THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Pessimism Extreme as Cyclical Bull Threatened

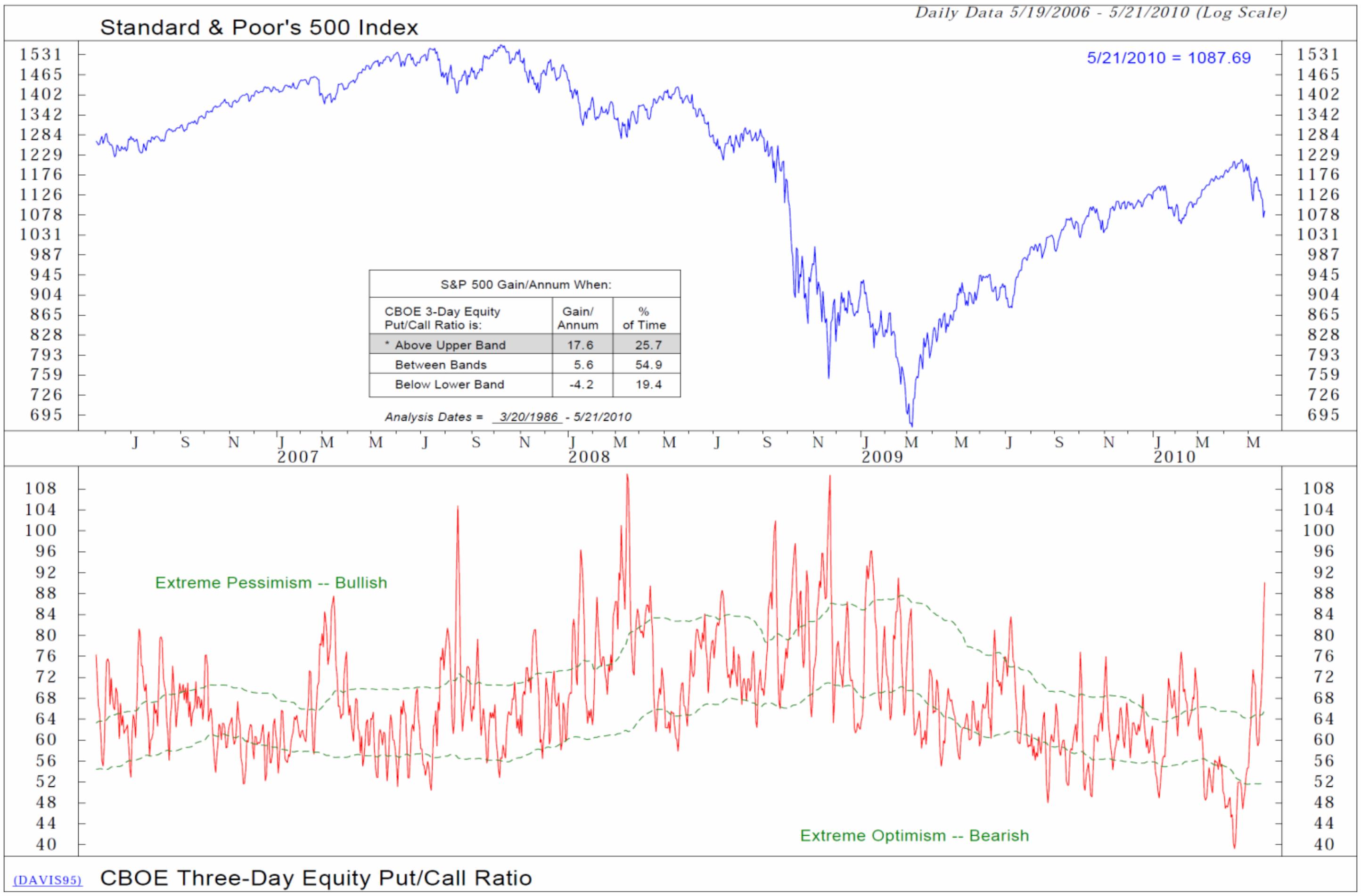
- We think the fundamental issue for stocks is whether earnings growth can continue through 2011 and believe the next cyclical bear market will not occur until investors begin to discount an earnings reversal. Given our view that earnings growth will continue in 2011, we remain cyclical bulls. The recent weakness in stocks, commodities and high yield bonds, combined with the decline in Treasury yields, presents a significant challenge to our optimistic outlook. Investor fears are focused on the sustainability of global growth. Overseas, the primary concerns are a growth slowdown in China and the prospect of an economic meltdown in Europe. In the US, growth remains dependent on government stimulus. We are fairly confident that China can reignite their economy by relaxing bank lending standards should growth slow too much, but we recognize that sustained growth in China requires a transition from investment and exports to domestic consumption. In our view, the European Central Bank (ECB) will need to act more decisively to prevent a deflationary reinforcing cycle from taking hold. So far their actions have not lived up to their rhetoric. We remain hopeful they will. The ECB can look to the Federal Reserve, which is setting policy for the weakest link in the US — the housing market — and with mortgage rates near record lows is doing its part to support home prices (and consumption).
- From a technical perspective the broad-based correction in risk assets is cause for concern, especially when overseas markets and commodities are included (US stocks have outperformed almost all international markets). A sustained break below the S&P 500's February low at 1050 would indicate that the current correction is more serious than previous pullbacks over the last year. We think a break below 1000 would raise the probability of a reversal in the primary trend and would suggest the market's growing expectation of an earnings downturn.
- We anticipate the formation of a decision box — a trading range often formed when investors are deeply divided about the outlook. During the rise from the March 2009 low of 666 to the recent high of 1220, the S&P 500 retraced two-thirds of the bear market's decline without a major correction. Technical analysis suggests the two-third retracement is a logical level for the market to encounter resistance. Thus we mark the top of our decision box at 1220. A positive resolution to the 2011 earnings growth outlook will be required to surpass this level in our view. Equally, we believe it is premature to assume that earnings will contract. Thus we think that the bottom of the box will be delineated when sentiment moves to levels of bearishness that exhausts the selling, which we expect between 1000 and 1050. In our view the S&P 500 could trade within this decision box all summer.
- RiverFront's long-term Price Matters[SM] analysis clearly favors risk assets such as stocks and higher yielding corporate bonds at current prices, and this bias is embedded in our strategic benchmarks. Tactically we have been reducing risk. Over the past few months we have reduced exposure to emerging markets by a third, cut European exposure to a minimum and eliminated commodities from our lower risk portfolios. Rather than raising significant amounts of cash, we have invested in high-quality US stocks, higher-yielding corporate bonds and initiated a position in the US dollar index. Thus, while we have become more defensive in anticipation of the current pullback, we have not positioned portfolios for a bear market.

