THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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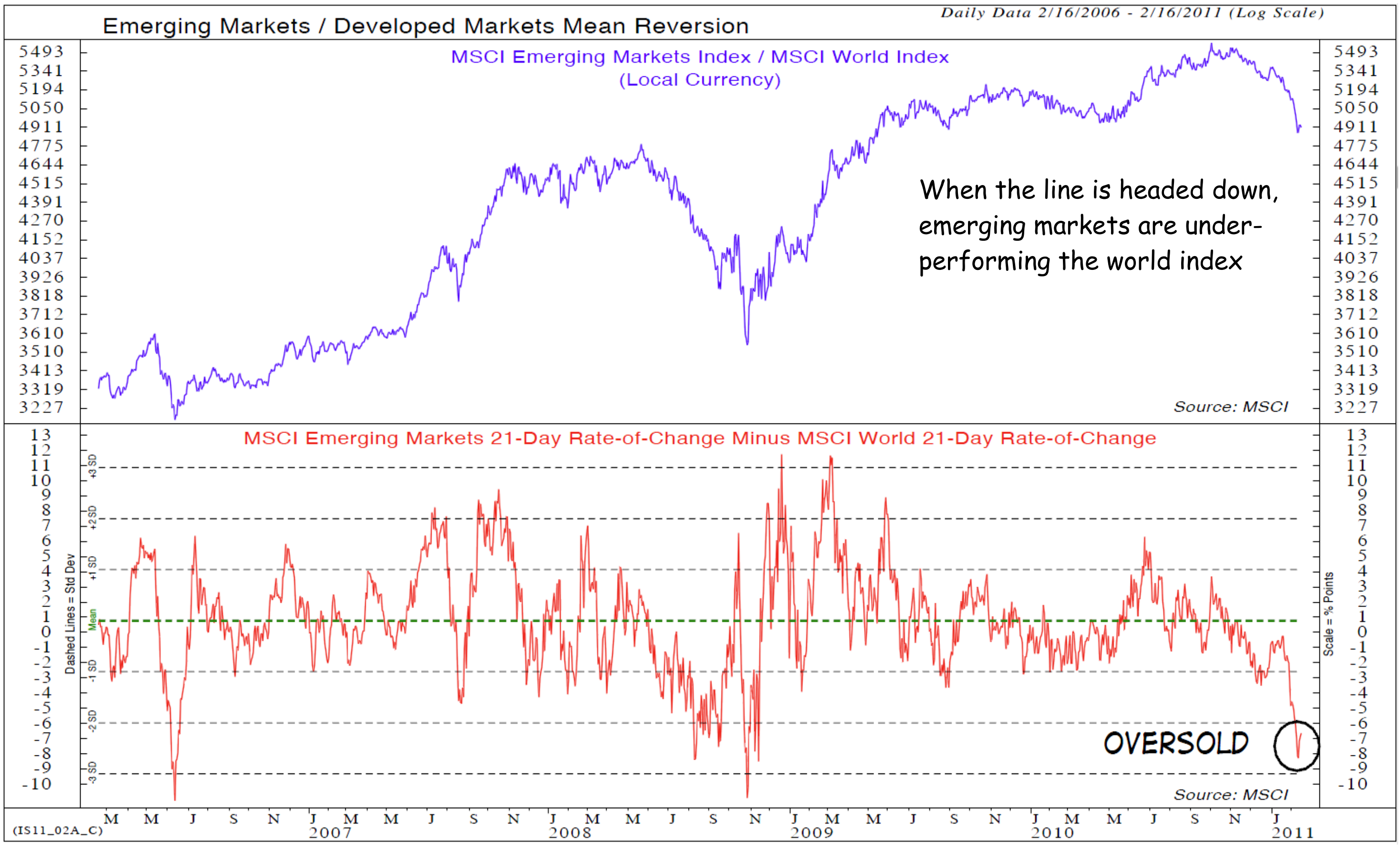
Germany Making Its Mark on the Eurozone

