Back From The Brink

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- **"The ECB is ready to do whatever it takes to preserve the euro,"** European Central Bank (ECB) President Mario Draghi declared last week. Furthermore, "German Chancellor Angela Merkel and French President Francois Hollande echoed Draghi's language after a telephone conversation [Friday], pledging to do everything to protect the single currency," Bloomberg reported. These comments helped lower Spanish borrowing costs as its 10-year bond yield fell back to 6.7% after having risen to 7.7% earlier in the week. Moreover, investor confidence improved, with risk assets rallying around the world and so-called 'safe assets' like US Treasuries selling off. **To sustain last week's market improvements, we believe the ECB must be willing to back up its rhetoric with actions, including the use of its balance sheet.** This would keep countries (and banks) solvent, at least over the short term, acting as a stop-gap measure to prevent catastrophic default and debt deflation.
- Over the longer term, we think institutional reforms must be implemented to preserve the structural integrity of the Eurozone, with banking supervision (and potential resolution authority) foremost among the necessary changes to achieve fiscal and monetary union. Indeed, for the European Stability Mechanism — the Eurozone's permanent bailout fund — to become operationally functional, bank oversight by the ECB is required. So while the ECB has pronounced an open-ended commitment to support the euro, its support for individual banks and countries is still conditional upon ongoing progress by policymakers towards restructuring that will credibly guarantee long-run institutional solvency. With the ECB rhetorically defending the euro and risk assets globally responding, the Federal Reserve may be less inclined to action and could also resort to just 'jawboning' following the end of its meeting this Wednesday.
- At roughly the halfway point in earnings season, second-quarter earnings and revenue results have been lackluster so far. While 67.1% of the companies have beat earnings expectations (which is around average), the beat ratio on the revenue front is far weaker at only 36.6% according to Zacks Investment Research. The ratio of negative-to-positive forecasts is the most negative since the second quarter of 2001 according to Thomson Reuters. Our own model of earnings surprise, which compares each S&P 500 company's reported result for the quarter with its estimate as of six months before the report date, suggests a below-average surprise ratio. We calculate that just 29.7% of the 266 companies that have reported earnings have beat expectations from six month ago, below the 45% average of the past four quarters, as shown in the table below. We think widespread expectation for monetary stimulus is helping to support US stocks, and such stimulus from the ECB and/or Fed seems increasingly likely over the next few months. However, we think the S&P 500's upside will be limited to around 1450 over the next six to nine months unless stimulus begins to positively affect business and consumer behavior, and corporate earnings and GDP growth starts to improve.

