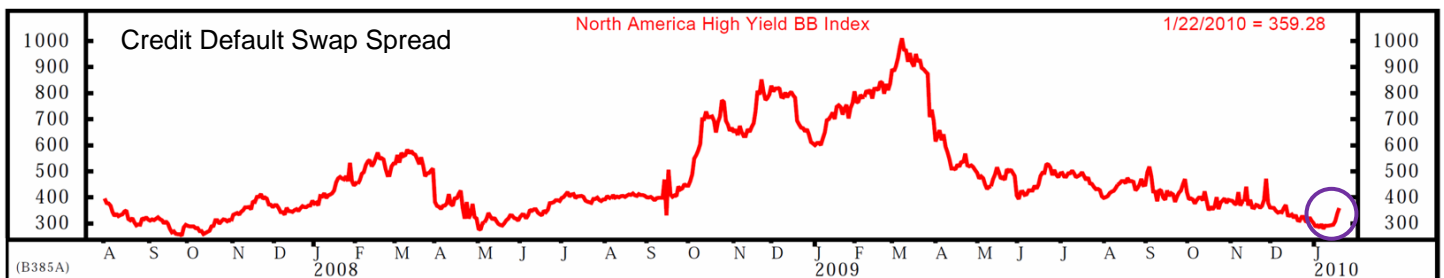




A Normal Correction

- Last week we wrote that extremely optimistic crowd sentiment was becoming a growing headwind for stocks, increasing the chance of a correction. In light of our optimism on corporate earnings in 2010, we view the S&P 500's 3.9% decline last week as only a pullback in the context of its primary uptrend. While our first level of technical support at 1120 was violated, we expect technical support between 1100 and 1080 to hold. However, a more severe correction to the 200-day moving average around 1007 is possible and would be consistent with pullbacks in strong rallies, like stocks had from July through January. Finding support above 1080 and crowd sentiment resetting back to neutral or even extreme pessimism are important conditions for us to maintain our near-term bullish view toward risk assets. We are watching the dollar and credit spreads for signs of a trend change; if the dollar and credit spread trends clearly turn upward, we will reassess our tactical view. (See "What Could Go Wrong," *The Weekly View*, 1/11/10).
- The US dollar index rallied about 5% from early December to just before Christmas, a move that looked like a countertrend rally. The dollar's downtrend appeared to resume in early January until last week, when it rallied sharply back to its pre-Christmas highs (see Weekly Chart). We view this rally as a flight to safety amid renewed uncertainty on the global economic outlook, namely over: 1) China tightening policy to brake its economy, especially since inflation (mainly from food) is accelerating rapidly; 2) disappointing US consumer and housing data to start the year; and 3) renewed concerns of sovereign default, particularly by Greece.
- In addition to dollar strength, credit spreads have begun widening. Although tighter than even just a few months ago and still near two-year lows (see chart below), credit spread narrowing may have become 'as good as it gets' especially in light of the uncertainties listed above. We do not see current credit spreads as an impediment to further stock gains, but continued credit spread widening (like in October 2008) would be another warning signal to pare back our overweight to risk assets and adopt more defensive positions.



