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# US Expansion Continues, Europe's Problems Persist, S&P Technical Picture Improves

• **The US Economy is expanding.** All of the major economic indicators released last week confirmed that the US economy is expanding and that, if anything, the expansion has gained a small amount of momentum. Both the manufacturing and non-manufacturing ISM indexes were above 50, indicating that the majority of purchasing managers are positive, and 200,000 nonfarm jobs were created in December. We believe that the US expansion is highly dependent on three factors:

1. The Federal Reserve continuing its policy of keeping both long and short-term interest rates low, allowing debtors to finance their debt at low rates and healthy debtors to re-finance debt and lower their debt service costs. **We believe the Fed will continue to be highly accommodative in 2012.** The consequence of the Fed's policies penalizes savers due to the lack of safe investments that offer yields above inflation, i.e. financial repression. Riverfront's *Outlook 2012: Navigating Policy Purgatory* offers suggestions as to how we would position portfolios for this environment.

2. International and domestic fixed income investors continuing to believe that US inflation will not accelerate enough to threaten US dollars' and the US Treasury's status as the world's preferred safe haven assets. **We think US Treasuries will remain the safe haven asset of choice.** The crisis in the euro region, including its banks, has only strengthened investors' preference to place their reserves in US dollars. There are few wage pressures, with US unemployment at 8.5%, and the slowdown in Europe and China has removed some of the material cost pressures.

3. Investors continuing to have faith that the US ultimately tackles its structural deficit problems. This issue has been postponed until after the 2012 elections, and the lack of budget cuts in 2012 should allow economic growth to continue. Should investors lose faith and become persistent sellers of US bonds, then the Fed will be forced to increase its bond purchases or allow higher long-term rates. This will become a bigger issue as the elections get closer.

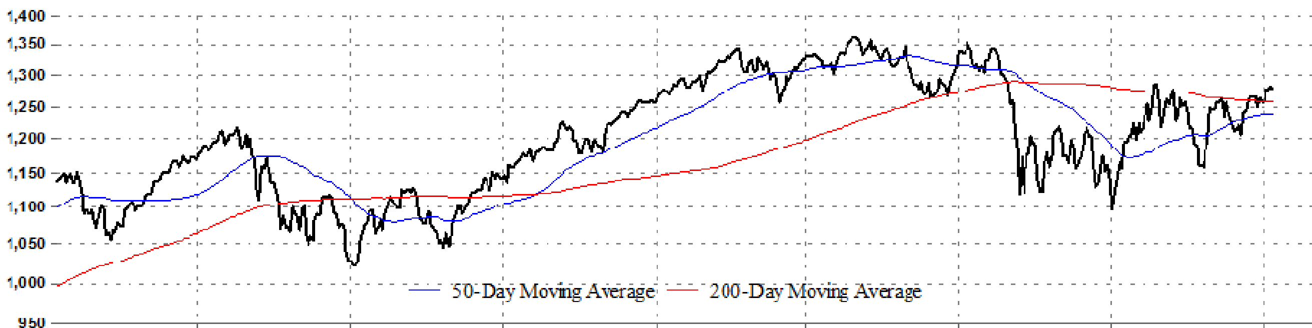
• **Europe's problems persist and the euro falls to a 15-month low.** We continue to believe that European policymakers still have not found the right policy mix. It also appears that the ECB's plan to offer three-year, 1% funding to European banks in unlimited quantities, subject to the banks posting collateral (including euro sovereign debt), has not induced banks to buy more euro sovereign debt despite the wide interest rate spreads. Of the €680 billion that banks have borrowed from the ECB (equivalent to $867 billion), €450 billion has been re-deposited at the ECB. As evidence that the policy is not working, the euro fell to new cyclical lows against the dollar last week, and Italy's funding costs rose

sharply. The rise in Italian 10-year government bond yields above 7% again suggests to us that the ECB's long-term refinancing operations are not having their intended effect of lowering borrowing costs for highly indebted sovereigns. We believe current Italian interest rates are unsustainable and make a plausible deficit reduction plan unworkable. We expect continued devaluation of the euro over the next few months in order to facilitate structural adjustments, restore competitiveness, and mark down debt.

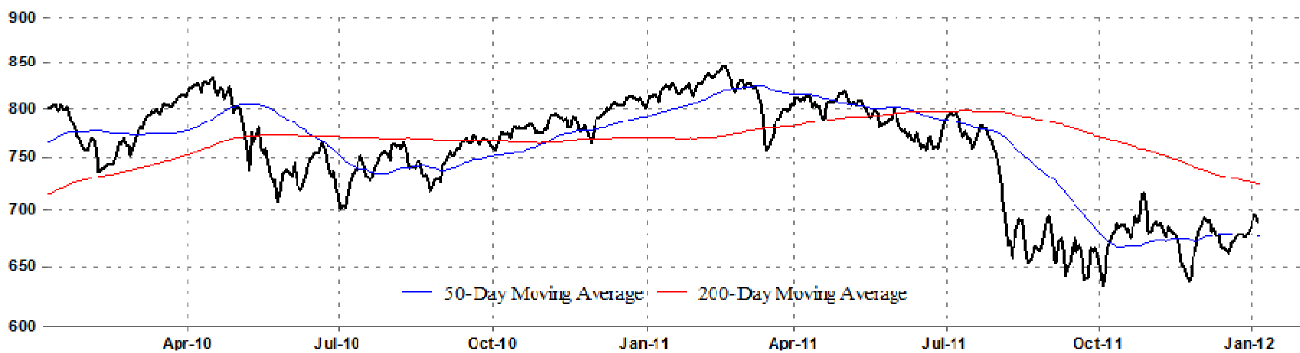
The charts of US and developed international stocks as measured by the MSCI EAFE (Europe, Australia, and the Far East) highlight the relatively stronger pattern of US stocks. Both indexes are US-dollar based, so the euro's weakness is reflected. With the New Year rally, the S&P 500 has nudged above its 200-day moving average and has a rising 50-day moving average. In contrast, EAFE's 200-day is clearly declining and its 50-day is flat. Our Price Matters[SM] work shows relative value in international stocks, but for now we believe the underperformance is justified by inferior growth prospects and inept monetary policy.

## THE WEEKLY CHART: US STOCKS REFLECT STRONGER FUNDAMENTALS

### S&P 500




### MSCI EAFE




*Source: FactSet Research Systems. Past performance is no guarantee of future results.*

*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 EAFE Index measures the equity market performance of developed markets, excluding the US & Canada. The index consisted of indices from 22 developed markets. It is not possible to invest directly in an index. 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.*