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

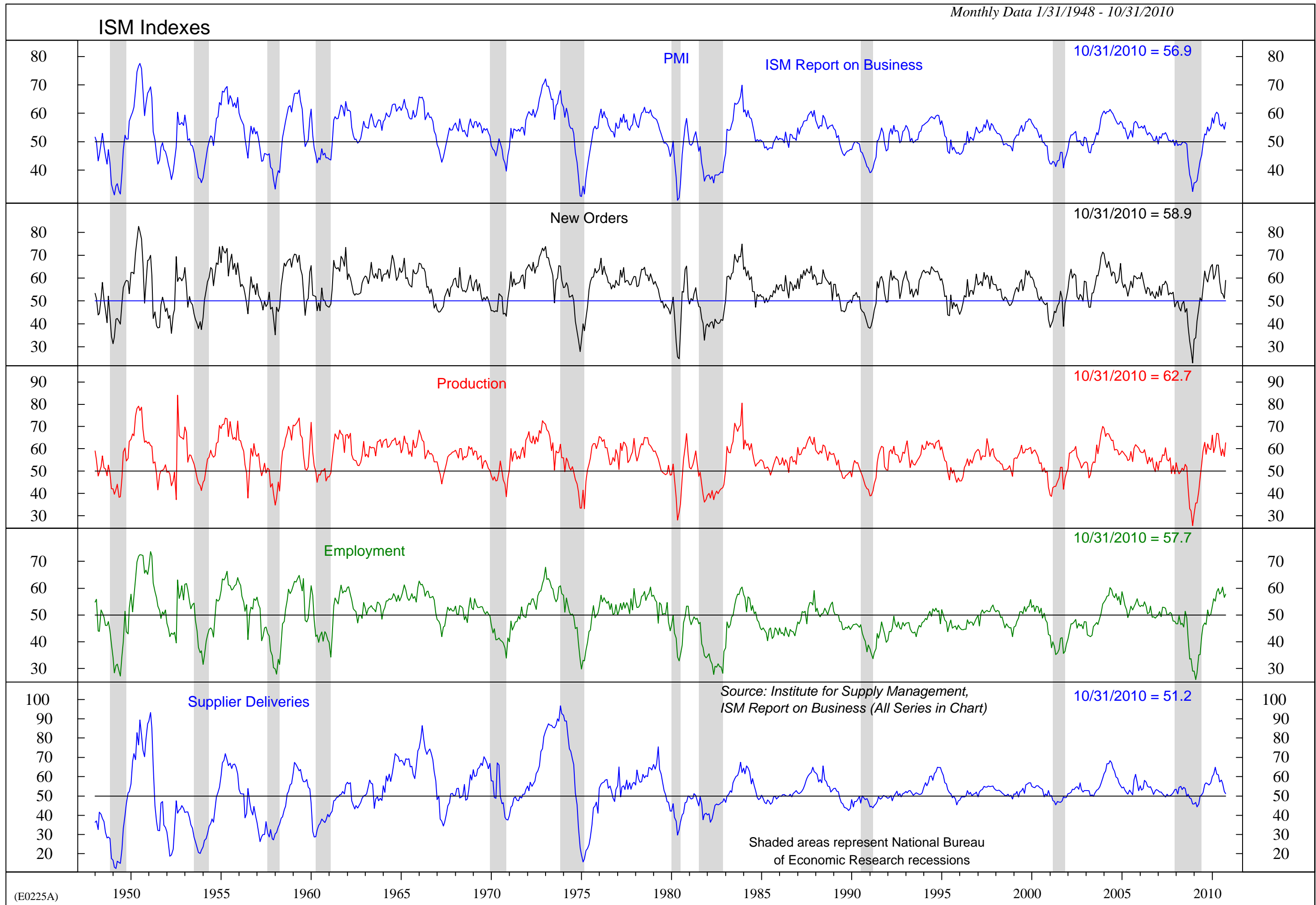
Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu November 1, 2010

