



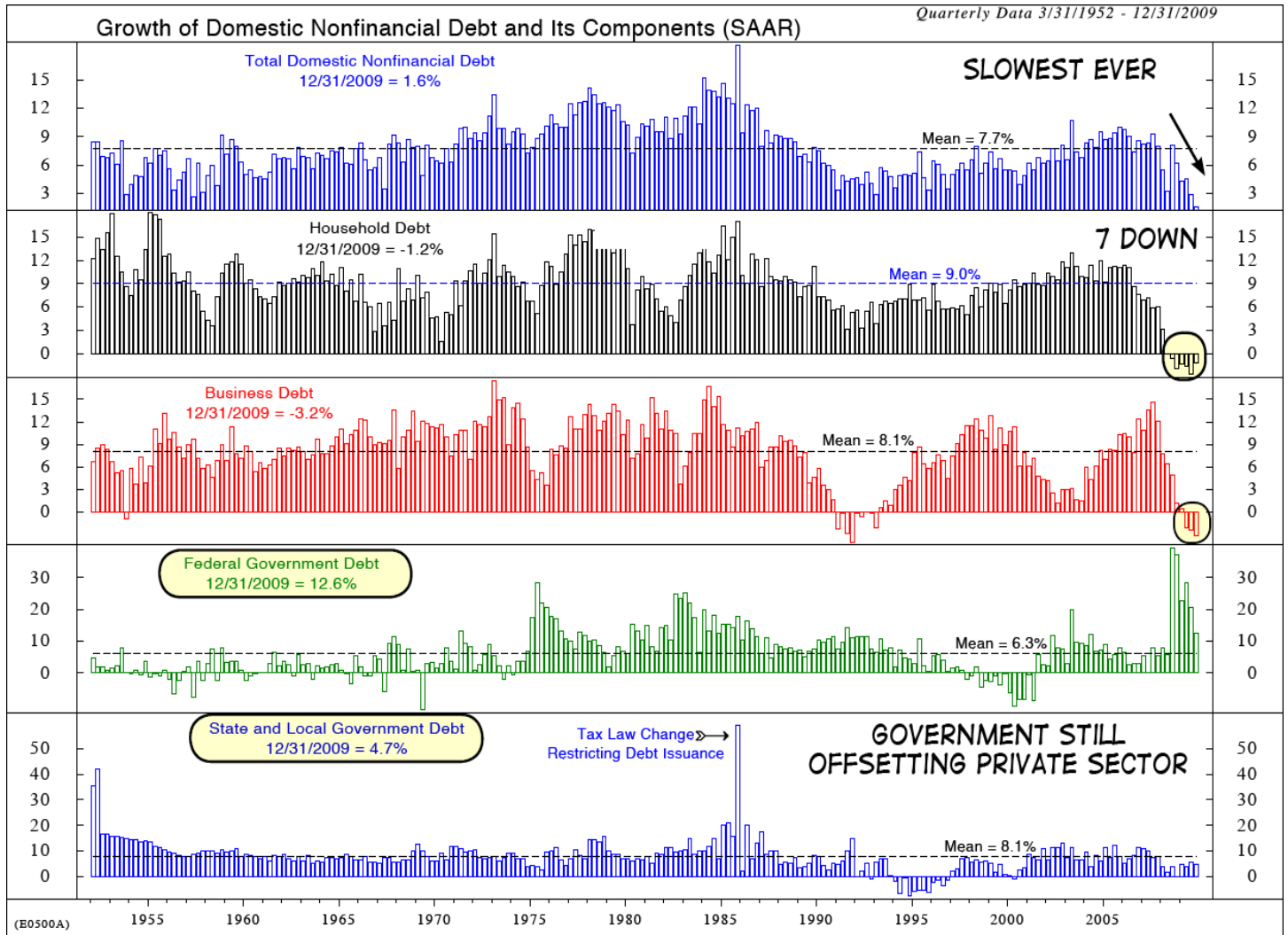
The Pros and Cons of Deleveraging

- US household debt fell last year for the first time since records began (see Weekly Chart). Household debt fell 1.8% in 2009 through a combination of pay downs and cancelations, e.g. through short sales, modifications or default. Business debt also fell 1.8% as corporations, like households, deleveraged and repaired their balance sheets. While household balance sheets have a long way to go, corporate balance sheets appear to be in much better shape, and businesses that can issue debt are able to borrow at attractive rates. We believe household deleveraging will be ongoing through 2010 — hence our view for a subpar recovery — but as household and business finances strengthen, the longer term prospects for private sector demand improve.
- To facilitate private sector adjustment, the government (especially at the federal level) is borrowing record amounts. Much of government borrowing is funding such things as unemployment insurance, which helps keep people in their homes (and paying their mortgages). The concern is that all this borrowing will not be temporary and therefore will ultimately be inflationary. However, total US debt growth has been the slowest on record (top panel of the chart). We believe this is reflected in low interest rates — the US Treasury can borrow at 3.7% over 10 years — hardly a sign of funding difficulties or inflationary fears. If it looked like the government would not be able to ‘get away with it’ then we think borrowing costs and inflation expectations would be much higher and/or the dollar much weaker. Indeed, *because the economy is weak*, the Fed clearly believes it can remain accommodative (buying government debt if necessary) without significant inflationary consequences, given private sector restructuring and higher productivity. For investors, this means staying overweight risk assets in our view.
- We recognize the government cannot borrow in excess of present and future revenue indefinitely, nor can the Fed perpetually monetize government debt. Ultimately, credible steps to bring government spending in line with income will be needed. Our point is simply that fiscal and monetary authorities have been granted considerable leeway by investors and this is good news for the economy. Corporations are flush with cash, have maintained high profit margins and, even with a subpar economic recovery, are on pace to recover 90% of 2007’s record earnings by year end 2011. One of our themes for 2010 has been that the earnings recovery will be V-shaped despite a subpar economic recovery. If we are right and 2011 is another year of growth then we believe the cyclical bull market in risk assets will continue.
