THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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What Could Go Wrong

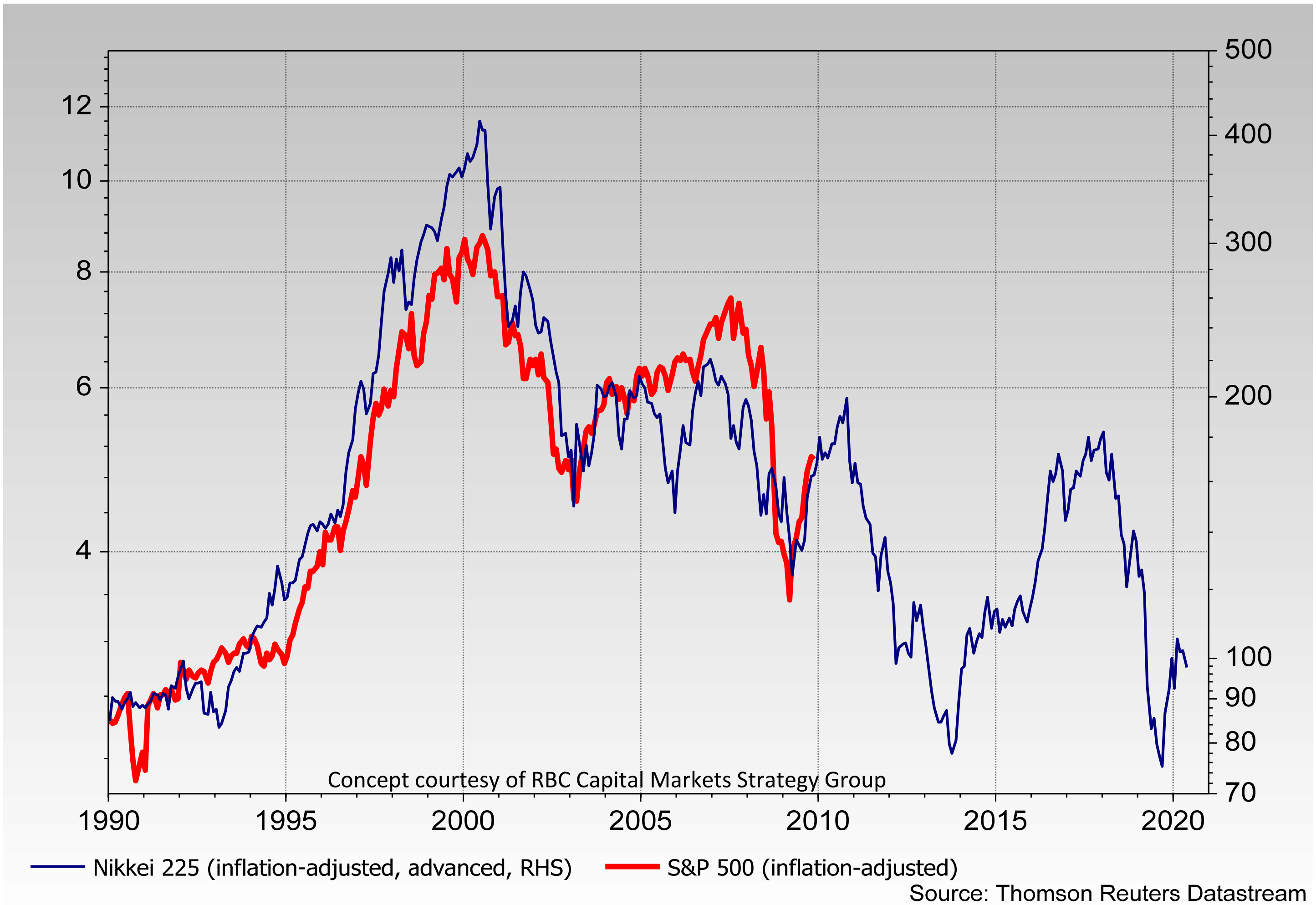
- For holders of risk assets, things are going right. Stocks, commodities and high yield bonds all made new cycle highs last week. We remain bullish of risk assets both fundamentally and technically, for the reasons set out in our 2010 *Outlook*. However, we need to understand and plan for what could go wrong. One of our key assumptions is "the Fed will continue to err on the side of reigniting inflation rather than risking a return of deflation and will not hesitate to extend its program of purchasing government debt beyond its scheduled termination in March if it deems necessary." Minutes released from the Fed's mid-December meeting revealed there is considerable debate about whether purchases of mortgage-backed securities should be extended. Inflation hawks are concerned about rising inflation expectations, the potential of inflating another asset bubble (like the 2003-2007 housing boom) and markets' growing dependence on monetary largesse. Inflation doves warn that without government support the still fragile recovery is liable to fall back into recession thereby risking deflation, especially if mortgage rates spike and cause another downleg in home prices. That in turn would further weaken both consumer finances and the banking system.
- We side with the doves and believe that Bernanke does as well. We think moderate inflation is preferable for a debt-laden economy and, as long as interest rates remain relatively low, recovery and growth should continue, i.e. reflation. While commodity prices are rising, core inflation (40% of which is the cost of shelter) should exert a moderating effect on overall inflation and help temper any increase in interest rates. Moreover, labor costs are contained (e.g. by China and India, not to mention high unemployment in the US) which also anchors overall inflation and interest rates, in our view. Thus we think the Fed will consider removing accommodation only when labor costs start to accelerate (after unemployment peaks). Lastly, because the US dollar remains the world's premier reserve currency, printing dollars is unlikely to lead to a funding crisis (a refusal to buy US debt) or currency collapse – *if it was going to, it probably would have happened already*. So while the dollar is likely to stay weak, we expect any decline to be orderly.
- Our second major assumption is that US companies will deliver a 'V'-shaped earnings recovery despite the structural problems that will prevent a normal recovery for the US economy. Our assumption is based on the belief that US corporate earnings are driven by global economic conditions and increasingly by emerging economies where recoveries are vibrant. Additionally, a weak dollar offers sales growth opportunities for US multinationals. Clearly, anything that might cause the global economic recovery to falter or a significant dollar rally is a risk to our scenario.
- The consumer is a greater concern in our opinion. As of the third quarter, 23% of home mortgage holders have negative equity, amounting to $2.9 trillion of debt on $2.2 trillion of property value (see *The Weekly View* 12/7/09). Although policymakers have discussed principal reductions, they have not been pursued to any significant degree. The alternative in our view is a steady drip of defaults and walk-aways over many years – a lost decade. In the meantime, we think papering over unproductive assets – either through regulatory forbearance or ongoing extension of government support – would only drain resources that could otherwise go towards developing more productive endeavors.
- Our investment strategy is to monitor the things that could go wrong and set levels or benchmarks that would elicit reevaluation. In our view, some important warning signals include:
    1. Long term interest rates rising above 5%.
    2. A clear change of rhetoric from the Fed towards the hawks or evidence that the Fed's balance sheet is shrinking accompanied by purchasing manager surveys below 50.
    3. Technical breakdowns by risk assets such as stocks, high-yield bonds and commodities. For the S&P 500, a break below 1000 would be alarming.

