

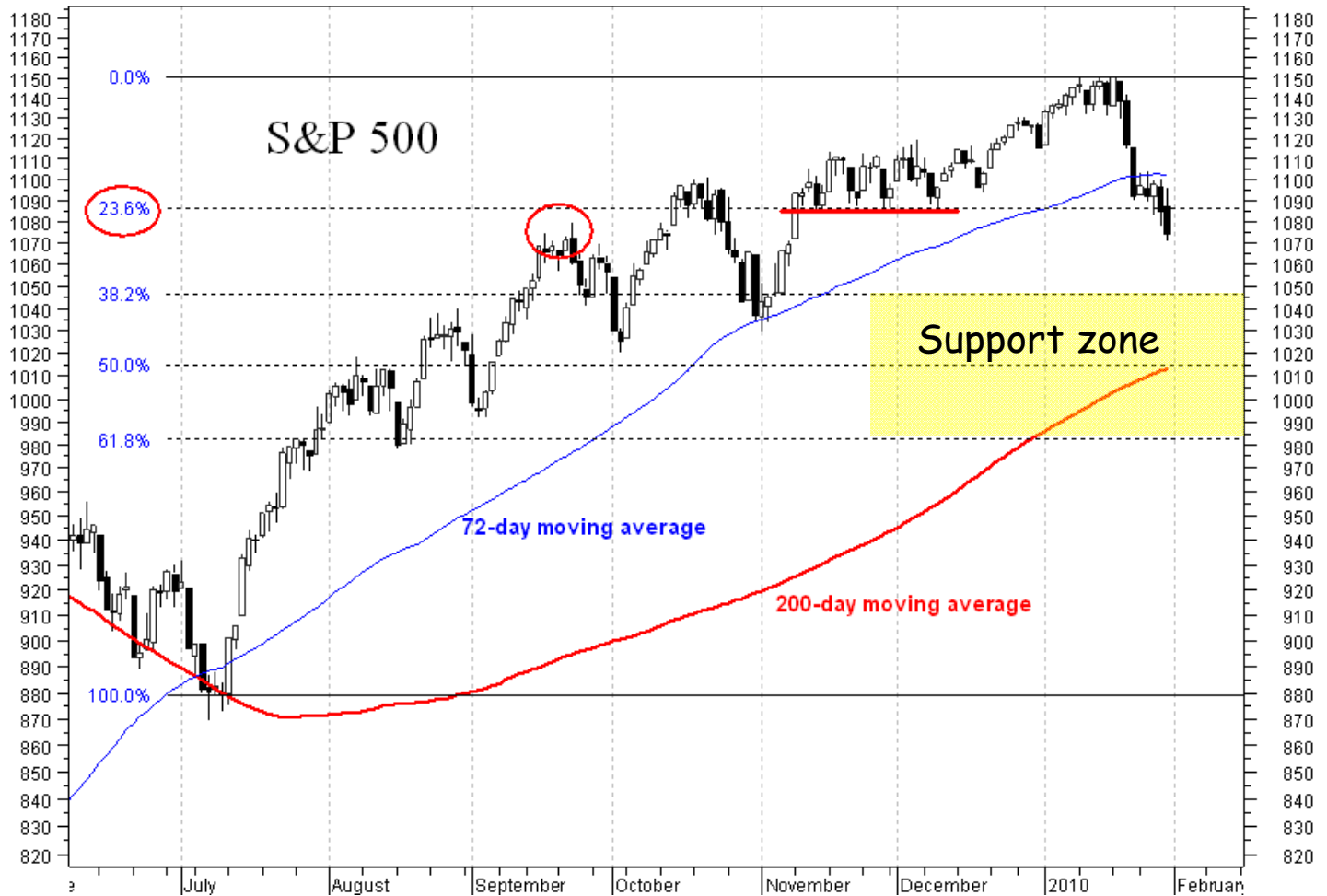


Still a Normal Correction

- The S&P 500 is flirting with our initial support level of 1080 and since our tactical discipline incorporates technical analysis, we are ready to lower our overweight to risk assets on a decisive breakdown. That said, we still expect this correction to be contained within a 'support zone' of 980-1050 (see Weekly Chart). We think there are several reasons for the correction: the dollar continues to rally, making new highs for the year, thus undermining the reflation trade; Greek credit spreads are making new 'wides;' and China appears poised for further policy tightening. We expect the dollar index – currently about 79 – to hit resistance around 81, but current momentum could carry it to the upper 80s. Initial relief following Greece's successful debt sale last week proved temporary as investors weighed the prospects of additional (and more expensive) debt sales later in the year, which raises the prospects of a bailout within the next several months. Under these conditions, we expect the euro – the dollar index's largest component – to continue its near-term weakness. Moreover, Greece is not the only Eurozone nation tackling a budget crisis; Portugal (among others) faces many of the same issues. This is all likely to keep the European Central Bank's monetary policy loose, which is good for global growth but bad for the euro.
- In addition to persistent sovereign debt concerns, recent turns in domestic policy also have potential implications for the dollar. High-profile defeats have curtailed the democratic administration's broad agenda and refocused their attention on job creation and the budget. Addressing rising public unease about budget deficits, President Obama said that because "families across the country are tightening their belts and making tough decisions...the federal government should do the same," in last week's state of the union address. While the proposed spending freeze is modest and not expected to take effect until next year, it marks a turn in budget priorities and an acknowledgement of political (not to mention economic) reality that we think is supportive of the dollar. In addition, Obama pushed to reinstitute the 'pay-as-you-go' (PAYGO) law that requires any new expenditure (or tax cut) be revenue neutral, with either matching tax increases or budget cuts elsewhere, rather than through further borrowing, thus ensuring the deficit does not grow. This law has already passed the senate and is expected to be passed by the house this week.
- The senate confirmed Federal Reserve Chairman Bernanke for a second term last week. However, the 70-30 vote was the narrowest margin in the history of the Fed (this distinction previously belonged to Paul Volcker's 1983 reappointment by 84-16). We think this reflects politicians' perception of public dissatisfaction with both Washington DC and Wall Street. With the Fed fighting for 'turf' and its chairman under intense scrutiny, the conduct of monetary policy has become more politicized. We still believe that the Fed will move to extend extraordinary support programs if necessary but Bernanke is believed to prefer a collegial consensus. Thus recent rhetoric by more hawkish members of the Fed – like Kansas City Fed President Thomas Hoenig's dissent toward keeping "exceptionally low levels of the federal funds rate for an extended period" at last week's monetary policy meeting – could begin to hold more sway, especially if the economy continues to improve.
