THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Investor Optimism – A Growing Headwind For Stocks

- Investor sentiment is a contrary indicator, which means that stocks generally deliver their best returns following periods of deep pessimism. Institutional investor sentiment started to recover from record levels of pessimism quite quickly following stocks' March 2009 lows, and returned to elevated levels of optimism by last summer where it remains. However, individual investors remained more cautious until recently (see Weekly Chart). The persistence of the stock market's uptrend combined with clear evidence of a robust recovery in corporate earnings has finally persuaded individual investors to become more optimistic. Ironically this will likely make further gains over the short term more difficult to achieve.
- Phil Roth, a founding member and former president of the Market Technician's Association, succinctly framed the purpose of technical analysis: rather than predicting the future, technicians "assess the trend and advise appropriate actions." In that light, from a technical perspective, we assess the stock market's uptrend as still intact. The S&P 500 has made a consistent pattern of higher highs and higher lows since July's bottom, which itself was a normal 24% retracement of the cyclical bull market's initial rally from the March lows. Furthermore, stock market measures of breadth – advancing issues versus decliners and stocks making new highs versus those making new lows – suggest relatively broad participation in the uptrend over the past six months and should support the trend's durability.
- Thus two out of three of our investing rules, *don't fight the trend* and *don't fight the Fed*, remain positive for stocks while only the third, *beware the crowd at extremes*, is signaling caution. With stocks around the world in clear primary uptrends and global monetary policy supportive, we do not expect investor sentiment to de-rail the current cyclical bull, but we believe elevated levels of optimism are a headwind and make corrections more likely.
- Ever alert for *What Could Go Wrong* (the title of our 1/11/10 weekly) we continually assess the stock market's trend for signs of change, mindful that short-term pullbacks and corrections that 'shake out' overly nervous investors are a normal element of uptrends. Consequently we draw lines in the sand that, if they are successively crossed, would reduce our confidence in the trend and ultimately would prompt action and risk management. The initial levels of support we see for the S&P 500 are 1120 (the 29-day moving average), 1098 (the 72-day moving average) and 1080 (the 24% retracement of the rally from July). Pullbacks to any of these levels followed by upside gains would reinforce our confidence in stocks' uptrend.

