THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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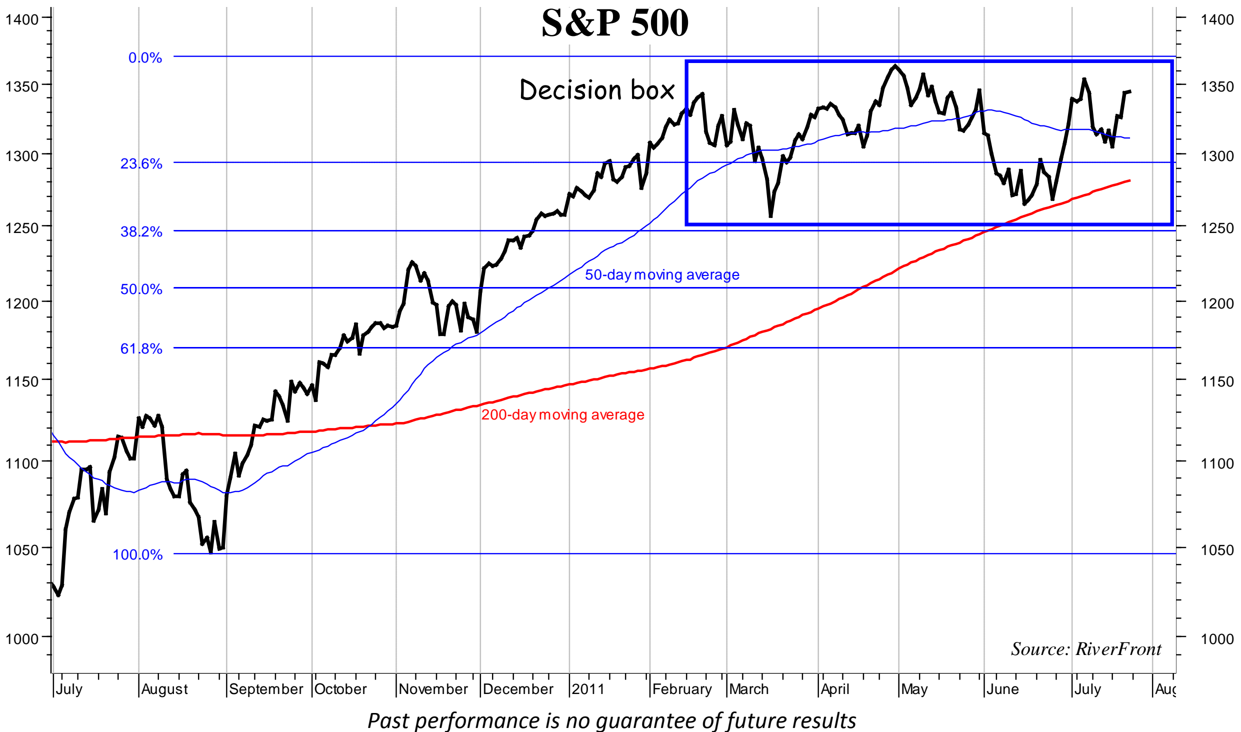
Missed Opportunity in US; Europe Makes a Start

