The Weekly View

RiverFront Investment Group

Asset Management • Investment Strategy • Advice

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

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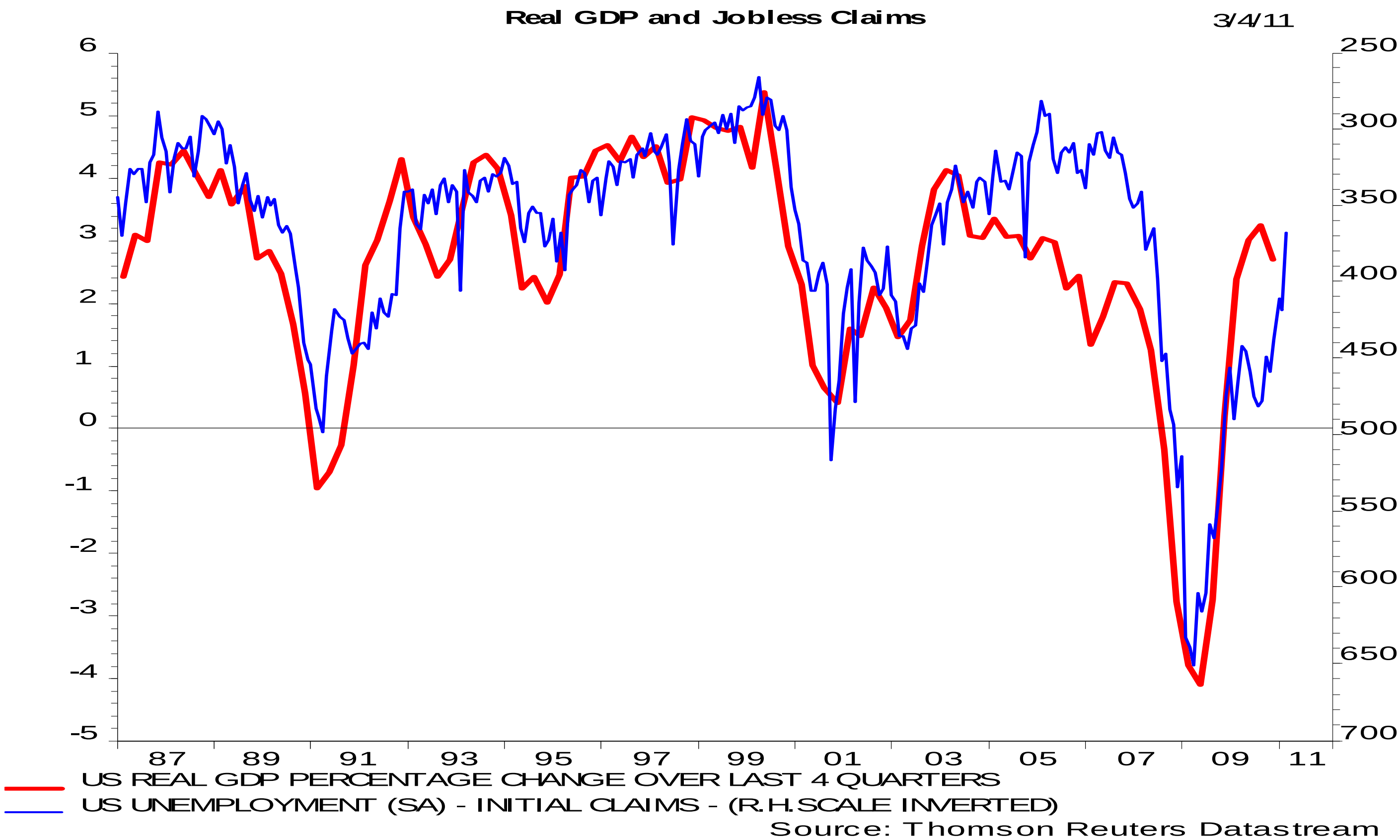
Good Economic News Not Good Enough For Markets Anymore

