THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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# Policy Deadlock

- The world appears mired in policy hell: Germany and France are unable to agree on a solution for the debt-laden countries in Europe; Republicans and Democrats are deadlocked in a 'game of chicken' over raising the US debt ceiling; and Chinese traditionalists and reformers are fighting over policies for the next five years. Despite all of these uncertainties, most global stock markets have rising primary trends, and both high- and low-quality US bonds reflect few signs of stress. We think this is because developed world central banks remain highly accommodative and investor pessimism is already prevalent. Among the major stock indexes, emerging markets are showing the greatest signs of stress as their central banks are tightening policy to dampen inflation. We think that investors, though nervous, are assuming policymakers will avoid making major mistakes. Our strategy is to reduce portfolio risk if markets break down or obvious policy mistakes are made. For now, we remain fully invested to our benchmarks.
- Rhetoric in the US is so partisan that facts regarding the debt limit are often obscured. According to the US Treasury:
    1. The debt limit is the total amount of money that the United States government is authorized to borrow to meet its existing legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds, and other payments.
    2. The debt limit does not authorize new spending commitments. It simply allows the government to finance existing legal obligations that Congresses and Presidents of both parties have already made. By contrast, a government shutdown caused by a temporary failure to enact appropriations bills, while unwise and highly disruptive, would not have the same long-term negative impact on the creditworthiness of the US.
    3. Federal government shutdowns have occurred a number of times over the last 30 years, whereas a default on the legal obligations of the United States government is unprecedented in the country's history. Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents.
- What if policymakers fail us? A recent *Financial Times* article offered the following list of 'Things affected by a US downgrade':

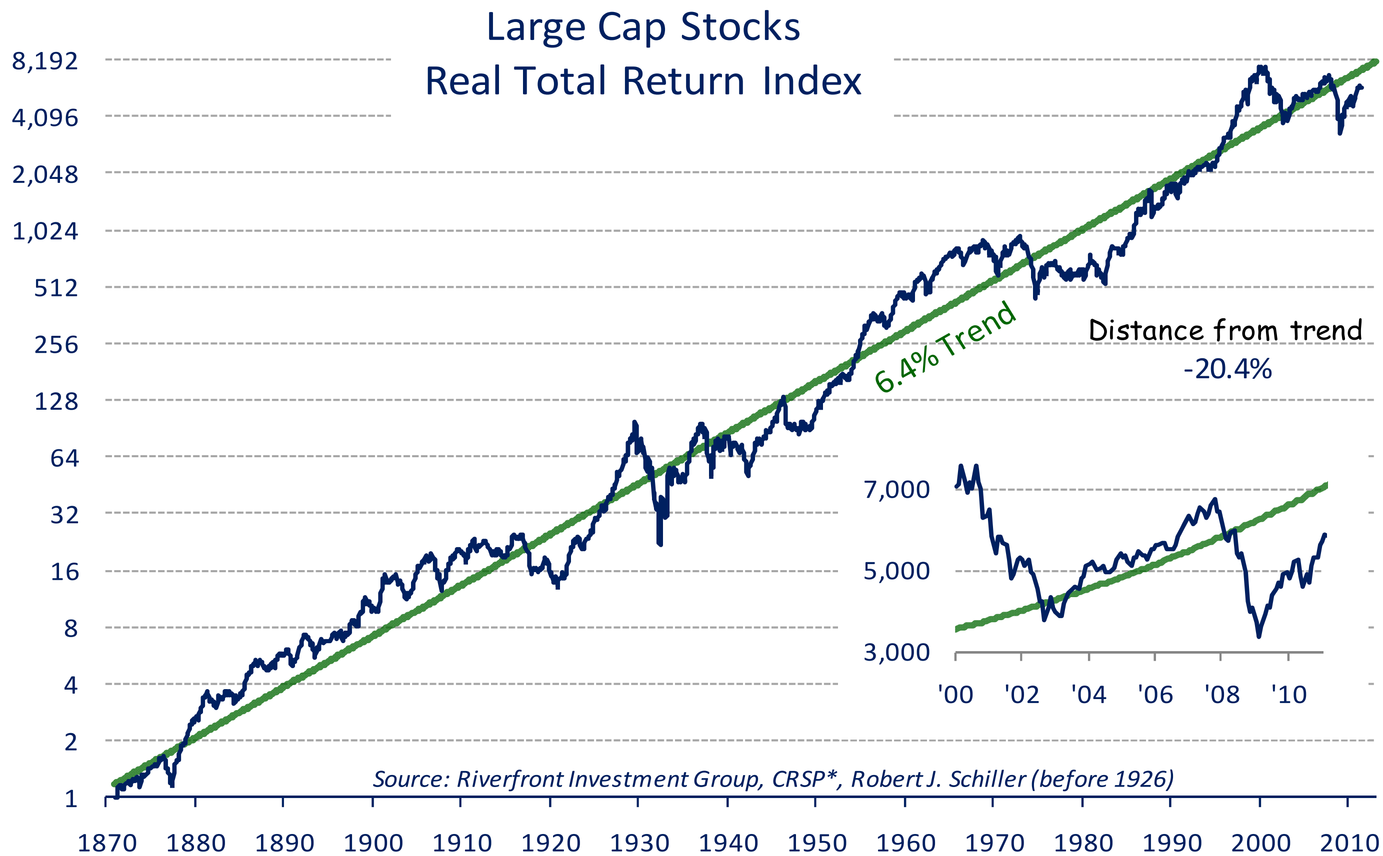
    1. Fannie Mae, Freddie Mac, FHLBs. 2. Liabilities guaranteed by the FDIC. 3. Some pre-funded municipal bonds. 4. Federal lease transactions. 5. Certain structured finance deals. 6. Some Israeli government bonds. 7. One Egyptian government bond. …Banks don't appear on the list above, but they are specifically mentioned in the Moody's report as things which *might* also be impacted by a US downgrade, given that the agency (still) factors in a degree of government support into their ratings. They also mention 'indirect linkages' which could allow a US downgrade to trickle down... So any list including indirect links could end up being rather longer.

