The Weekly View
RiverFront Investment Group
Asset Management • Investment Strategy • Advice

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Climbing the 'Wall of Worry'

- The S&P 500 has now broken out above its two-and-a-half month 1100–1220 trading range, despite almost universal skepticism regarding policy deliberations in Europe and near-record equity mutual fund outflows. We think the stock market's strength is primarily due to an excess of pessimism and economic/earnings growth that remains positive, rather than any particular good news. In our view, a break above 1260 (the initial breakdown level in early August) would confirm the resumption of a cyclical bull market, but the initial breakout above a volatile trading range strengthens our view that the S&P 500 has made its low for the year. Seasonal tendencies now favor stocks, valuations are attractive, and investor sentiment remains pessimistic despite the rally, which suggests that stocks still have a substantial 'wall of worry' to climb before extreme optimism would imply limited short-term upside potential. Over the past several weeks, we have reinvested the cash we raised in early August, moving our portfolios to a more neutral position. Our focus has been on international markets and high yield bonds. We are not yet fully invested to our strategic benchmarks, which strongly favor risk assets, but are no longer positioned for a correction.
- Watching the 'sausage making' of a Eurozone rescue plan in real time has done little to assuage our belief that the results will be compromised and inadequate to the task. Thus, the bar is set low. However, even without consensus on some big issues by principal participants — France and Germany — we take some consolation from the almost universal agreement among European (and global) policymakers that a Lehman-like failure of one or more of the Eurozone financial institutions should be avoided at all costs. Furthermore, and perhaps more importantly, European policymakers have the ability to prevent such an outcome, especially if the European Central Bank's (ECB's) recent willingness to utilize its balance sheet continues. Although the details of allocating losses remains under discussion — loss allocation is always politically contentious and the leaders of the ECB think that this is the purview of fiscal authorities — we increasingly believe that the ECB (and others) will ultimately do what it takes to preserve the integrity of the banking system. In short, we think investors can take some comfort that although the process is still subject to considerable uncertainty, the eventual goal of financial stability is not.
- We are taking another look at gold, which has fallen back to its primary uptrend. Any resolution to Europe's sovereign debt crisis (and the US' mortgage overhang) involves extremely accommodative monetary policy for at least the next year, in our view. This entails negative real interest rates, which erode the value of most safe-haven assets and savings vehicles, i.e. financial repression. Gold has been the traditional beneficiary and has demonstrated its 'store of value' function as one of the top-performing asset classes since central banks adopted extraordinary measures three years ago. Now, with the ECB (reluctantly) expanding its balance sheet and the Fed "poised" to enact QE 3, as reported by the *Wall Street Journal*, the reflation of monetary assets is on track. From a timing perspective, gold's recent 14% correction has pushed crowd sentiment into extreme pessimism (a positive signal from a contrarian perspective). Thus, we see a potential opportunity to acquire a good 'portfolio diversification tool' at attractive levels given the monetary environment.

Fed gains authority to end 'too big to fail'

