Martone Capital Management: Weekly Investment Commentary (10/3/2012)

The pause in the rally we have seen over the past couple of weeks can be attributed to some profit-taking on the heels of a multi-month uptrend in U.S. stocks. It is also likely, however, that investors are coming to grips with the fact that the world continues to face some serious risks and are recognizing that not all of the world's problems can be solved by central bank action.

Economic data was mixed last week. On the negative side, second-quarter gross domestic product growth was revised lower from 1.7% to 1.3%, confirming that the United States was in the midst of a soft patch earlier in the year. The big positive surprise, however, was the much-larger-than-expected increase in consumer confidence (likely helped by rising home prices). Higher levels of confidence are critical in terms of driving longer-term growth, since they can promote gains in consumer spending, which, in turn, can lead to better jobs growth, creating a self-reinforcing cycle.

Outside of the United States, we believe the ongoing European debt crisis will continue to exert strong deflationary pressure on the global economy. The programs launched by the European Central Bank should help contain the crisis, but will not do much in terms of promoting economic growth. We expect that Chinese growth may bottom in the fourth quarter, but any upturn will be modest since the eurozone crisis has cut deep into Chinese export markets.

With economic growth almost everywhere at below-normal levels and many regions plagued by enormous fiscal challenges, it is easy to make a bearish case for risk assets, including stocks. The primary positive factor underlying equities appears to be the concerted actions of central banks to help stabilize the global financial system. So far this year, the positive forces have been winning out, but to many, the rally in risk assets is looking tired.

In our view, we do believe that the market does need to take some time to digest the gains that have been made in the last several months. Whether that takes the form of some sideways action that would allow fundamentals to catch up or some sort of pullback is debatable, but it would be unreasonable to expect a string of uninterrupted gains in the coming months. That said, however, we do think that the positives outweigh the negatives over the longer term and as we have stated in the past, we expect that stocks will outperform Treasuries and cash over the next twelve months.