

# RIVERPOINT

CAPITAL MANAGEMENT  
INVESTMENT ADVISORS

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## INVESTORS RE-FOCUS ON EUROPE AFTER U.S. RATINGS DOWNGRADE

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*Only a handful of times in the past 120 years have stocks had a week like last week.*

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The past month has seen heightened volatility in the equity markets. Last week was exceptionally volatile – stocks gained or lost at least 4% of their value for four consecutive days. Going back to the late 1800s, there have only been five other stretches of such wild swings: October 1929, September 1932, April 1933, October 1987 and November 2008.

What's powering this rollercoaster? In a word: uncertainty.

We've discussed how investors disdain uncertainty in the past, and now the "U" word is rearing its ugly head again. With the threat of a government default behind us, Standard & Poor's headline-grabbing downgrade of American debt – from AAA to AA+ - really had no impact on the fixed income markets. In fact, bond yields actually fell following the announcement, countering the normal response to a credit rating downgrade. Instead of selling, investors snatched up US Treasury bonds as issues in Europe have stepped front and center once again.

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### The RiverPoint Team

Valerie L. Newell, CPA  
Leon H. Loewenstine, CPA  
Victor R. Lassandro III  
Pamela F. Schmitt, CFA  
Ryan L. Brown  
Anthony Roberts III, CFA  
Kirk M. Koppenhoefer, CFA

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Greece has been bailed out and appears to be on the right (albeit very arduous) track, having passed the necessary budget cuts to get their fiscal house back in order. The bulls-eye that was on the Greeks has now moved to Spain, Portugal and Italy, causing their borrowing costs to rise significantly. With the prospects of these larger economies now being questioned, the size of the old bailout fund seems insufficient to many investors. Now the pressure is rising on the Euro Zone's leaders - Germany and France - to save the rest of the group. Of course, backstopping everyone else's problems would weaken their standing, which is the main reason behind the hesitancy of the Germans and the French. All the while, rumors popped up (rumors that have since been shot down) that European banks – a large percentage of their capital being made up of European government debt – were experiencing significant withdraws as large clients feared that write-downs

on European bond holdings would leave the whole European financial system vulnerable.

We argue that this is highly unlikely, mainly due to the fact that exposure to troubled European debt is easily ascertained. By knowing exactly how much troubled debt each bank owns, it is a fairly simple process to come up with how much the bank could possibly lose and how its financial strength would be impacted. For example, the problem with AIG a few years ago was that no one knew exactly what their exposure to credit default swaps was or how much the insurance giant could potentially lose. But, if a regulator knows that a bank owns €10 billion worth of Greek debt, then the most that bank could lose is €10 billion. While not an ideal situation, the issues facing the European banking system should be much more transparent and easier to navigate than those faced by their American counterparts a few years ago.

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*The argument could be made that credibility among political leaders has reached a low point.*

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Of course, one could argue that politicians had more credibility a few years ago. The debt ceiling debacle in the US and the hesitancy of European officials to act decisively on the debt crisis raise serious concerns about political leadership around the world. These questions are more disturbing to us. If history is a guide, then America will emerge from this period of uncertainty like it always has. The European Union – a monetary union unlike any seen before – has no such track record. The path ahead for the EU is largely unknown. What we do know is that it will likely take some time – a few years, minimum – for the member countries to rehabilitate their economies back to good health. It is with this in mind that we have structured our client portfolios with a diverse group of blue-chip stocks that are leaders in their industries. In recent months, we have intensified our focus on stocks that pay robust, well-covered and growing dividends - for example, stocks like Emerson Electric and Ecolab. Both have declined 15-20% in the recent sell-off and trade at price-to-earnings ratios 25% below their 10-year historical averages. These companies pay healthy dividends that are growing two-to-three times the rate of inflation and have posted consistent earnings growth over the past 20 years. In light of the Federal Reserve's intention to keep interest rates low until 2013, we believe that dividends will be very important factor to overall investment returns in such a low-rate environment. We also continue to insist that high-quality corporate bonds offer superior value to US Treasury bonds in this low interest rate environment. To prepare for a period of slower global economic growth, we are maintaining our conservative asset allocations. Our expectation is that the market will continue its oscillations, especially as we approach the November deadline for the federal budget "Super-committee."