December.

Once again, investors are focused on a fiscal deadline manufactured by Washington. The scheduled spending cuts (known as the "sequester") originally set to take effect on January 1 before being pushed back for two months are now set to hit this Friday. Absent some quick progress over the next few days, cuts totaling around $85 billion will go into effect at the end of this week. In our opinion, the odds favor the likelihood that the cuts will happen, at least on a temporary basis. Congressional Republicans appear to have grown more comfortable with the prospect of the scheduled cuts actually occurring (even though a significant percentage of the cuts will hit military spending, normally a taboo subject for the GOP) and, at this point, we would not be surprised to see the March 1 deadline pass without a new deal. While some of the sequester may be rescinded during budget negotiations in March, at least some of the cuts are likely to stick.

So should the sequester take effect, what will it mean for investors? We would emphasize that while the size of the cuts is relatively modest, they will be disruptive. In our view, the combination of the sequester and previously enacted higher taxes will create a fiscal drag of over 2% on US gross domestic product for 2013. This is a large hit for an economy that barely grew by that amount last year. Even before accounting for the sequester, we have been seeing some softness in the economic data, chiefly in the form of weaker consumer spending triggered by higher payroll taxes. Although we think investors are correct to focus on the risks of slower growth, we do not share the belief that the Fed is close to moving away from its easing stance. Especially if the sequester does hit, the Federal Reserve is likely to continue its asset purchase programs.

All of this is not to say that stocks will be unable to make additional gains for the rest of the year, but we do think equity markets have a tougher road to travel. To date, the advances we have seen in the markets so far this year have been driven largely by flows into stocks without any real change in fundamentals. If anything, we expect the overall economic environment to deteriorate a bit in the near-term as consumers and investors adjust to an increased fiscal drag. This suggests that market volatility should increase in the coming months. The fiscal drag does look to be a temporary issue, meaning that volatility could present buying opportunities for investors with longer-term time horizons. All investors, however, should expect more bumps along the road.