



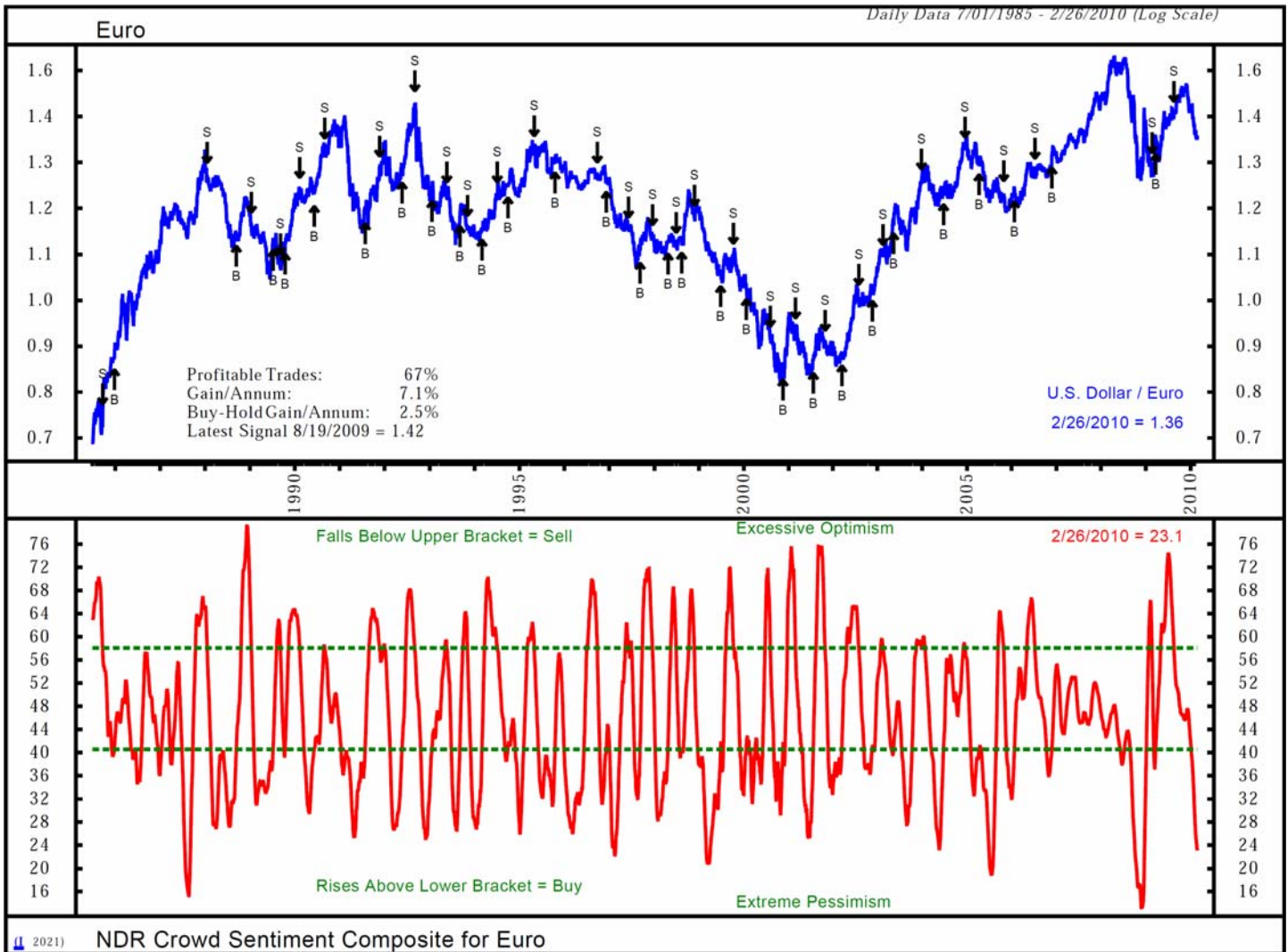
The New 'Golden Rule'

