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

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Germany Steering Europe Towards Fiscal Union

- The outlines of yet another Eurozone fiscal policy were disclosed to the media over the weekend. We think it is clear that Germany is using the current crisis environment to force budget deficit targets on Eurozone members. Unlike the 3% of GDP targets agreed to at the founding of the Eurozone, these new targets are expected to be enforceable (somehow) by a centralized European authority. It also seems that Germany's Chancellor Angela Merkel has persuaded France's President Nicolas Sarkozy to go along. This would involve a significant loss of sovereignty and means the weaker countries must choose between Eurozone membership and the ability to determine their own budgets. If accepted by the major members of the Eurozone, the pact also means further budget austerity. Market reaction has been initially positive since there is hope that, if this deal is enacted, the European Central Bank (ECB) will be more willing to buy and hold sovereign debt. We see this as the only legitimate bullish scenario, and believe that without a major change in both rhetoric and action from the ECB, this plan will result in economic weakness.
- We are in the uncomfortable position of trying to gauge what politicians and central bankers are discussing behind closed doors and make judgments as to their outcomes, rather than forecast earnings and growth from traditional economic factors. This is not our typical skill set and leads to higher levels of turnover, forcing us to become more reactive when we judge incorrectly. Since other market participants face the same challenges, this also causes high levels of general market volatility and uncertainty.
- Global stocks have thus far rendered a clear negative judgment on Europe's efforts, with most moving averages falling and Monday's rally merely a recovery from a deeply oversold position, in our view (see Weekly Chart). At the end of September, global stock markets reached pessimistic nadir and then rallied substantially in October – the MSCI World Index was up 8.6% – supported by strengthening US economic data and the previous European budget and stability fund deal. However, these rallies stalled in all regions at (now falling) 200-day moving averages – our proxy for the primary trend. Starting November 11, with global equity markets about 7% above current levels, we began a process of risk reduction.
- This risk reduction was prompted by our worries about the ECB's willingness to support the October deal, the viability of the stability fund following the Greek referendum fiasco, and the sharp rise in Italian, Spanish, and French bond yields. Prior to last Wednesday, November 23, we had raised between 8% and 9% cash, leaving all portfolios defensively positioned with a bias to both US and high quality/low volatility stocks. Last Wednesday's further reduction was triggered at our stop level of 1190 on the S&P 500 (approximately current levels following today's rally). In addition to selling Europe, we reduced our emerging market exposure due to its historically high volatility and tendency to underperform in times of market stress.
- We use beta relative to the S&P 500 as a measurement of risk. This needs to be fully considered because of the flaws of historical beta as a forward-looking guide — betas can and do change in real time, but nonetheless give us a gauge to target risk. Beta is designed to measure the upside and downside percentage capture of a portfolio or individual security relative to the S&P 500; thus a portfolio with a beta of 0.5 should move up or down about half as much as the market. Currently, our portfolios' betas range from 0.25 in our most conservative, to 0.9 in our most aggressive portfolio.
- While we are now clearly defensive, we are willing to adapt to major policy changes in Europe or China that could improve the outlook. However, as we wrote in our last *Weekly View*, we are concerned by the growth implications of the events in Europe and the ECB's apparent determination to drive change through economic austerity, along with its refusal thus far to adopt a more accommodative policy. We continue to expect the US to be a relative outperformer while primary trends are falling.

We believe investors with a 3- to 5-year time horizon can remain invested and minimize risks

Despite our short-term caution, we think there are significantly better alternatives than cash for investors with at least a 3-year time horizon. For example, our Conservative Growth & Income model has an effective equity exposure of 25% and also has 20% in higher yielding bonds, so the portfolio yields significantly more than cash and more than high-quality bonds. In our view there is minimal principal risk over a 3-year holding period, and we can increase stock weightings by 10 to 20 percentage points quickly when conditions change. We would urge investors who have become uncomfortable with current levels of price volatility to consult with their financial advisors to find a portfolio with which they can feel comfortable. Our Price Matters[SM] valuation work strongly suggests that with US large cap stocks 31% below trend (developed international is -46%), those who stay invested will be rewarded.

The Weekly Chart: Europe: The Primary Trend is Falling

In the chart above, which shows European stock prices in local currency, the 200-day moving average (our proxy for the primary trend) has been falling for about three months. The deal struck in October, which dealt specifically with Greek debt and European bank capital, caused a sharp rally that failed below the primary trend as the critical issue of the stability fund's capital remained unresolved and European banks sold bonds aggressively. Monday's bounce is also reflected. In our view, European stocks will not break above the primary trend until a solution is found that brings investors back as buyers of Europe's sovereign debt, and/or the ECB is persuaded to become a strategic buyer as part of a coordinated austerity strategy. The current plan, as floated, has many issues still to be resolved, in our view.

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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. The MSCI World Index is a stock market index of 1,500 stocks of all the developed markets in the world, as defined by MSCI. The index includes securities from 24 countries but excludes stocks from emerging and frontier economies. 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. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.