THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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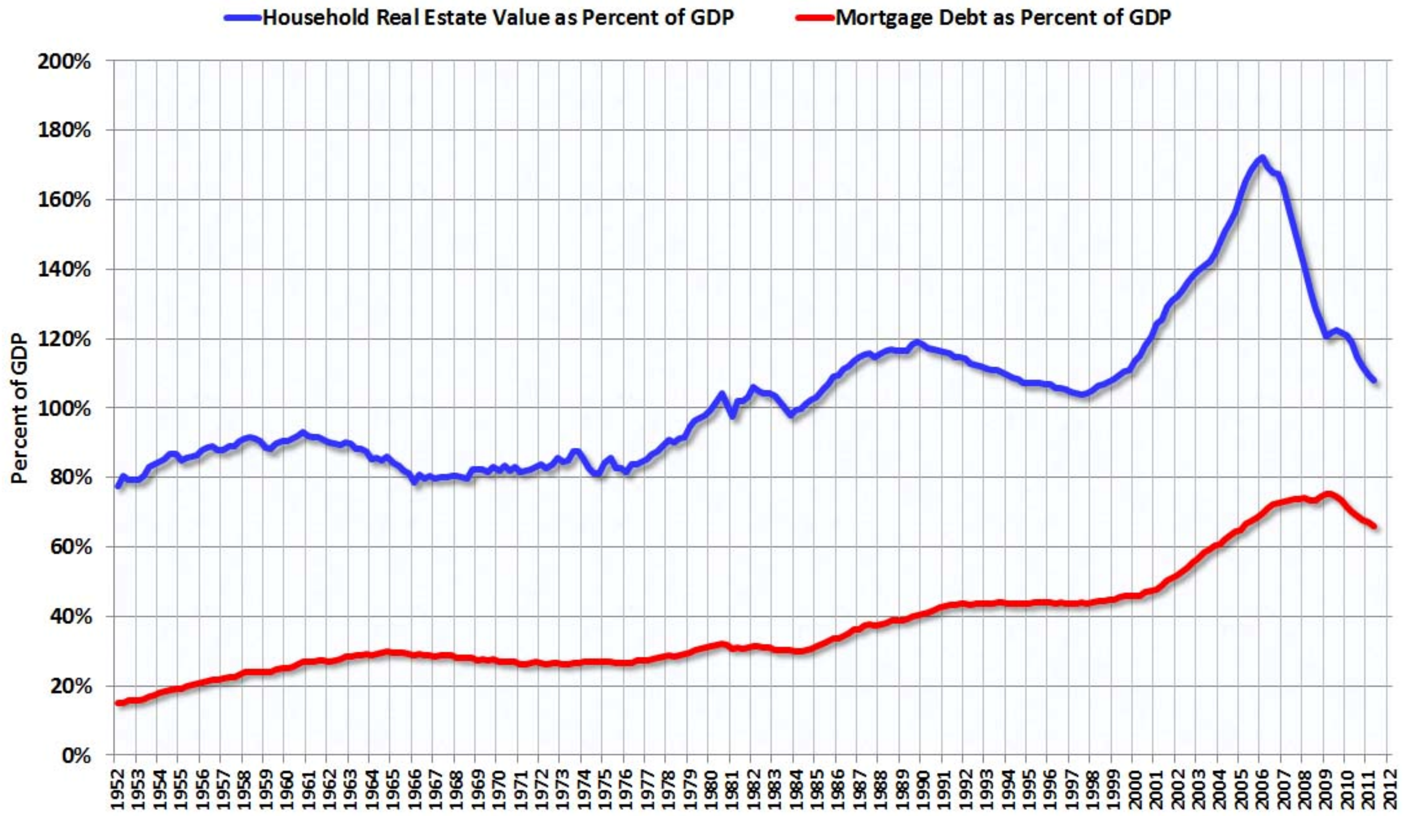
A Way But Not the Will