- There's an old saying that goes: "he who has the gold, makes the rules." Since President Richard Nixon took the dollar, and by proxy the world, off the gold standard in 1971, and after four decades of fiat currency experimentation, we think the financial version of the golden rule can be amended to: "he who *creates the money*, makes the rules." In the US, the Federal Reserve creates the money and it has chosen a path of underwriting government spending and reflating credit and stock markets, which has resulted in economic growth. In Europe, the European Central Bank has become less accommodative, there is no centralized fiscal expansion and economic growth is near zero.
- In his pre-chairman days, Ben Bernanke became famous for saying in a 2002 speech: "the US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost." Back then, no one could have foreseen the extent to which the US would use the printing press but Bernanke, perhaps more than anyone, understood its power, which is why another Great Depression has been avoided, in our opinion. Now, having averted catastrophe by using extraordinary measures, we believe Bernanke is becoming more assertive in a number of policy issues — exercising his right to make the rules — in order to address the weaknesses that he believes led to the crisis, as well as consequences arising from the extraordinary measures.
- Possibly because of the apparent inadequacies of leadership from congress and the administration, Bernanke ventured into non-monetary policy prescriptions normally off limits to Fed Chairmen in congressional testimony last week.
 - On the deficit: "it is very, very important for congress and the administration to come to some kind of program, some kind of plan that will credibly show how the United States government is going to bring itself back to a sustainable position."
 - On imbalances with China and its currency peg: "It would be a healthier situation if China saved less and we saved more, and as a result they were not accumulating dollar assets so quickly and we had a more balanced financial picture," adding that China should allow more flexibility in its exchange rate.
 - On congressional attempts to take away the Fed's bank supervisory role: "stripping the Federal Reserve of supervisory authorities in the light of the recent crisis would be a grave mistake... It's hard for me to understand why in the face of a crisis that was so complex and covered so many markets and institutions, you would want to take out of the regulatory system the one institution that has the full breadth and range of those skills to address those issues."
 - On Fannie Mae and Freddie Mac — government-owned businesses that provide the bulk of mortgage financing in the US — Bernanke indicated that he would like to see them privatized, after calling them platypuses -- "neither fish nor fowl" (i.e., neither fully public nor fully private).
- We agree. Unfortunately many decisions lie with a congress that seems incapable of tackling complex problems. We think investors should take some measure of relief that Bernanke and the Fed are unlikely to jeopardize the recovery and are doing everything in their considerable power to create the conditions for sustainable economic growth. We think two recent examples illustrate this commitment.
- First, Bernanke stated last week that "there may not be a significant reaction" to mortgage rates following the expiration of the Fed's mortgage-backed securities (MBS) purchase program at the end of March because simply holding onto their existing MBS portfolio is "going to keep rates down." Although we remain concerned that ending MBS purchases will cause mortgage rates to rise substantially, we are also confident that the Fed would likely resume purchases to bring rates down in support of the housing market. Indeed, the mere ability — and stated intention — of the Fed to resume mortgage purchases if conditions warrant may prevent hedge funds and other market speculators from aggressively selling mortgages once the Fed's purchase program ends. To be sure, some are less amenable to ongoing intervention, like Dallas Fed President Richard Fisher ("unless we have some ungodly crisis I cannot imagine"). But even as an inflation hawk, Fisher admitted "inflation is not the issue" now and that ultimately the Fed would do "whatever is most practicable and efficient."
- Second, the Fed has bolstered the tools it has available to influence market outcomes, which we think makes their pronouncements more credible. Last week the Treasury announced the revival of the Supplemental Financing Program (SFP) that it has with the Fed. The SFP allowed the Treasury to borrow on the Fed's behalf to fund the central bank's credit easing

operations during the worst of the financial crisis. Indeed, at one point, the Fed had considered requesting congressional authority to issue its own notes — ‘Bernanke bonds’ — bypassing Treasury entirely. After credit eased, the SFP was unwound, dwindling to \$5 billion from a peak of over half a trillion SFP bills outstanding. Following congressional approval to raise the debt ceiling in late January, the Treasury has subsequently expanded its SFP facility to \$200 billion. Combining the SFP with the Fed’s already announced money market fund repurchase programs provides the Fed with the flexibility to expand its balance sheet or shrink the money supply to fight potential inflation without resorting to outright sales from its mortgage-backed securities portfolio.

- In Europe, the fate of Greece is in German and French hands since they are the dominant Eurozone powers. Preliminary signs suggest they will guarantee Greece’s loans in exchange for fiscal austerity. The stakes are high and so some sort of compromise seems likely, which should keep the euro under pressure. As our chart shows, euro pessimism is now extreme, which suggests a short-term reversal of the recent decline, but longer term we think the euro has further to fall.

The Weekly Chart: Euro pessimism may postpone decline



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