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

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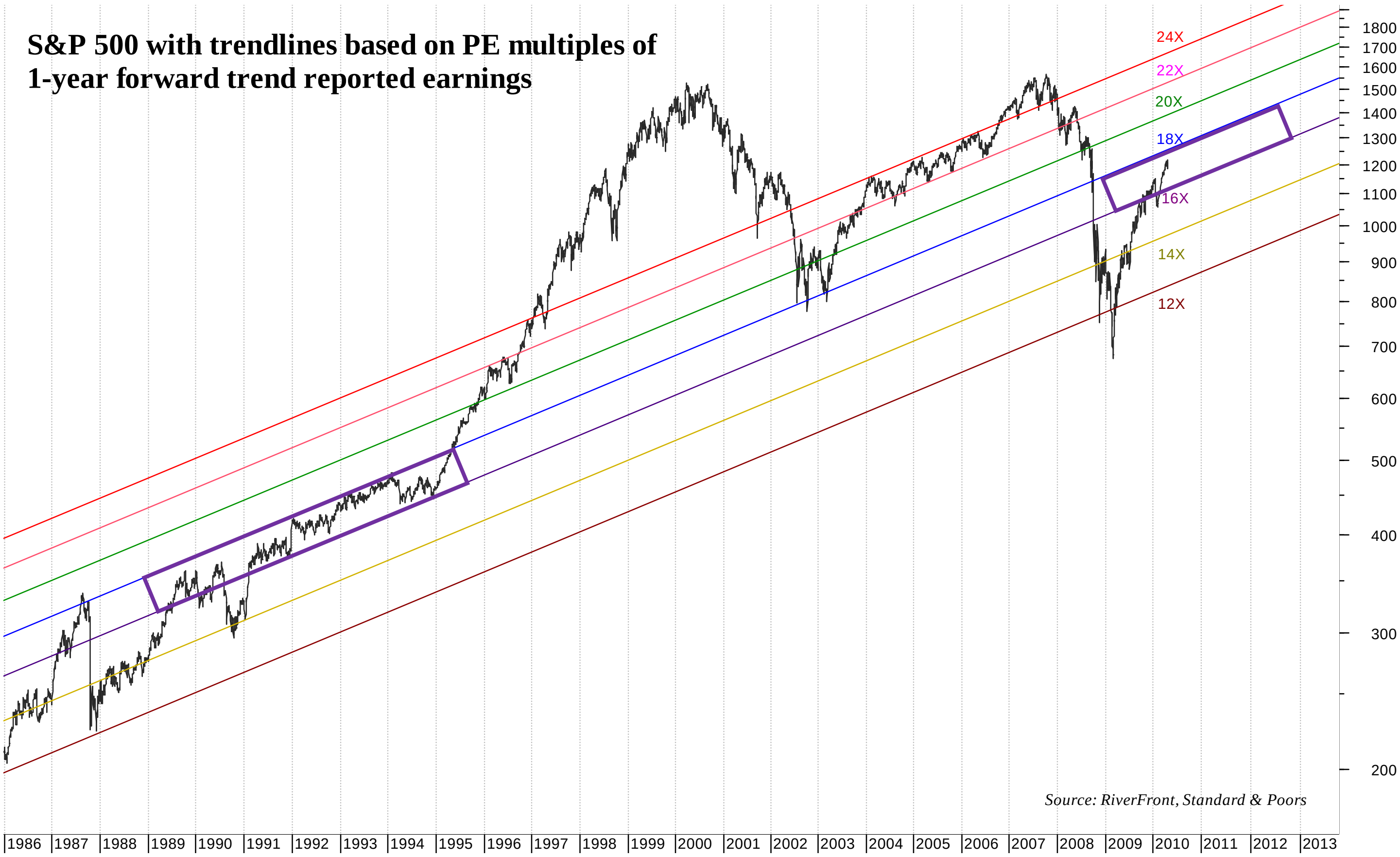
European Central Bank Blinks