- Along with greater uncertainty surrounding the Fed's exit strategy, China is facing a delicate balancing act of its own, trying to tamp down resurgent inflation. After raising the reserve requirement and issuing guidelines to restrict credit, regulators are stepping up efforts to curb and, by some accounts, suspend bank lending entirely. China has relied on 'administrative controls' in the past with some success at engineering soft landings after rapid credit expansions. Indeed, it appears that the recent example of the US' credit bubble is helping steer Chinese regulatory authorities' decision to limit credit sooner rather than later. Much of China's bank lending can still be controlled by the state and so should be seen as an extension of fiscal policy in our view. Thus the recent directive to limit lending can be seen as an unwinding of the huge and effective stimulus in place since the first quarter of 2009. Preventing a credit bubble from forming should ultimately be positive for China's economy. However, authorities run the risk of becoming too heavy handed in the process. Further dampening our enthusiasm for emerging markets' short term outlook for is that India continues to tighten monetary policy as well. While, like China, refraining from interest rate

hikes for the time being, India's central bank raised reserve requirements for banks last week. In sum, we think prudent steps to manage excess credit growth and proactively rein in inflation should be applauded, but risk assets will tend to suffer over the short term.

The Weekly Chart: A normal correction



Past performance is no guarantee of future results

Our chart shows the progress of the stock market's correction thus far. We saw initial support for the S&P 500 at 1080 – the 23.6% retracement of the July through January rally, which acted as overhead resistance in September and then served as support through much of November and December (all circled in red). While there has yet to be a decisive break below 1080, this correction marks the first time since last July that the S&P 500 has fallen below its 72-day moving average, and the flattening out of this moving average highlights the market's loss of momentum this year. We still think 1080 could hold, especially given that the optimistic sentiment extremes we wrote about two weeks ago have mostly fallen to neutral levels. If 1080 is decisively broken on the downside, we will begin the process of lowering our portfolios' risk levels, but continue to believe that the S&P 500 will find significant support somewhere between 1050 and 980 (the 38.2% and 61.8% retracement levels) and/or its 200-day moving average at 1013.

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