



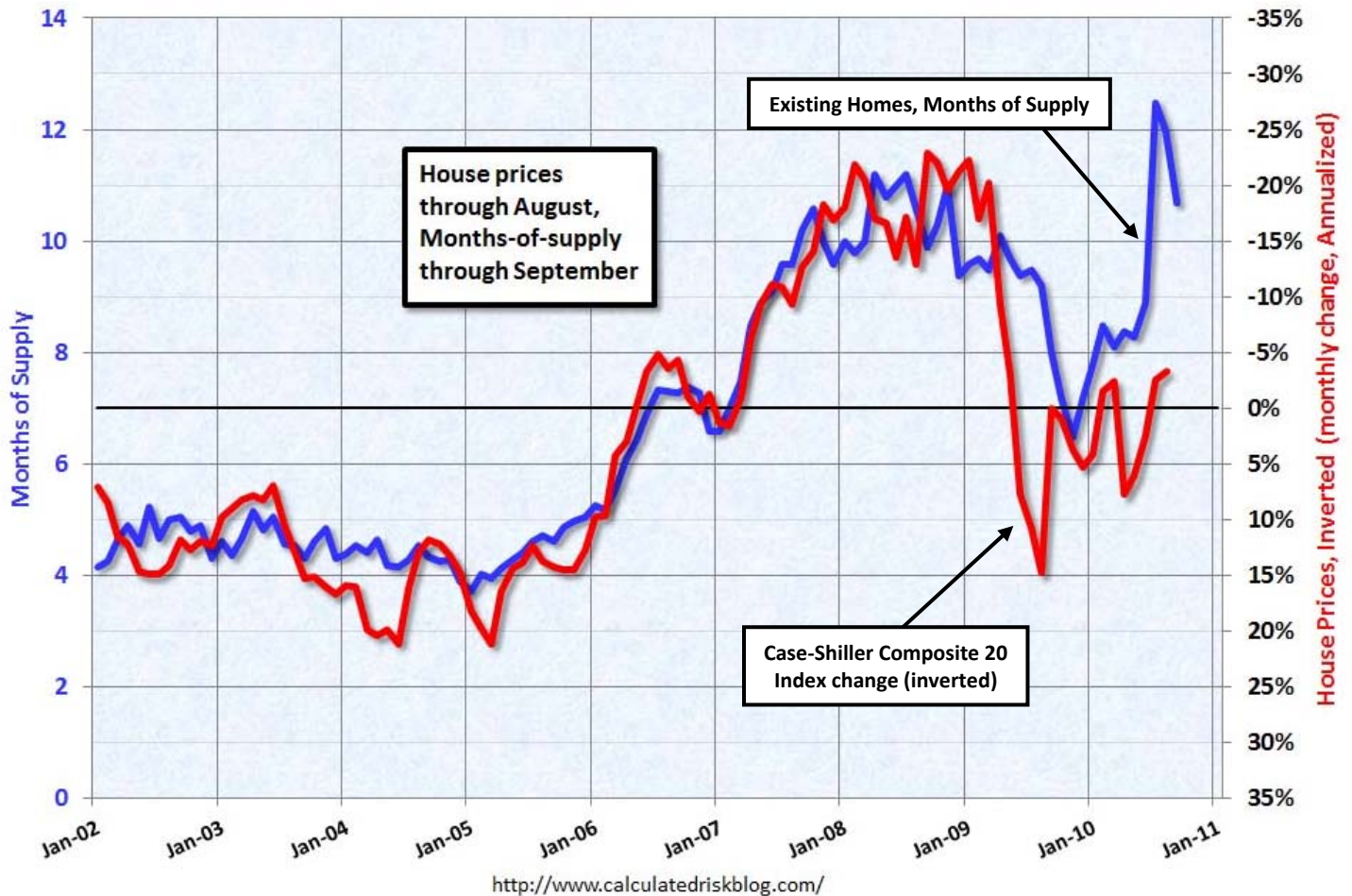
## A Man and His Mandate

- Despite intense international and domestic opposition, Ben Bernanke's Federal Reserve vigorously defended its QE (Quantitative Easing) program last week through a series of speeches and editorials. The QE debate is intense, but we believe that as long as the Fed has a mandate to maximize employment, Ben Bernanke will continue on his current course. The intensity of the Fed's defense, combined with supportive inflation data suggests to us that the Fed intends to implement the full \$600 billion of its QE program despite the opposition, thus providing ample liquidity support for financial assets.
- The Consumer Price Index (CPI), the Bureau of Labor Statistics' headline inflation indicator, showed inflation rose 1.2% year over year, while core inflation, which excludes food and energy, fell to 0.6%, an all-time low since records began in 1957. The main transmission mechanism for higher inflation — wage growth — is near a record low 1.5%, while inflation expectations remain 'well anchored' with five-year bond market implied inflation at 1.6%. Although 10-year implied inflation expectations have risen to 2%, this is still below any point since 2004. Recall that the Fed considers 'price stability' to be inflation between 1.5% and 2%. However, Bernanke argues that inflation should be higher than 2% for long enough so that price levels 'catch up' to what they would have been if inflation had risen at a steady 2% rate through the recession. Regardless, we think inflation remains too low (and unemployment too high) to be consistent with the Fed's mandate, and expect the Fed to use all the tools it has available to achieve its objectives. Note that the Fed considers a 5% to 6% unemployment rate as consistent with 'full employment.' We do not believe investors should 'fight the Fed,' and with the stock market's trend still rising and crowd sentiment no longer extremely optimistic (although still with considerable room to move lower), we remain bullishly positioned.
- House prices rose 3% in 2009 and are up 2% so far year to date (according to the S&P/Case-Shiller 20-City Composite Home Price Index), better than the Federal Reserve's 2009 bank stress test 'baseline scenario'. This was primarily due to Fannie Mae and Freddie Mac, easy Fed policy, the homebuyer tax credit and extended emergency unemployment insurance, in our view. However, in recent months, home prices nationally have begun declining again. S&P predicts that home prices will fall another 7% to 10% through 2011 due to excess supply over demand (see Weekly Chart). If this occurs, which we think is