THE Weekly View

RIVERFRONT INVESTMENT GROUP

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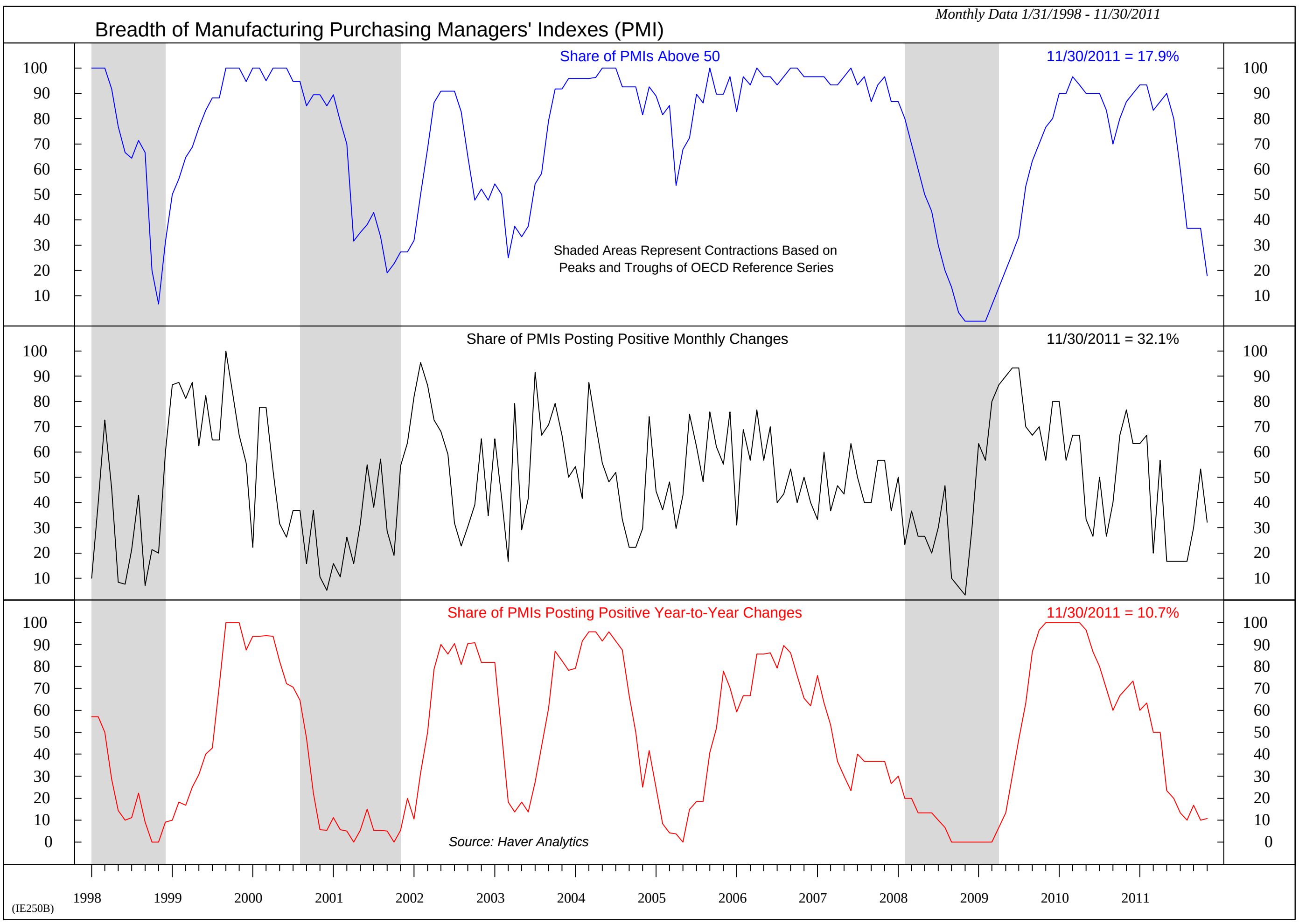
Austerity First, Then ECB May Act

