THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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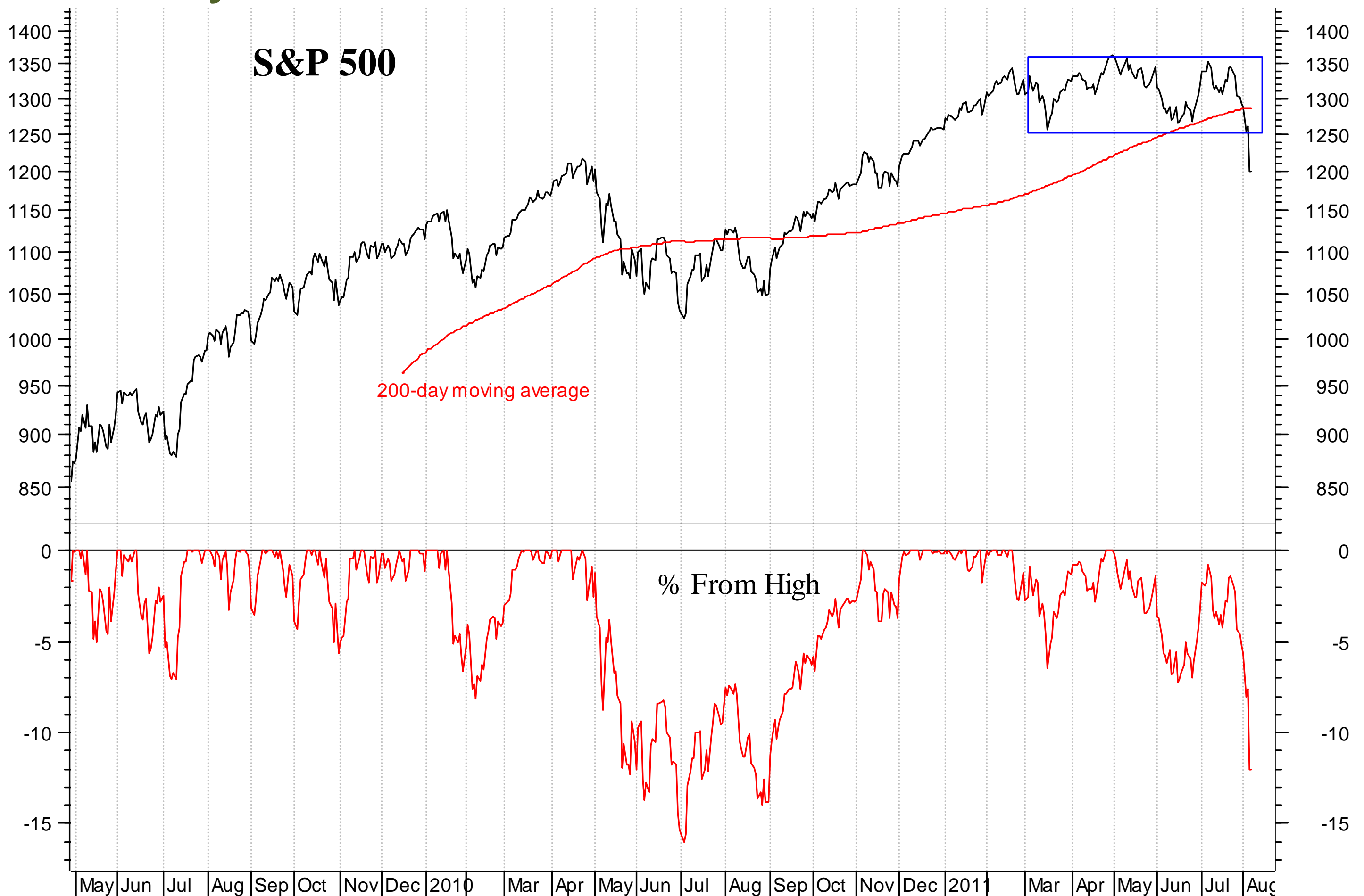
Slow to Overreact

