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

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu June 21, 2010

Why We Are Still Cyclical Bulls

- Two of the three conditions we laid out to sound an 'all clear' last week have been fulfilled. On the positive side, high yield credit default swap spreads have fallen below 625 and are now at 574. The S&P 500 has closed above its 200-day moving average — our proxy for the primary trend — each day since last Tuesday, now appears decisively above it and the trend is still rising. Meanwhile, 10-year Treasury yields remain below 3.3%. Recall that we would like to see a rise above 3.4% as further evidence that global investors' flight to safety is abating.
- Treasury yields can be separated into real yields and inflation expectations (see Weekly Chart). Real yields, as measured by TIPS (Treasury Inflation-Protected Securities), can be viewed as the bond market's assessment of economic growth, adjusted for inflation. Subtracting real yields from Treasury yields provides the market's inflation expectations. Since early April, 10-year Treasury yields have fallen from 4% to 3.2% as of Friday's close. Real yields have decreased from 1.7% to 1.2%, while inflation expectations have declined from 2.3% to 2%. Thus, of the 0.8 percentage point drop in Treasury yields over the last two months, 0.5 has come from growth and 0.3 from inflation.
- We see several reasons why markets might be discounting average annual real GDP growth of only 1.2% over the next 10 years (with 2% inflation): as stimulus and inventory effects fade, we expect savings to rise, dampening consumption; housing activity is stalling as government support is withdrawn; Chinese tightening and policy decisions in Europe are likely to restrain trade, while state and local cutbacks in the US continue to drag on growth (not to mention the effects of the Gulf oil spill). Longer term, there is also concern that high debt levels and poor demographics will sap growth in the US and developed markets, especially relative to emerging markets that are becoming increasingly productive and competitive.
- We think the market's assessment of economic growth is too low. In late 2009, growth expectations as measured by the 10-year TIPS yield were 1.1%, which proved overly pessimistic. That yield rose to 1.7% by early April as economic recovery began to take hold in the fourth quarter last year and into 2010. Now, anticipating a second half slowdown, markets appear to be pricing out most of the economic recovery. We do not believe this is justified because:
  - Forward looking US purchasing manager indexes (PMIs) remain above 50, as do PMIs globally, indicating expanding economic activity
  - Private job and income growth remains positive (albeit subdued relative to past recoveries)
  - The Federal Reserve is committed to underwriting growth and not worried about inflation
  - The European Central Bank, while reluctant, is committed to preventing contagion
  - China is engineering a soft landing and becoming more consumer oriented, as evidenced by its latest decision to (modestly) increase exchange rate 'flexibility'
- Perhaps most importantly, markets are giving fiscal and monetary authorities considerable leeway to sustain growth as necessary, given the lack of private demand. The US can still borrow at very attractive rates with 10-year Treasury yields at 3.2%, which we view as strong evidence that there is no difficulty funding debts and deficits. Moreover, with credit spreads still relatively low, creditworthy companies that need (re)financing are having little trouble issuing debt, although the flight to safety in recent weeks has dented corporate issuance somewhat. In addition, structural rebalancing is occurring — unproductive workers have been shed, corporate profit margins have improved, debts are being written off while banks are being recapitalized, governments around the world are learning to live within their means (we will see about deficit reduction plans in the US) and, in our view, a growing middle class in emerging markets is filling the demand void left by developed markets. All of this should lead incrementally, if haltingly, to sustainable net private demand creation globally.
- Despite low government borrowing rates, investors remain concerned about deficits. As Martin Wolf, éminence grise of the *Financial Times*, wrote in "Why plans for early fiscal tightening carry global risks" last Tuesday:

