THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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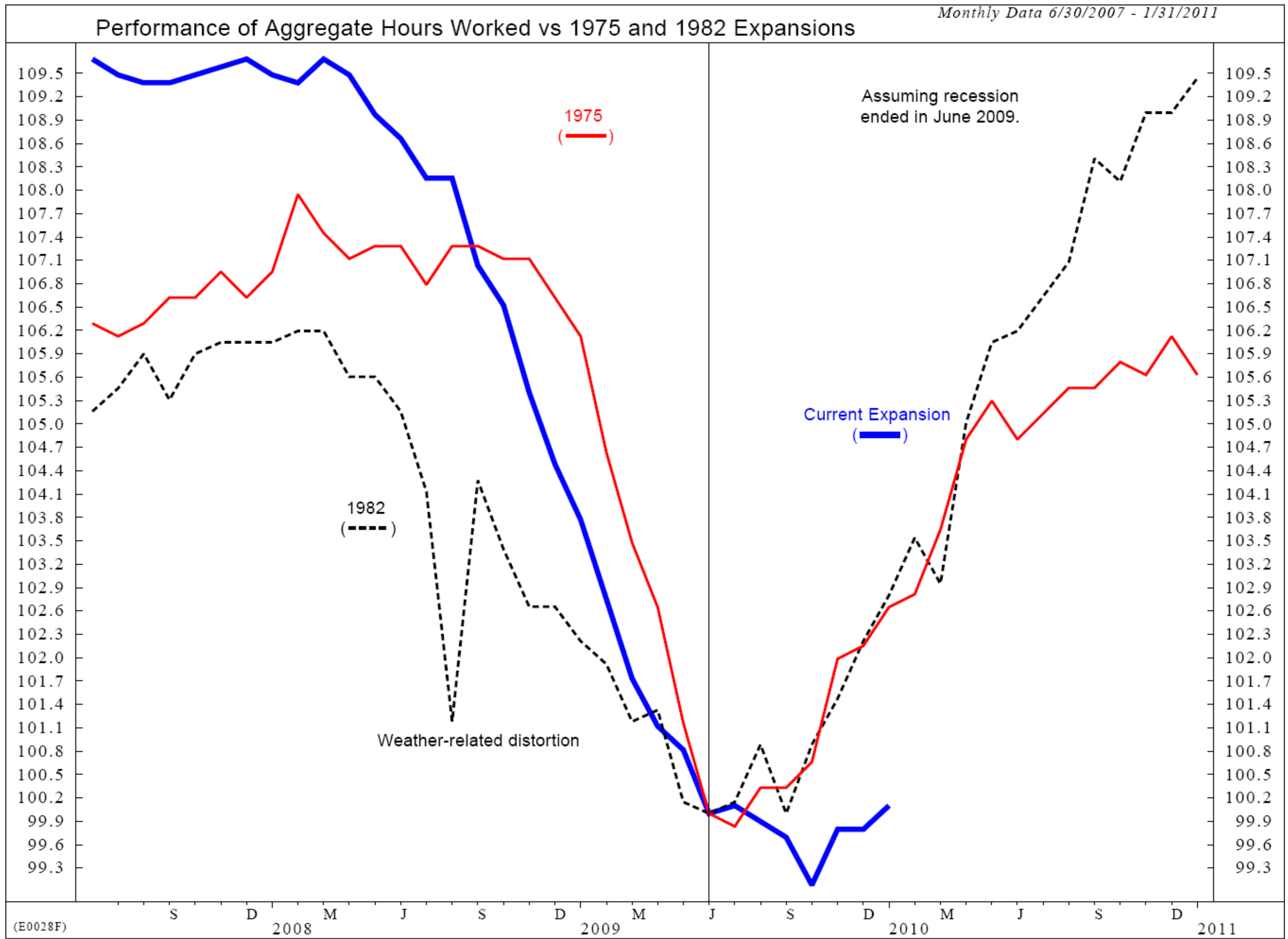
3 Rules Still Favor the Bulls; But What About the PIIGS?