- European finance ministers gathered over the weekend at the prompting of US Treasury Secretary Timothy Geithner, who urged greater coordination among the Eurozone's myriad financial institutions: "What is very damaging [in Europe] from the outside is not the divisiveness about the broader debate about strategy, but about the ongoing conflict between governments and the central bank, and you need both to work together to do what is essential to the resolution of any crisis... Governments and central banks have to take out the catastrophic risks from markets... [and avoid] loose talk about dismantling the institutions of the euro." Despite Secretary Geithner's admonishments, European policymakers made no progress on the main issue, which in our view is that monetary union without fiscal union is no longer tenable.
- To move beyond the current bear market in European risk assets, we believe the sovereign debt of all members (after some write downs) will need to be underwritten by the collective in the form of pan-euro bonds, and perhaps funded in the short term by the ECB. One viable solution could be the ECB announcing its willingness to cap funding costs for Italy and Spain, which would eliminate a potential nightmare scenario of Italy defaulting, should its funding costs reach a tipping point (Greece, Portugal, and Ireland all ran into trouble when their 10-year interest rates exceeded 7%). Italy's benchmark 10-year bond yields have risen to 5.5% from 3.9% a year ago. Italy has the world's third-largest debt market with more than $2.2 trillion in debt, larger than that of Spain, Greece, Portugal, and Ireland combined and more than a quarter of the country's debt will mature by the end of 2012. We believe Europe has ways to tackle its problems, but not the political will to act. Therefore we remain in a 'show me' mode, as we do not think European policymakers have moved far from their 'let's protect our own' attitude.
- FedWire, a news service of the Federal Reserve, recently published a bulletin reporting that, "Fed Chairman Ben Bernanke has asked Philadelphia Fed President Charles Plosser and Chicago Fed President Charles Evans, two intellectual adversaries, to work with Vice Chairwoman Janet Yellen on how the Fed can better explain its economic goals to the public. One issue high on the agenda: Detail what changes in unemployment and inflation it would take to make the central bank veer from its low interest-rate policy, according to people familiar with the matter." According to the *Financial Times*, this amounts to a preview for Wednesday's FOMC announcement: "Specifically a commitment to keep the federal funds rate at its current level until the unemployment rate has fallen to 7 per cent-7.5 per cent, provided core inflation does not exceed 3 per cent." Rather than a specific timeframe of committing to zero short-term interest rates (through mid-2013), this would make monetary policy more conditional upon the labor market's health, which we would view as a further easing from current circumstances (as long as core inflation remains anchored).
- Although we continue to think the odds of a US recession hang in the balance, a growth slowdown is increasingly evident for the US economy. One of our favorite coincident economic indicators, the four-week moving average of initial jobless claims, is beginning to creep higher again, although it is still consistent with modest GDP growth. Regional manufacturing surveys in New York and Pennsylvania improved somewhat in September, but continued to indicate overall contraction in activity for the second month in a row and suggest a below 50 reading for September's national ISM manufacturing index when it comes out in two weeks. Retail sales stalled in August and trade activity, as measured by statistics from the Port of Long Beach (the largest port in the US), has weakened in three of the past four months, with container shipments off 11.2% from last year. Small businesses also continue to languish, with their outlook for business conditions six months from now dropping to its lowest level since 1980.
- As we wrote last week, evidence of a growth slowdown justifies a policy response, in our opinion. But while we think further monetary easing is almost certain at this point, as telegraphed by members of the Federal Reserve's operating committee, we doubt that it will be very effective, as even Chairman Bernanke has acknowledged. In

contrast, President Obama has proposed a fairly aggressive plan for fiscal stimulus amounting to about 3% of GDP, but fundamental political disagreements over its long-term consequences — whether it will provide a bridge to sustained growth or simply lead to higher debts — makes its passage unlikely, in our view.

- We think the status of household balance sheets is a greater concern. According to the Federal Reserve's Flow of Funds report released last Friday, household net worth fell $149 billion, to $58.5 trillion, during the second quarter (and will likely fall further in the third quarter). Although $8.9 trillion above its 2009 trough, it remains 11% below its $65.9 trillion peak in 2007. Much of this loss can be attributed to declines in household real estate values (see Weekly Chart). Until the associated mortgage debts are retired, we are skeptical that a durable expansion can be sustained regardless of the policy responses from governments and central banks.

The Weekly Chart: Debt overhang lingers over households and banks



Household real estate values have fallen $6.6 trillion from 2006 peak levels, to $16.2 trillion in the second quarter, which is a little over 100% of GDP (blue line in the chart). However, mortgage debt has only fallen $678 billion from its 2009 peak to about 65% of GDP (red line). This suggests several more years of deleveraging and billions more in losses from foreclosures and write downs before household debt burdens decline to more normal (and sustainable) levels. To accommodate this transition, the Fed has reduced short-term interest rates to zero, which has helped conventional 30-year fixed mortgage rates decline to a record low 4.1% for creditworthy borrowers. While reducing interest costs in this manner has provided some relief for households, homeowners' equity in their real estate is still near record lows at 38.6% (until 2008, it had always been well above 50%). Since roughly 30% of owner-occupied households have no mortgage, that means the approximately 52 million households with mortgages have far less equity in their homes. Indeed, about a quarter of them are 'underwater' with negative equity. We view this as an ongoing problem for banks, especially to the extent that government mortgage agencies are able to 'put back' bad loans to their originators (and/or sue them) to defray taxpayer expenses.

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