

R I V E R P O I N T R E P O R T

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EUROPEAN, ECONOMIC UNCERTAINTY BRINGS VOLATILITY BACK

Since the bottoming out last March, the equity market had ridden a pretty smooth upward trajectory. Until recently, that is. Concerns over the economic conditions in Greece and other European countries seemed to generate consternation among investors, causing the market to undergo its largest correction since the darkest days of 2009. These worries, combined with mixed economic data at home, have caused investors to ask if the equity rally is on its last legs? Or, are investors just using a fresh round of concern as an excuse to realize profits following a tremendous rally?

Questions about the health of the European Union (EU) and the Euro currency are at the forefront these days. Over a decade ago, Western European countries agreed to use a single currency to simplify business across their borders. The initial pact mandated broad fiscal guidelines for each member country to follow, the thought being that the guidelines would ensure each country would be strong enough financially to maintain the value of the group's currency – a test of the old maxim “a group is only as strong as its weakest member.” The global recession, along with irresponsible fiscal management among some of the group's members, has thrown the region into disarray.

Greece has been at the center of the euro zone sovereign debt problems, with Spain, Turkey, Ireland, Italy and Portugal (the group has been derisively referred to as “the PIIGS” in the press) also contributing to the worries. The problem with Greece is that, due to a history of poor fiscal management, its overall level of indebtedness greatly exceeds the guidelines set forth by the European Union. This large debt burden is putting the country at risk of default, which is weakening the currency of the entire group.

The best solution to such a problem would be for the government in question to rein in spending; however, Greek citizens have made it abundantly clear that they do not support such a plan, staging mass protests across the country. Aside from spending responsibly, a country in Greece's predicament typically would have its central bank devalue its currency in order to effectively cut the value of the outstanding debt. Or, the country could institute easy monetary policy and begin “printing money” to stoke economic growth. In the United States, the Federal Reserve and the Treasury Department together have enough tools at their disposal to enact such corrective measures. The EU, on the other hand, was set up without a regulatory body that has the power to implement broad fiscal and monetary policy for the group. True, the European Union does have a central bank (the European Central Bank, or ECB), but it only has the authority and power to impact inflation. Having the ECB step in to try to fix this problem would be akin to bringing a knife to a gunfight. Greece, by virtue of its membership in the European Union, is unable to pursue either of these solutions because it has no say over the currency of the group. The other countries that are having issues – Spain, Turkey, Ireland, Italy, Portugal – find themselves in the same jam, where monetary policy solutions are not available to treat their problems.

There have been reports that some of the economically and fiscally stronger euro zone countries, notably Germany and France, are prepared to provide some sort of assistance to their struggling partners in order to protect the value of the Euro. Unfortunately, the early reports lack details, leading to speculation by some investors that this support won't materialize and Greece will default on its debt, bringing the Euro currency down with it. We don't see this happening, primarily because Germany and France stand to lose a great deal economically if the Euro currency falters. Nonetheless, this uncertainty has caused interest rates on troubled European debt to rise and the Euro to weaken which, in turn, only exacerbates the fundamental problems. As we've seen, markets abhor uncertainty; this concern about the euro zone has ultimately made it difficult for investors to build a strong conviction, and this lack of conviction has created more volatile markets.

On top of the uncertainty in Europe, the broad economic picture at home remains muddled. The positives and negatives seem to come in equal measure, which is leading to extreme views for the economic outlook on both sides of the spectrum – for every “early stages of a recovery” story there's a “we're headed for another recession” report following on its heels. The following excerpt from the Federal Reserve's Federal Open Market Committee minutes, from its January meeting, discusses the fourth quarter and highlights this lack of clarity:

“Consumer spending was well maintained in the fourth quarter, and business expenditures on equipment and software appeared to expand substantially. However, the improvement in the housing market slowed, and spending on nonresidential structures continued to fall. Recent data suggested that the pace of inventory liquidation diminished considerably last quarter, providing a sizable boost to economic activity. Indeed, industrial production advanced at a solid pace in the fourth quarter. In the labor market, layoffs subsided noticeably in the final months of last year, but the unemployment rate remained elevated and hiring stayed weak. Meanwhile, increases in energy prices pushed up headline consumer price inflation even as core consumer price inflation remained subdued.”

We've dug more deeply into the data and determined that the economy is doing pretty well, but not great. Economic data releases for January have continued to provide some support of a nascent recovery as well as signs that the recession isn't completely in the rear-view mirror. Again, investors don't like uncertainty, and the lack of a clear-cut direction for the economy has left the market open to heightened volatility – without conviction either way, investors will remain prone to jumping in and out according to the news.

Part of our fundamental research is to critically examine quarterly earnings releases to check the progress of the individual stocks that we own. While “cost cutting” was the overriding theme in the second and third quarters of 2009, the good old-fashioned revenue growth that we have been looking for finally made its way back on the scene during the fourth quarter. While it doesn't hold true for the entire economy, some Technology, Consumer Staples and Consumer Discretionary companies have confidently announced that the situation is indeed improving. The number of management teams that reported earnings that were “better than expected” as opposed to “not as bad as feared” continues to increase from prior quarters. Management tone and future guidance also continues to improve. The Financial sector continued its tough sledding, but signs of credit stabilization have become apparent. Going forward, a continued rebound in corporate spending is imperative for a sustained economic recovery. The American consumer will also have to resume spending, which will depend on an improvement in the labor market.

Given this tug-of-war between recovery and recession, we are maintaining a conservative stance. We are looking to add equity exposure selectively, using the market volatility to purchase stakes in superior companies at attractive valuations. Uncertain times can often produce opportunities, and, as always, we are keeping our eyes on the market in order to capitalize on any opportunities that come our way.

<u>Market Summary</u>	<u>2/28/10</u>	<u>2010 Price Change</u>
Dow Jones Industrial Average	10,325	-0.99%
Nasdaq Composite	2,238	-1.36%
Standard & Poor's 500 Index	1,104	-0.95%

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