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

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Wanted: Coherent Policy Response

- With the S&P 500 trading below both its 50- and 200-day moving averages, and the 50-day in a clear downtrend, we have enough technical concerns to remain defensive. The 200-day moving average of closing prices is our proxy for the primary trend and, similar to the summer of 2010, it has stopped rising and is moving sideways, making our rule 'don't fight the trend' unclear, but with the risks firmly to the downside. Our caution is reinforced by our fundamental view that, absent sufficient policy response, the odds of a US recession have risen to around 50/50 and Europe's sovereign debt situation has moved to crisis mode with no apparent plan for resolution. This is reinforced by an important technical breakdown in the euro. Offsetting the primary trend's lack of clarity, the messages from our two other investment rules, 'don't fight the Fed' and 'beware the crowd at extremes' are favorable for stocks. The Federal Reserve has committed to keeping short-term interest rates low for two more years and has begun discussing additional stimulative options. Sentiment, as measured by the Ned Davis Research Crowd Sentiment Poll, has been extremely pessimistic since late July and remains at levels that have historically been good for stocks. Finally, RiverFront's long-term Price Matters[SM] framework, which is based on an inflation adjusted total return index of large cap stocks, suggests stocks are about 30% below their 85-year trend, a condition that has never resulted in negative real returns over the subsequent seven years throughout the period.
- Real US interest rates are now negative for maturities out to 10 years, as measured by Treasury Inflation Protected Securities (TIPS) yields. *Financial Times* chief economics commentator Martin Wolf wrote last week: "We must listen to what bond markets tell us... They are saying: borrow and spend, please... What matters is how borrowing is used." While it remains to be seen whether and how much, if anything, of President Obama's job plan is enacted by Congress, according to Goldman Sachs: "this proposal could shift the fiscal impulse in 2012 from -1.1% of GDP to +0.4% of GDP." As we wrote last week, we believe fiscal stimulus is justified given the rising risk of recession and government's low (indeed negative) borrowing costs. However, to echo Wolf's point, we think any stimulus must focus on infrastructure investment rather than short-term consumption to be effective, and such a change to President Obama's proposal might make it more palatable to the House.
- Monetary policy rhetoric is also ramping up. Last Thursday, Chairman Bernanke expanded on his Jackson Hole speech by adding that "the Federal Reserve will certainly do all that it can to help restore high rates of growth and employment in a context of price stability." This is a significant escalation from merely contemplating the Fed's 'range of tools' to providing additional monetary stimulus, in our view. Furthermore, as expressed more forcefully by Chicago Fed President Charles Evans last week: *"Suppose we faced a very different economic environment: Imagine that inflation was running at 5% against our inflation objective of 2%. Is there a doubt that any central banker worth their salt would be reacting strongly to fight this high inflation rate? No, there isn't any doubt. They would be acting as if their hair was on fire. We should be similarly energized about improving conditions in the labor market... a fairly conservative estimate of that natural rate is 6%. So, when unemployment stands at 9%, we're missing on our employment mandate by 3 full percentage points. That's just as bad as 5% inflation versus a 2% target. So, if 5% inflation would have our hair on fire, so should 9% unemployment."*
- To the extent that more aggressive policy stimulus is applied, we would normally expect recession odds to begin diminishing and for risk assets to rally. However, US policy actions must also be considered in the context of an impending Greek default that could create fears of a 'Lehman-like' disorderly debt deflation. We think Europe's monetary and fiscal authorities have adopted a 'let's protect our own' attitude, and we see little willingness to compromise in the manner necessary to prevent a Greek default. Furthermore, policymakers' actions have been insufficient to deal with the consequences of default; hence, a disorderly wind down of overhanging sovereign debt is becoming more likely as risks remain substantial, unresolved, and rising. A potential silver lining is that a Greek default (depending on how it is handled) might finally force recognition that unserviceable debt must be restructured, forcing policymakers to confront reality and make plans to deal with the default rather than trying to prevent a default financial markets consider inevitable. This would be a first step on the road to recovery, in our view, and an initial sign of progress.

- Four weeks ago, we thought that the S&P 500 would likely trade within a range of 1120 to 1250. Our Weekly Chart shows that the lower end of this range has been tested three times, providing some hope that 1120 will again act as downside support. A break below 1120 would signal further deterioration in Europe's debt crisis, in which case our next area of potential technical support would be between 1000 and 1040. Our chart shows several technical factors that are disconcerting: Attempts to retrace the mid-July through early-August decline have been anemic thus far; the rally from the lows failed at the 50% retracement level. The S&P 500's Relative Strength Index (RSI), which compares the magnitude of a stock's recent gains to the magnitude of its recent losses, has stalled around 45 (strong rallies typically produce readings above 70), as may be seen in the bottom panel of our chart. Next, there has been a technical event called the 'death cross' (see red circles in chart) where the 50-day moving average crosses below the 200-day moving average. This crossover has done a good job of staying on the right side of longer term trends but, like any price momentum tool, this indicator gives false signals more than half the time. Its effectiveness is that false signals generally produce small losses whereas good signals have captured all significant trends (see *The Weekly View*, 7/6/2010, for more information on the 'death cross'). Over the next few weeks, we will watch for breakouts above or below the trend channel from the early August bottom to help decide whether the S&P 500 will break out of the top or bottom of our trading range. Meanwhile our portfolios remain defensive and hold 10% to 20% cash. We are very aware that last summer's death cross and flat primary trend were followed by a 30% rally, but we think coherent policy responses are necessary to reprise last summer's outcome.

The Weekly Chart: Déjà vu – a flat primary trend and a 'death cross'

Past performance is no guarantee of future results

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