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RIVERFRONT INVESTMENT GROUP

THE WEEKLY VIEW

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Stealth QE Helping Europe…For Now

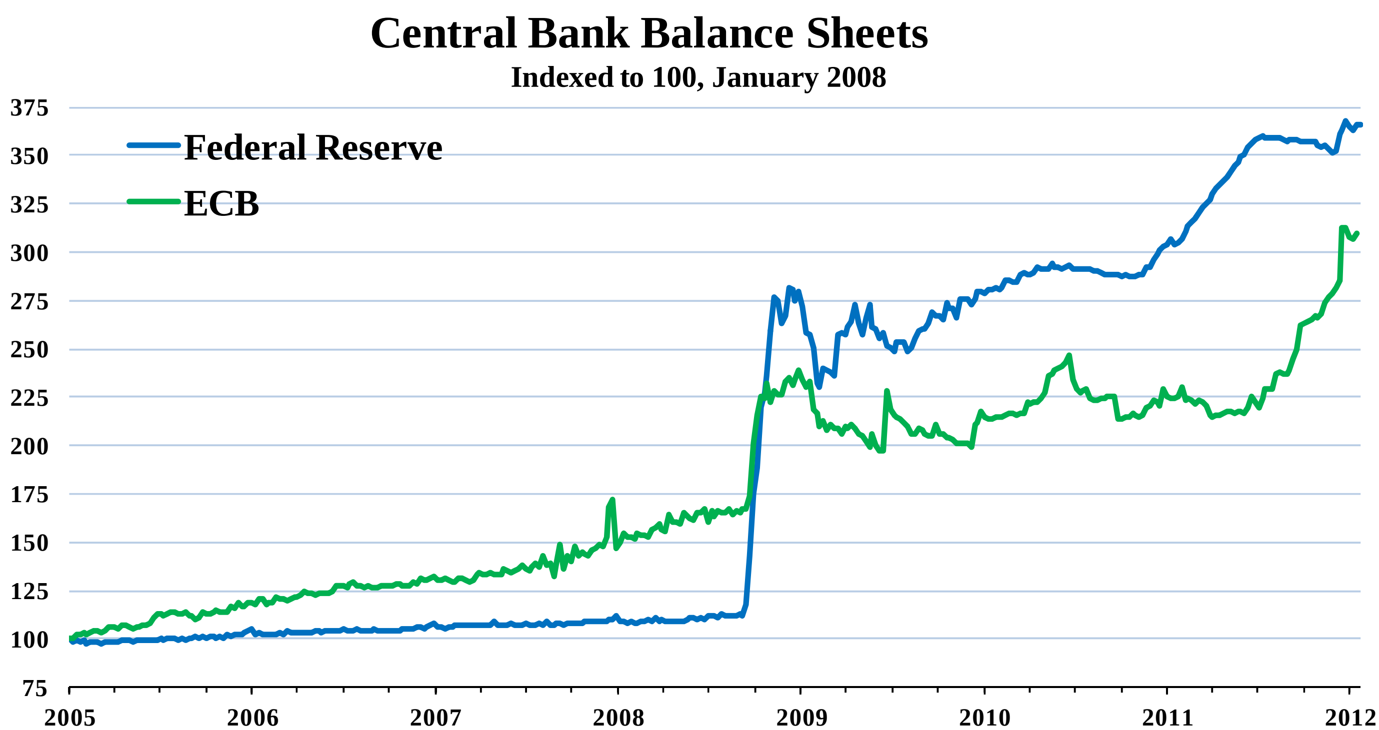
- European stocks are up about 6.5% so far this year compared to 4.8% for the S&P 500 primarily, in our view, due to investor enthusiasm regarding the European Central Bank's (ECB's) long-term refinancing operation (LTRO). This ECB tactic offers unlimited three-year funding (loans) to Eurozone banks and accepts a wide range of collateral; many banks have taken advantage of this. The LTRO has eased Europe's near-term liquidity problems, and while the ECB is not calling it quantitative easing (QE) we regard it as 'stealth QE'. This is because the ECB creates money for these loans by crediting the banks' cash accounts, which increases the monetary base and is reflected in the expansion of the ECB's balance sheet in the last quarter of 2012 (see Weekly Chart). The Federal Reserve's QE expanded the balance sheet in a similar manner, except that the Fed actually purchased bonds rather than putting a time frame on their repurchase and holding collateral. Thus, stealth QE has allowed the ECB to provide monetary stimulus without appearing to capitulate to politicians' demands of bailing out the Eurozone.

