Michael Jones, CFA – Chief Investment Officer / Rod Smyth – Chief Investment Strategist August 23, 2011

# Stuff Happens, but Price still Matters

*Policy mistakes have caused us to reassess 2012 earnings, economic growth, and asset price ranges. Short-term risks have risen, so have longer term return prospects, in our view.*

**Our *Mid Year Outlook* of just a month ago was based on the economic framework of "muddle through" and gave policymakers some credit for, at the very least, not making major mistakes. We therefore expected stock markets to hold their March lows, but they have not. In our view, the reason for the breakdown in stocks and the spike in bond prices is that US and European policymakers have recently made significant blunders and, as a result, have lost credibility with investors, consumers, and business leaders.**

**"Dogmatic ECB policy and the political paralysis among European governments are the biggest threats to the global financial system" writes BCA this week, and we agree. We think US politicians have added to the problems by taking entrenched positions, thus signaling to investors that they are unlikely to address US fiscal problems until after the 2012 elections. With the elections set to be a referendum on two very different views of fiscal policy, business decision makers will be making hiring and investment decisions without clear policy direction, likely making them more cautious.**

Having raised cash in early August as markets signaled a clear change of view, we spent the last weeks rebuilding a global economic outlook for 2012 and reassessing our shorter term market views in light of recent policy decisions. Our conclusion is that Europe is headed for recession, absent a dramatic and in our view unlikely ECB policy reversal. We think the US will see marginal growth with risks to the downside and that emerging economies will experience a shift in growth from investment to consumption as China alters its spending, while Brazil, India, and others are likely to cut interest rates. This shift would benefit global companies that produce consumable goods (including agriculture and energy) and hurt global producers of industrial/infrastructure capital goods.

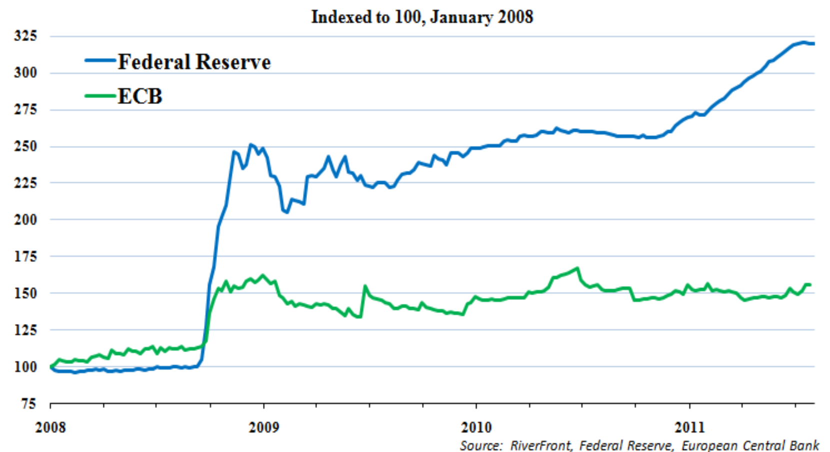
**Financial Market Outlook – Short term:** We see high volatility continuing in the short term and estimate that 2012 S&P 500 earnings will be around $80 and not the $100 that would be possible in a muddle through scenario. Versus the S&P 500's 1120 level on Aug 19, we anticipate a three-month trading range of 1020 to 1220 as investors assess the probability of a global recession and/or a European financial crisis. We expect a corresponding range for 10-year Treasuries of 2% to 3%. We think a break above 1250 or 3%, respectively, would signal an "all clear"; whereas a break below 1000 or 1.5% would indicate that investors expect another significant global recession. We expect Europe to underperform, but are opportunistic buyers of high quality stocks, emerging markets and high yield bonds, as we still believe policymakers and even the ECB will respond to deteriorating market and economic data. If we are right, then we think the Euro will fall, presenting us with a rebalancing opportunity and the chance to benefit from Euro weakness versus the dollar.

**Longer term:** In our Price Matters℠ work, the price declines in stocks have pushed large cap equities to more than 30% below their long term trend, a level of undervaluation from which stocks generated positive long term returns even in the depths of the Great Depression and average 5-year historical real returns exceeded 12% per annum over inflation. We therefore think a return to the S&P 500's previous high around 1550 is a very reasonable five-year target, offering stock investors 10% per annum nominal total return potential. Equally, recent price spikes by investment grade bonds suggest to us that fixed income investors are now at even greater risk of losing money after inflation. We believe these losses are likely to occur, not as a sudden loss due to rising interest rates, but rather as a steady erosion of principal as the Fed repeats its post WW II strategy of keeping interest rates below the rate of inflation for many years to come (witness the recent Fed announcement that its zero interest rate policy will be maintained for at least 2 more years). **The value of knowing your timeframe, investing accordingly and being willing and able to take a longer term view has rarely been greater in our opinion. We passionately believe that shorter term risk management can enable our clients to ride out market volatility, and thus remain long-term investors.**

