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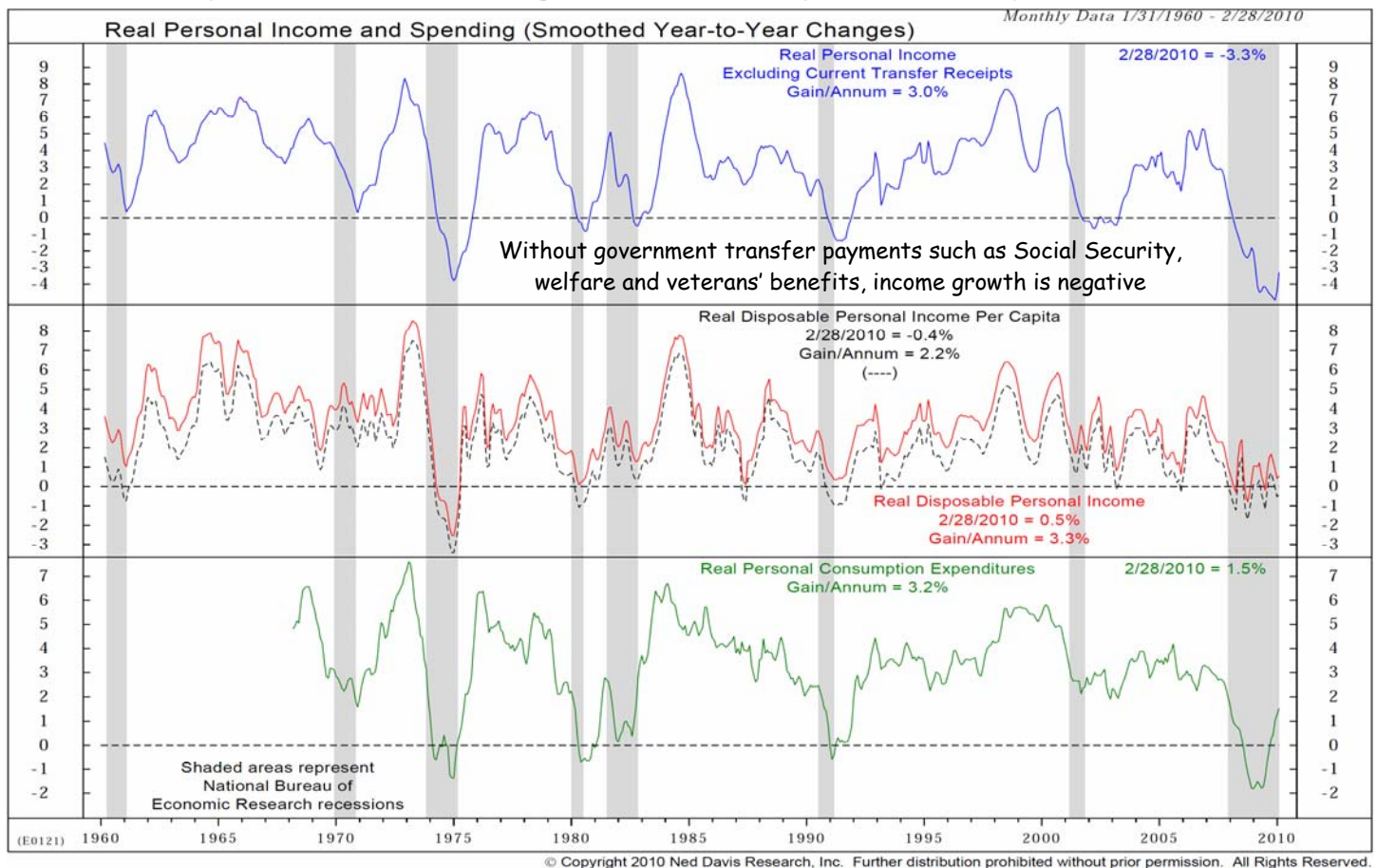
## Optimism Extreme: Reduce Risk But Stay Overweight

- Despite Greece, Goldman Sachs, financial regulation and persistent fears about US debt, stocks continue to rise, climbing the proverbial 'wall of worry' to such an extent that crowd sentiment has risen to optimistic extremes last seen when the S&P 500 hit its record high in October 2007. We believe excessive optimism increases the likelihood of a correction and so have implemented risk reduction trades. As believers in the current cyclical bull, we are still overweight risk assets, but less so. Specifically, we have lowered exposure to Latin America and emerging Asia due in part to the policy implications of monetary tightening in China and India. This is likely to dampen growth in Asia and reduce marginal demand for commodities from Latin America over the near term. Emerging markets enjoyed considerable outperformance following our decision to go overweight a year ago but since February, this relative outperformance has faded. Our long-term fundamental optimism for both regions is undiminished, but we will look to redeploy these assets elsewhere. For now we are holding some cash.