- We expect short-term rates to stay low. Considerable debt overhang in residential and commercial real estate persists and so the workout/write-off process should be prolonged. For example, owners’ equity as a percentage of household real estate was only 44% in the fourth quarter (the post WWII norm is over 60%). Thus on average, US households do not actually own their homes; their lenders do (nowadays including the Fed). Moreover, the average masks the reality: about a third of the nation’s 75 million homeowners own them outright. Thus the average equity in households with mortgages is much less than 44% and furthermore one quarter of mortgage holders owe more than their homes are worth, i.e. negative equity. At a minimum we think household owners’ equity needs to climb back above 50% to put consumer balance sheets as a whole on more solid foundations, which could take several years. This is one of the main reasons we expect the Fed to remain accommodative and err on the side of growth for the foreseeable future. The issue for longer term (5 to 10 year) rates remains credibility in our view (see *Raising the Risk Level to Elevated, Weekly View 2/22/10*). If rates were to start rising because of either growing credit concerns or inflation expectations we would likely pare back risk assets and position more defensively. However, we would be less concerned if rates rose along with improving economic growth; indeed, in that case we think investors might even welcome higher yields.
- Since mid-December, 10-year Treasury yields have formed a triangle pattern, i.e. lower highs and higher lows. Technicians regard a breakout from such triangles as a signal for the subsequent direction of the trend. We expect 10-year yields, currently 3.7%, to trade in a 3.5 to 4.5% range this year. We see initial upside resistance at 3.8% (the neckline of a two-year inverse head and shoulders pattern), 4% (the 2009 high) and then 4.8% (the 24-year downtrend line). Since we believe the risk/reward ratio is unfavorable, RiverFront currently has no position in Treasury bonds. When the Fed

eventually does begin its next tightening cycle, they believe long-term rates will stay low, as they did in the 2004-06 cycle. We are more skeptical.

- The S&P 500 encountered technical resistance at 1150 last week for the second time this year. In early January it spent seven days around this level and then fell by about 8%, a shallow pullback typical of bull markets, which served to dampen the extremely optimistic market sentiment of two months ago. While our main sentiment indicator has risen from pessimism to the middle of its neutral zone (suggesting that the current uptrend has further to go), several of our shorter term sentiment measures have again reached levels of excessive optimism suggesting that 1150 will not be breached in the very short term and that the S&P 500 could retreat and find support around 1100. As we wrote last week, our technical objective is 1170 to 1200 on a breakout above 1150 and we still think this will occur during the spring, but we think there will be a better opportunity to increase stock exposure in the next few weeks.

The Weekly Chart: Government Offsets Private Sector Deleveraging



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