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The Market Once Again Needs Policy Makers to Step Up

After almost a year of fairly steady appreciation, the market has recently seen a return to levels of volatility reminiscent of the bear market of 2008. Despite this high volatility and even a “flash crash” on May 6th, the market remains close to its 200 day moving average and has not broken through the lows witnessed in the February correction (see the current Weekly View for more details).

We believe this market pullback is an ordinary correction within a cyclical bull market. This optimistic outlook is predicated on two assumptions:

1. **Global growth will be supported by acceleration in Chinese policies designed to spur domestic consumption.** Chinese consumers will increasingly replace overly indebted US consumers as the primary source of global demand. With continued demand from China, the US will decelerate into a “New Normal” rate of growth but will not slip back into recession.
2. **European policy makers retool their response to the debt crisis in southern Europe to address both the liquidity and solvency problems faced by these economies.** The European Central Bank (ECB) follows the example of the Federal Reserve and begins aggressive quantitative easing purchases of European government debt. These purchases create liquidity and buy time for the recently announced \$1 trillion bailout package to facilitate a restructuring of unsustainable debt levels in several European countries.

Assumption #1 - Increased Confidence in Global Growth

The market’s challenge in coming weeks is that investors will see mounting evidence of the economic slowdown that we have long forecast, while weaker sovereign credits within the Euro block are likely to see continued selling pressure. For this news to be absorbed without additional downside, we are likely to need encouraging news on the political and policy front. First, the US/China economic summit that begins today needs to provide tangible evidence that China is accelerating its transition from an export oriented economy to one driven by domestic consumption.

The most encouraging signal China could provide to financial markets is to allow appreciation in the yuan. However, the surge in Chinese imports over the past year suggests that they have many policy levers at their disposal to stimulate consumption and imports beyond just the value of the yuan. Investors may be even more interested in policy pronouncements concerning the Chinese property markets, and whether policy makers believe they have achieved the cooling off in property prices they have been seeking. The market is increasingly concerned that China policy may go too far in slowing their economy, and would welcome guidance about how soon policy makers will take their foot off the brake.

Assumption #2 – A Comprehensive Solution for the European Debt Crisis

Rising LIBOR spreads suggest that the ongoing credit crises across much of southern Europe is beginning to restrict liquidity in the European banking system, as money market funds curtail investments in European bank certificates of deposit.¹ On May 10th the ECB announced a quantitative easing (QE) program that could address these liquidity concerns, but thus far their \$28 billion in purchases resemble the hesitant response of the Bank of Japan far more than the bold, decisive actions of the Federal Reserve. The Federal Reserve purchased \$1.7 trillion in mortgage backed securities and

government bonds in response to the US mortgage crisis, and despite having officially suspended these purchases in March the Fed bought approximately \$23 billion over the past 2 weeks. Thus the Fed is providing nearly as much QE support to US markets as it winds down its program as the ECB is providing as it initiates QE. For policy to be effective the ECB will have to become far more aggressive in the coming weeks, in our view.

Quantitative easing can provide liquidity and buy time, but ultimately Europe needs a strategy for dealing with the excessive debt of its member countries. The US is dealing with the excess debt of nearly 7 million mortgage borrowers by allowing most of them to remain in their homes without making a mortgage payment. Since FNMA and FHLMC own most of these mortgages, allowing these borrowers to remain in their homes relieves the pressure of excess debt immediately while distributing the ultimate losses across US taxpayers. We can debate whether this is the best or lowest cost strategy for dealing with these excessive debt burdens, but at least the US has a comprehensive strategy. Between the Fed's aggressive quantitative easing and the Treasury's support of FNMA and FHLMC, the US has addressed both the liquidity and solvency elements of the mortgage crises. The market is seeking a similar comprehensive approach from Europe.

Large, dramatic purchases of Euro block government debt would simultaneously signal that the ECB is addressing emerging liquidity pressures in the banking system and providing vital support to debt markets in Greece, Spain and other heavily indebted European countries. The ECB must convince financial markets that at least one European policy making body can take decisive action, and the sooner they take such action the less action they will have to take, in our view.

If quantitative easing is used to address immediate liquidity needs in the European market, we believe that the \$1 trillion European bailout fund is a logical building block for addressing excess debt levels. The fund's current design appears predicated on the assumption that the only problem is Greece's ability to sell its debt at an acceptable interest rate in the private market. The actual problem is that Greece has too much debt (along with the rest of the PIIGS). Instead of simply helping Greece make its interest payments and retire maturing debt, the bailout fund needs to be applied to facilitating a more comprehensive debt restructuring. The market does not believe that budget cuts alone can solve the debt problems for the PIIGS, and European policy makers need to propose a credible plan for addressing these solvency concerns.

Conclusion

The current market situation, clinging to technical support levels while hoping for appropriate response from global policy makers, has created an uncomfortable sense of déjà vu among market participants. We have seen this movie before as the mortgage crisis unfolded in the US, and we did not like the twists and turns it put us through. However, we find comfort in the fact that most policy makers have fresh memories of the consequences in 2008 and 2009 of unfocused and uncoordinated policies. The recent spike in market volatility is an unmistakable reminder that when policy makers fall behind the pace of events the market reaction can be violent and uncontrollable. The market is sending a clear warning to policy makers and we believe that they are getting the message.

1 – New York Times, May 17th, 2010. www.nytimes.com/2010/05/17/business/global/17fear.html

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