- A month ago we wrote that fiscal austerity measures in the Eurozone were further along than in the US, but we thought that faster US growth would mostly offset the near-term deleterious effects of Eurozone budget balancing, likely keeping the euro range bound versus the US dollar. However, we think that Germany's economic strength and its increasing dominance in Europe bolsters confidence in the euro's future. Ireland will be a test case, but we think debt restructuring is more likely than a euro breakup. Our view is evolving towards intermediate-term euro strength in light of the following recent developments.
    1) With signs of developed economies' inflation picking up, central bank responses are becoming increasingly differentiated. The Federal Reserve's clear focus has been on 'core' inflation. They do not see rising commodity prices producing sustained broad-based inflation, given high unemployment and unused capacity. Meanwhile, although we had expected the European Central Bank (ECB) to become less hawkish (since bond markets have imposed growth-reducing budget constraints) the ECB has instead become more hawkish, consistent with its sole mandate to keep inflation in check. Germany has emerged from the global financial crisis and great recession holding Europe's fiscal purse strings – they will write the largest 'bail out' check as the weaker members restructure debt. Thus, Germany is now exerting its influence. In exchange for financial support, Germany is requiring euro-adopters to accede to structural adjustments intended to reduce government deficits, raise efficiency, and improve overall Eurozone competitiveness. We view Germany's apparent deft political maneuvering, such as sacrificing its unofficial ECB presidency for backing on wider reforms, as a transparent attempt to remake the Eurozone in its own image (Deutsche Bundesbank President Axel Weber had until recently been the leading candidate to be appointed in October). Furthermore, the lead candidate now to head the ECB -- Italian central bank governor Mario Draghi -- has started to echo German demands for fiscal accountability and comprehensive crisis management. Draghi, a former vice chairman and managing director at Goldman Sachs International, is seen as more congenial than Weber, and hence likely to be more effective at an institution that requires consensus-building. In short, progress towards balanced budgets continues in the Eurozone and is ahead of the US and its states. We think this is supportive of the euro.
    2) The Fed has upgraded its assessment for 2011 US GDP growth to 3.4–3.9% last week (versus a previous estimate of 3.0–3.6%). We think this is too optimistic. As federal support for states is withdrawn, we believe state and local budgets will be increasingly taxed — in some cases literally — thereby diminishing growth nationwide. Budget conflicts at both state and local levels are coming to a head this year, as demonstrated in Wisconsin currently, and political consensus for resolution is uncertain. We see little potential for dollar strength until there is progress on budget impasses, which are already affecting sentiment towards municipal bonds, as investment has flowed out of the market. This is raising state and local funding costs, which will likely slow economic growth even further, particularly as falling home prices depress property tax receipts. Moreover at the federal level, although bond markets have yet to force any short- or long-term fiscal retrenchment, focus on budget politics has sharpened. Potential outcomes include spending cuts/tax increases or, if no compromise is reached, higher interest (and mortgage) rates as the US' creditors require higher risk premiums, particularly if alternatives challenge the dollars' reserve currency exclusivity.
- Stock market sentiment has again reached optimistic extremes, as measured by the Ned Davis Research Crowd Sentiment Poll as well as the Investors Intelligence Advisory Services Survey. Based on one of our key rules of portfolio management — *beware the crowd at extremes* — we believe optimistic sentiment reflects investor complacency and is a noteworthy condition for a stock market pullback/consolidation. As such a correction occurs, we think emerging markets will probably have a period of relative outperformance. Emerging market stock indexes

have diverged significantly from developed markets this year (see Weekly Chart) as many emerging market central banks have begun to tighten more aggressively to fight rising inflation. We think many emerging market central banks are still behind the inflation curve and until they get ahead, emerging market underperformance will likely continue. However recent underperformance has reached a magnitude that appears oversold and justifies at least a 'relative' bounce, in our view. Regionally, we believe Latin America is poised to be a relative outperformer among emerging markets because their central banks are generally in front of the inflation curve and thus better positioned to cut rates when inflation eventually subsides.

- The long-term potential of emerging markets as a source of global growth is well known. Positioning for that growth is less clear cut. We have been increasingly shifting our portfolios from direct exposure to more indirect plays such as globally-oriented developed world companies, commodity sectors/countries, and currencies of commodity-oriented countries. Once we think that emerging market central banks are getting inflation under control and/or developed market central bands signal less accommodation, we will likely return to a larger direct weighting.

The Weekly Chart: Emerging Market selling overdone short-term, but no sign of a relative upturn.



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Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation.

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