- The S&P 500 broke below our 1250-1365 'decision box' last Thursday, after falling below our initial expected support level of 1295 on Tuesday. We judged both of these breakdowns to be decisive, and thus began the process of reducing our portfolios' risk by lowering beta and raising some cash; RiverFront's Moderate Growth & Income Portfolio now holds 19% cash. Since the debt ceiling circus has ended for now, we think the main issue for financial markets is the probability of another recession, and markets appear to have become more sensitive to incoming economic data rather than earnings. Although we are not yet convinced that the cyclical bull market has ended, we see sufficient fundamental and technical reasons for defensive action. Last week's 7.2% decline in the S&P 500 has left the market cheaper, oversold (down too far too fast) and with extremely negative crowd sentiment. As long as we continue to believe recession will be avoided, we will look for evidence that the market is stabilizing before we redeploy cash.
- One of our favorite maxims is 'markets are slow to overreact,' and stocks seemed to be overreacting last week. The S&P 500 was only 1.5% off its 2011 high of 1364 just two weeks ago, despite Japan's earthquake, tsunami, and nuclear meltdown in March, Europe's ongoing financial woes, the debt ceiling/budget deficit imbroglio, sharp downward revisions to GDP, and a struggling jobs market. Strong earnings growth, a cheap US dollar, and an accommodative Federal Reserve were sufficient to keep stocks in a rising trend. Unfortunately after weeks of anticipation of the August 2 debt ceiling 'deadline,' stocks sold off once they realized that Washington only managed to kick debt ceiling and budget problems down the road. As a result, we must acknowledge that recession risks have risen. Economic growth slowing to current levels – ISI Group has called it 'stall speed' – has historically led to recession. However, since a portion of this slowing was due to the effects of the earthquake, we still think the odds of recession are well below 50%. Last week's jobs report and purchasing managers surveys, while not great, suggest the economy is still growing. That said, we are worried that the stock market still has some downside potential since the overreaction phase seemed to just get started last week, hence our risk management tactics.
- Emerging markets have been raising interest rates for the last year in an effort to slow their rapid economic growth. We think a reversal of these policies offers the greatest potential for economic growth and would benefit US stocks. However, it may take a few more months before emerging markets' inflation has cooled enough for central banks to end their tightening cycles and become more accommodative to growth.
- The Bureau of Labor Statistics (BLS) employment situation report for July, released last Friday, was better than economists' consensus expectations and also much improved from June. The establishment survey's employment gains for the prior two months were revised higher by a cumulative 56,000, so including July's 117,000 job gains; the three-month average is 72,000. This is still relatively weak growth, but growth nonetheless, which suggests that mounting recession fears could be premature. Furthermore, excluding government job losses of 37,000, private sector job creation of 154,000 was significantly stronger than the previous few months (which were below 100,000) while aggregate payrolls (hours worked multiplied by hourly earnings) have rebounded, implying that household income growth should be able to continue supporting economic recovery.
- The BLS report's household survey, from which the unemployment rate is derived, was more disappointing. The unemployment rate ticked down to 9.1% because 374,000 people left the labor force. Labor force participation (the number of people employed or looking for employment as a percentage of total population) has moved steadily lower even since the end of the 2001 recession, highlighting the woeful state of the job market. The participation rate has fallen from 67.3% in 2000 to 63.9% currently, the lowest since 1984. Part of the participation rate's decline may be due to demographics, as baby boomers start to leave the labor force, but we believe that the greater impact could be from expiring unemployment benefits (jobless claims recipients are required to be actively seeking work).
- Other employment data released last week help confirm Friday's BLS report. The Automatic Data Processing (ADP) employment report showed private nonfarm payrolls rose by 114,000, led by small and medium-sized businesses.

Meanwhile, initial jobless claims continue to trend lower, although the four-week moving average is still above 400,000, a level that corresponds with slow, but ongoing, economic growth.

- The Institute for Supply Management data released last week also reflected slower but still positive growth. Both the manufacturing and non-manufacturing purchasing manager indexes (PMIs) remained above 50 in July, indicating expanding business activity. The manufacturing survey fell 4.4 points to 50.9 while the non-manufacturing survey fell 0.6 points to 52.7. Somewhat worrisome, in our view, the manufacturing survey's new orders component, which often leads the overall index, dropped 2.4 points to 49.2, indicating contraction. PMIs around the world mostly remain positive but have been decelerating – the global manufacturing PMI has declined for five consecutive months, to 50.6. As markets price in increasing odds of recession, and policy support (especially from emerging markets) remains on hold, we will wait for further confirmation by domestic and international PMIs falling below 50 to downgrade our expectation of 'muddling through' economic growth.

The Weekly Chart: Downside breakout from decision box



The top panel of our chart shows the S&P 500's breakdown from both our 1250 to 1265 'decision box' and the 200-day moving average. The bottom panel shows the amount in percent that the S&P 500 is below its most recent high, a concept inspired by Jim Bianco. The S&P 500 closed last week 12% below its 2011 high; last summer it was 16% off its high, which would be equivalent to about 1146 this year. Our next levels of potential technical support are 1170 and 1140. Below that, we see the 2010 lows (1010 through 1040) as the next technical support.

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