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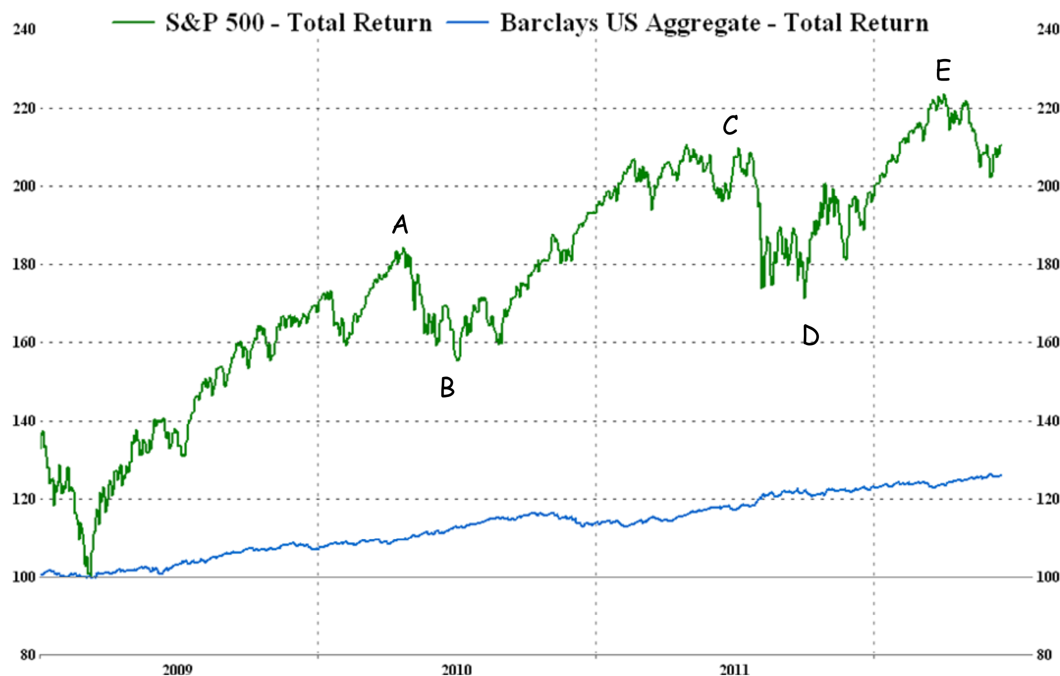
THREE STEPS FORWARD, TWO STEPS BACK

The S&P 500 has established pronounced annual patterns of returns since it bottomed in early 2009: Money printing by the Federal Reserve and/or the European Central Bank (ECB) ignites a 30–40% rally. The rally runs into resistance in the summer due to both a fiscal crises in the US – end of stimulus in 2010, debt ceiling fiasco and ratings downgrade in 2011, fiscal cliff in 2012 – and the same set of unresolved problems in Europe (Greece, Ireland, Portugal, Italy, and Spain). These concerns prompt a sell-off that has retraced one-half to two-thirds of the prior market gains until another round of money printing restarts the process with a market rally.

Although this 'three steps forward, two steps back' pattern has caused unsettling amounts of volatility, the S&P 500 has more than doubled since the market low of 2009 (see chart below). By contrast, fixed income investments have only returned about 25% over that same time period (based on the Barclays Aggregate Bond Index). Now that almost every major fixed income asset class is trading at record low yields (the Barclays Aggregate yields 1.9%), bonds are mathematically unable to continue generating even this modest level of return. As an extreme example of the limited upside available to bonds, **if the yield on the Aggregate dropped to 0%, bonds would only produce a price gain of approximately 9%.**



A. Euro crisis and US fiscal issues
B. Fed prints $
C. Euro crisis and US fiscal issues
D. ECB prints €
E. Euro crisis and US fiscal issues

Source: FactSet Research Systems; Past performance is no guarantee of future results.

We have argued that because 'three steps forward, two steps back' pattern has become so ingrained in investor expectations, the 2012 summer pullback is likely to be a more normal 5-10% correction rather than the 20% market declines of 2010 and 2011. Many investors have come to expect a central bank response to market declines and fear missing another rally after the money is printed. Thus far, our forecast has proven correct, with the S&P 500 finding support about where we expected at 1266 (near its 200-day moving average). Expectations of central bank policy have become so intertwined with financial markets that a mere *rumor* of coordinated central bank intervention prompted a 1-2% rally late last week.

Although our scenario appears to be playing out, we must acknowledge that markets face a series of key events over the next few weeks: formation of a new Greek government, details of the Spanish bank bailout, and news regarding China's stimulus plans (if any). **We believe that each of these events must be resolved positively for our scenario to hold or, in the case of a bad outcome, be met with immediate and decisive money printing by a major central bank** (the ECB and/or the Fed). If events turn out worse than expected and central bank intervention is delayed, then investor faith in the 'three steps forward, two steps back' could be shaken and support levels tested.