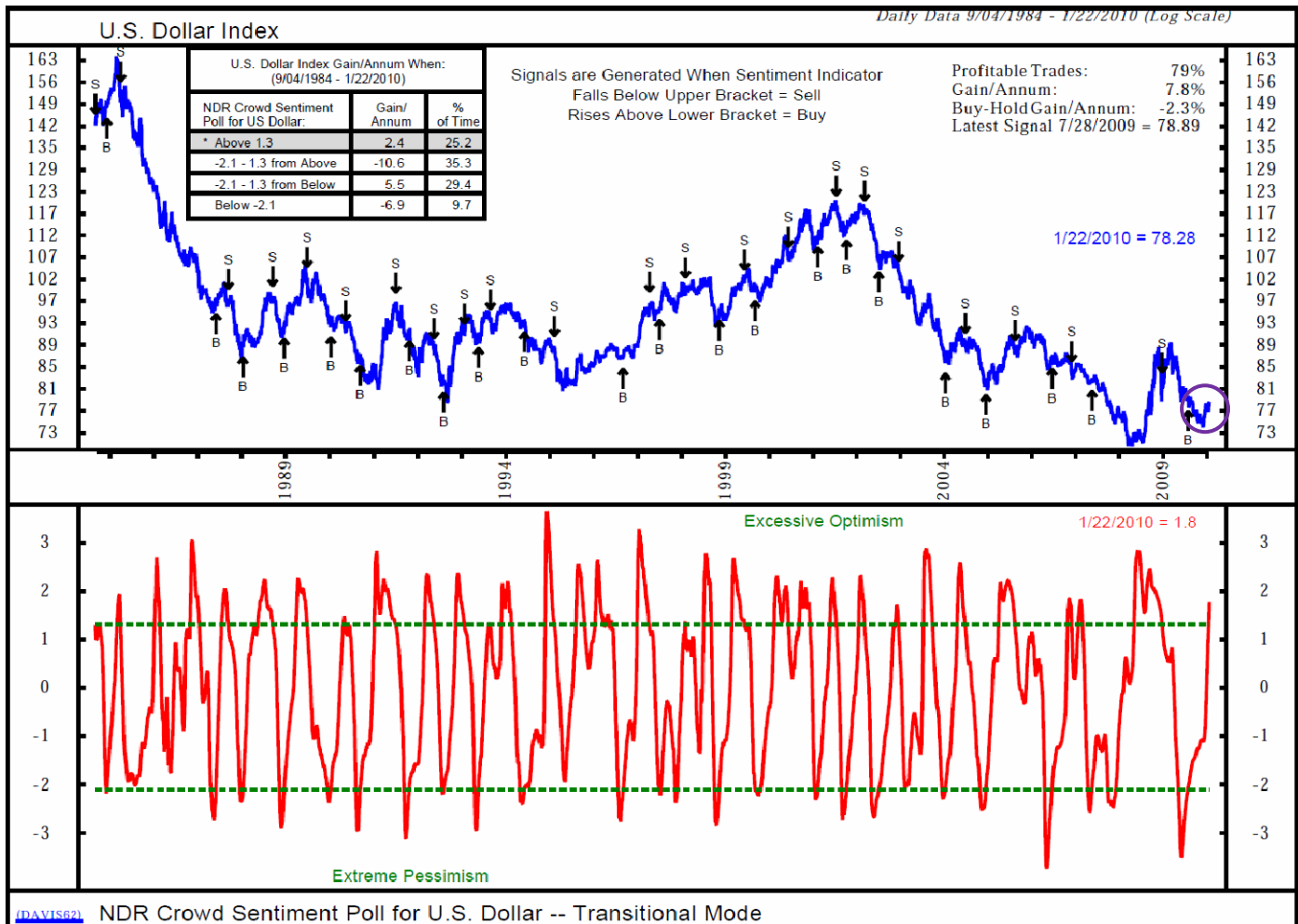
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- China's management of resurgent inflation is one of the global economy's most pressing issues in our view. In RiverFront's *Outlook 2010*, we said that allowing the yuan to appreciate would be the best way for China to tame inflation and help rebalance the economy. The steps taken to date, however, consist of raising banks' reserve requirements and restricting credit. Chinese money supply growth has fallen to about a 16% three-month annualized growth rate from close to 50% in 2009, but it will need to fall to around 10% for inflation to be brought under control in our view. China's recent actions could achieve results in the coming months if the government maintains its resolve, but we believe they risk choking off growth in the process. Ultimately we still think yuan appreciation will be necessary to tamp down rising Chinese inflation and sustainably balance growth.
- Personal consumption and housing remain foremost among US economic problems and recent data suggest little relief. Weak consumer surveys and lackluster housing activity are reminders that after inventory rebuilding and government support fades, economic growth is likely to decelerate in the second half. A long workout process – working off bad debts and restructuring the economy toward full employment – still lies ahead. We believe that the Fed will be able to manage this process effectively but we have greater doubts about the administration and

congress. While we believe that reform of health care and financial regulation is necessary, the political process is fraught with uncertainty and there is no guarantee that reforms will be appropriate.

- Rising debt levels around the world are increasing the risk of sovereign default. Even as state coffers are depleted, borrowing is surging to meet the demands placed upon governments. Those countries that entered the Great Recession with poor finances are now worse off and still struggling to meet their obligations. Iceland and Dubai were at the forefront last year, with both entering into negotiations with their creditors when their ability to service their debt was in doubt. Similarly, Greece's ability to service their debt is now being questioned. This week, a Greek debt issue will test the market. We think Greece will be able to raise the funds, for a price, which should help to alleviate fears of default. A successful Greek debt sale, in turn, would also help relieve upward pressure on the dollar, in our view.

The Weekly Chart: Dollar Optimism Becoming Excessive



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Past performance is no guarantee of future results

We think the US dollar index could approach 81 over near term, but further gains would likely require a flight to dollar safety from trouble in sovereign debt markets, which we currently do not foresee. Moreover, like stocks, it is difficult for the dollar to sustain a strong rally when sentiment has reached excessive optimism, as seen in the chart above.

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