Japan – a cautionary tale: similarities and differences with the US

Closing in on its *second* lost decade and still saddled with high debt, Japan continues to struggle with deflation. Years of near-zero interest rates and quantitative easing have failed to spark any inflation; 10-year Japanese government bond yields have not been above 2% in over a decade. Clearly, accommodative policy alone has not been sufficient to revive growth and, arguably, has enabled economic stagnation by prolonging the life of unproductive assets that should have been shuttered and written off long ago. If the US is to avoid this trap, we believe that along with *temporary* policy accommodation, private sector restructuring must still take place. While US households have begun to repair balance sheets, substantial debt overhangs still exist.

We see the biggest difference between Japan and the US in the corporate sector. For the first half of the 1990s, Japanese companies took little action, waiting for the government to deliver growth. In the second half of the 1990s the global economy was strong enough to offset weakness at home. Thus real restructuring did not begin until the 2002 global recession. In contrast, US companies cut costs so quickly that profits turned up in 2009, well before sales. If we are right and profit margins return to record levels, the US will follow a very different path than Japan in the next decade.

The Weekly Chart: US stocks tracking Japan's lost decade so far



Past performance is no guarantee of future results

The chart above shows the 'real' price performance of the S&P 500 Index (adjusted by CPI) overlaid with Japan's CPI-adjusted Nikkei 225 Index moved ahead 10½ years from June 1979. As may be seen, although the scales differ, the S&P 500 since 2000 appears to be tracking Japan's 1990s 'lost decade.' Whether the next decade for the S&P 500 follows the path set out by the Nikkei 225 depends a great deal on successful corporate restructuring and government policies. We are optimistic on both fronts, but acknowledge that policy mistakes could still derail the recovery. In the near term, premature exit from policy accommodation risks a 'double-dip' into recession, which could cause another severe down leg in stocks. (Rising trade protectionism might also prove a spoiler.) Longer term, if household balance sheets are not repaired, government debt is likely to continue mounting, prolonging the US' relative decline and extending the secular bear market.

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