THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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The Primary Trend: Flat

- Of our three investment rules — don't fight the trend, don't fight the Fed, and beware the crowd at extremes — we believe don't fight the trend deserves the most weight in tactical decisions. However, the trend has been virtually flat for nearly a month measured by our usual gauge of the primary trend, the 200-day moving average. Thus, while the trend is not yet negative, our belief in the cyclical bull market has diminished, especially in light of the so called 'death cross' (when the 50-day moving average crosses below the 200-day) that we wrote about in *The Weekly View*, 6/6/10. Both of these technical indicators come with an important caveat: like any price momentum tools, they give false signals more than half the time. Their effectiveness is that false signals produce small losses whereas good signals have captured all significant trends.
- For the last two months, we have argued that if the US can avoid an economic and earnings downturn in 2011, then the bottom of our 'decision box' for the S&P 500 at around 1000 will hold. However, due to the deteriorating technical picture, clear evidence that the economy has lost momentum, and recognizing many of our clients' desire to preserve capital, we have reduced risk assets by roughly 25 percentage points in our three most conservative portfolios. Conservative Growth & Income, Moderate Growth & Income, and Conservative Growth, now have cash levels of 27%, 26% and 22% respectively. We view these defensive measures as an insurance policy, where the premium is the lost opportunity if the S&P rallies and the primary trend re-asserts itself.
- There is no special magic to our measure of the primary trend, the 200-day moving average. It is probably the most widely used of the longer-term moving averages, which tends to make its signals self-fulfilling. Days like last Friday, when the S&P 500 turned down sharply from resistance, confirm the relevance of moving averages (see Weekly Chart) and suggest that the bulls lack confidence. There are alternative gauges of the primary trend that are just as valid; a quick survey of chart watchers at RiverFront reveals the use of 252-day (one year) simple and exponential moving averages, the 189-day exponential moving average and the 200-day exponential moving average. But the story on all of these primary trend measures is basically the same: all had turned down by the beginning of 2008, reversed upward by mid-2009 and flattened out in mid-June of this year. Bullish signals that would suggest a resumption of an upward primary trend — the S&P 500 and/or its 50-day moving average crossing above the 200-day moving average (one of our three 'all clears', see *The Weekly View*, 6/14/10) — seem likely to take some time.
- Whereas the primary trend for the stocks is flat, the primary trend for bond yields has now turned lower, and this has added to our caution regarding risk assets. The 10-year Treasury yield fell back below 3% last Friday as consumer price indexes continued to decelerate with the year-over-year June 'core' CPI falling to 0.9%, its lowest growth rate since 1961. Ten-year inflation expectations as measured by the TIPS spread are at 1.7%, which suggests that bond investors are unconcerned about the government inflating away its debts. Indeed, we believe deflation is a greater threat over the near term, especially if unemployment insurance is not extended, with 2.5 million already losing jobless benefits since they expired June 2. Longer term, we think inflation is more worrisome, particularly if recession probabilities rise and the Fed contemplates resuming quantitative easing. Last week, the minutes to their June monetary policy meeting were released saying, "the Committee would need to consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably."
- We have advocated three main explanations as to why bond yields have declined: 1) lower inflation, 2) slower growth, and 3) a (relative) flight to safety. In addition, we think there may be another plausible explanation. Michael Pettis, a finance professor at Peking University's Guanghua School of Management, suggests that with Chinese trade *surpluses* rising again (as US trade *deficits* widen) "the more capital [China] must invest abroad." He posits that a 'capital tsunami' is coming to the US — to a lesser extent this is also coming from other net exporters such as Germany and Japan. In other words, it appears the world's major net exporters are trying to once again

position the US as the consumer of last resort and, in the process, accumulating Treasuries and driving their yields lower. If US trade deficits continue widening, we believe this is increasingly likely to result in trade friction.

- Recall that our second 'all clear' to add risk assets back into our portfolios is for the 10-year Treasury yield to rise back above 3.4%. To the extent that declining bond yields also reflect tensions around rising global imbalances as well as growth and deflation fears, we are comfortable maintaining a defensive posture in our portfolios.
- In contrast with our first two 'all clear' indicators, the high yield credit default swap (CDS) spread actually registered a positive reading last week as it fell back below 625 basis points to close the week at 600, a sign of improving credit conditions (a basis point equals 1/100th of 1%). With two of the three still signaling caution, we are unwilling to turn more bullish overall, but we think the contraction in credit spreads helps validate our recent addition to corporate bonds, and argues against a double-dip recession.

The Weekly Chart: Cyclical bull losing momentum

Past performance is no guarantee of future results

Our chart highlights two potentially negative long-term technical signals: the end of a rising primary trend (200-day moving average has flattened) and the 'death cross' (the 50-day moving average cross below the 200-day). Also shown is a downward sloping trend channel starting from the S&P 500's late-April peak, which helps frame the markets intermediate-term downtrend of lower highs and lower lows. If the S&P 500 is able to hold at support around the middle of this trend channel, which is also around the bottom of our decision box, we can have a bit more confidence that the cyclical bull market is still alive.

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