MV Capital Management Midweek Market Commentary

Transition: Synthetic Rally to Organic Growth?

October 18th, 2012

At the end of the third quarter the S&P 500 was perched at 16.44% year to date, a stark contrast to where we were at the same time last year at -8.68%. Driving this rally, as we have noted in a handful of these market commentaries, have been the policy measures made by central bankers around the globe. The Fed initiated a massive undertaking with so-called QE3 (or QE4ever as the financial wags put it) by pledging to buy a theoretically unlimited amount of federal debt. That followed on the heels of the aggressive measures announced earlier in the summer by ECB head Mario Draghi to "do what it takes" to shore up the Eurozone. What has ensued is what we refer to as a *synthetic rally* – a rally that is not being driven by fundamental economic drivers, but rather by policies meant to stimulate the economy.

So why is it important to recognize the difference between a synthetic rally and an organic growth-driven rally? In large part because of the unique nature of the unknowns. Investors, analysts and sundry financial experts alike are struggling to anticipate and make sense of what factors are really driving current market conditions during this policy driven period. With the announcement of QE3, one would have normally expected treasury yields to rise – however, yields have still not reached the already meager levels seen at the beginning of the year. This is a prime example of the lack of rhyme and reason that keeps market observers perplexed as they look for signs of transition back to organic growth and a more "normal" valuation-driven climate.

This transitional period will likely be fraught with the kind of volatility that investors have become (reluctantly) accustomed to over the past 4 years. Contributing to the turbulence will be an unhealthy admixture of political factors and wagers about the unknown, but inevitable, end of spoon-feeding by the Fed. Most immediately the passing of the 11/6 election and pending fiscal cliff loom large, but renewed inflation risk and sharply higher interest rates also lurk in the copses in the not-too-distant future.

A real growth period will announce itself by headline numbers like GDP and unemployment rates – but we may expect fleeting glimpses of the promised land via economic indicators such as consumer confidence and the various housing numbers which, as they start to rise, reflect and also encourage improvement in public sentiment. Current numbers are beginning to show some of these tantalizing glimpses, and that could turn into a high-likelihood case for 2013.

But even if that becomes our likeliest-case scenario we are mindful that the path is not paved nor the way smooth. Many variables remain to play out, starting with an election whose outcomes will very likely be dominating influences in the days and weeks after November 6.

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MVCM 2012 0058
DOFU: October 2012

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