THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu July 26, 2010

Emerging Markets' Uptrend Resumes, Developed Markets Still Undecided

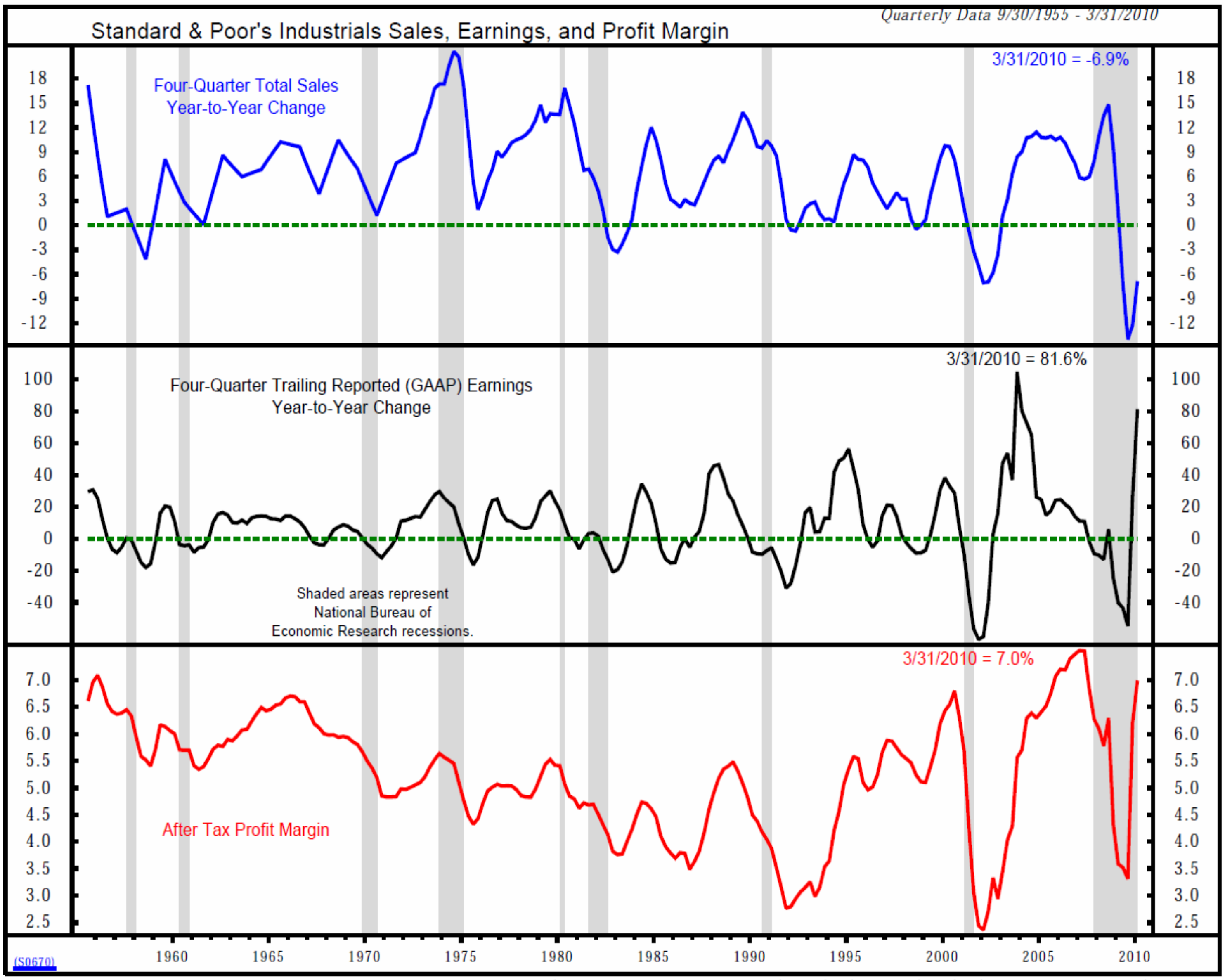
- In the last two weeks, the S&P 500 is up about 8%, closing last week at 1100, the midpoint of our 1000 – 1220 'decision box'. This has coincided with the reporting of second-quarter earnings where, once again, companies are showing their ability to drive up profit margins in a difficult economic environment (see Weekly Chart). We believe the bottom of the decision box will hold because the US will not experience an earnings downturn in 2011. That said, we are acutely aware of the risks to world growth from deleveraging and the possibility that policy mistakes could extinguish fragile recoveries. Thus, as risk managers, we have been concerned by the clear downturn in the intermediate trend (the 50-day moving average) of stock prices, the flattening out of the primary trend (200-day moving average), and the clear downturn in Treasury bond yields. We have therefore adopted a slightly defensive position in our portfolios since the markets seem to be telling us that our optimism is misplaced.
- In the US, second-quarter earnings were helped by strong economic momentum at the beginning of the period and so it is likely in our view that third-quarter earnings, will be a better litmus test. We therefore expect the S&P 500 to continue to oscillate around a flat 200-day average for most of the summer. We expect the current rally to stall out below 1140 and anticipate a potential entry point in the fall. In our view a break above 1140 in the current rally would be a positive technical sign, but we think it unlikely.
- We have a lot of respect for GMO's chief investment strategist, Jeremy Grantham, both as a value investor and as a commentator who speaks his mind. Two sentences in his July letter caught our attention: "Suddenly (for me), it is fairly clear that a weak economy and declining or flat prices (CPI) are the prospect for the immediate future," and "Running at the same rate of change in attitude as both the market and general opinion is both frustrating and unprofitable." We agree on both counts, and have found ourselves somewhat frustrated by a lack of conviction regarding developed economy growth rates. For most of the second half of 2009 we were more bullish than consensus due to healing credit markets and our expectation for a 'V' shaped recovery in earnings. The rising stock prices supported this view, which made staying with it relatively easy.
