**Martone Capital Management: Weekly Investment Commentary (1/15/2013)**

In our view, the current short-term market rally can be attributed to three factors, the first two of which are likely to be temporary. The first is obviously the relief over the fiscal cliff deal. By the end of 2012, investors had become increasingly nervous over the fate of the fiscal cliff and were selling off stocks. Given that the January 1 deal averted a worst-case scenario, some of these same investors have moved back into the markets. As a related point, we also saw some investors selling winning investments in December in an attempt to generate capital gains in 2012 before capital gains taxes were scheduled to increase in 2013. Because capital gains rates did not change for most Americans, however, many investors are now buying back the stocks they had sold.

Second, stocks are benefitting from a normal period of seasonal strength. While the so-called "January effect" may not be as significant a trend as some would believe, there is a modest historical tendency for stocks to advance in the first month of the year. This year, we have been seeing inflows into equities, with much of the money moving into higher-risk areas of the markets and into emerging markets equities in particular.

The third factor is that economic data has generally been better than expected, not just in the United States, but also globally. Manufacturing data from China is confirming that an economic hard landing has been avoided and we are also seeing some similarly positive signs from the US financial services sector. In our view, the global economy is starting 2013 with some momentum.

The question that clearly arises from all of this is whether or not the equity rally will continue. For the year as a whole, we would expect equity markets to continue to advance and to outperform bonds, with the best performance likely coming in emerging markets. That said, however, we expect the current pace of gains to slow - if not immediately, then probably by February.

There are several reasons to be at least somewhat more cautious in the near term. First, we expect a good deal of headline risk coming in the next couple of months. Investors should expect continued dysfunction from Washington as lawmakers wrestle with the debt ceiling, scheduled spending cuts and the need for continuing budget resolutions. Not only are the odds of some sort of "grand bargain" diminishing, but the current bickering raises the possibility of another last-minute showdown and a potential debt downgrade.

Outside of the political risks, we do have some lingering concerns about the economy. Once we get a look at January month-end data, we will see the first clues about how higher taxes are impacting the economy. Notwithstanding some of the stronger data we cited earlier, we are expecting the first quarter to show relatively soft economic data. In particular, we are concerned about consumption levels weakening in January as people come to grips with smaller paychecks.

We would also point out that although these risks are clearly evident, investors seem to be overly complacent. One way this can be measured is by looking at market volatility. The VIX Index (a widely followed measure of stock market volatility that is also known as the "fear index"), fell last week to its lowest level since June 2007. To us, this suggests that there is not much bad news priced into market right now, meaning that any negative shock would have the potential to drive markets lower. The bottom line is that while we think stocks are reasonably valued (particularly outside the United States), we would expect tougher going as we head into February.