THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Psychology and Reality: Consolidation Likely

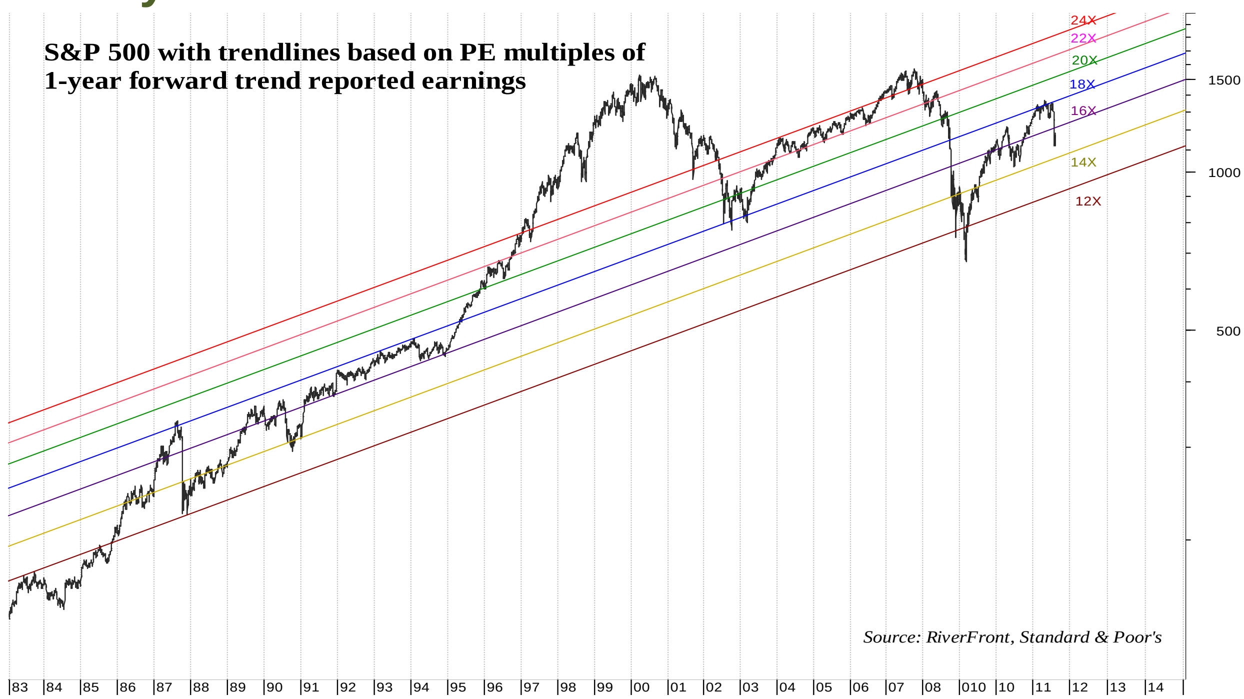
- While the extreme nature of the sell-off in risk assets over the last two weeks was part of our contingency planning, its magnitude still surprised us. We must now assess what it means and whether it is excessive, or prescient. What is clear is that investors are increasingly convinced a developed-world recession is coming, and we think they are assigning it about a 70% probability. This probability is likely based off high yield spreads, Treasury yields, and stock valuations. We currently disagree, and put the chance of recession at less than 50%. Our contention rather is ***painfully slow growth*** due to highly accommodative central bank policy**.** That said, we recognize the fragility of the global financial system and, perhaps more importantly, the potential self-fulfilling nature of falling global consumer and business confidence. We have repositioned portfolios, raising 10% to 20% cash, so that we can take the time to assess the fundamentals, and we believe that stocks will consolidate in the weeks ahead as other investors do the same. Our best guess is that a decision box trading range will form between the recent S&P 500 low of 1120 and the breakdown level of 1250. In our opinion, stocks are attractive now in any scenario other than an economic and earnings recession, while high quality bonds are poised to underperform in any scenario other than global recession.
- On a positive note, data on jobs and retail sales reported last week generally supported our economic view. Initial jobless claims fell by 7,000, to 395,000, the lowest in four months, as the four-week moving average fell for the sixth consecutive week to 405,000. Jobless claims have a good inverse correlation with GDP growth, and we would regard a drop of the four-week average below 400,000 as strong evidence against an impending recession. July's retail sales rose 0.5% month to month, in line with expectations, with core sales (excluding autos, gasoline, and building materials) up 0.3%, slightly better than expected. Additionally, June's retail sales growth was revised up to 0.3% from 0.1% and core rose to 0.4% from 0.1%.
- Strategically our Price Matters℠ framework means that, following the decline, we expect higher 7- to 10-year returns from stocks and lower returns from bonds since our end points have not changed. We believe it is crucial that clients and their advisors carefully select their timeframes and their willingness to withstand the kind of volatility we have just seen. As we have been recently, we will continue to be much more aggressive in reducing risk in our more conservative portfolios, but we do not seek to avoid risk altogether since we believe 'low-risk assets' can carry long-term dangers as well — for example, last week 10-year TIPS (Treasury Inflation Protected Securities) yields went negative. Fortunately, the kind of higher quality, dividend-paying stocks in which we remain most heavily invested performed relatively well.
- Tactically, our risk management disciplines are in a high state of alert due to the stock market's breakdowns below levels we regarded as strong support, as described in our prior Weekly, so we have taken the defensive actions discussed above. (Please contact your financial advisor for details). Two of our three rules for investing — *Don't Fight the Fed* and *Beware the Crowd at Extremes* — have become more positive for stocks. The Federal Reserve has extended its timeframe for being accommodative, announcing after last week's meeting that it anticipates "exceptionally low levels for the Federal Funds rate at least through mid-2013." This, combined with its downgraded economic outlook, suggests the Fed is prepared for further stimulus if they perceive the need.
- Ned Davis Research's crowd sentiment polls for stocks, both daily and weekly, have fallen sharply into extreme pessimism from neutral a couple of weeks ago. The University of Michigan's Consumer Sentiment Index, which we regard as a longer-term sentiment gauge, fell to its lowest level since 1980. Furthermore, valuation for stocks has become attractive based on both the one-year forward price-to-earnings (PE) ratio of trend earnings (see Chart of the Week), and RiverFront's Price Matters℠ model, which shows stocks more than 40% below their long-term trend, a level that has historically been a good buying point for investors with time horizons of five years or more.
- Our third, and perhaps most important, short-term investment rule — *Don't Fight the Trend* — is where we see cause for concern. The 200-day moving average, our proxy for the primary trend, has flattened and is no longer rising. This is similar to last year, when the primary trend was flat from late June through September. If recession is avoided, we think the primary trend will turn up again.
- Two other developments from last week should provide investors further cause for guarded optimism:
  1. The European Central Bank (ECB) has reluctantly begun buying Spanish and Italian debt in the secondary market, driving yields there down a percentage point to just over 5%. We believe this shows the ECB's commitment toward containing the crisis by utilizing its balance sheet to backstop ailing sovereign debt markets — similar to Fed purchases of agency debt that