Policy Differences Creating Distortions in the Tri-Polar World

- Our Midyear Outlook introduced the concept of a tri-polar world, characterized by distinctive long-term economic outlooks among countries and regions based on policy choices, growth prospects and structural differences. Countries in our tri-polar world were put into one of three categories: the good, the not-so-bad and the ugly. Developing economies were 'the good' due to their low debt levels, modest labor costs, and potential for accelerating domestic consumption. 'Not so bad' developed economies (primarily the US, UK, Germany and Scandinavia) have greater flexibility, relatively productive work forces and aggressive, independent central banks. The 'bad' developed economies (southern Europe, Ireland, and Japan) are suffering from unsustainable debt levels and uncompetitive work forces, and will likely face a prolonged period of economic stagnation, in our view. We continue to see this framework as relevant, but the policy choices of the Federal Reserve, the European Central Bank (ECB), the Bank of Japan, and the Chinese government are creating distortions. We discuss the impact of these distortions below.
- The ECB has surprised us. We had expected it to offset the fiscal tightening that is occurring across Europe with a highly accommodative monetary policy and a weak currency. Instead, the ECB's balance sheet has contracted by 4% since mid-August, and we realized that policy is not being set for the 'weakest links' of southern Europe, but rather for Germany, whose economy is in relatively healthy shape. After falling 20% versus the dollar since December 2009, the euro's dollar value has rebounded from $1.20 to $1.40 since June. We believe this appreciation will only add to the problems faced by southern European countries and so we plan to continue avoiding them. We have slightly increased exposure to the rest of Europe and expect to further add to these positions, especially if the euro shows signs of weakening. Europe's outperformance over the last few months has primarily come from currency appreciation.
- Despite the yen's strength – up more than 50% versus the dollar since 2007 – Japanese stocks in US dollar terms have underperformed both the US and world markets, making four-year relative lows. Unlike southern Europe, Japan has the policy option of weakening its currency; however, despite a recent announcement of planned quantitative easing (QE), the yen remains stubbornly strong, which suggests that markets are unimpressed by the proclamations of policymakers. We continue to avoid exposure to Japan.
- The Fed, on the other hand, has been the most vocal proponent of QE and the markets have taken them at their word. Since Ben Bernanke's August 27th speech at Jackson Hole, when he stated that "the FOMC will strongly resist deviations from price stability in the downward direction" the S&P 500 is up 12%, the dollar is down 6% and 5-year Treasury yields are down to 1.2% from 1.4% without the Fed doing anything at all. On Wednesday, the Fed is expected to provide clarity as to the extent and duration of their QE strategy; the expectation is that at least $500 billion of additional balance sheet expansion will be authorized.
- The anticipated increase in QE by the Fed and the dollar's subsequent decline is creating excess liquidity in most emerging markets. Currencies that float freely have appreciated significantly, while China-managed currency and Hong Kong's peg to the dollar have prompted asset and commodity price inflation. As long as the Fed is determined to print money and China is determined to only allow marginal increases in the yuan, then inflation of both goods and asset prices is likely to continue, in our view. Simply put, interest rates in most developing economies are too low relative to the growth rates of their economies, thus leading to tremendous demand for credit. Who wouldn't want to borrow money below the rate of economic growth? This will likely lead to excess investment and potentially another asset price bubble.

- Western governments persistently argue that it is in China's self interest to allow the yuan to appreciate. China accepts the principal of a stronger yuan, but differs on the timetable. China has been very clear that it will not be pushed into rapid currency appreciation and seeks a gradual transformation of its economy to be driven by domestic consumption. Europe and the US believe that the best course of action would be an aggressive approach towards currency strength. The resolution of this debate will likely be one of the most important factors in determining global economic stability. For now, the undervalued yuan seems to be creating distortions in the price of developed world debt and emerging equity.

The Weekly Chart: 'Not so bad' ISM survey



©Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.
See NDR Disclaimer at www.ndr.com/copyright.html . For data vendor disclaimers refer to www.ndr.com/vendorinfo/ .

One of our favorite, most timely indicators of economic activity, the Manufacturing ISM Report On Business, rose 2.5 percentage points, surprising on the upside with a reading of 56.9 (top panel of chart). A reading above 50 indicates the manufacturing economy is expanding; below 50 indicates contraction. According to ISM, "The past relationship between the PMI and the overall economy indicates that the average PMI for January through October (57.4 percent) corresponds to a 5.2 percent increase in real gross domestic product." Furthermore, the forward-looking new orders component (second panel) jumped 7.8 points in October. Because the service sector accounts for about 70% of the US economy, much more than 50 years ago, we are not looking for 5.2% real GDP growth. However, this better-than-expected manufacturing report supports our view of slow economic growth and no double-dip recession…not so bad.

Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • www.riverfrontig.com
RiverFront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. The S&P 500 is an unmanaged, weighted index of 500 stocks providing a broad indicator of price movement. Individual investors cannot directly purchase an index. Investors must make their own decisions based on their specific investment objectives and financial circumstances.