THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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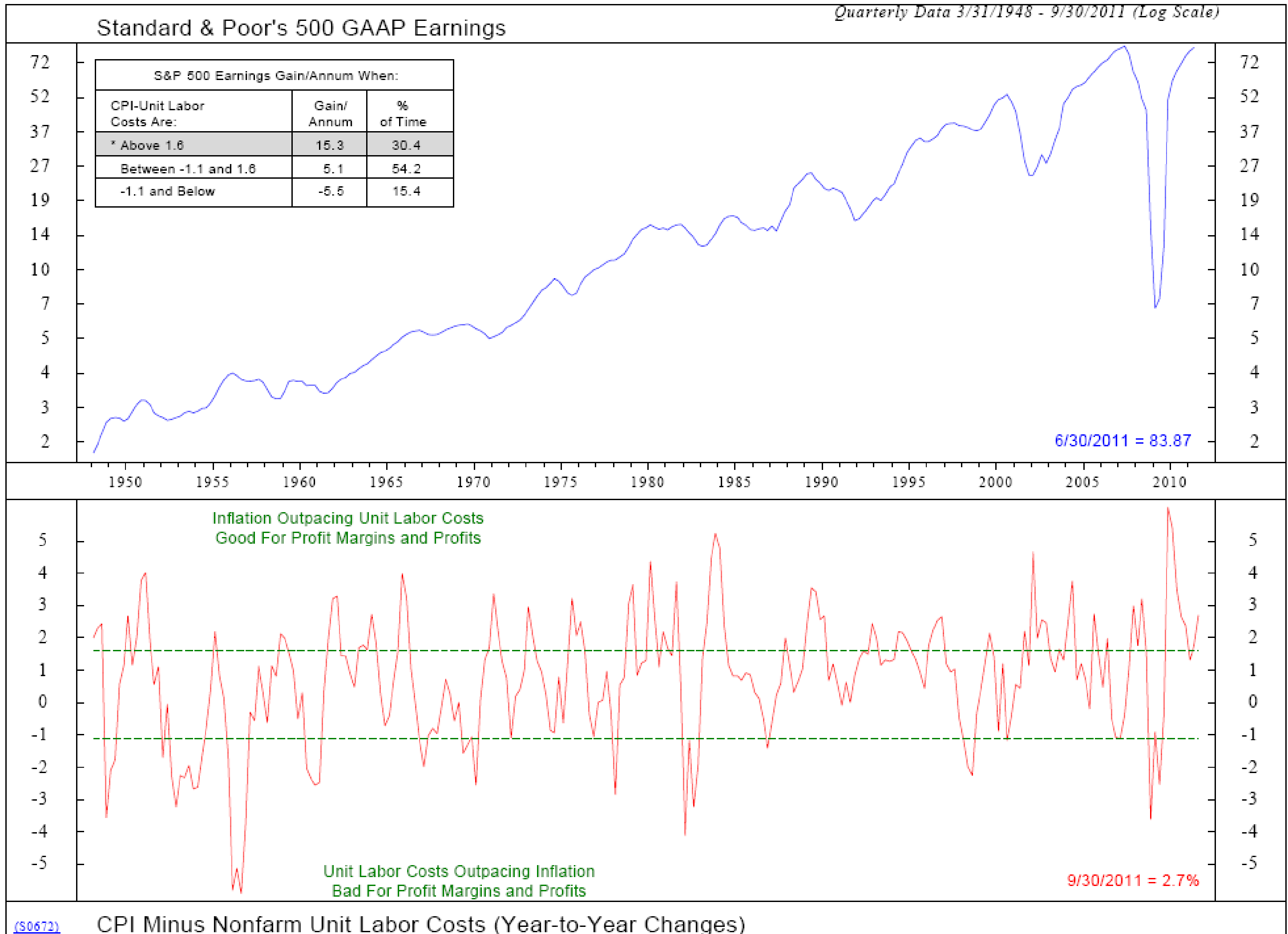
Lowering European Weightings

