RIVERFRONT
INVESTMENT GROUP

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THE WEEKLY VIEW

A Dangerous Game of 'Chicken'

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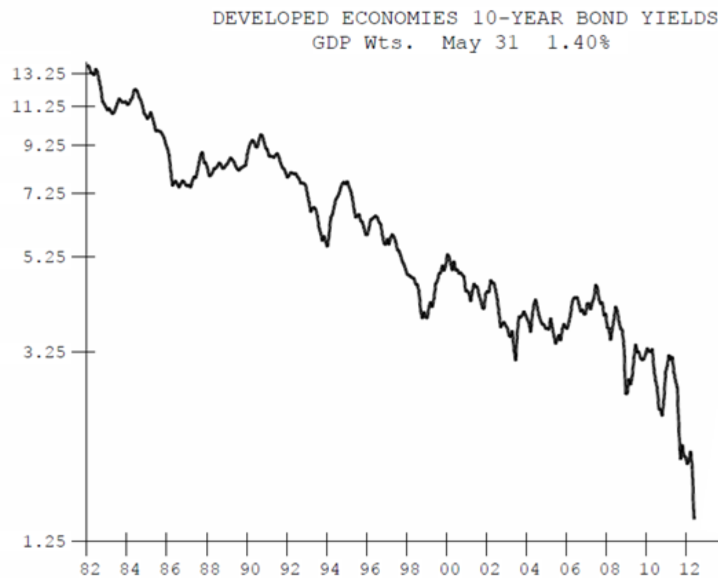
- **Growth momentum in the US, China, and Europe is slowing rapidly;** German, UK, Swiss, US and other 'safe haven' bond markets are priced for a global recession (see Weekly Chart) and European politicians are playing a high stakes game of 'chicken.' We believe Germany recognizes that it stands to suffer greatly from a collapse of the euro, but is clearly unwilling to extend budget support without budget control – no 'taxation' of German citizens without 'representation' in the form of budget oversight. France, on the other hand, is terrified of, and so far unwilling to cede European budget control to Germany. They remain deadlocked, and we believe a global recession hangs on their ability to break the deadlock. We think Germany expects to get the concessions it wants, but that its plan B may be a withdrawal from the euro, but we can only guess.
- Unlike bond investors, stock investors have been fairly patient (the MSCI World Stock Index is about flat for the year) because while they recognize that global stock markets have 10%-plus downside if policymakers fail and a global recession ensues, they also see 10%-plus upside in the event of a breakthrough agreement from Europe. However, we believe stock investors have also been patient because US economic and earnings growth held up well through the first quarter and valuations in international markets are cheap by historic standards.
- We believe that patience is rapidly running out and our inclination has been, and continues to be, to act preemptively to de-risk portfolios. In a *policy purgatory* world where we will not know the outcomes of political brinkmanship, we cannot invest merely on hope in our portfolios, especially those with a more conservative mandate. Having de-risked portfolios close to the March/April highs, we added some risk back in early June, believing that stocks would respond positively to any good news, since sentiment had swung from optimism to pessimism. Thus far the rally has been half-hearted, and our confidence in policymakers has diminished.

Another Fed meeting, another European crisis summit – more Policy Purgatory. The Federal Reserve substantially lowered its 2012 economic growth projections last week to 1.9–2.4% from the 2.4–2.9% rates they were expecting in April. They also now expect unemployment to remain above 8%, whereas they previously thought it would drop below that level by year end. On the positive side, inflation is expected to decelerate to 1.2–1.7% from the previous 2% forecast (with energy prices falling to new lows), which opens the door for the Fed "to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability." Their next meeting concludes on August 1.

While the Fed extended 'operation twist' through year end as markets anticipated, there was hope for even more accommodation, such as extending guidance for the zero interest rate policy out to 2015 and/or including mortgage-backed securities among its asset purchases. However, with inflation expectations still above 2%, signs of improvement in housing markets and increased bank lending (especially for corporate loans), it seems the Fed needs more evidence of economic deterioration and financial distress before it would be willing to act more forcefully by significantly expanding its balance sheet.

The election of a pro-bailout/pro-euro Greek party and lower-than-expected capital needs for Spanish banks helped alleviate some immediate concerns in Europe late last week, in our view, but the burden of debt, recession, and lack of reforms remains a toxic mixture that threatens the global economy. Yields on Spanish 10-year sovereign bonds have fallen back below 7%, the threshold that has required emergency bailout funds from European authorities in the past, but ongoing deposit flight and economic weakness suggest the crisis has not yet been arrested. Without adequate sovereign guarantees, central bank backstops or plans to restore competitiveness, a potential euro-breakup – Europe's 'Lehman moment' – still looms. Thus, investors' growing impatience with policymakers' lack of decisive coordinated action, combined with deteriorating economic data, caused us to reduce risk in our more conservative portfolios last week.

THE WEEKLY CHART: BOND YIELDS SIGNIFICANTLY BELOW 2008-'09 LEVELS



Souce: ISI Group; Past performance is no guarantee of future results.

Yields on perceived safe sovereign assets have fallen well below their 2008-'09 'great recession' lows, as shown in the chart above. To us, this means that investors are terrified of the legitimate risks facing the global economy. While those risks are real, the price of 'safe' assets is at an extreme and has just gone parabolic. In our view, voters will only tolerate recession for so long before they vote for more fiscal/monetary stimulus at the risk of inflation. Thus we believe long-term investors should be in no doubt that stocks are positioned to significantly outperform bonds. Our ownership of cash and cash-like short-term corporate bonds – currently about 30% of our Moderate Growth & Income portfolio – is a temporary, but we believe necessary, risk management measure. The US private sector and select global companies remain dynamic and dominant, and we believe they are well positioned to meet the changing wants and needs of an increasingly global population. These entities are more flexible and responsive than almost any other institution in the world. Thus, we believe short-term tolerance for volatility, appropriate asset allocation, cash flow, and emotional fortitude are the keys to surviving the current environment.

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