helped calm US mortgage markets. We believe this is a positive step in preventing an immediate crisis from blossoming, but resolving the situation fully requires further fiscal backing of its bailout fund to recapitalize the banking system and that still needs to be ratified by all Eurozone nations.

2. China is allowing a faster appreciation of the yuan. With the Fed pre-committing to lower-for-longer interest rates, the US dollar has been weakening as global investors seek higher yielding (positive real return) assets. Because the yuan is managed against the dollar, it has generally been weakening along with the dollar among most currencies, but the cost to China has been increasingly unwanted Treasury exposure as a result of its currency interventions. We believe allowing the yuan to strengthen more against the dollar is a tacit admission by China's foreign exchange reserve authorities that its intervention policies are unsustainable. Recognition of this reality should facilitate global rebalancing and supports economic growth, in our view.

- Generally it appears that monetary authorities worldwide are trying to compensate for fiscal uncertainty created by political leaders. While not an ideal situation by any stretch — one would of course prefer them working in concert — we expect central banks globally to succeed in their efforts to maintain financial stability and avoid economic recession, especially given their overwhelming incentives for institutional preservation. With central banks increasingly coordinating their efforts at stabilizing the global financial system to permit orderly deleveraging and structural rebalancing of the economy, we believe safe-haven assets are becoming overbought, particularly with respect to attractively valued risk assets.

The Weekly Chart: Stocks attractive if recession avoided



We have always regarded valuation as a blunt instrument that reveals more about the subsequent bull or bear market than it does about the timing of the top or bottom. Thus, valuations are most useful at extremes. In the chart, we calculate PE trendlines using mid-cycle or 'trend' earnings to try and eliminate the effects of business cycles. We believe this more closely approximates sustainable earnings growth. Since earnings are currently 20% above trend, we believe our valuations are conservative. The S&P 500 bottomed at below 12x trend reported earnings during the Great Recession of 2008-09, and rose to about 18x (1314 is 18 times 2011 trend earnings of $73) as investors anticipated continued earnings growth. Historically, 18x has been an important valuation level; it was a ceiling from 1987 through 1995 and was the trough in 2002-03. Current valuation is around 15x forward trend earnings, roughly equivalent to last year's low and at the low end of the 20-year range. These low valuations are consistent with the pessimistic sentiment readings from our other sentiment gauges and, if the market's primary trend turns upward, would present a good long-term buying opportunity, in our view.

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