- For the last few months our fundamental conviction has been challenged both by the magnitude of the global slowdown and our fear of European policymakers pursuing distinctly Hoover-esque[1] policies. As mentioned above, both the bond and stock markets have sent 'return to deflation' warnings. A determined 'reflationist' would be aggressively buying stocks and selling long dated bonds, but we are only willing to recommend the latter. At current yields we see little or no real return potential from Treasuries so we do not own any, preferring cash and short maturity corporate bonds as our 'safe assets'. As for stocks, global central banks and governments have largely stopped pursuing reflationary policies, leaving valuation as the bulls' main argument. We agree that stocks are attractively valued, and have built this into our strategic benchmarks, but we have always regarded valuation as a blunt instrument that is insufficient on its own to drive tactical decisions. Our lack of high conviction regarding 2011 growth, and real fear among much of our client base has kept us from buying developed market stocks.
- The emerging markets are a different story. They have outperformed developed markets since late May, their intermediate trends are now rising and they are trading comfortably above their primary trends, which are gently rising. We have been persistent buyers. Although we already had about one quarter of our equity allocation in emerging markets, we added to our positions in both large- and small-cap emerging markets last week. We have high fundamental conviction regarding emerging markets and are encouraged they have resumed their uptrend.

[1] Herbert Hoover was the US president from 1929 to 1933, holding office during the early stages of the Great Depression. He was criticized by economists for raising tariffs and refusing to run government deficits. These policies are widely believed to have made the depression worse.

Corporate profits: Good news is bad news

We believe the ability of companies in aggregate to deliver positive earnings surprises is ending. Our Weekly Chart illustrates the remarkable recovery in corporate profits and margins (middle and bottom panels in the chart), despite only modest improvements in sales (top panel), which had the worst decline in the post-war period. The good news — profit margins have returned rapidly to near record levels — is also the bad news. Significant margin expansion from already near record levels is now unlikely in our view, and profits are vulnerable to a fall in demand. If the economy can avoid a double-dip recession, we see plenty of room for sales growth. So while profits have not necessarily peaked, earnings growth is now dependent on sales growth in our view.

The Weekly Chart: Little Room for Margin Improvement



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