Formation of a new Greek Government

The New Democracy Party's victory lessens the chance that a Greek exit from the euro is imminent, but its euro membership remains questionable unless party leaders can assemble an effective governing coalition. New Democracy and likely coalition partner PASOK have received voter support to adhere to the bailout conditions, and European decision makers are likely to ease some of the more onerous terms of Greece's austerity package. However, markets want to see a coalition government that not only pledges support for the bailout agreement but actually implements its terms.

We do not believe that a Greek exit from the euro represents much of a direct threat to the global banking system – most of the Greek debt held by banks was written off during last summer's debt renegotiation. However, subsequent to the collapse of Lehman Brothers and AIG, market attention immediately turned to the next most vulnerable members of the financial system (Wachovia and Merrill Lynch). If Greece cannot form a government that will enforce the terms of its bailout agreement, depositors will likely continue to flee Spanish and Italian banks and their government borrowing costs will continue to climb. Containing this Greek contagion is likely to require that the ECB announce renewed large scale Long Term Refinancing Operations (LTRO) (more printed money).

Effective Spanish Bank Bailout

Last week Spain received the promise of a €100 billion loan to finance a recapitalization of its banking system. The good news was the loan's size (about twice market expectations) and the fact that it came without the imposition on the Spanish government of further budget cuts and tax increases. This is the first time Germany has allowed money to be pledged without additional austerity requirements. The bad news is that virtually no details of the bailout plan have been released, causing markets to assume the worst given the dismal track record of European decision makers during this crisis. Spanish bonds yields have soared since the bailout announcement and anecdotal reports suggest that bank depositor outflows have accelerated.

European leaders need to announce details of the bailout plan in the immediate future, in our view. Investors are skeptical that Spain can support its existing debt burdens and the additional borrowing required to bailout its banks. This skepticism was reflected by falling bond prices and multiple credit rating downgrades after the bailout announcement. Thus we believe when the bailout's details are unveiled, the structure must reassure investors that the banks, not the Spanish government, will service the debt. To provide such assurance, we believe that the bailout money needs to be senior to both existing shareholders and bondholders.

Subordinating existing stock and bond investors to the bailout money creates a strong incentive for banks to repay the debt and provides for a substantial capital cushion to protect the Spanish government against potential losses. Bank shareholders and bondholders will suffer significant losses under this structure, but that should be expected for investors

in companies that need a government bailout (the US was ruthless in its treatment of Citicorp preferred stockholders and GM and Chrysler bondholders). Without a structure that reassures investors that the Spanish government will not have to repay the bailout loans, Spain could face a continued downward spiral in its ability to borrow in the capital markets. Existing bailout mechanisms are not big enough to compensate.

Europe has the US bailout programs as a guide and the plummeting value of Spanish bonds as a warning. Thus we expect the details of the bailout structure will provide essential protections for Spanish sovereign bond holders. If European decision makers fail the relatively simple task of structuring an acceptable bank bailout plan, then Spain could quickly lose its ability to sell bonds in the private market and the ECB will have to resume purchases of Spanish bonds quickly and on a large scale (more printed money). To provide more than just short-term support to financial markets, these bond purchases should occur within a larger bailout mechanism (such as allowing the European Stabilization Fund to borrow from the ECB).

Chinese Stimulus Plan

Markets have responded strongly to each episode of money printing by major central banks because aggressive money creation has played a critical role in solving past debt crises. Printing money ensures that a government has the cash to meet its obligations, essentially substituting a slow default through currency devaluation and inflation for a more immediate and disruptive outright default. The US and UK have embraced this option and markets are hopeful that Europe will as well. However, printing money by itself cannot generate economic growth.

After four years of subdued spending, US consumers are helping drive global economic growth thanks to lower debt burdens and improving housing markets. However, improved growth prospects for US consumers are needed to offset almost certain US fiscal tightening in 2013 and thus cannot be the sole support to the global economy. To reassure markets that the global economy will avoid recession in 2013, we are expecting China to announce further stimulus policies in the near future.

After our trip to China late last year, we concluded that China faced a real estate bubble similar to the US savings and loan crises of the late 1980s and early 1990s. We believed that the aftereffects of this bubble would subtract several percentage points from China's GDP but that, if the government eased monetary policy in a timely manner and provided sufficient stimulus, the Chinese economy would respond and an economic hard landing would be avoided. Last week, China finally accelerated its stimulus efforts with its first interest rate reduction in four years and an easing of financial regulations. However, these moves are not likely to be sufficient to counter current economic trends in China.

