THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu

September 7, 2010

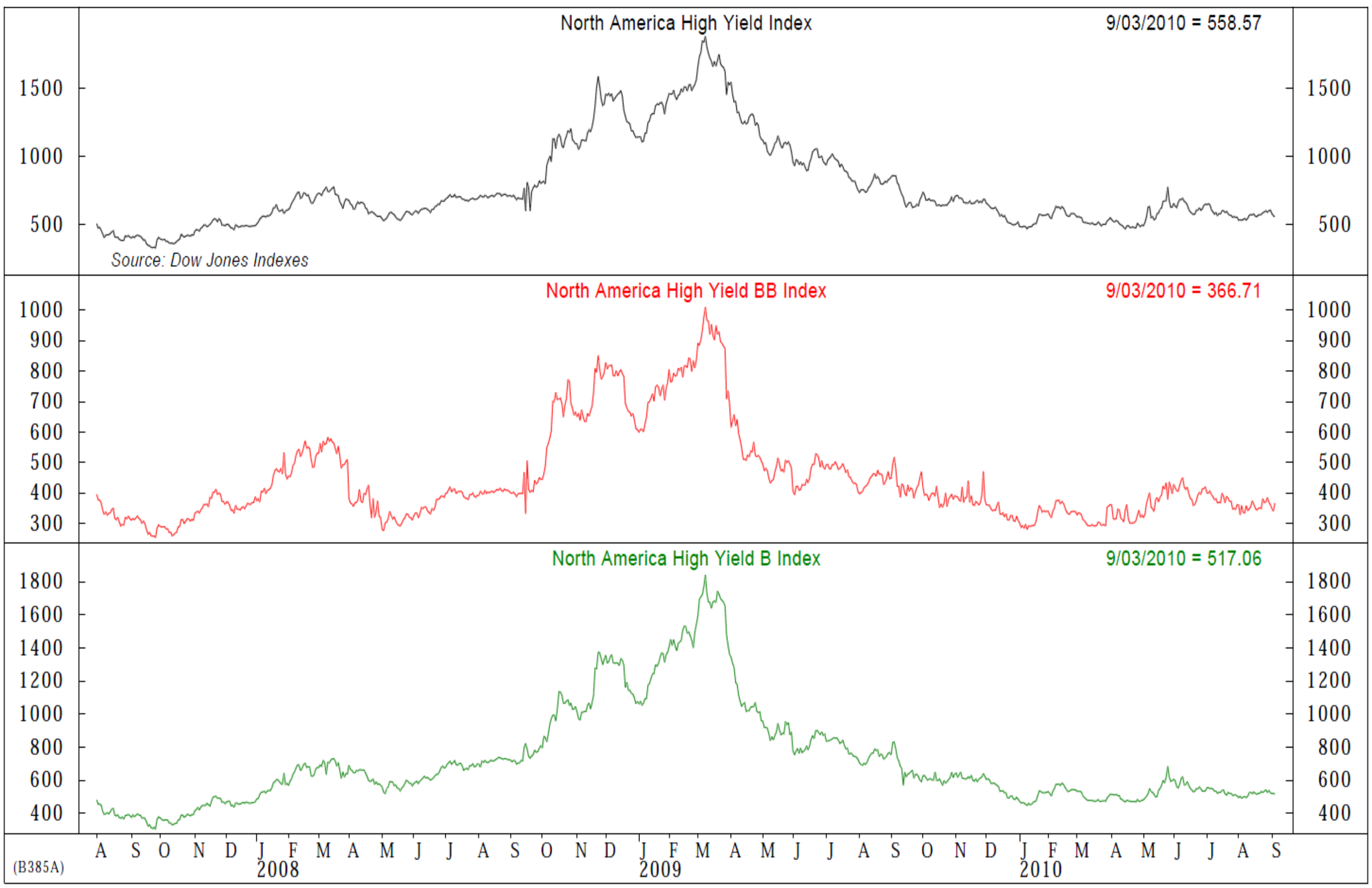
Decision Box Holds As Double-Dip Risk Diminishes