    Thus, both stock and bond markets appear highly vulnerable to an outright failure by politicians to reach some sort of agreement in both the US and Europe. While we still believe outright failure is unlikely, we think a weak deal that fails to address longer-term issues could cause also cause markets to break below their rising trends in the short term. Last week, Moody's placed the US on downgrade watch, saying this action "signals our view that, owing to the dynamics of the political debate on the debt ceiling, there is at least a one-in-two likelihood that we could lower the long-term rating on the US within the next 90 days." Also finally stepping up to the ratings plate, Standard & Poor's stated that the US would likely lose its AAA rating in the next three months if it did not cut the deficit by $4 trillion over the next ten years.

    According to ISI Group, S&P's announcement raises the odds that a significant debt reduction package ($2 trillion or more) is passed in the next few months and even puts a larger package back on the table. It also raises the odds that Congress will have to pass a short-term increase in the debt ceiling to regroup and try to pass a larger package. There is precedent for a relatively benign bond market response to a sovereign debt rating downgrade, especially when investors anticipated it. ISI Group points out that S&P downgraded Belgium, Ireland, Italy, Portugal and Spain from AAA in 1998 and a week later 10-year bond yields for those countries were just 6 bps (basis points) higher on average; a month later they were 8 bps lower and a year later they were almost 100 bps lower. Japan lost its AAA rating in 2001 and its 10-year yields were only 12 bps higher a year later.
- The Eurozone lacks a fiscal authority equivalent to the US Treasury that can implement an 'orderly' wind down and disposal of impaired assets. Without such an entity, the prospects for defaults are increasing not only for Greece, but for the entire Eurozone, which is reflected by widening credit spreads for not-so-peripheral Italy. The challenge is to craft such a fiscal institution credibly and practically in a short period of time, and this may be where policymakers are ultimately headed. As

peripheral European sovereign debt spreads have widened, German yields have fallen, suggesting that Germany has at least the wherewithal (if not the will) to come to the aid of its distressed neighbors by 'lending' its balance sheet, in turn helping its own banks. With a recent history of disorderly defaults etched into policymakers' memories, we believe institutionalized bailouts are still the most likely outcome of the Eurozone's debt crisis. Indeed, Eurozone finance ministers recently stated their intention: "To this end, Ministers stand ready to adopt further measures that will improve the euro area's systemic capacity to resist contagion risk, including enhancing the flexibility and the scope of the EFSF [European Financial Stability Facility]...".

## The Weekly Chart: The trend can prevail




*Past performance is no guarantee of future results*

For 140 years, US large cap stocks have risen at a trend rate of 6.4% on a total return inflation-adjusted basis. That period has encompassed two world wars, deflation, depression and two periods of high inflation. It has also included the great US century of global economic, political and military dominance. We believe this long-term trend is sustainable as long as the emerging world fulfills its potential for growth and the US tackles its structural problems. The US' position as the world's superpower and the global nature of US companies – the S&P 500 generates nearly half its earnings overseas – underscore the trends' sustainability, in our view, but we do not expect this index of large cap stocks to rise much above its trend in the next seven to ten years.

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