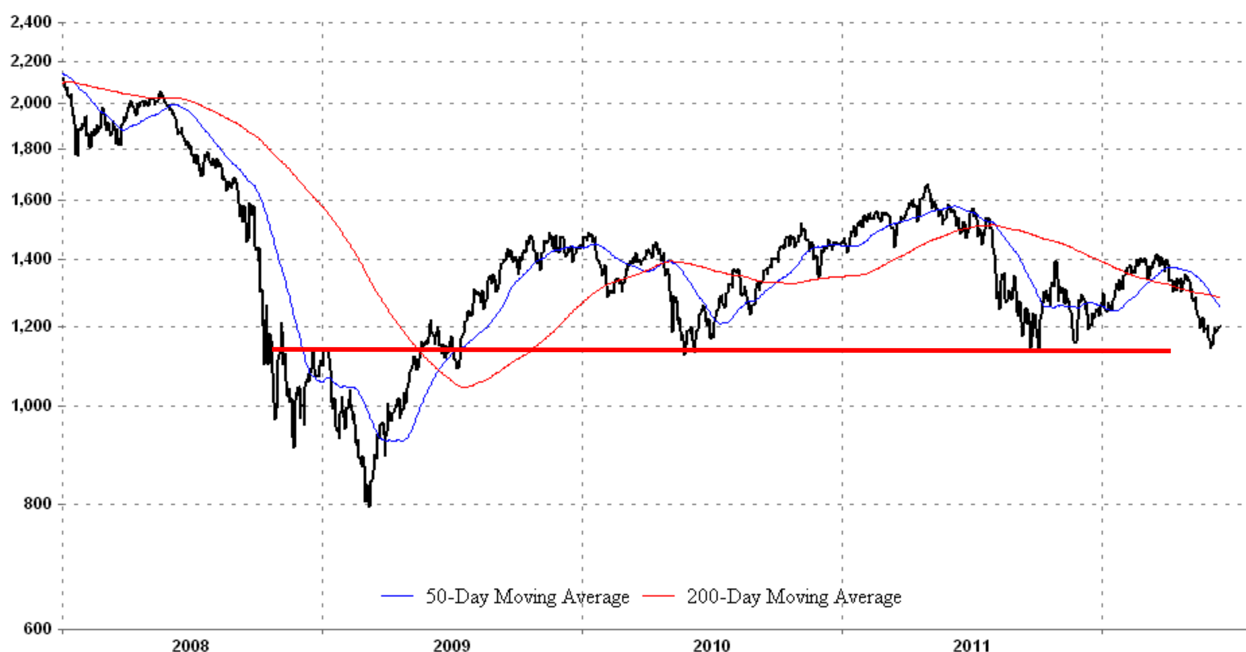
For all of its talk about transitioning to a consumption-based economy, China's growth remains largely dependent upon investment spending. Private real estate investments are severely hampered by policies enacted to fight the real estate bubble and the residual oversupply of office space and high-end housing. Plans to relocate more than 300 million Chinese from rural to urban locations over the coming decade suggest much more infrastructure and affordable housing investment is required, but thus far China has not announced any specific investment plans. With Communist party legitimacy almost entirely dependent upon delivering acceptable economic growth, China's leadership has ample motivation to act in a more decisive manner. Otherwise, markets may add a hard landing in China to the other headwinds facing financial markets.

Our Technical Line in the Sand

We have described market conditions over the past few years as 'policy purgatory' because market direction has become so dependent upon the actions of politicians and central bankers. In the coming weeks, we expect policymakers to either arrive at the correct policies or get close enough so that money printing by central bankers can once again compensate for any policy shortcomings (as has occurred for the past three summers). **With so many policy decisions pending over the next few weeks, we will be watching European equity markets to either confirm our expectations or revise our outlook and portfolio strategy.** European stocks have not followed the 'three steps

forward and two steps back' pattern of US equities, as shown in the chart below. Instead of finding support at successively higher levels as the S&P has done, European stocks have repeatedly fallen back to support levels first made in the summer of 2009.

The inability of European stock markets to make consistent upward progress reflects profound problems in Europe's approach to its crisis ('Hoovernomics'), while the ability to hold at a consistent support level rather than revisit the lows of 2009 proves the power of central bankers to ease market concerns. A successful test of these support levels in early June convinced us to increase portfolio risk to a more neutral level, after having appreciably reduced risk in April. If, contrary to our expectations, Europe breaks through the 1125–1175 support zone identified in the chart, then either policy outcomes have been too disappointing or central bankers too slow. Such a failed test of support would force us to question our optimistic outlook with respect to future policy and adopt a more defensive portfolio strategy.



Source: FactSet Research Systems; Past performance is no guarantee of future results.

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Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

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