likely, banks should still be able to pass the new stress tests, but more residential properties are likely to go 'underwater' with a mortgage balance higher than the home value. More homeowners facing such 'negative equity' — currently around 11 million, or 23%, of households with mortgages — could add to the roughly 8 million seriously delinquent homeowners, many of whom have not made a mortgage payment in more than two years, thus raising default prospects. Currently most of these delinquent mortgages are being subsidized by Fannie Mae and Freddie Mac, which continue to grow losses at taxpayers' expense. As the likelihood of a bipartisan resolution to Fannie and Freddie's growing debts is low, it seems increasingly likely to us that those entities will continue to make mortgage payments for underwater homeowners, further delaying a resolution to the housing crisis and keeping downward pressure on house prices. Along with unresolved mortgage securitization irregularities (see *The Weekly View* 10/11/10) this is likely to keep earnings and stock prices of banks under pressure. With banks unable/unwilling to substantially increase their lending, US economic growth is likely to stay muted.
- President Obama's bipartisan deficit commission appears to have failed to reach a compromise and recommend a specific deficit-cutting plan, since the commission was unable to reach consensus and has released multiple plans, first by its co-chairs and then by other members. Similarly, negotiations to extend Bush tax cuts appear to have reached an impasse, making it unlikely that the issue will be resolved before year

end. We still expect a deal to be reached, perhaps with Republicans agreeing to an extension in unemployment benefits, a commitment to raise the deficit ceiling, and/or comprehensive tax reform in exchange for an extension of all the Bush tax cuts. Without an extension, we think the stock market will have trouble decisively breaking to new highs, and the economy is likely to suffer in the short term, although long-term budget issues will need to be addressed.

## The Weekly Chart: Home-supply overhang implies lower prices

Existing Homes: Months of Supply and House Prices



This week's chart compares the change in existing home prices (red line, inverted right scale) to existing home inventories (number of months it would take to draw down inventories at the current sales rate). While inventories are down from their peak, at 10.7 months they are at still at elevated levels, which is the basis for S&P's prediction that home prices will fall another 7% to 10% through 2011.

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