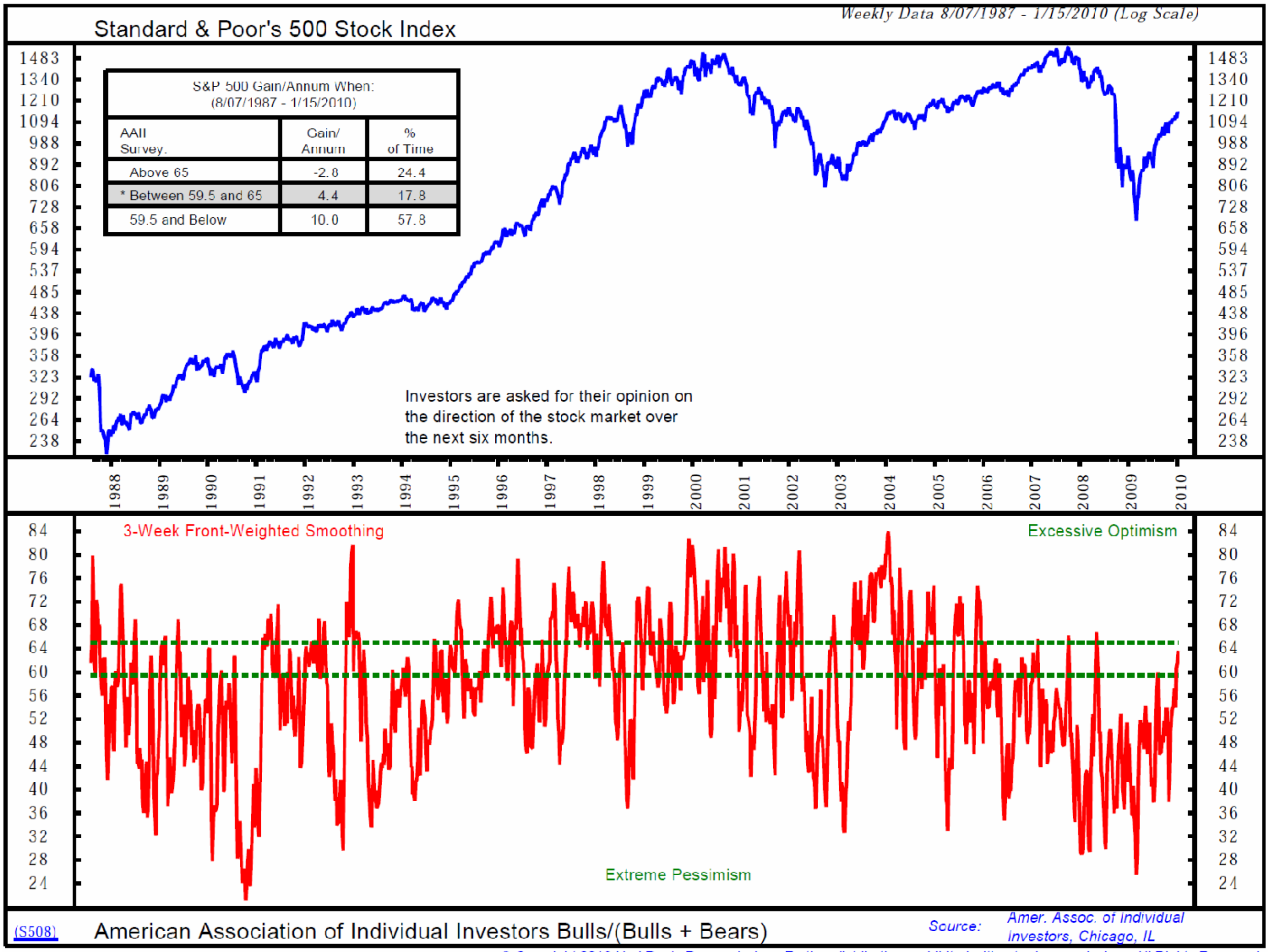
Chile: a high quality emerging market opportunity

On Sunday, Chileans elected a right-of-center government for the first time since the country ousted former dictator General Pinochet 20 years ago. The new President, Sebastian Pinera takes over from a pragmatic left-of-center government that has delivered stable growth and earned Chile its reputation as the Singapore of Latin America. Chile's stock market has become a consistent outperformer in both up and down markets – and we think this will continue in 2010 for a number of reasons.

Chile has a solid balance sheet led by a fiscally responsible government that believes, "being a Keynesian means being one in both parts of the cycle" (a quote from finance minister Andrés Velasco). This means that government savings during good times can be used for fiscal stimulus during the bad without depleting government finances (a concept that has been forgotten in the US and other developed countries). This has smoothed, rather than exaggerated, the impact from the global cycle that has whipsawed other Latin American countries. Coming out of recession, we think Chile is better positioned in terms of trade and government finances than many other emerging markets (and most developed markets). Because of its prudently managed economy and fiscal conservatism, Chile is expected to join the ranks of developed markets within the decade. The Organization for Economic Cooperation and Development (OECD) – a club of high-income countries – recently asked Chile to join.

We think the Chilean market offers stable sector diversification with a barbell between Utilities (30%) and Materials/Industrials (40%, split evenly). We think this offers an attractive mix of downside protection and upside capture, especially given our view of a global cyclical upswing led by emerging markets. The Chilean economy is still primarily a commodity- and mining-based economy, and is particularly exposed to copper. Copper prices have been trending higher, which we expect will continue as global reflation ensues. Chilean mines have also attracted foreign investment as China attempts to gain leverage on iron ore pricing from mining giants Rio Tinto and BHP.

The Weekly Chart: Even Retail Investor Sentiment has Revived



Past performance is no guarantee of future results

The bottom panel of the chart shows the percentage of bulls among all individual investors in the survey that are not neutral (bulls plus bears). The table in the top left corner highlights our rule *beware the crowd at extremes* – stocks typically have their best gains when the crowd is excessively bearish, and vice versa. Individual investors have been very bearish for most of the last three years and only recently have reduced their pessimism. As sentiment becomes more bullish, so does our expectation for a correction.

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