- Key data reported last week suggests that the economy is somewhat healthier than markets had expected. We think the data lowers the risk of a 'double-dip' recession and bolsters the case for the bottom of our decision box to hold — 1010 on the S&P 500 — but provides insufficient support for a breakout above technical resistance at 1140. Stocks rallied strongly and bond yields rose midweek after the Institute for Supply Management (ISM) manufacturing survey gained 0.8 points, to 56.3 in August, led by production and employment. Even Friday's release of the *non*-manufacturing survey, which showed a 2.8 point decline to 51.5 (a level over 50 generally indicates expansion) did not quash the rally, but illustrates the fragility of the current expansion since services represent a much greater share of the US economy (around 85%).
- Private nonfarm payrolls increased by 67,000 in August, more than consensus expectations of around 40,000. Moreover, the previous two months' job reports were revised higher by 123,000. Overall, however, private job creation has been meager, averaging only 78,000 over the last few months. This has not been enough to lower the unemployment rate, which ticked up to 9.6%. Furthermore, employment gains have been concentrated in health care and temporary workers; not the sign of a broad-based recovery.
- We think that the recent economic data still portrays an economy struggling with high unemployment, debt, and an oversupply of housing; we see nothing on the immediate horizon that might spur growth out of the low-demand mire. The only sources of potential demand are from emerging market consumption and strong corporate cash flows, which could be deployed beyond just merger and acquisition activity. Our portfolios are positioned for a sluggish recovery in the developed world and vibrant growth in emerging market economies, which we believe will sustain earnings for global companies. Our overall risk asset weightings are well below the levels of May 2009 to May 2010, but we are willing to maintain core stock exposure due to our belief in its longer term outperformance potential. In contrast, our bond portfolios are positioned defensively with short maturities and an overweight cash position.
- The 10-year Treasury yield rose to 2.7% as the week ended after briefly touching 2.4% intraday a week and a half ago. We think 10-year Treasury yields below 3% are consistent with an economic slowdown but that the odds of a recession rise as yields fall below 2.5%. Treasury bond purchases by the Federal Reserve may be distorting the bond market's message somewhat, but the Fed has stated it will only implement 'quantitative easing 2' if the economy worsens markedly. The Fed's challenge is that monetary policy is not effective in boosting growth when banks are reluctant to lend and borrowers to borrow. This is known as a 'liquidity trap' and is evident in the falling velocity of money (the rate at which money changes hands in everyday business transactions). We think the Fed will expand its balance sheet to sufficiently raise inflation expectations if economic conditions deteriorate. Whereas the Fed has thus far mostly utilized its balance sheet to help financial markets, we think they are feeling empowered to act more forcefully to bolster growth.
- Fiscal policy is the other macroeconomic lever and President Obama is now pushing for further fiscal stimulus. With such low Treasury yields, the cost of deficit spending is not currently a constraint — Charles De Gaulle called this a*n exorbitant privilege* which the US enjoys as the issuer of the world's reserve currency and its preeminent superpower. However, the current political environment and the public's budget concerns suggest that further major stimulus is unlikely before the November elections. Following the elections, further fiscal policy becomes more likely if the recovery is unable to gain momentum.
- Corporate bonds usually provide one of the better warning signals of a recession. This is probably because corporate bond investors get a small premium return in a healthy environment, but can lose substantially in the

event of default. We therefore monitor the difference in yield between corporate and Treasury bonds, known as the credit spread, to gauge the risk of recession. Given the “unusually uncertain” economic backdrop that Chairman Bernanke describes and the decline in Treasury yields since April, credit spreads remain remarkably stable and are well below levels that would indicate a double dip. This reflects credit markets’ confidence in the monetary and/or fiscal policy backstops for the economy in our view. High yield credit default swap (CDS) spreads, which reflect the cost of insuring against default, have remained mostly stable through the summer, around their current level of 558, amid a record pace of high yield debt issuance. Thus credit markets are signaling few economic concerns. Most corporations have had little trouble refinancing as cash flows have improved and balance sheets have strengthened. In sum, despite the recent economic soft patch, the drop in Treasury yields, and the lack of further imminent monetary or fiscal stimulus, we think the risk of a double-dip recession is not high enough to warrant a further de-risking of portfolios.

Weekly Chart: Stable credit spreads reflect few concerns

High Yield Credit Default Swap Spreads



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