- Renewed mass demonstrations in Bahrain, escalating violence in Yemen and Libya, and potential unrest in Saudi Arabia (although still contained, in our view) are driving oil prices higher. Meanwhile, the risks to sustainable economic growth are rising as surging energy costs are overshadowing improving economic news in the US — as evidenced by the Institute for Supply Management (ISM) purchasing manager surveys and the Bureau of Labor Statistics (BLS) nonfarm payroll report released last week. With crowd sentiment still at optimistic extremes, we think rising oil prices will make it harder for stocks to rally to new highs. Furthermore, the expected June 30th end of the Federal Reserve's quantitative easing (QE) purchases is drawing nearer, adding to the stock market's concerns. QE has kept longer-term interest rates lower than they would have otherwise been, helping to support home prices and compress credit spreads. Last year, the S&P 500 fell by more the 10% after the Fed ended its first QE program and took off again when Ben Bernanke foreshadowed QE2 in an August speech at the Fed's annual Jackson Hole retreat.
- At this time, our best guess is that Saudi Arabia will be able to maintain production and make up for any shortfalls from other North African and Middle East oil exporters, holding West Texas Intermediate (WTI) to below $120 a barrel (Brent crude is likely to remain more volatile). We think the global economy will be able to cope with this scenario. However, we think growth would progressively slow if oil prices continue to rise and begin to approach a tipping point that could threaten another recession if prices move towards $145 per barrel, the July 2008 high. For the US, gasoline at $4 per gallon considerably altered consumer behavior in the summer of 2008, when spending on gasoline reached 4.1% of disposable personal income (DPI). ISI Group points out that since then, DPI has risen by 3.6%, so for gasoline to reach the same percentage of DPI, it would have to rise to $4.14. This is not our view at the moment, but a risk that investors should recognize is growing, given political instability and uncertainty in a key oil exporting region of the world.
- Rising oil prices have overshadowed positive economic news in the US. Both the ISM manufacturing and non-manufacturing surveys rose to new recovery cycle highs, signaling robust US growth, while the unemployment rate dipped below 9%, and yet stocks failed to rally on the announcements. In addition to oil, we think another major worry for investors is the expected cessation of the Fed's quantitative easing program at the end of June. With sustainable growth now becoming entrenched and job growth solid enough to reduce unemployment (see Weekly Chart) — long the missing ingredient that the Fed has stated is necessary for the economy to make a full recovery — investors must start looking forward to the gradual removal of extraordinary Fed accommodation. The Fed has already begun experimenting with ways to unwind its bloated balance sheet without disrupting markets, while expectations are growing that the Fed could raise short-term rates by year end.
- We think stocks should be able to continue rallying despite the Fed beginning to ease off from its extraordinary policy accommodation, but that the recent pace of appreciation (a 40% annual rate for the S&P 500) is more likely to be tempered as the second half of 2011 approaches. Good economic news no longer necessarily or unambiguously translates into gains for the market, in our view. Moreover, we expect less accommodative policy to be particularly bearish for bonds, both on an absolute total return basis and relative to stocks. We think 'normalized' 10-year Treasury yields could trade as high as 5% over the next year from current levels of about 3.5%, which would imply a 6.5% rate for 30-year fixed conventional mortgages. Higher mortgage rates, in turn, suggest further pressure on home prices as buyers and sellers adjust to maintain affordability. Credit spreads would also likely widen somewhat from near record lows, as investors who have 'reached for yield' find that their safety cushions are not as plush in a rising rate environment.

Dollar Losing Reserve Currency Market Share

In a comprehensive *Wall Street Journal* article last Wednesday, UC Berkeley economics professor Barry Eichengreen laid out some of the causes and potential consequences over the next decade of the US dollar ceding some of its overwhelming status as the world's reserve currency to competitors. We touched on some of this in *The Weekly View* two weeks ago when we became more bullish of the Eurozone and the euro — namely relative to the perceived safety of US Treasuries, which could become jeopardized if trade and long-term budget imbalances are not corrected. With 85% of foreign-exchange transactions still conducted in US currency and global trade in commodities almost entirely denominated in dollars, Eichengreen explored the impact of the dollar's share loss to credible alternative reserve currencies. For financial markets, he notes that the US dollar and Treasuries could become less attractive as safe-havens during periods of financial market turmoil; indeed the euro has appreciated by 3% versus the dollar since Egypt's protests began. US companies may lose the "convenience of using the same currency [when] paying their workers, importing parts and components, or selling their products to foreign customers [and] will have to cope with some of the same exchange-rate risks and exposures as their foreign competitors." For US households, prices of imported goods will rise and living standards will be reduced, and for the government, financing is likely to become more difficult. In light of US policymakers' inability to agree on how to reduce the deficit, we have no exposure to US Treasuries. Additionally, we recently trimmed our existing position of high yield bonds, which no longer have upside potential similar to stocks, in our view, due to their near-record tight spreads to Treasuries and our expectation for higher interest rates.

The Weekly Chart: Missing piece of recovery falling into place



Even more than the ISM surveys and the BLS' employment report, perhaps the most important economic news last week was weekly jobless claims' decisive break below 400,000 (thin blue line, right-hand *inverted* scale). Although this data is volatile, as illustrated in the chart, the trend in unemployment insurance claims is falling and correlates with year-over-year economic growth of around 3% (thick red line), which suggests the economy is in the process of making a full recovery.

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