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

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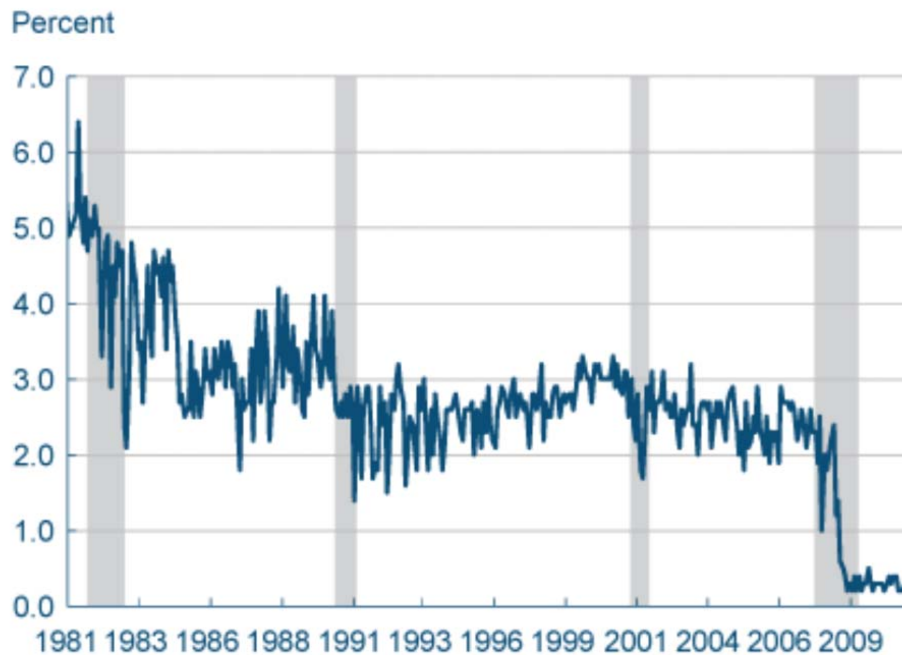
A Tale of Two Unions

- The United States and Europe are both recovering from a decade of rampant credit growth that has crippled their economies, but each union's response to its problems — mortgage debt in the US and euro-denominated sovereign debt in the EU — could hardly be more different. At issue is how losses are to be allocated. This involves governments and central banks negotiating the tradeoffs between debt repayment versus default, austerity versus growth, and access to funding markets versus state support. The ultimate goal for both unions is the orderly unwinding of those commitments that have little chance of being fulfilled. In Europe, losses will likely fall to bondholders and taxpayers with the split yet to be determined. In the US, foreign bondholders are being hurt by a weak dollar, but the pain to domestic bondholders is more subtle. They are suffering financial repression through the 'death of a thousand cuts' as most shorter-term maturities are not keeping pace with inflation.
- The US is choosing aggressive monetary easing, a weak dollar, and large budget deficits, creating the potential for inflation down the road; i.e. setting policy for the weakest link. Europe is forcing austerity on its weak countries in order to preserve the European Central Bank's single mandate of fighting inflation, thereby setting its policy for its strong core, especially Germany. With Europe willing to risk deflation and the US determined to prevent it, we think it makes little sense that US and German 10-year bonds both yield around 3%. We believe 3% US yields reflect both the effectiveness of the Fed's policies to keep long- and short-term rates low and the US' superpower and reserve currency status.
- In the US, budget cutting at the state level is becoming increasingly urgent with new fiscal years beginning in July, while federal budget negotiations are starting at $2 trillion in cuts over the next ten years. Furthermore, mortgage debt remains ill-supported, with stubbornly high unemployment and lagging household incomes (see Weekly Chart), and its cost will largely be absorbed by taxpayers via Fannie Mae and Freddie Mac if not put back to the banks. As this situation eventually clears, facilitated by Treasury borrowing and the Federal Reserve, an end state for deleveraging households is coming slowly into view (as evident in the falling financial obligations ratio). We think a household recovery that supports both savings and consumption will continue, albeit fitfully.
- While bond markets appear sanguine about the prospects of US corporations, households, and governments somehow reducing debt towards manageable levels, concerns have intensified for some 'peripheral' EU states, notably Greece. Greece's creditors remain intransigent on restructuring even as some form of Greek default appears almost inevitable. So far, the path of least resistance consists of muddling through with a 'voluntary rollover' of Greek debt that implicitly leaves Greek taxpayers on the hook to aid private creditors — an unstable situation as reflected in credit spreads. The growing risk is that Greek voters conclude that the pain of abandoning the euro might be preferable to current depression-like conditions. We believe a Greek withdrawal and total default has the potential of being Europe's 'Lehman Brothers' and would lead to significant financial instability. The politically powerful generally set the agenda, but they must still be careful of overreach. As a negotiating tactic, taking extreme positions may make sense under the circumstances, but we think European policymakers recognize the risks and that a compromise will be reached.
- The politics of burden-sharing will shape the respective outcomes for both 'unions.' The most likely outcome is for growth and employment to grind higher, gradually supporting mortgage payments and home prices and/or increasing tax receipts to fill up state coffers. In some countries and municipalities, however, debt restructuring and potential principal write downs may be required before growth can resume. We continue to

believe that, to preserve the system, fiscal and monetary institutions will inevitably act out of expedience, although we would prefer that authorities would simply concentrate on the best ways to promote growth and employment (without relying on ever greater amounts of leverage).

- In conclusion, bad loans resulting from irresponsible lending and borrowing and the collapse in trust over the value of underlying collateral and revenue streams continue to plague the developed world. Even after extraordinary measures taken by fiscal and monetary institutions during the depths of the financial crisis, confidence-sapping debt overhangs remain unresolved. While there is little appetite among authorities from destabilizing defaults, neither is there much enthusiasm for taxpayer-funded bailouts or central bank monetization. Hence, we believe portfolios should be positioned for slow growth in the developed world and maintain a high-quality bias.

The Weekly Chart: Household income expectations suggest sluggish growth is the 'new normal'



The University of Michigan's Survey of Consumers asks participants: "By about what percent do you expect your (family) income to increase during the next 12 months?" Households expect their family income to increase only 0.2% over the next year, much below the inflation rate, as illustrated in the chart above from the Cleveland Federal Reserve Bank. The Cleveland Fed says: "In light of relatively slow compensation growth, slack labor markets, and a somewhat bleak expectation of future income gains, it's hard to imagine that recent spikes in food and energy prices have touched off a price-wage spiral. More likely, these relative-price increases will cause consumers to trim spending elsewhere in their budget or save less before they go asking for a raise."

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