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CAPITOL MARKET REVIEW

Investment Banks: Hopium Prompts a Short Squeeze Rally in Equities…Stocks Should End the Year with Small Gains…Bonds and Commodities Continue to Warn of Economic Malaise

At the Close: SPX 1240 US10Y 1.91% Gold $1615 Oil $97.22 Dec. 20, 2011

On the strength of German economic data and mildly positive US housing data US stocks staged a strong "short-covering" rally today. As it has been for months, volume was very light and relative valuations in US Treasury securities and global commodities continue to signal both caution and subdued economic growth.

As Thanksgiving approached, Capitol Markets Report penned a note explaining the need for many fund managers to generate returns in the waning days of 2011 in order to eclipse a given index. (Growth stock managers need to beat the Russell 1000 Growth Index. Large Cap Managers need to beat the S&P500 index, etc.) Many fund mangers, both long-only, (mutual funds,) and their more aggressive colleagues at hedge funds had been trailing their indexes.

Given the technical nature of trading since the onset of the credit crisis in 2008 and the fact that retail investors continue to drain assets from equity markets that many deem too volatile, investment markets continued to be driven by computers and the need to generate alpha at all costs. (Alpha being the return above what could be achieved investing in an index fund, including fees.)

The problem has been the political risk of the tape. Unsettled fiscal and monetary policies in both the Eurozone and the US have led to a series of both sharp sell-offs and equally strong reversal rallies that even seasoned traders find impossible to manage. Indeed some of the world's best investment minds have confessed to being unable to add value in these markets and have actually closed their funds. It's been that kind of year.

Given the calendar, the manner in which established global investment banks seek to make their money, and the actions of global sovereigns and central banks, CMR concludes that US stock indexes will post minor gains on the year. However, as CMR has cautioned repeatedly, investors and politicos should not take the levels of equity indexes, historic low yields in US Treasuries and manageable pump prices and shopping carts as a measure that the economy could not lapse into near recessionary activity in a few short months.

Even the most optimistic bulls are urging caution. The President, who has every reason to cheer for the economy continues to speak in measured tones. Incumbents in both political parties are racing to extend tax holidays, while simultaneously refusing to cut federal spending too sharply. Congress continues to wrestle with what would normally be feel-good deficit spending measures important to re-election prospects. Yet Congressional leaders and even Tea-Party neophytes must choose their words carefully regardless of whether they're voting for or against these measures.

CMR continues to advise that most macro fiscal and monetary issues remain un-solved and sadly not even thoughtfully addressed. Numerous emergency measures remain stretched to their limits. In no particular order, these include: food stamps, unemployment benefits, payroll taxes to support social security, moratoriums on foreclosures, TARP for smaller banks, Federal Reserve ZIRP, and many others too numerous to mention.

As year-end approaches an even more contentious 2012 awaits. Can the can be kicked into the Lame Duck session? CMR is concerned that may prove to be the only chance for real reform.