RIVERFRONT INVESTMENT GROUP

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THE WEEKLYVIEW

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Bernanke: Read My Lips

The S&P 500 rose to record highs last week on remarkably dovish comments by Federal Reserve Chairman Ben Bernanke that helped alleviate market concerns over imminent tapering of quantitative easing (QE). In a question and answer session at the National Bureau of Economic Research, Bernanke said the unemployment rate understates labor market weakness and the inflation rate remains too low, unequivocally concluding: “both sides of our mandate -— both the employment side and the inflation side — are saying that we need to be more accommodating... that highly accommodative monetary policy for the foreseeable future is what’s needed.” Bernanke also noted that fiscal policy was also “quite restrictive” and that financial conditions have tightened recently with the rise in Treasury yields, both of which could potentially jeopardize economic expansion. Hence the Fed “would have to push back against that.” We remain unconvinced that the Fed will taper this year given elevated unemployment, the global economic slowdown, and barely positive purchasing manager indexes that suggest growth is unlikely to accelerate much in the second half.

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Beyond whether and when to taper, it seems clear to us that the Fed is at pains to separate QE from its interest rate policy, with distinct conditions surrounding both. Tapering is about whether to ease less (how much to step off the gas); rate hikes will eventually be about how restrictive to get (hitting the breaks). Both are contingent on inflation expectations staying anchored. From what we can surmise, tapering requires a 7% unemployment rate coupled with increased hiring and quit rates (people quitting jobs to pursue better opportunities). Some have speculated tapering could occur as early as autumn but we think that would take an appreciable acceleration in second-half growth, which we do not currently expect. For actual rate hikes, the Fed would have to see 6.5% unemployment, which we believe unlikely before 2015. Furthermore, as Bernanke has stressed, “6.5 percent is a threshold, not a trigger. There will not be an automatic increase in interest rates when unemployment hits 6.5 percent.” We think that the Fed understands the importance of debt service costs to funding the US deficit better than most investors. Thus, we believe interest rates will be held down for years, supporting debtors and financial markets while penalizing savers holding cash.

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Chinese Finance Minister Lou Jiwei’s comments on China’s GDP growth in 2013 -— “we don’t think 6.5 percent or 7 percent will be a big problem” -— surprised financial markets last week. It made many investors suspect that China will undershoot the government’s official target for 7.5% growth in 2013. Although we believe lower growth in China is desirable and indeed inevitable as it transitions from an investment and export-led economy towards one that is consumption and service-oriented, we remain concerned about the implementation, particularly as Chinese authorities simultaneously try to deflate a credit bubble. While we agree that 6.5% to 7% growth is unlikely to be a big problem for China, we see growing risks that growth may fall below

We are underweight China and emerging markets overall because we believe there is room for further market disappointment.

6% – a 'hard landing' that could have a negative impact on the rest of the world. As the Weekly Chart shows, China's year-over-year real GDP growth has not been below 6.6% for more than 20 years. Furthermore, the economy rebounded quickly – a 'soft landing' – when growth was last below 7% in the fourth quarter of 2001 and the first quarter of 2009. We believe there is room for further market disappointment given the government's crackdown on unscrupulous lending (curbing credit growth and trade), Chinese purchasing manager indexes for manufacturing point to continued contraction, reluctance on the part of government to provide fiscal stimulus, and consensus expectations for growth currently still above 7%. Hence, we are underweight China and emerging markets overall.

THE WEEKLY CHART: DOWNSIDE RISKS TO CHINESE GROWTH; CREDIT CURBS AND ECONOMIC TRANSITION COULD PRODUCE A 'HARD LANDING'