S&P 500 Earnings Surprise

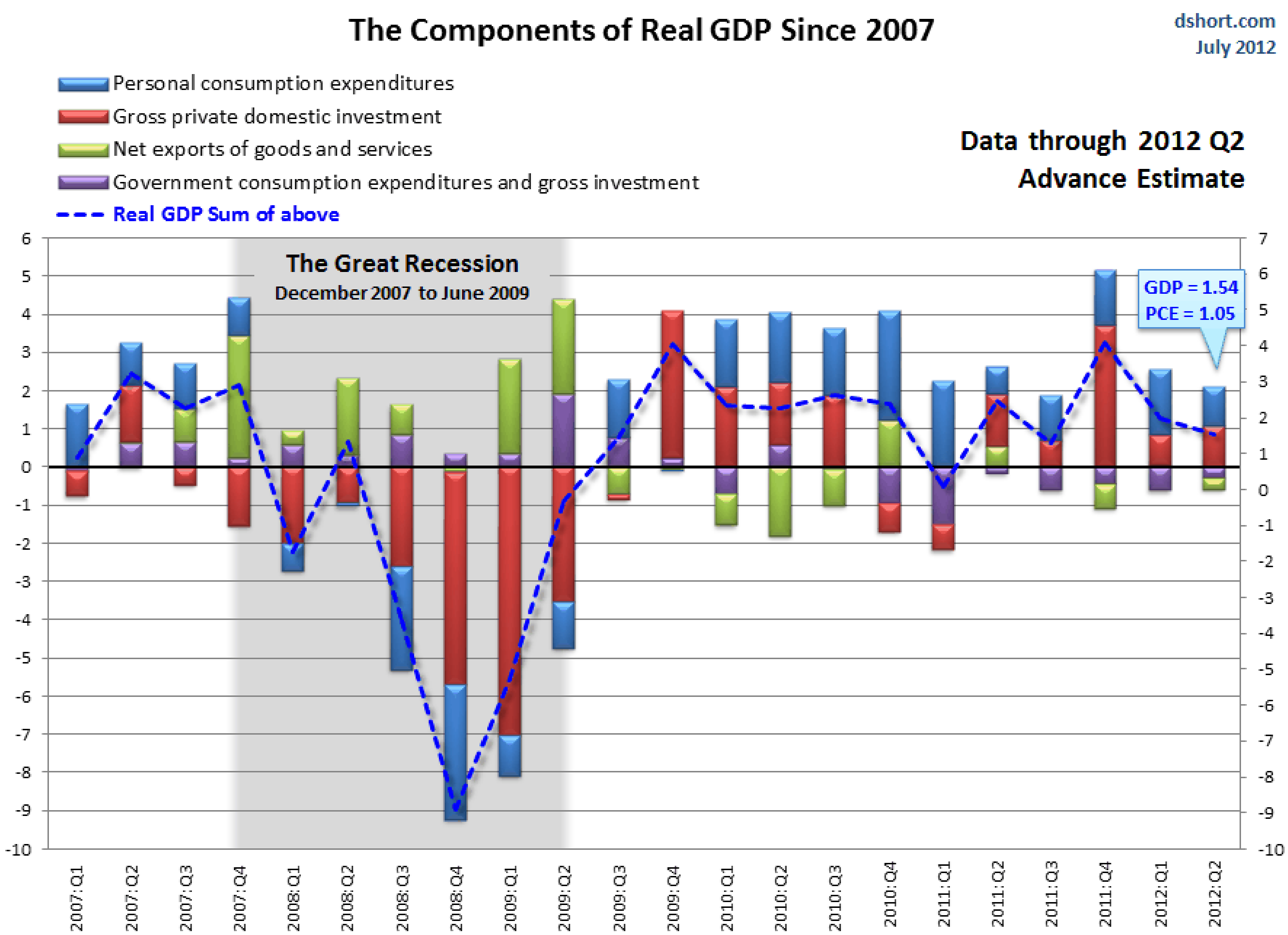
Actual QEPS vs estimate 6 months prior to report date

	2Q2011	3Q2011	4Q2011	1Q2012	2Q2012*
% Above Estimates	44.6%	45.3%	43.5%	46.0%	**29.7%**
Median Positive Surprise	14.7%	12.1%	16.4%	18.5%	10.9%
Median Negative Surprise	-14.0%	-12.0%	-16.2%	-20.0%	-14.4%

*companies rptd 266

- The advance estimate for second-quarter US real GDP indicated a rise of 2.2% *year over year*, which is in the middle of the Fed's 1.9% to 2.4% projected range for 2012, while inflation expectations that are still over 2% remain above levels at which the central bank chose to intervene previously. We think this should reduce the urgency for the Fed to announce new stimulus measures following this week's meeting.
- A pick-up in annualized investment growth to 8.5% during the second quarter was able to largely offset a deceleration in personal consumption to 1.5%, which also matched overall GDP. Investment and consumption each contributed about one percentage point to GDP, with trade and government spending together subtracting about half a percentage point (see Weekly Chart). Encouragingly within investment, residential construction continued to grow strongly at 9.7%, while equipment and software rose at a 7.2% rate, reflecting ongoing housing recovery and business confidence.
- **In RiverFront's base case scenario, where Bush tax cuts are largely extended next year and the government subtracts less than one percentage point from growth (averting most of the 'fiscal cliff'), we expect that the US economy will avoid recession but decelerate to the low end of a 'new normal'-like expansion pattern of around 1%.** In our pessimistic scenario of policy inaction domestically and globally (especially from Europe and China) we think a recession is probable and could cause about a 2% drop in US GDP. Alternatively, if policymakers are able to act effectively, we believe the economy could rise 2% next year. At this time we assign about a 50% probability to our base case scenario, 30% to the optimistic, and 20% the pessimistic scenario. **We had been more pessimistic until last week but with the ECB's stated commitment to preserve the euro, we have become more optimistic.**

THE WEEKLY CHART: INVESTMENT PICKS UP SOME SLACK FROM CONSUMPTION



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