- Over the weekend the bailout package for Greece was finalized. For us, the most significant development was that the European Central Bank (ECB) agreed to accept all Greek government debt as collateral when lending to banks, indefinitely suspending minimum credit-rating thresholds as their part in the 110 billion euro ($145 billion) bailout, which has been orchestrated by the European Union (EU) and the International Monetary Fund (IMF). We believe this shows that the ECB recognizes the deflationary implications of its members' various budget crises and is willing to use its balance sheet to help, much as the Fed has done for the mortgage crisis.
- Europe's troubles may be a blessing for the US, likely keeping global monetary policy loose for some time. Just six months ago, the overwhelming consensus was that the US dollar index would weaken. The dollar remains in a downtrend against many currencies but has been in a clear rising trend against the euro since the beginning of the year. The euro's structural problems, exposed by the Greek crisis, have reinforced the US dollar's position as the world's preeminent reserve currency, making a dollar crisis unlikely in our view. We believe the euro can fall further and would not be surprised at another 10% decline.
- European stocks are becoming cheap on a trend earnings basis. By our calculations, Europe is trading on 12 times trend earnings compared with the US at 17 times. Despite this, we remain underweight Europe. First, as countries tackle their budget problems, Europe is likely to endure much slower growth, making a return to trend earnings more difficult. By comparison, the US will post above-trend earnings this year and next if consensus forecasts are accurate. Second, it is rare for Europe to outperform when the euro is weakening. Europe's current woes, if overcome, may position it as a great opportunity in the future, but we think it is premature to act now.
- The Federal Reserve upgraded its assessment of the US economy last week but signaled that it was in no hurry to raise interest rates. Specifically, they mentioned that the "labor market is beginning to improve" and that "household spending has picked up." However, the Fed maintained that, "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." Thus despite the emergence of modest employment growth and a surge in retail sales growth that we wrote about last week, the Fed appears focused on longer term structural weakness in the economy. Indeed, the core-PCE price index – one of the Fed's preferred measures of inflation – decelerated sharply to just a 0.6% annual rate in the first quarter from 1.8% the previous quarter. This is the lowest it's been since 1959. Even including food and energy, the PCE price index is only 1.5%, well within the Fed's inflation comfort zone. The upshot of low inflation for markets is low interest rates. After briefly flirting with 4% at the beginning of April, the 10-year Treasury yield has since fallen back to 3.7% (helped by Greece) and is near its lows since the start of the year. We think the Fed, like us, remains concerned about the extent of a second half slowdown as boosts from inventory and government stimulus fade.
- Rising for the first time in two years, inventories accounted for half of the 3.2% growth in first-quarter GDP. Although we view this as a positive sign of rising business confidence, its effect is likely to fade later in the year as the cycle progresses. Increased business confidence was also evident in the 13.4% increase in equipment and software investment, but this was tempered by a 14% decline in commercial real estate. Residential real estate investment also fell 11.9%, implying that property markets remain oversupplied. With the expiration of the home buyer tax credit, we expect home building will continue to detract from economic growth this year.
- Personal consumption expenditure (PCE), the bulk of the US economy, grew 3.6% accelerating from 1.6% the previous quarter, but as we mentioned last week this is probably unsustainable given subdued income growth. Although, disposable personal income (DPI) increased $42 billion in the first quarter, without government transfers, DPI would

have declined $174 billion. Also discouragingly, trade subtracted about half a point from growth from first-quarter GDP as imports increased more than exports. One of the main conditions necessary to meet RiverFront's 'optimistic scenario' for GDP is that net exports become an increasing share of economic growth. Hopefully, when China revalues its currency, US net export growth will revive. Finally, government spending also subtracted from growth as a 3.8% state and local contraction more than offset a 1.4% expansion at the federal level.

The Weekly Chart: Stocks at early-1990s' valuations



We use trend earnings as a valuation yardstick in order to remove the effects of the economic cycle. To do this we calculate the 80-year trend of S&P 500 earnings, which is rising at a 6.1% rate. In our chart, which begins in 1986, each parallel line represents a different price to earnings ratio (PE) based on one-year forward trend earnings. Currently S&P trend earnings for 2011 are $72 (operating earnings are likely to be significantly higher) hence the current PE is 17. Using this framework, we can see that the March 2009 low was similar to the 12 times level hit after the 1987 market crash. From 1991 to 1995 the S&P 500 traded between 16 and 18 times, a range we think is likely until earnings turn down again. This would imply a trading range of 1120 to 1300, compared to the current level of 1200.

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