- *Investor Optimism – A Growing Headwind for Stocks* was our title three weeks ago. How things have changed. The Ned Davis Crowd Sentiment Poll, which was then at the high end of 'extreme optimism,' has dropped through neutral and is now flirting with pessimism, although nowhere near the extreme levels of last March. Since we view investor sentiment as a contrarian indicator, our third rule, *beware the crowd at extremes* is no longer negative for stocks. Our other two rules, *don't fight the Fed* and *don't fight the trend*, have grown less supportive, but neither have turned negative, hence our belief that the current weakness is only a correction.
- Stocks are in the middle of their first consequential correction since last July and many technical indicators have turned short-term bearish. Shorter-term gauges of the trend – such as the 50 or 72 day moving averages – have now turned down and are acting as resistance on rallies. For the longer-term technical picture, as long as the S&P 500 can hold above our 980 to 1050 support zone, and we think it will (see last week's *Weekly View*), the cyclical bull market remains intact. Investors will likely become more cautious the longer this correction lasts, but we point out that in 2004 (a year of economic recovery and fears of Fed tightening) the S&P 500 drifted lower for nine months before the bull market resumed.
- Regarding the Fed and monetary policy, there have been two important changes in recent weeks, one domestic and one international, which challenge reflation trades. In the US, markets are preparing for the Fed to stop buying mortgage bonds. Indeed, the Fed's balance sheet seems to have stopped expanding and thus in one sense, the Fed is becoming less supportive for reflation trades than it has been over the past year. However, we can hardly call the Fed hawkish with interest rates remaining near zero and its balance sheet at record highs. The international issue is the budgetary woes of the PIIGS (Portugal, Ireland, Italy, Greece and Spain) and how the European Central Bank and European governments will respond. A bailout, though politically unpalatable, is undoubtedly being considered. Over the weekend, the possibility of International Monetary Fund (IMF) involvement was raised: "We are there to help. I have a mission in place providing technical advice at the request of the Greek government and if they ask me to intervene, we will do it," IMF Managing Director Dominique Strauss-Kahn told France's RTL radio. If the IMF becomes involved, the euro could rally temporarily, but an IMF restructuring will be deflationary and will slow Europe's already tepid recovery in our view. We are underweight Europe.
- Secular bull markets in Asia, Latin America, Canada and Australia – last year's winners and outperformers for most of the last decade – have had some of the biggest corrections in 2010. If our view that the dollar is forming a sustainable bottom against the yen and the euro is correct, then commodities will probably remain under pressure. When we look to add stock exposure, we will likely focus on the US along with industrial and technology leaders like Korea, Taiwan, Sweden and perhaps Germany. Since we do not believe China is seeking to aggressively slow its economy, but rather, is merely removing excess money creation, we will look for emergent relative strength in China, Hong Kong and Singapore as an opportunity to increase these positions as well.
- Several key economic reports were released last week starting with the Institute for Supply Management (ISM) manufacturing survey of purchasing managers, which increased 3.5 points to 58.4 in January, its highest level since 2004. This was its sixth month above 50, which indicates expanding manufacturing activity. The manufacturing ISM report correlates highly with year-over-year growth in the S&P 500 and helps confirm our belief that the primary trend for stocks remains up. The ISM non-manufacturing survey, also reported last week, only increased 0.7 points to 50.5, just edging into expansion territory. The non-manufacturing survey's employment component stayed below 50 for the 25th consecutive month, notable since the service sector constitutes over 80% of US private employment.
- January's job report contained some encouraging signs: manufacturing employment increased for the first time in three years and the unemployment rate declined from 10% to 9.7% as the labor force actually grew. Additionally,

aggregate hours worked rose (see Weekly Chart) which, when combined with rising average hourly earnings, translates into greater take home pay for households. Overall, however, the economy still lost 20,000 jobs during the month. While the employment situation has improved in recent months, a sustainable recovery requires several months of job gains approaching 200,000 in our view. Judging by the ISM non-manufacturing employment index and initial jobless claims, which seems to have stalled above 450,000 a week, further progress is necessary before a jobs recovery can be confirmed.

The Weekly Chart: Finally…a jobs recovery?



Past performance is no guarantee of future results

Following one of the worst post-WWII era declines in aggregate hours worked an improvement is developing. One of the major reasons we remain optimistic regarding risk assets is our belief in continued economic and earnings growth through 2011. If the employment picture is finally turning around then it would be typical for the improvement to last several years.

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