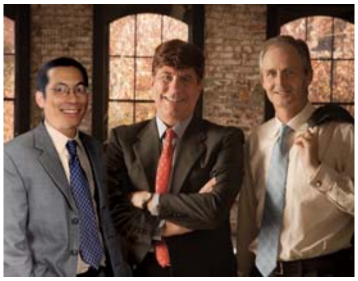
Upside Breakouts for Stocks and Interest Rates



From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

- **The S&P 500 broke above 1400 last week, reaching its highest level in four years. This upside breakout, a positive technical signal in our view, reinforces our belief that stocks are in the midst of a cyclical bull market that should last at least through this year.** We recommend investors recognize that volatility has been unusually low so far in 2012 and is likely to increase as the summer approaches and the election becomes a two-person contest. We raised our 2012 S&P 500 trading range to 1250 – 1500 at the beginning of February based on (1) the European Central Bank's (ECB's) success in stabilizing Europe's banking system and lowering Italian and Spanish bond yields, and (2) economic data from around the world that was showing a pickup in growth.
- We have continued to add stock exposure to our portfolios this year, but we are not currently inclined to aggressively chase stocks or raise the upper end of our trading range. Here's why: **While two of our investing rules are solidly on the side of stocks – *don't fight the Fed* and *don't fight the trend* – our third rule, *beware the crowd at extremes*, is not supportive and suggests some restraint.** The Ned Davis Research (NDR) Crowd Sentiment Poll for stocks, while not at the optimistic extremes that often accompany peaks in stocks, has entered the low end of the extreme optimism zone. Furthermore, we think there is a good chance for a second-quarter consolidation, or sideways movement, based on the average behavior of the previous 18 cyclical bull markets as calculated by NDR. Thus, since the S&P 500 is 7% away from the top of our range and 11% above the bottom, the recent stock additions to our portfolios have been in higher quality stocks with increasing dividends. We expect to become more aggressive in our equity selection – e.g. small/midcap stocks and emerging market stocks – when/if a pullback or consolidation occurs.
- **Interest rates also made an upside breakout last week. After 19 weeks of ranging between 1.8% and 2.1%, the 10-year Treasury yield rose to 2.3%, the first time it has been above its 200-day moving average since early July 2011.** The rise in yields was driven by several factors, including the successful results from the Fed's stress test for banks, a widespread increase in US retail sales, and a bigger-than-expected drop in unemployment insurance claims. Our initial technical target for 10-year Treasury yields is 2.5%, but we could easily see them rise to 3% if positive economic data continues and inflation expectations creep higher. Following our February sale of long-term Treasuries – held as a potential hedge to help protect against a Lehman-like, systemic collapse in the European financial system – our portfolios currently have no exposure.
- **Household debt service ratios – the ratio of required debt payments to disposable personal income – fell to 10.9% in the fourth quarter, a 17-year low and down from an early 2008 high of 13.9% (see the Weekly Chart).** This reflects a four-year process of US household deleveraging by paying down, refinancing, and restructuring debt, as well as record low interest rates. We see the low household debt service ratio as a big plus for the US economy since it frees up more of consumers' income to spend on goods and services, i.e. consumption, which is about

70% of the US economy. Indeed, the tables within the chart show that since 1980, periods when the debt service ratio was less than 11% were the best environment for both nominal and real GDP growth and employment gains. **The low debt service ratio also helps explain rising consumer confidence despite the spike in gasoline prices, the first quarterly rise in consumer credit since the second quarter of 2008, and the outperformance of the consumer discretionary sector in 2011.**

- The low debt service ratio is also likely responsible for the surge in auto sales that began last year. Auto sales peaked four years ago; with the average car loan's term at around five years, many car loans have been paid off and consumers now have extra cash flow to spend or to make payments on a new car, helping those banks that have rebuilt their balance sheets and are able to lend. Furthermore, NDR observes, "Autos are extremely important this economic cycle because a) autos represent a larger portion of the economy than housing, and b) the auto bailout makes them symbolic of the recovery from the 2008-09 crisis."

THE WEEKLY CHART: HOUSEHOLD DEBT BURDEN NEAR RECORD LOWS