- Europe is still playing a dangerous game of 'chicken,' as its leaders seek to forge an ambitious, centrally enforced debt reduction plan, which we think will result in a multiyear economic depression for debt-burdened countries (the PIIGS). French President Nicolas Sarkozy said last week, "there can be no common currency without economic convergence... It must be made clear that a debt of a euro member will be repaid." The French/German alliance knows the banking system can't afford another bailout along Greek lines. It also seems clear that before the European Central Bank (ECB) will support Eurozone bond markets, countries will have to surrender budget sovereignty to a centralized authority; ECB President Mario Draghi has said that without fiscal union its bond purchases (quantitative easing) "can only be limited." Germany and the ECB are driving a hard bargain, and while investor sentiment has swung from fear to hope as German Chancellor Angela Merkel, Italian Prime Minister Mario Monti, and Sarkozy seek to forge a grand fiscal plan, the hard work of agreement and enforcement is still ahead. The problem is that without a common electorate and 'federal' taxing authority (as in the US) enforcement across the Eurozone must rely on treaties that have yet to be enacted. We are underweight Europe, but believe that European bond market stability and progress towards enforceable fiscal rules will likely allow global stock markets to move higher.
- The S&P 500 rose 8% last week to 1244, and flirted with its 200-day moving average — currently 1265 and falling — as US economic data continue to show slow growth and marginal labor market improvement. The rally was ignited by coordinated action among the world's main central banks — the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Swiss National Bank, and the Federal Reserve — to ease dollar funding. Although helpful, central bank actions to provide dollar liquidity are not a replacement for long-term funding solutions and structural adjustments, in our view. The coordinated nature of the move allowed investors to begin pricing in the possibility of global monetary reflation. However, the ECB has to join in to make this action credible.
- China also started to ease last week, lowering its reserve requirement ratio by half a percentage point to 21% for large commercial banks (17.5% for smaller banks). This was its first cut in almost three years, and we believe that it marks a shift in policy that could produce further easing if economic growth and inflation slows further, particularly if European recession becomes contagious. Beyond monetary policy in China, BCA Research notes that: "fiscal policy will play a much bigger role than monetary in boosting growth this time. There has been a slew of fiscal easing policies in recent months: income tax cuts, tax reductions for micro-firms, tax reforms for the service industry in certain cities, and most recently an increase in allowance for low-income households. Moreover, public-sector capital spending will likely ramp up again in the coming years." We expect that reforms for rebalancing away from investment and export led growth towards a more consumption- and service-oriented economy will accelerate with next March's leadership transition. In the meantime, judging by China's stock market, which is notably underperforming the rest of the world, policymakers in China are acting too timidly.
- The US economy's slow expansion is continuing despite Europe's troubles — the US purchasing manager index (PMI) for manufacturing strengthened in November despite contraction in much of the rest of the world (see Weekly Chart) while US employment growth accelerated. The US' PMI rose 1.9 points in November to 52.7, while its leading new orders component climbed 4.3 points to 56.7, suggesting further growth ahead. Moreover, the export component increased 2 points to 52, while imports fell half a point to 49, suggesting that US trade continues to improve. Incidentally, the *Wall Street Journal* reported last week that the US is, "on track to be a net exporter of petroleum products in 2011 for the first time in 62 years." On the jobs front, nonfarm payroll employment increased 120,000 in November, while the prior two months were revised higher by 72,000, bringing the three-month average to 143,000. Furthermore, improving job growth is starting to help the unemployment rate, which dropped four-tenths of a percentage point to 8.6%. However, about half of this drop was due to a decline in the

labor force participation rate, which at 64% is the lowest since the 1980s (it peaked over 67% in the late 1990s) — adult male attrition is the biggest factor here, whereas its rise was mostly due to increased female participation beginning in the 1970s. The bottom line is that payroll employment remains well below its 2007 peak, but gradual improvement is likely as long as the economy continues to expand. Thus we finish where we started, namely that Europe is still central to the direction of global stocks and we think any agreement that does not result in permanently lower Italian and Spanish bond yields will fail. The stakes are high and talk is easier than action, so we are not fully invested in international stocks and continue to hold around 10% cash.

The Weekly Chart: Most of the world is slowing



The chart highlights contraction in most of the world's manufacturing purchasing managers' indexes, which are based on monthly surveys intended to provide an advance indication of economic activity by tracking changes in production, new orders, inventories, employment, and prices. While November's US manufacturing PMI was 52.7, only 17.9% of the PMIs reported globally were above 50 (a reading above 50 indicates expanding activity). Also unlike the US, only 32.1% of these global PMIs rose in November, as shown in the middle panel. This highlights the difficulty much of the world will face regarding economic growth in the face of the fiscal austerity that will accompany any agreements the Eurozone is able to cobble together.

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