- Along with January's rally in European stocks, the effects of stealth QE are also evident in the Eurozone's sovereign bond markets. Since last November, Italian 10-year bonds have fallen to 5.9% from 7.5%, and Spanish yields are down to 4.7% from 6.7%. A rate of 7% is currently viewed as the threshold that would raise the probability of defaults based on the Greek and Irish experience. The LTRO strikes us as a 'can kicking' solution that does not really address Europe's longer term problems, but it has greatly eased the worries of a collapse of the Eurozone this year and has bought policymaker more time to concoct a longer term solution. Thus, we have reduced our underweight to developed world equity markets and are now only slightly underweight to benchmark in our growth portfolios and neutral in our income oriented portfolios. Longer term, we still have concerns because there are tough decisions to be made. For example, according to the Keil Institute for the World Economy, Greece must accept a 83.8% reduction in the value of its bonds (the haircut) before its debt burden becomes sustainable (assuming economic growth of 2% and current interest rates) (source: *Der Speigel)*.

- The advance estimate for fourth-quarter US real GDP was reported at a 2.8% annualized rate last Friday, slightly below consensus views for 3%. However, a build-up in private inventories accounted for more than two-thirds of fourth-quarter growth, without which the economy grew by only 0.8% based on final sales of domestic product. Thus, inventories could subtract from GDP growth in the next few quarters as they are consumed. Federal government spending contracted by 7.3% in the fourth quarter and subtracted 0.6% from GDP. We expect government spending to be a drag on GDP in 2012. Inflation rose a mere 0.4%, based on the GDP price deflator, but this resulted in nominal GDP growth of just 3.2%, well below its average growth rate of 6.8%. ISI Group continues to point out the importance of nominal GDP growth and believes that at least 5% growth is required to prompt corporations to add jobs and increase capital spending. We think US GDP growth will remain lackluster in 2012; our baseline case is for 1.8%. In our optimistic scenario, in which funding mechanisms of €1.5 to €2 trillion are implemented to backstop Eurozone debt and help revive European economic growth, we estimate US GDP could grow about 3% in 2012.

- The Fed concluded its two-day meeting last week with the announcement of its intention to keep short-term interest rates low until 2014 (versus 2013 previously). This could be viewed as policy easing. For the first time, the Fed introduced an official inflation target of 2% based on the price index for personal consumption expenditures, which Fed Chairman Bernanke has advocated for many years. The Fed also revealed the short-term rate target projections. Of the 17 members that participated in the meeting, 11 participants expect the current rate of 0.25% by the end of 2013 and six expect rates of 0.25% by the end of 2014. In the 'long run,' 16 participants expect rates of 4% or higher. Emerging market inflation is beginning to subside along with global growth as a result of policymakers' 2011 tightening strategy. Finally, Bernanke seemed to raise the possibility of QE3 for the Fed, saying, "If inflation is going to remain below target for an extended period and employment progress'' is very slow, then "there is a case'' for additional monetary stimulus. We think the case for more stimulus will continue to strengthen if the trends of low inflation and 'muddle through' economic growth evident in fourth-quarter GDP continue much longer. Thus, with the Fed easing policy and hinting at QE3 and the ECB engaging in stealth QE, think stocks can continue to grind higher.

THE WEEKLY CHART: ECB PLAYING CATCH UP WITH THE FED



Source: RiverFront, Federal Reserve, European Central Bank

The central banks of the world's two main reserve currencies have more than tripled their balance sheets since 2005, when the Fed's was still below $1 trillion and the ECB's was just over that amount (in US dollars). The Fed's balance sheet is now close to $3 trillion and the ECB's is just over $3.5 trillion after a string of extraordinary measures following the Lehman Brothers' collapse in September 2008. For the top eight central banks over the last six years, combined balance sheets have expanded to more than $15 trillion from $5.4 trillion, according to Bianco Research. By design, central bank operations to leverage their balance sheets have helped support risk assets with the intention of lowering both public and private funding costs while pushing investors further out on the risk curve. Hence, the recent rally in global stock markets has corresponded with the latest trillion dollar push by the ECB.