THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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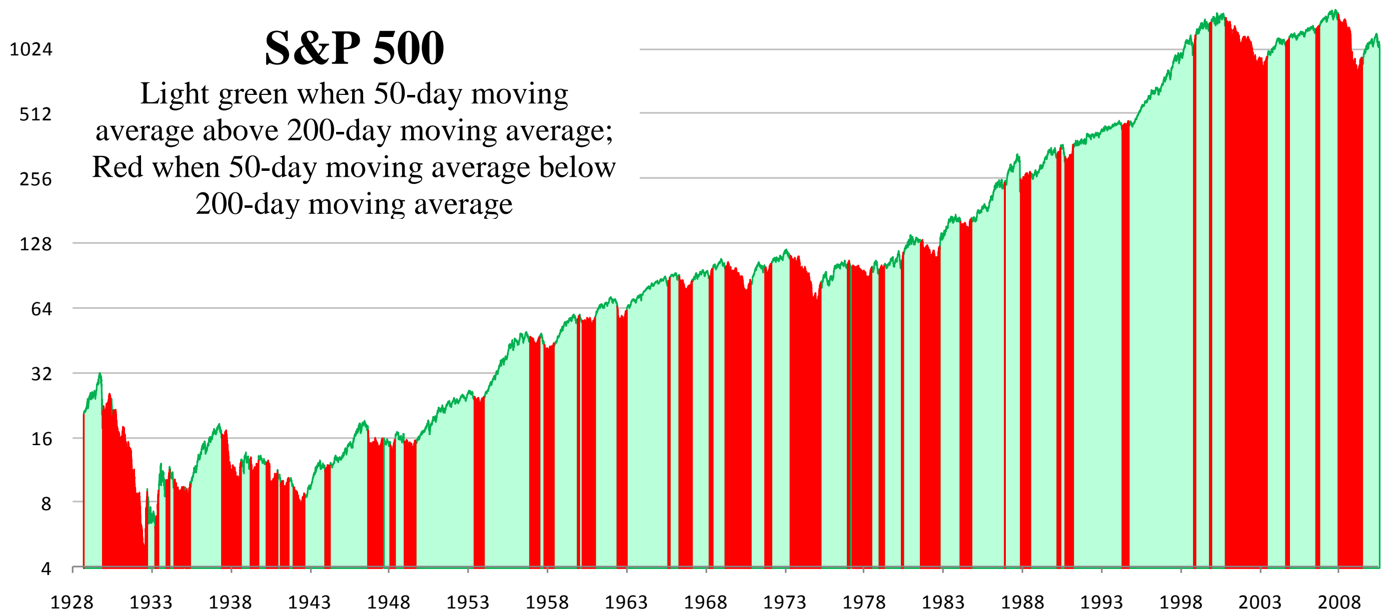
Cyclical Bull Visibly Weary

