Martone Capital Management: Weekly Investment Commentary (3/4/2013)

Now that the sequester has hit, many investors are wondering what the $85 billion in federal spending cuts will mean for the US economy and markets. In the very short term, the answer is - not much. By the second quarter, however, the story will be different.

Why? The sequester is not the same as the fiscal cliff everyone was worried about earlier this year. If the United States had gone over the fiscal cliff, the full brunt of the tax increases would have hit disposable income immediately, and by extension, consumption. In contrast, sequester-related spending cuts will not happen immediately, or all at once.

Assuming the sequester is not reversed during March's budget negotiations, the spending cuts will be phased in over the coming months. As such, they are likely to make their initial impact on the economy in April, becoming visible in the economic data in May.

One implication of the sequester is that it will probably keep an already dovish Fed in easing mode, at least for the first half of the year. With the sequester representing yet another headwind, the Fed is even more likely to take its time before withdrawing monetary accommodation.

Of late, gold prices have been falling, largely due to investor nervousness over the longevity of QE. However, on Tuesday, following Mr. Bernanke's very dovish testimony, gold rallied more than 1%. To the extent monetary policy remains accommodative, it is likely to benefit gold.

The reason is that monetary policy - as measured by real interest rates - is a key driver of gold's performance. Gold typically does best when real (inflation-adjusted) rates are low or negative, as they are today, as this removes the opportunity cost of holding gold. "Looser-for-longer" monetary policy supports this environment and suggests investors should maintain some small, strategic allocation to gold. What would change our view? Should the economy start to accelerate and the Fed signal an end to QE, that would suggest trimming or removing the allocation to gold. But given that the sequester and the challenges still facing the consumer are keeping the economy in slow-growth mode, we believe the Fed will be on hold for at least the first half of the year, which may help bolster gold prices.

Another asset class we believe will benefit from continued Fed accommodation and slow but positive economic growth is high yield fixed income. Easy monetary policy and low rates allows companies with lower credit ratings to refinance their debt at favorable levels, leading to continued low default rates. Were the environment to shift toward rising rates, that would change, but we don't see that in the near term.