- We cut our direct exposure to Europe in our portfolios last week. This was a reversal of recent additions, but conditions have changed markedly from just a few weeks ago, in our view. Our rationale is as follows:
    1. The late-October Merkel-Sarkozy plan, which appeared to set Europe on a better footing, has stumbled over funding the proposed €1 trillion stabilization fund. Policymakers lost critical momentum over the Greek referendum fiasco, and the ECB chose not to use aggressive quantitative easing to prevent an untenable rise in Italian, French, and Spanish bond yields. Confidence has fallen amid political squabbling, and now the European Financial Stabilization Fund appears unable to issue bonds to provide relief.
    2. The stress test imposed on European banks, while credible, is also causing concern. The banks are required to substantially raise their capital ratios by next summer – a good and prudent step – but appear to be having difficulty raising private capital. Rather than turn to the government, banks are choosing to de-lever and we suspect have become the main sellers of Italian, Spanish, and other euro sovereign debt. With the ECB buying reluctantly rather than assertively, the 'game of chicken,' which we described last week is resulting in a self-fulfilling loss of confidence.
    3. The Merkel-Sarkozy axis has split over the stance of the ECB. As far as we can tell, the ECB's strategy is to maintain a near-crisis environment in order to force structural economic change. This could have long-term benefits, but carries significant short-term economic risk. We think Europe is in recession, which will intensify as taxes are raised and deeper cuts are made to public services.
- While European and emerging markets broke below technical support levels, US stocks have generally shown relative outperformance — falling less — but are also flirting with technical support. Given the S&P 500's close below 1220 last Friday, we need to see 1190 hold as support to confirm our view that the lows of the year were made in October. Fundamentally, US economic data has been supportive, particularly with weekly initial jobless claims' four-week average falling below 400,000 for the first time in seven months. This suggests ongoing gradual improvement in labor markets, which is necessary for sustainable economic expansion next year and beyond, in our view. October retail sales, excluding gasoline, rose 0.7% and are up 6% year over year — a strong start to the fourth quarter, which likely reflects further GDP growth. Meanwhile, the Philadelphia and New York regional manufacturing surveys for November suggest that national manufacturing activity continues to expand, albeit slowly. This was supported by a 0.7% increase in October industrial production. Despite considerable uncertainty, this shows that managers have some confidence to make capital expenditures and invest in their businesses.
- Unfortunately it appears unlikely that the congressional super committee, tasked with reducing budget deficits, will agree to a plan by November 23 (which would be voted on December 23). Without a plan, automatic reductions are triggered, but only starting in 2013, notably after both the elections and the expiration of Bush tax cuts. If Congress does nothing, the trigger permits the debt ceiling to be raised, thereby avoiding a repeat of a potentially destabilizing (and unnecessary) default, which led to the super committee's establishment in the first place. Barring a last minute deal, it looks as though the 2012 election's budget battle lines have been drawn: both sides claim to recognize the need for credible deficit reduction, but they remain deeply divided on the balance between spending cuts, Medicare overhaul, and tax hikes/reform. Since expectations for the super committee have been low, market reaction to their failure to reach agreement may be less than last summer's impasse, but it is still disappointing.
- With the US economy growing and US corporate earnings at record levels (see Weekly Chart) while Europe is entering recession, we think much of the hope for global growth in 2012 lies with China's policymakers. Chief Investment Officer Michael Jones tackled this issue in the *Strategic View*, 11/14/11. We conclude that China has the wherewithal and incentive to prevent a hard landing for its economy. Seeing evidence that their 2010/11 tightening

is having its intended effect at dampening speculation, China's monetary authorities are becoming less restrictive, in our view, and are now eyeing the European-led global slowdown. As long as inflation does not rise unexpectedly, we expect China (and other emerging markets) to loosen their tight grip on credit and encourage growth, although probably not as recklessly as in 2008 and 2009. Some emerging market countries, such as Brazil and Indonesia, have already begun the process of undoing tightening measures enacted earlier in the year. Frustratingly for us, emerging markets have been among the worst performers in 2011. However, we are more hopeful for emerging markets in 2012 as earnings have grown and valuations have fallen below those in the US. As soon as we see signs of durable relative strength, we plan to raise weightings.

The Weekly Chart: Low labor costs support profit growth



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Labor accounts for around 70% of US business costs, so when employment costs are low and productivity — output per hour — is high, US profit margins and profits tend to do well, which should eventually lead to more investment, hiring, and growth. Unit labor costs have risen 1.2% over the last 12 months through September, well below the 3.9% rate of inflation. As seen in the bottom panel, the 2.7 percentage point difference means that reported S&P 500 earnings are likely to remain elevated.

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