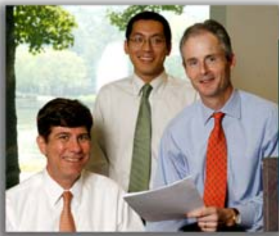


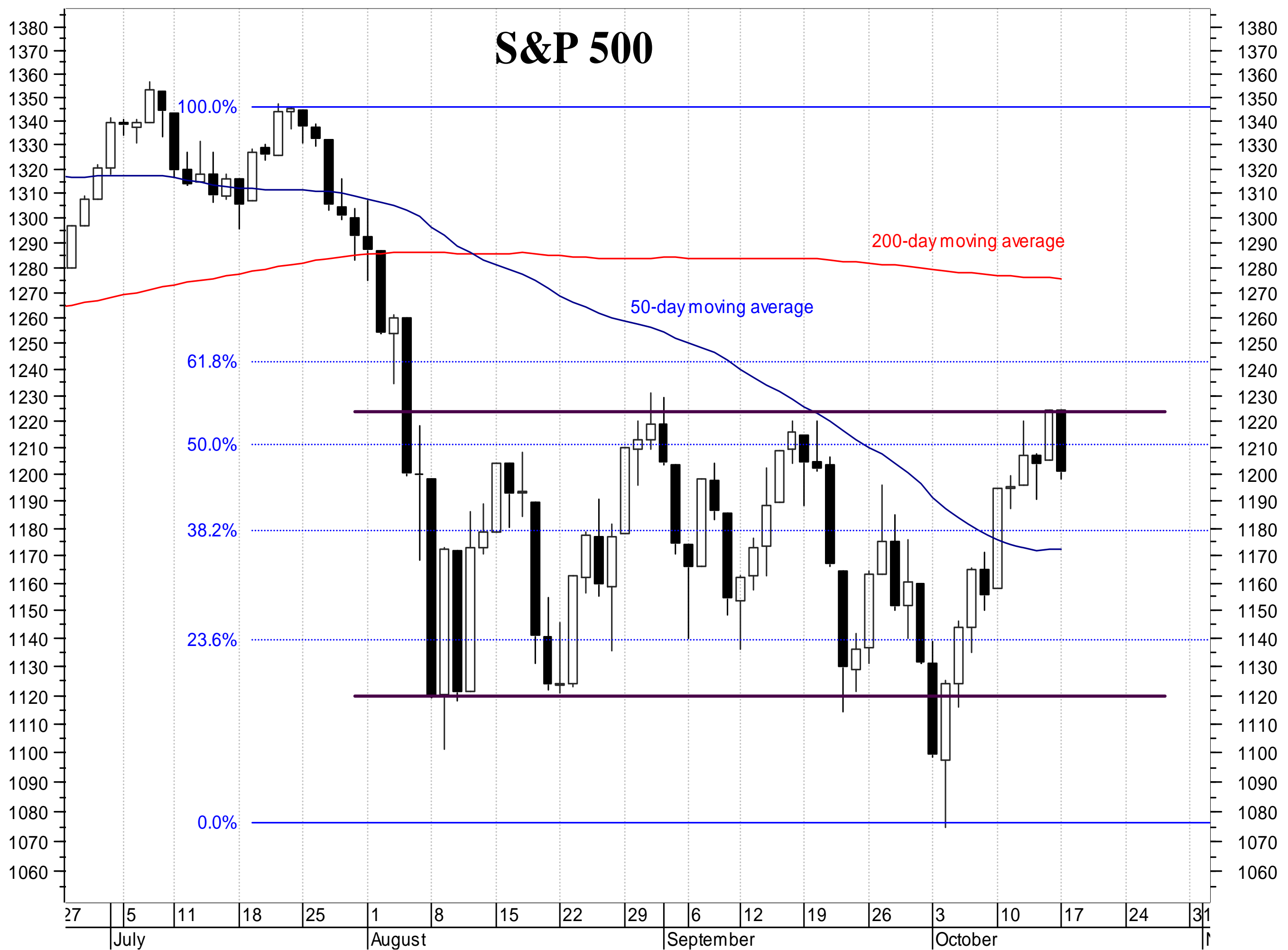
THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu October 18, 2011