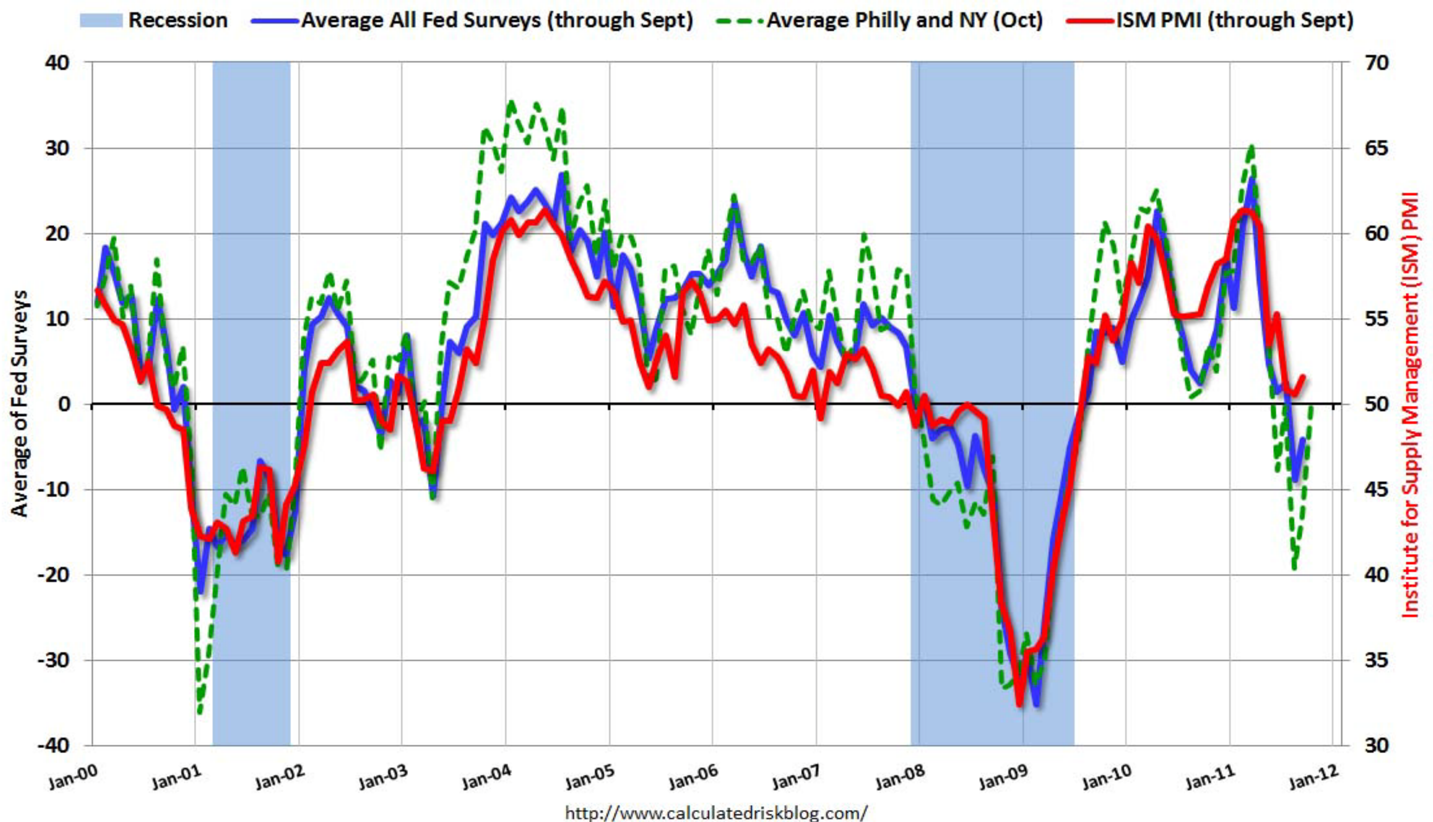
Reflecting central banks' original mandate to guarantee financial stability along with price stability — the Bank of England was created in 1694 to be a 'lender of last resort' (Sweden's Riksbank was established earlier in 1668) — Federal Reserve Chairman Ben Bernanke remarked last week on the 'Effects of the Great Recession on Central Bank Doctrine and Practice' concluding that: "One of the most important legacies of the crisis will be the restoration of financial stability policy to co-equal status with monetary policy... the crisis has forcefully reminded us that the responsibility of central banks to protect financial stability is at least as important as the responsibility to use monetary policy effectively in the pursuit of macroeconomic objectives."

In that regard, the Fed announced last week that it has finished its 'living will' proposal for banks (and systemically important non-bank financial institutions) given the resolution authority granted by the Dodd-Frank Wall Street Reform and Consumer Protection

Act. The biggest companies — "those with $250 billion or more in non-bank assets"— must submit their plans on how to resolve themselves by July 2012 (progressively smaller companies have until the end of 2013).

In essence, this is a shot at the 'too big to fail' mentality that has been at the heart of recent financial turmoil (and Wall Street protests). Without the ability to fail, 'creative destruction' is hamstrung and business decisions go awry from moral hazard (lack of incentive to guard against risks) and agency problems through lack of accountability. In our view, the consequences are that capitalism is perverted, trust in the system and its institutions is eroded, and the economy stagnates as a result. Although the credibility and willingness of the Fed to exercise its newfound resolution authority may remain in doubt, 'living wills' are being implemented and the Fed is gaining the ability to unwind systemically important and heretofore 'too big to fail' financial institutions. At the margin, we think this helps restore financial stability and, hence, investor confidence.

The Weekly Chart: Not yet out of the woods, but getting closer



The August plunge of the 'Philly Fed' and 'Empire State' manufacturing surveys — from the Philadelphia and New York regional Federal Reserve banks, respectively — helped kick off recession worries. As seen in the chart above from Calculated Risk, the average of the two surveys (green dashed line) fell to -20, the equivalent of 40 for the ISM manufacturing survey, which has signaled recession in the past. Instead of falling further, however, it subsequently rose back to zero in October. We think this partially negates its latest recession warning, especially with the national ISM manufacturing survey (red line) failing to confirm with a drop below 50, which would indicate contracting business activity. We believe short-term recession fears would be eased further if other regional Fed manufacturing surveys (averaged by the blue line) also rise to zero or above. Our odds of a US recession remain around 50%, but recent data have been more hopeful.

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