THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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Raising the Risk Level to 'Elevated'

- In 2007 we wrote a weekly called *Don't Leave the Party, But Start Drinking Water*. Its purpose was to warn investors that risks were increasing, but that our indicators suggested that the bull market had further to go. We have a similar view today. However the party analogy seems inappropriate for a cyclical bull market that has merely regained about half of its 2007 to March 2009 decline. This time we feel it is more appropriate to use the five US security risk categories: low, guarded, elevated, high and severe. We think growing investor skepticism regarding sovereign credit has the potential to escalate and hence we now regard risk levels as elevated.
- Judging by rebounding US stock and credit markets last week, investors seem willing to shrug off the problems in Greece and other fiscally challenged European economies. We think the markets' better tone reflects the recognition that the US and UK (whose budget deficits relative to GDP are similar to Greece) control their own currencies and can print the money to service their debts. Thus both are highly unlikely to default. By contrast, Greece has little control over its situation, beyond dramatic spending cuts or default, because they are unable to print euros, the currency in which their debt is issued. It is this risk of default that is driving up Greek interest rates. In recent weeks we have reduced our portfolios' risk by raising some cash, reducing commodities, shortening bond durations, lowering exposure to European stocks and increasing exposure to high quality domestic stocks. We are currently about neutral to our strategic benchmarks, and so are not taking a bearish stance, but we do think the risks have risen.

Sovereign risk: Being right or making money

Ned Davis coined the phrase "being right or making money" and advocates emphasizing objective indicators over making predictions. We agree. While our Treasury bond indicators are very bearish, our stock indicators are not yet flashing warning signals, so for now, we are alert to the possibility of several scenarios. One such scenario, a loss of confidence in sovereign debt, could unfold as follows.

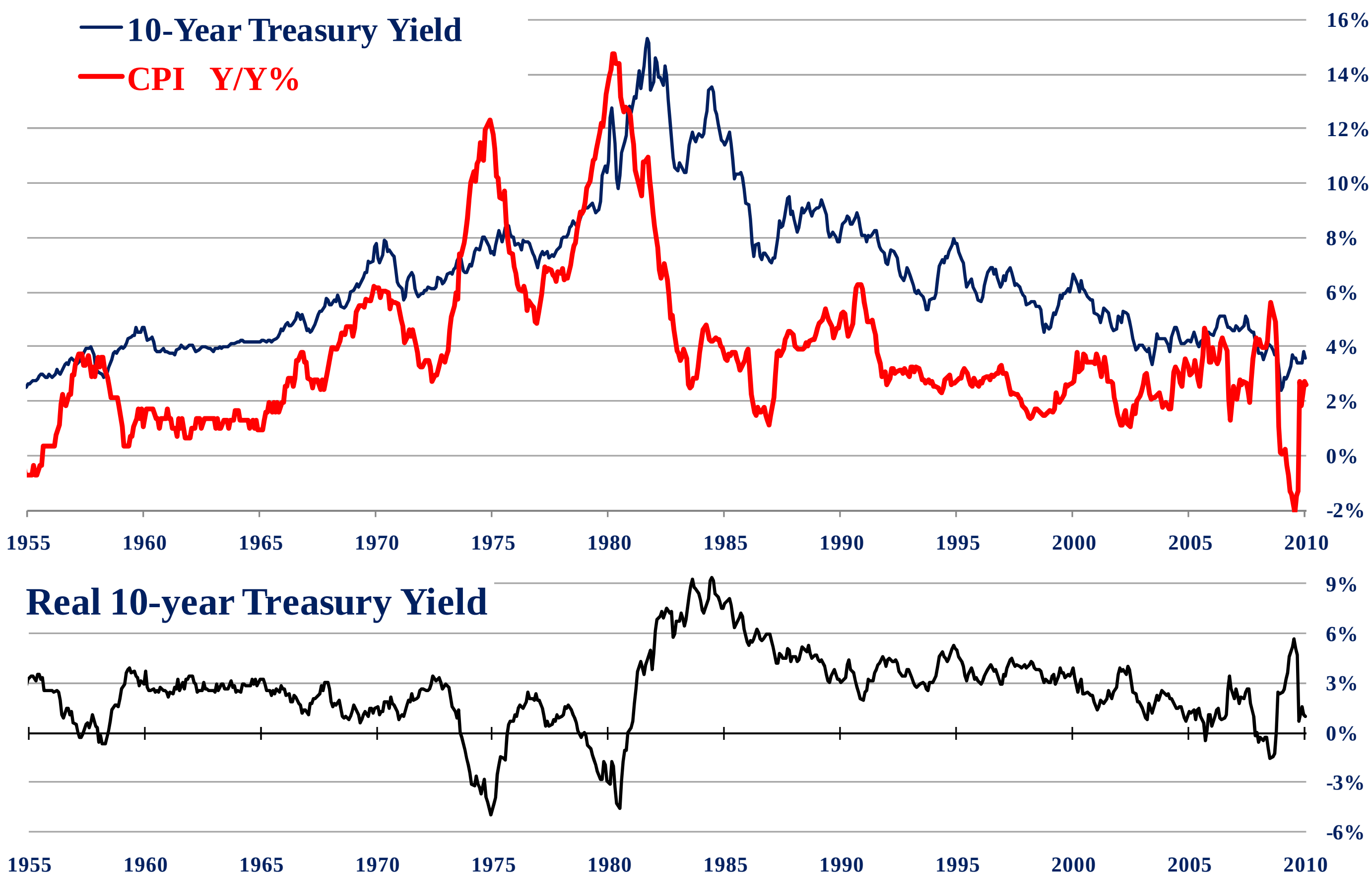
The developed world's reaction to weak consumer balance sheets has been increased social spending, government stimulus programs, bank bailouts to enable banks to write off consumer debt and in a few cases, tax cuts. Thus governments have transferred debt from consumers to public balance sheets through increased budget deficits. The benefit of this strategy is that governments can usually borrow money much more cheaply than individuals (as is the case in the US, see Weekly Chart). The risk is that this merely shifts a consumer debt crisis to a sovereign debt crisis. This is why we think Greece is important. If, unlike the subprime crisis, the PIIGS (Portugal, Ireland, Italy, Greece and Spain) debt problems can be contained and if investors do not then turn a skeptical eye on the UK and USA, then the bull market in risk assets will likely continue. On the other hand, if investors demand 10-year Treasury rates much over 5%, the risk of a 2011 recession could cause the bear market in risk assets to resume. As in the title of RiverFront's 2010 Outlook, policymakers face *A Delicate Balancing Act.*

