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Temporary Pullback in Developed; Bear Market in Emerging

RiverFront's *Outlook 2014* reiterated our caution regarding emerging markets, and last week's pullback in global stock markets reflected their structural weaknesses. We are particularly concerned about commodity-sensitive countries with large current account deficits and/or high inflation. We see a recipe for further underperformance by emerging markets when these factors are combined with reduced demand from the world's largest commodity importer — China (which is attempting to rebalance its economy) — and the potential for political instability from 2014 elections in Thailand, Indonesia, South Africa, India, Turkey, and Brazil.

Emerging markets as a whole are no longer enjoying the tailwind of rising commodity demand and face the headwind of a difficult economic transition from export-led growth to domestic consumption.

Following three years of underperformance, there has been some hope that emerging markets could stabilize, as developed markets like the US, Europe, and Japan experience synchronized growth. However, developed market expansion has relied heavily on increasing export competitiveness and has not been primarily consumption-led, to the detriment of emerging markets, in our view. Furthermore, emerging market stocks, bonds and currencies have consistently reacted negatively to the prospect of the Federal Reserve 'tapering' its bond purchase program, a process which has only just begun.

Longer term, we are hopeful that reforms and structural adjustments in some emerging markets, when combined with their favorable demographics, will end their underperformance. We see more potential in Asia; Latin America's historic tendency towards political populism has reappeared to the detriment of several countries, notably Argentina and Brazil.

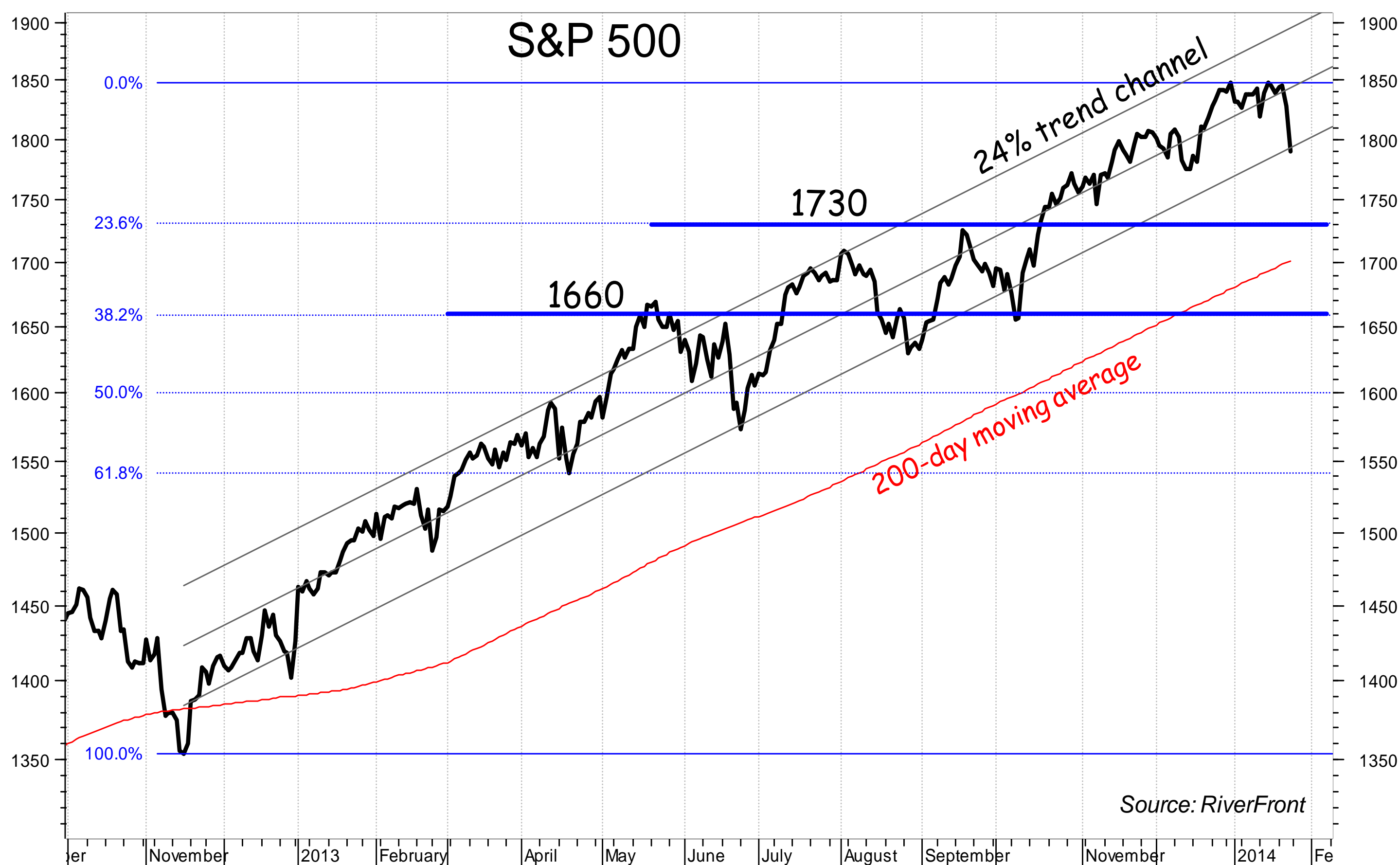
Traditional 'safe-haven' assets are not risk free. With growth improvement likely in the developed world, we believe the current pullback in stocks will be temporary.

With emerging market risks rising last week, global stock markets sold off as investors sought refuge in traditional safe-haven assets like Treasuries, gold, and Japanese yen. While these assets have performed well in previous stock market corrections, we remind investors they are not risk free. Indeed, gold has lost a third of its value since Sept 2011, and we expect Treasury yields to resume their uptrend once the current correction ends. Regarding the yen, the Bank of Japan shows no sign of stopping its asset purchases (quantitative easing), which have been effectively devaluing the yen. Safe haven assets are only likely to outperform for a prolonged period in the event of a recession, for which we assign a low probability this year. Thus we believe the current pullback in developed markets will be temporary.

The S&P 500 fell 2.6 % last week and is 3.1% below its January 15 record high. After rising 33% in 2013, with extremely optimistic stock sentiment and average daily volatility the lowest it's been since early 2007, we are not surprised by the recent pullback. That said, we think the quality of the S&P 500's next bounce will

help determine if there is potential for a tradable correction. More likely, we expect the S&P 500's growth rate to decelerate from the rising 24% annualized channel (grey lines in *The Weekly Chart*) that has tracked the index's growth since November 2012. Since that time, declines from the highs have been relatively shallow – the biggest one was the 5.8% drop from the May 2013 peak after the beginning of the Fed's 'taper talk.' Based upon typical retracement levels following rallies, our initial support level for the S&P 500 is around 1730. This represents the 23.6% retracement of the November 2012 through January 2013 rally and would also be similar in magnitude to last May's pullback. We would also expect the 200-day moving average – currently at 1700 and rising by more than one point a day – to act as support. If the S&P 500 is able to find support around these levels, we would view that as evidence of a more moderate pace of ascent, breaking the pattern of the 24% trend channel. A breakdown below these support levels, which we do not expect, would mean the next level of technical support is around 1660, the 38.2% retrace of the 14-month rally, the May 2013 peak and a support level last October.

THE WEEKLY CHART: TECHNICAL SUPPORT LEVELS



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