**Economic Outlook In Greater Depth**

We believe policy announcements from both the US and Europe reveal a fundamental misunderstanding of the source of the problems and the path to potential solutions, and that this revelation triggered the sudden collapse in market confidence. In the US, business decision makers are seeking clarity on who will bear the burden of deficit reduction, and without clear policy direction are likely to assume the worst for their individual circumstances and be very cautious in spending and hiring decisions. The 10-year, $2.4 billion deficit reduction deal was too small to put the country on a sustainable fiscal path and defers the majority of its tax and spending decisions until this November. Thus, the budget agreement failed to resolve either short-term or longer term policy uncertainty, and the ugliness of the process signaled that true resolution of the US fiscal problems must await the 2012 elections. **This prolonged uncertainty and the subsequent stock market declines will likely depress hiring and cause US economic growth to decelerate from an average of approximately 2% to about 1%, with the odds of recession increasing substantially, in our view.**

European policy makers may have been even more unsettling to markets than their US counterparts. Investors are seeking a source of financing that is large enough to ensure that Spain and Italy will receive sufficient funding irrespective of market pressures. The only likely source for such funding is either significant European Central Bank (ECB) bond purchases or a "Euro Bond" mechanism that would allow the stronger European countries to provide an unlimited credit backstop to their weaker neighbors.




Thus far, the ECB purchases of debt have been far less aggressive than comparable purchases by the Federal Reserve (less than $200 billion compared to the more than $2 trillion in purchases by the Fed) and the ECB has stated that it will cease these purchases altogether once the European bailout fund is up and running. Although this bailout fund is far too small to ensure funding for Spain and Italy, the leaders of both France and Germany flatly rejected either increasing the size of the fund or establishing a Euro Bond program. Thus, Europe remains mired in a "Hoovernomics" combination of tight monetary and tight fiscal policies. **Absent substantial policy changes, Europe is likely to slip into recession in the coming months with the potential for fiscal and banking crises should any of the weaker economies determine that default on their debts is preferable to continued economic depression.**

**We believe that reaccelerating growth in emerging markets will somewhat offset declining growth in developed economies and prevent a second global recession.** For the past year, these economies have fought inflation through higher interest rates and other measures designed to slow their economic growth. As the adjacent chart indicates, the recent plunge in oil and other commodity prices suggests that food and energy prices will likely start falling on a year-over-year basis in the next few months. This silver lining in the recent market turmoil could deflate inflationary pressures in the emerging markets faster than anticipated. As the major emerging economies cease interest rate increases or, better yet, allow interest rates to come back down, this easing of emerging market monetary policy can provide a powerful source of global growth in 2012, in our view.

The primary risk to emerging market growth, in our view, stems from China's immediate need to transition away from growth driven by "investment" spending on infrastructure and real estate projects and toward consumption-led growth. Such a transition will not happen immediately, but China has signaled through tax policy and a slight acceleration in yuan appreciation that it is promoting such a transition more aggressively. The Chinese government has also identified low-cost housing as the area of investment that it will use as a bridge between the period in which investment and infrastructure spending declines and consumer spending ramps up. We believe that with ample foreign currency reserves China will successfully manage this transition at the cost of a higher value for the yuan. This transition would sharply alter the nature of China's demand for foreign goods, however, and the beneficiaries of the next phase of China's development (consumer goods, agricultural products, and energy) will be very different from the beneficiaries of the investment phase (capital goods manufacturers and industrial commodities).

**Summary: We expect a noticeable deterioration in global demand, especially for investment goods, and a corresponding decline in global earnings. The key to the extent of any further short-term downside in global stocks remains with policymakers, and we must be willing to remain flexible. We are positioned for some further stock market weakness and have the cash to take advantage of potential bargains in the asset classes we believe offer strong five-year risk-reward characteristics. This makes us opportunistic buyers of high quality stocks, emerging markets, and high yield bonds.**

The following table summarizes our views:

| | Policy Decisions | Economic Impact | Investment Strategy |
|---|---|---|---|
| *United States* | $2.4 trillion deficit deal increases fiscal policy uncertainty | Consumer and CEO confidence shaken, hiring remains subdued and growth decelerates to 1%. | High quality, global companies with substantial emerging market presence. Emphasize consumable products and deemphasize capital goods producers. |
| *Europe* | Rejecting all mechanisms that could backstop Italy & Spain. | Tight monetary & fiscal policy leading to recession, with risk of financial crisis. | Likely to be the worst performing equity market until ECB alters its policies. |
| *China* | Tax cuts and accelerated yuan appreciation likely. Investment emphasis shifting to low-cost housing. | Seeking to accelerate consumption and wean economy off spending on infrastructure & investments. | Transition in purchasing from hard commodities and industrial infrastructure to consumer products, agricultural goods and energy. |
| *Emerging Markets* | Fighting inflation for the past year. Declines in energy pricing should allow interest rates to decline. | Potential reacceleration in emerging market growth could prevent renewed global recession. | Equity markets offer the most attractive long-term growth opportunities as interest rates decline. |

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RiverFront uses earnings consistency and balance sheet strength to define quality.

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