- We executed tactical risk reduction trades last week to become approximately 7% underweight our new strategic benchmarks. Our three most conservative portfolios, Conservative Growth & Income, Moderate Growth & Income, and Conservative Growth now have cash levels of 29%, 28% and 20% respectively. Recognizing our clients' desire to preserve capital in these portfolios, we have reduced risk assets by roughly 25 percentage points in the last six weeks. We have done this despite ongoing pessimistic investor sentiment because:
    1. The primary trend (our proxy is the 200-day moving average) has stopped rising and we are concerned that it is about to turn downward.
    2. The European Central Bank seems reluctant to take more aggressive measures to allay sovereign debt fears in the Eurozone.
    3. Recent decisions by European governments to impose austerity measures are likely to push Europe back into recession.
- We continue to believe that technical support for the S&P 500 at around 1000 — the bottom of our 'decision box' — will hold, but view these latest trades as an insurance policy in case it does not. If support holds and we see progress on outstanding market issues (e.g. growth and sovereign debt concerns) we plan to redeploy cash on a tactical basis in anticipation of moving back towards the top of the decision box around 1200. Conversely, if the decision box is resolved to the downside, we will likely reduce risk assets even further.
- Three weeks ago we set out three conditions for an 'all clear' signal for risk assets: The first condition was that the S&P 500 had to rise above its 200-day moving average currently at 1111. This was briefly achieved from June 15 through 21, but Friday's close at 1022 left the S&P 500 8% below its 200-day moving average, in our view, supporting our defensive bias. Furthermore, the S&P 500's 50-day moving average fell below the 200-day moving average. This technical condition is often referred to as a 'dead cross' and has a complex history (see Weekly Chart). Given the negative implications if these recent technical signals play out, combined with stocks' trend of lower highs and lower lows since April, our tactical discipline requires us to remain defensive.
- The second condition — 10-year Treasury yields rising above 3.4% — has not only failed to occur, but Treasury yields have moved decisively lower to just below 3%. We view this as a continuation of the flight-to-safety trade and confirmation that the bond market is more worried about growth than inflation (or government budget deficits, for that matter). As we wrote last week, we would actually welcome higher interest rates from current low levels because that would indicate better growth expectations and that the flight to safety is abating. With 10-year Treasury yields below 3% we do not think that fundamental concerns about growth have been adequately addressed to the market's satisfaction.
- Our third condition was that the high yield credit default swap (CDS) spread needed to fall below 625. Like the S&P 500 and its 200-day moving average, this briefly occurred. While the spread has since backed up to 653 it still remains well below levels reached in the wake of Lehman Brothers' bankruptcy. However, a move over 700 (along with a break below 1000 on the S&P 500) would significantly raise the prospect of a double-dip recession in our view.
- Although market signals suggest that the risk of recession is starting to rise, fundamental data out last week continue pointing to growth, albeit not as strong as earlier in the year. The Institute for Supply Management (ISM) manufacturing report fell 3.5 points in June to 56.2, but remained above 50 indicating continued expansion in business activity. We think the slowdown in manufacturing activity is consistent with our view of a second half slowdown in the economy and not a return to recession. Furthermore, global purchasing manager surveys also generally reflect slower, but ongoing, expansion in manufacturing activity.

- The June jobs report showed employment declining 125,000, but excluding government, which was affected by large numbers of census workers finishing their temporary service, the private sector gained 83,000, up from 33,000 the previous month. Among private sector jobs, goods-producing employment declined 8,000 led by construction work. Private services employment increased 91,000 led by leisure & hospitality, temporary help, transportation & warehousing, and health care work.
- While the economy continues to add private sector jobs, which we view as positive, we consider the rate of growth anemic and unlikely to sustainably reduce unemployment. The unemployment rate did decline to 9.5% from 9.7%, but that was primarily due to people leaving the labor force, which we do not view as a sign of economic strength. In addition, aggregate payrolls — a comprehensive look at employment that combines the total hours everyone has worked with how much they were paid — declined 0.3% after rising 0.6% in each of the prior two months. Hopefully, aggregate payroll growth will resume in the coming months, following the temporary setback from the cessation of census work, and allow income gains to underpin sustainable recovery and a continuation of the cyclical bull in stocks.

The Weekly Chart: Moving average crossovers – a complex history



Our chart illustrates periods where the S&P 500's 50-day moving average (DMA) has been above (light green fill) or below (red fill) the 200 DMA beginning in 1928. The 50 DMA crossover has done a good job of staying on the right side of longer term trends in our view but it is not the most timely indicator – for example, from the March 2009 low it did not signal 'buy' until late June by which time the S&P 500 had already risen 31%. Furthermore, **like any price momentum tool, this indicator gives false signals more than half the time. Its effectiveness is that false signals produce small losses whereas good signals have captured all significant trends.** While we still expect support to hold at bottom of the box (the S&P 500 at around 1000), our confidence is being tested by the prospect of a bearish signal.

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