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

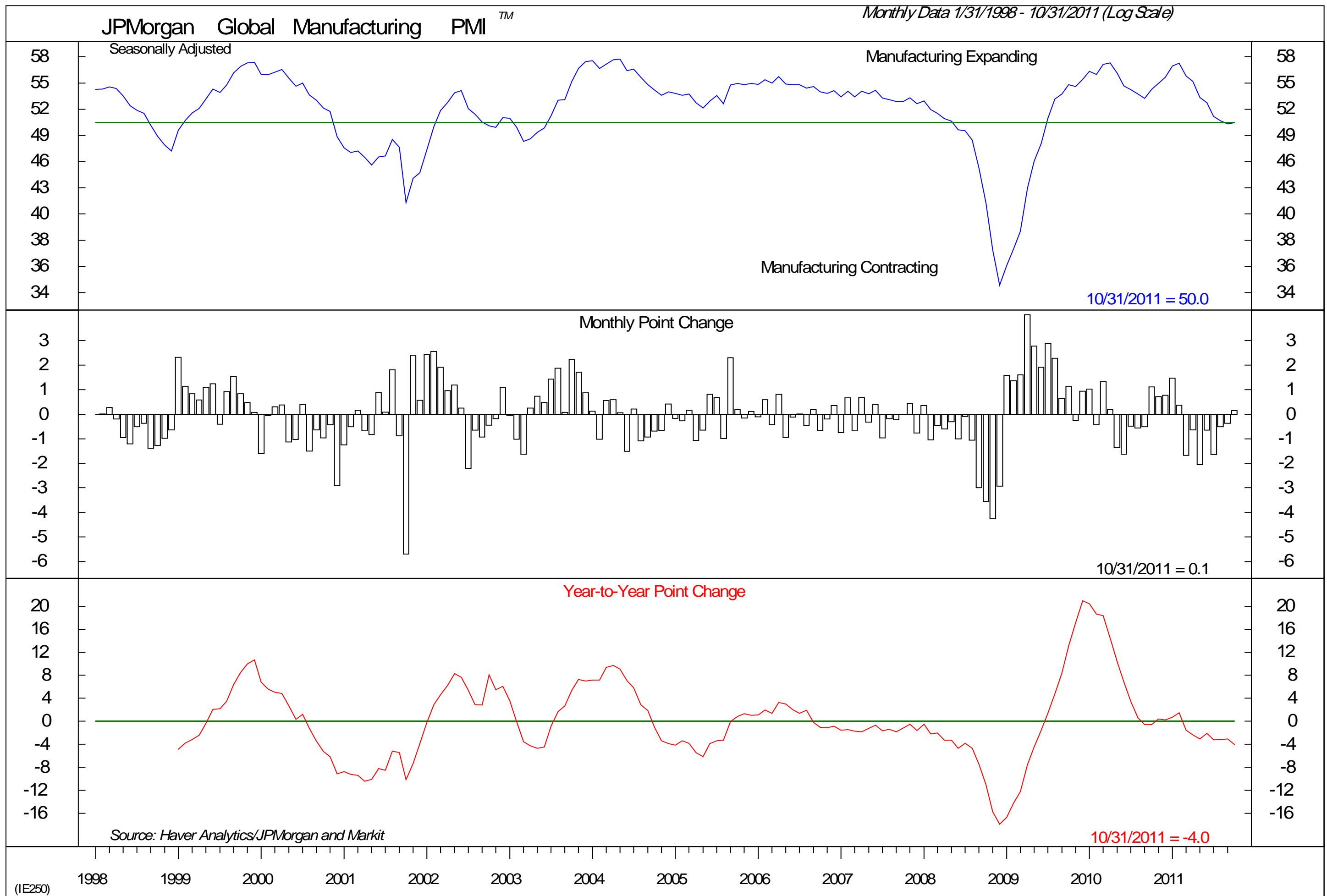
Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu November 7, 2011