Rapid Rally Hits Resistance

- **While we think the S&P 500 likely made its low for the year at the beginning of October, we expect continued volatility as news, rumors, and posturing come from Europe. The rally has quickly hit major technical resistance and backed off, and we are looking for a higher low to confirm our view (see Weekly Chart).** Fundamentally, we think earnings growth will continue to slow after peaking at a record 99% year-over-year growth rate in the third quarter of 2010 and profit margins will begin to contract as benefits from cost cutting become more difficult to achieve. ISI Group forecasts S&P 500 trailing-four-quarter earnings to increase 3% year over year in the second quarter of 2012, which translates to $94, essentially unchanged from current levels, and we think this is a good base case. ISI's forecast for weakening earnings is based on the global economic slowdown, a flattening yield curve, and somewhat rising unit labor costs. Applying a conservative price-to-earnings ratio of 12 to $94 earnings would be about 1130 for the S&P 500, which we think underpins our expectation that Oct 10th marked the low for stocks.
- **In a nutshell, we believe stocks have rallied as the momentum of bad economic news has given way to 'not so bad' news.** This will continue only if European leaders' *Plan B* has considerably more credibility than has been delivered thus far, in our view. We believe the following conditions are necessary for stocks to continue the current rally into the first half of 2012:
  1. No US recession: We currently view odds for recession next year as 50/50. Our odds improve if progress is made in Europe (lowering contagion effects) and US housing and mortgage markets begin to stabilize (see Weekly Chart), with home prices finally finding a floor (even as household deleveraging occurs). Emergency unemployment benefits are set to be phased out by year end and will expire by mid-2012, removing a key support for many households suffering from long-term joblessness. Our favorite 'recession watch' indicators – initial jobless claims, the ISM indexes and credit spreads – currently indicate slow growth, but no recession.
  2. Europe avoids sovereign debt meltdown: The 'plan to have a plan' with ECB (and IMF) backing has provided some breathing room for Eurozone policymakers. However, the 'devil is in the details' and we think that a successful plan requires a credible recapitalization of the banking system with an orderly mechanism to write down unsustainable sovereign debts while committing to eventual fiscal union. This process will likely take several months. While a European recession still looks likely next year (as austerity kicks in) it is much better managed with a functioning banking system, which lowers transmission risks to the rest of the world.
  3. US budget resolution: Similar to Europe, the Congressional 'super committee' has been tasked with developing a plan to cut future budget deficits by at least $1.2 trillion over the next decade, with a 'trigger' mechanism to automatically cut spending, including politically painful reductions to the Pentagon and Medicare, if consensus cannot be reached by December 23. So far, discussions have been shrouded in secrecy, but a coherent plan that is adhered to could catalyze greater market confidence as future uncertainty diminishes.
  4. Global rebalancing: We think a handoff of consumption demand to developing economies' emerging middle class is the key determinant to ongoing global growth over the intermediate term. This entails increased exports from developed nations and greater imports by developing nations. China, which is only in the early stages of its transition to a more consumption-driven economy, has the most to gain — hence our longer-term optimism that rebalancing will eventually occur. With the downside of overreliance on investment becoming more evident, however, China's incoming leadership faces difficult choices upon taking office next spring, and current policymakers have yet to respond to slowing global growth. **A policy shift to monetary easing by most developing economies would be one of the most positive catalysts for better performance in 2012, in our view. We think this is likely and so are maintaining our emerging market weightings.**

The Weekly Chart: Stocks both volatile and indecisive



Source: RiverFront Investment Group; Past performance is no guarantee of future results

The S&P 500 has rallied nearly 14% from its October 3rd intraday low to last Friday's high. We wrote last week that stocks had likely hit their lows for this year, based on extremely pessimistic sentiment, hopeful signs that European policymakers were working towards a solution for their debt crisis, and incoming US economic data that suggested slow growth but no recession. Now the rally has run into the 1220 resistance that has contained it all summer – since early August, the S&P 500 has ranged between 1120 and 1220 (with a two-day dip down to 1075), as may be seen in our chart. Given this volatility, we think the moving averages present a clearer picture.

The 50-day moving average, which has been in a clear downtrend since July, reflecting increasing investor pessimism, has flattened as the return of some hope has allowed prices to break above it. The 200-day moving average, which we see as the primary trend has turned down slightly, but has been fairly flat, reflecting a major pause in the uptrend which began in 2009. The 200-day will likely act as significant overhead resistance even if the index manages to break above the summer's trading range.

If our more optimistic thesis is correct, the S&P 500 will make a higher low somewhere between 1150 and 1180 in the coming weeks and eventually break up through the primary trend, with the objective of recovering to 1360 in the next six months. A decisive and persistent break below 1150 would call our view into question.

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