Europe: Meltdown unlikely

In our view the ECB is about to play as important a role in the fortunes of global markets as the Fed did in the fall of 2008. European governments have concocted their equivalent of the US' TARP, but we think the ECB will need to be assertive in using their balance sheet to restore confidence. ECB president Jean Claude Trichet has 16 months of his eight year term remaining. He is one of the prime architects of the euro, and will not want to see it disintegrate on his watch. We believe the ECB's recent endorsement of, and role in, the Eurozone bailout plan signaled its willingness to expand its balance sheet and engage in Fed-like quantitative easing. Now, the balance sheet actually needs to expand.

We see Germany as the relative winner within Europe. Germany is the most underleveraged major economy in the developed world with total debt as a percentage of GDP at 200% compared to the US and Japan at around 350%. German unit labor costs are about 10% lower than the rest of Europe, it has a 12% savings rate and is the second biggest exporter after China. We have often observed that when a central bank sets policy for the weakest link in the economic chain, the strongest link benefits. With the ECB now forced to set monetary policy for its weakest links — Portugal, Ireland, Greece and Spain — we believe the euro will continue to weaken and thus boost Germany's competitiveness. Germany is the prime reason we do not see a meltdown in Europe's economy. At 27% of the Eurozone's economy, we think Germany's expected growth of 1.5% to 2.5% will offset most of the decline in currently troubled countries, whose combined GDP makes up only 18% of the Eurozone. France and Italy combine for 38% and they too should benefit from a weaker euro. When combined, we think Europe will have around zero growth over the next year.

The Weekly Chart: The crowd at a pessimistic extreme



Past performance is no guarantee of future results

Our chart illustrates the extreme pessimism of stock options traders, which has historically been a positive for stocks. As the table in the top panel shows, extreme options traders' sentiment has usually been a contrary signal for the subsequent direction of the S&P 500. The bottom panel is a three-day moving average of the daily put/call ratio from the Chicago Board Options Exchange (CBOE), which is the total number of put options traded divided by the number of call options traded on a given day. A put appreciates in a falling market while a call appreciates in a rising market.

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