Europe's Attention Turns to Italy

- The Greek crisis has never been just about Greece, in our view; rather, it has been about whether Greece's problems could be isolated before they 'infected' major European economies such as Spain and Italy. In a clear sign of a different regime, Mario Draghi, newly appointed (Italian) European Central Bank (ECB) President, cut short-term rates 25 basis points to 1.25%. In a press conference, Draghi hinted that the ECB would remain flexible in buying bonds even after an expected bailout mechanism is established (the details of which remain unknown). Somewhat worrisome to us, however, is that when asked whether the ECB could become the lender of last resort for governments, Draghi responded: "No I don't think that is in the remit of the ECB. The remit of the ECB is maintaining price stability over the medium term." Draghi is in a delicate position regarding the ECB's mandate and must weigh his comments carefully, but we are inclined to pay more attention to his actions than his words. In addition to cutting rates, the ECB has been buying Italian government debt. As Ben Bernanke said recently, "One of the most important legacies of the crisis will be the restoration of financial stability policy to co-equal status with monetary policy." We think the ECB's short-term focus is financial stability.
- With Italian 10-year yields rising to 6.4% last week, bond markets are testing the ECB's (and European finance ministers') resolve. In our view, 7% is a 'tipping point' for any large debt-laden country and is the level at which Greece, Portugal and Ireland were forced to accept assistance. If Italian yields continue to rise towards 7% and beyond, without the ECB or a nascent bailout fund stepping in, we will reassess our exposure to European stocks. We are currently neutrally positioned, having raised weightings on Oct 11. The stakes in Europe are high, the markets appear to offer value, and we think the pressure on Europe's banking system will keep European policymakers very focused on finding a way forward.
- US markets continue to hold up relatively well, despite lingering Greek/Italian uncertainty. The S&P 500 tested and stayed above technical support at 1220, while 10-year Treasury yields similarly held above 2%, which we regard as positive signs from both the stock and bond markets. Given extremely pessimistic sentiment, we think stocks can continue to climb higher as long as evidence continues to grow that suggests recession is being averted and earnings are holding up, both of which remain the case.
- The US economy continued to generate jobs, with a gain of 80,000 in October, while the prior two months were revised higher by 102,000, bringing the three-month average to 114,000. Aggregate payrolls — hours worked times average hourly earnings — also increased 0.3% suggesting that, along with job growth, incomes are rising (and keeping up with inflation). In addition, employment gains were enough to slightly lower the unemployment rate by a tenth of a percent to 9.0%, while the broadest measure of unemployment — which includes underemployed, discouraged, and 'marginally attached' workers (not included in the labor force) — fell to 16.2% from 16.5%. Meanwhile, the employment-population ratio ticked up to 58.4%, although prior to the recession it had been above 60% since 1985. In short, while employment is rising, its growth remains slow, reflecting the overall economy.
- Acknowledging the subpar recovery and expansion, the Fed substantially lowered its economic projections for the next few years. Whereas the Fed had expected economic growth of about 2.8% this year and 3.6% next year, it now believes growth will be around 1.7% and 2.7%, respectively. The Fed also raised its projection for the unemployment rate next year to around 8.6% from 8.0%, still lower than current levels but not as much of an improvement as previously forecast. Perhaps most importantly, they think core inflation will remain below 2% and that overall inflation will moderate to core next year from its current rate of 2.9%. We think this is significant because as long as inflation remains 'contained,' the Fed can aggressively pursue expansionary monetary policy.

- Both the ISM manufacturing and non-manufacturing indexes remained in expansion territory for October. Furthermore, new orders (a leading component) and employment continue to grow, indicating ongoing hiring. Third-quarter productivity remained strong, with a rebound of 3.1% annualized growth (the second quarter was revised to -0.1% from -0.7%, as output was higher than previously thought). Thus, there have productivity increases in eight of the last nine quarters, which we think underlies corporate strength and managers' impulse to hire. Unit labor costs fell by an annualized 2.4% in the third quarter and are up just 1.4% year over year. While this dampens consumer demand and top-line sales growth, it helps business and profit margin since available workers are plentiful and inexpensive, and it likely keeps inflation low.

The Weekly Chart: Global manufacturing has stalled



©Copyright 2011 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.
See NDR Disclaimer at www.ndr.com/copyright.html . For data vendor disclaimers refer to www.ndr.com/vendorinfo/ .

Along with the US, manufacturing activity is expanding in key economies, including China, India, and Japan; for much of the rest of the world it is rapidly contracting. As a whole, global manufacturing activity can be viewed in the chart above courtesy of Ned Davis Research. The Global Manufacturing Purchasing Managers Index is at 50, the border between expansion and contraction (top panel). Judging by the PMI data, Europe is already in recession, whereas the US is merely growing slowly. The key to 2012 growth lies with the developing world and especially with China, in our view. We think China is becoming less concerned about inflation. If we are correct and China starts to promote growth again, then the global PMI indicators should pick up somewhat from here.

Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • www.riverfrontig.com
RiverFront Investment Group, 1214 East Cary Street, Richmond, VA 23219

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. The Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future.