- Policymakers around the world are generally failing to tackle long-term structural issues. This was most evident in the US where, over the weekend, talks between President Obama and Speaker Boehner broke down without agreement. We make the following judgments:
  1) With the opportunity for a 'comprehensive' deficit reduction deal fading fast, a 'kick the can to the 2012 elections plan,' which raises the debt ceiling but leaves the major decisions for the future seems most likely. While this may provide some relief to those worried about default, we think it means slower growth, lower consumer and business confidence and therefore, less job creation. Thus we think the upside for stocks is more limited but that the cyclical bull can grind higher so long as the global economy grows.
  2) We are assuming that a last minute deal will be reached and that there will be no default. We have a clear set of contingency plans should that not be the case (see Weekly Chart and commentary).
  3) We think US debt will likely be downgraded, but this will not have major consequences absent a default — US Treasuries continue to be the largest, most liquid bond market in the world, and the dollar continues to be the world's reserve currency. We think this will keep 10-year Treasury yields around or above 3%.
  4) Since the Japan earthquake in early March, the S&P 500 has been in a 'decision box' between 1365 and1250. Stocks have absorbed a tremendous amount of bad news: a global economic slowdown, the worsening of Europe's debt crisis, stalling improvement in US labor markets and the recent debt ceiling debate. The offset to all these issues has been strong earnings from US companies and a still accommodative Federal Reserve. In our judgment, a breakdown below the 'decision box' will be required to signal a change in the primary trend, which is currently rising. We are fully invested in stocks but our portfolios have a strong bias to quality and dividends. We have no Treasury bonds.
- European leaders introduced a new Greek 'bailout solution' last Thursday with three main points:
  1) Greece will be able to 'selectively default' by "extending average maturities of privately held claims from 6 to 11 years," according to the statement, at much lower rates amounting to about a 20% reduction in total Greek debt. From Reuters': "the EU will provide 'credit enhancement' for Greece's private-sector bonds." This is a key provision that should prevent a collapse of the Greek banking system. However this credit support will not stop the rating agencies from concluding Greece has defaulted and rating their bonds accordingly. We agree with Reuter's assessment that this deal "can quite easily be scaled up and used as a framework for future default/restructurings... there's nothing here to reassure holders of Portuguese and Irish bonds — or even Spanish and Italian bonds, for that matter — that they're home safe."
  2) The European Financial Stability Fund (EFSF) will have the ability to buy bonds in the secondary market. We think this is the key takeaway and provides the 'flexibility' to prevent or confer bank losses and recapitalizations (not without some arm-twisting), although these costs would still ultimately be borne by taxpayers. This is similar to when TARP provided the Fed the ability to pay interest on excess reserves, which allowed its balance sheet to expand. The EFSF has already been made permanent — it will become the European Stability Mechanism in 2013 — and may eventually be allowed to issue some kinds of 'Eurozone bonds' (the EU's equivalent to Treasuries). However, the success of this facility would require further fiscal consolidation within the Eurozone, in our view. Recall, Alexander Hamilton's first act as the US' Treasury Secretary under President George Washington was to assume the states' debts thereby establishing the nation's credit (in exchange for having the capitol located on the Potomac).
  3) While finance ministers committed to a renewed adherence (if not enforcement) of the old Masstricht Treaty deficit limits of 3% of GDP by 2013, there is at least some recognition that Greece and other debt-burdened

Eurozone countries will need to grow even to meet reduced commitments. Hence, while austerity remains the order of the day, Greece, Ireland and Portugal will have access to EU funding at about 3.5%. There is also apparently a stimulus plan for Greece in the works that was initially billed as a 'Marshall Plan' but we suspect will be more modest.

- In all, market responses were positive with the euro stabilizing around $1.43 and credit spreads narrowing substantially. While encouraging, private sector haircuts are still likely to be determined and imposed outside of Greece, but in a structured manner that lowers the systemic risk of a disorderly default and collapse of trust in the financial system.

The Weekly Chart: A risk management plan



Past performance is no guarantee of future results

We still believe that US stocks are in a cyclical bull market but we have developed strategies to protect assets if stocks react too unfavorably to the growing uncertainties of reaching the debt ceiling. Strong corporate earnings and the S&P 500's rising primary trend form the basis of our belief in the cyclical bull market. Our proxy for the primary trend, the 200-day moving average, has risen more than 10% this year and has yet to show any sign of flattening out, much less reversing to the downside, as may be seen in our chart. We expect the S&P 500 will likely range in a 'decision box' between 1250 and 1365 for the next three months. If stocks rise to the top of the box or even above, we will use optimistic sentiment extremes (NDR's Crowd Sentiment Poll is our favorite measure) as a primary signal to reduce portfolio risk over the short term. However, because we are worried that stocks could decline more quickly than they could rise, we are taking a more incremental approach to risk management rather than wait for a downside breakout of our decision box. Thus we will begin risk reduction measures if the S&P 500 decisively breaks below 1295 – the 23.6% retracement of the August 2010 thru April 2011 rally, which also acted as overhead resistance in January and June 2011.

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