Europe's response to the crisis is critical in our view. Europe can pursue reflationary policies as the US and UK have done, i.e. accommodate Greece with ECB (European Central Bank) purchases of Greek debt, cut interest rates, and encourage euro weakness. We think this is unlikely given the ECB's mandate, which solely focuses on inflation, and the ECB's lack of accountability to European governments. A more likely tack is that Europe requires Greece and potentially the other PIIGS (if they ask for help) to enact deep spending cuts (as the IMF does when it restructures a country). They may even call in the IMF to help. If Europe follows this path it is likely to be deflationary and the euro will probably stop declining and may strengthen. Attention could then turn to the UK and subsequently the US.

We see four alternatives facing heavily indebted countries: do nothing and risk a loss of confidence, raise revenues (taxes), cut spending, or print the money to buy the debt (which should eventually lead to inflation). Both the US and the UK central banks have been buyers of government debt. These purchases – combined with low inflation caused by the deep global recession and the presumption that the deficits will eventually decline – have allowed long-term government bond yields to remain low. However, long-term rates will rise if inflation expectations grow in the absence of a credible long-term plan to reduce the deficits. Based on our expectation of 2 to 3% inflation, 4 to 5% 10-year Treasury yields seem probable. Leadership is required to reduce the deficit. Thus gridlock in Washington is counterproductive and the absence of a credible plan could lead to a return of recession, this time with the Fed's hands potentially tied by lost credibility and rising long-term rates.

We again stress that this gloomy scenario is neither predetermined nor inevitable, but is more likely than before the Greek crisis in our opinion. The script will unfold based on the choices that policymakers, companies and individuals make along the way. We believe markets will provide warning signals: a break below the S&P 500's support z one of 980-1050, a sustained widening of credit spreads, and a break above 4% for the 10-year Treasury yield. In the longer run, we think stocks are priced to deliver superior, risk-adjusted real returns over Treasury bonds. Specifically, we expect high quality, dividend paying, global franchise stocks and emerging markets to outperform and sovereign debt, especially US and UK debt, to underperform. We will adopt a highly defensive position if necessary, but "being right or making money" suggests this is premature.

The Weekly Chart: 10-year rates barely above inflation



Source: RiverFront, BLS *Past performance is no guarantee of future results*

The inflation adjusted or 'real' yield in the bottom chart is the difference between nominal Treasury yields (thinner blue line, top chart) and inflation (red line). Real 10-year Treasury yields have averaged 2.5% for the past 50 years. Given our expectation of 2 to 3% inflation, nominal Treasury yields could approach 5% if the real yield, currently around 1%, reverts towards its long-term average.

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