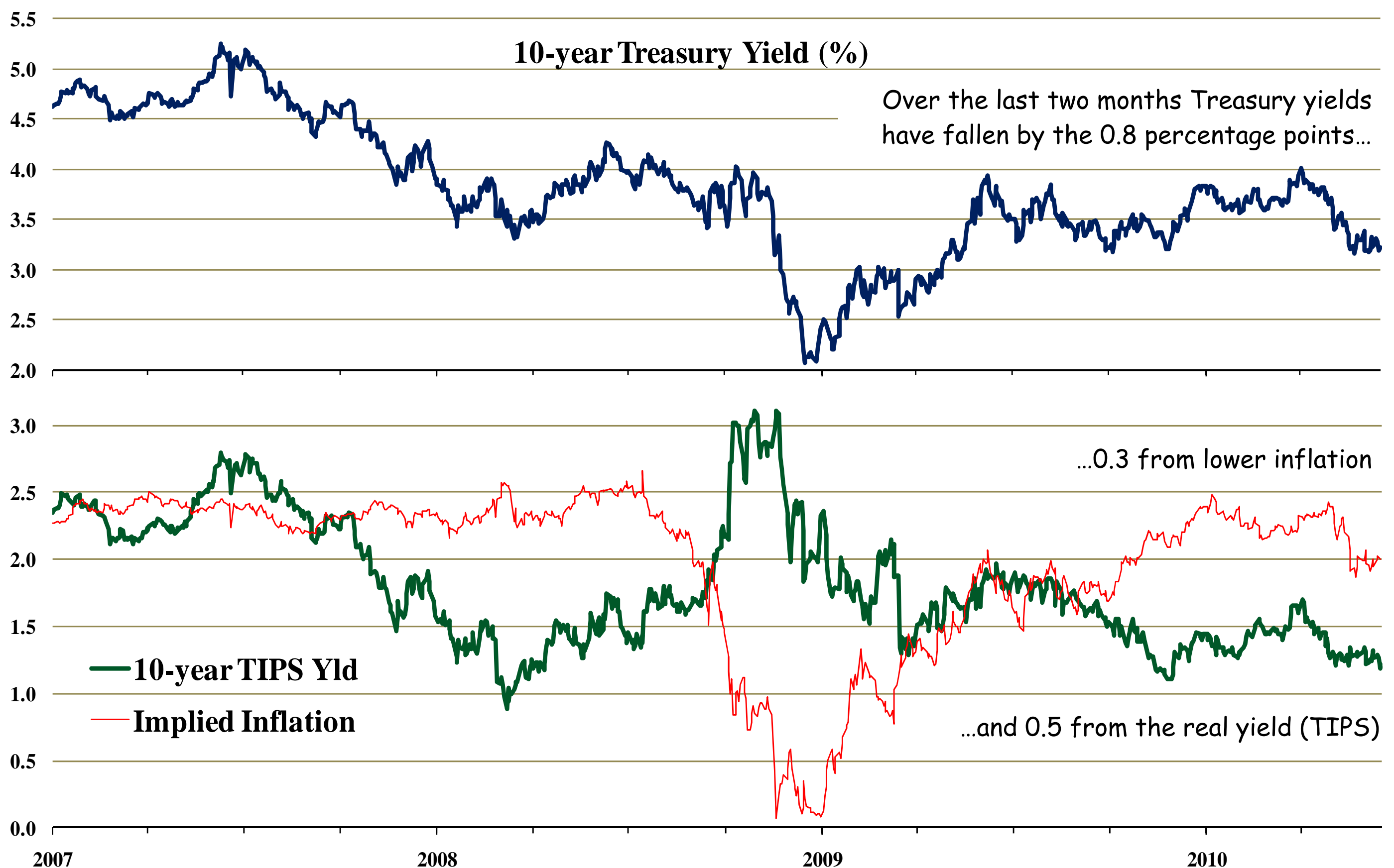
> "Sensible people believe that the biggest danger now is delaying fiscal tightening. They do so for four reasons. First, they fear that the financial markets, having turned on Greece, Portugal and Spain, will soon turn on the UK and even the US; second, they believe that deficits crowd out the private spending needed for recovery; third, they argue that high deficits must lead to inflation; and, finally, they believe fiscal deficits fail to support demand."

Wolf goes on to dismiss these concerns, arguing that fiscal deficits did help support demand (and prevent a depression). He concludes:

> "As long as output remains depressed, the fiscal support is most unlikely to be inflationary... Nor will it crowd out the private sector: it is more likely to crowd it in. The big question, then, is whether deficits can be financed. My answer is: yes... Markets do not trust in the political sustainability of hair-shirt economics. *It is not so much fiscal deficits as an inability to grow out of them that is worrying*... Fiscal stabilization that supports growth is welcome. Premature fiscal stabilization that undermines it is yet another folly." (our emphasis)

We agree and believe that growth, not deficits, is the greater concern. Fortunately, low rates allow government(s) to support growth as necessary, which is why we maintain our bullish fundamental outlook. So while the bad news is that low Treasury yields reflect poor growth expectations, the good news is that also means the government still has the ability to do something about it.

The Weekly Chart: Bonds price out inflation and growth



Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • www.riverfrontig.com
Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

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