- The Federal Reserve's easy-money policies and its willingness to monetize debt is a critical component of the current cyclical bull in our view. The Fed's challenge is to remain accommodative without raising inflation expectations or debauching the dollar. So far we believe it has been able to meet this challenge because its current policies are appropriate for an environment of subdued bank lending. After the tech bubble that ushered in the new century and the recession that followed, the Fed lowered rates to 1% in 2003 saying that "policy accommodation can be maintained for a considerable period." During that time stocks rallied and, as the recovery took hold, continued rallying even as the Fed switched to saying that it would "remove policy accommodation at a measured pace." We think this dynamic bears a striking resemblance to the current situation. The Fed's present stance is that economic conditions "warrant exceptionally low levels of the federal funds rate for an extended period." As a result, stocks' primary trend is rising, the cyclical bull is intact and we remain overweight risk assets. At some point, the Fed will begin to remove policy accommodation. The sustainability of the bull market will depend on the deftness of its exit strategy.
- The fed funds futures market suggests rate hikes will begin by year end, with the probability rising to 78% by December. We think slower second-half economic growth, as inventory rebuilding and government stimulus begins to fade, could forestall Fed tightening. Regardless, as markets begin to anticipate a less accommodative Fed, we think stocks' rate of ascent is likely to slow through the summer with sector leadership shifting more defensively as a result.
- Greece was in the headlines again last week. We started writing about Greece in January and, three months later, doubts about its ability to service its debt linger. Most recently, Greek deficits were revealed to be significantly higher than originally thought (indeed, to bring the story full circle, Goldman Sachs helped mask Greek debts). This revelation has caused Greece to formally request previously agreed upon assistance from the European Union and International Monetary Fund. The challenge is that European governments must pass legislation requiring parliamentary approval for a bailout. Opinion polls suggest a Greek bailout remains deeply unpopular among contributing members. We think this is a situation similar to the contentious Troubled Asset Relief Program (TARP) bailout package that was passed in the wake of Lehman Brothers' bankruptcy. For the good of the whole — i.e. the financial system and, in Europe's case, its currency union — an unpopular measure will eventually be adopted, in our view, but not without some gut-wrenching brinkmanship, as this saga has already demonstrated.
- Like us, markets appear to be assuming that the EU cannot afford to let Greece default, since the consequences could resemble the Lehman debacle. While unlikely, such an outcome cannot be completely dismissed in our view. Lehman did fail, with catastrophic consequences, and if Greece were to default we think financial markets, especially in Europe, would be similarly roiled given European bank exposure to Greek debt. Furthermore, just as attention turned to other financial companies after Lehman failed, countries in similar situations to Greece (e.g. Portugal, Ireland and Spain) would likely face withering scrutiny which could drive up their cost of borrowing and create a self-fulfilling prophecy of debt default and economic retrenchment. We remain substantially underweight Europe with a negative position against the euro, but plan to reduce risk assets further if European plans for resolution fail and contagion spreads.
- The Securities and Exchange Commission's recent allegations against Goldman Sachs highlight (some would say not coincidentally) the need for financial regulatory reform. The charges shed new light on the structured products and securitization process at the heart of the credit crisis — unregulated derivatives, lack of transparency, conflicts of interest that led to poor underwriting and, perhaps most of all, moral hazard that makes a mockery of prudent leverage and capital adequacy. While we do not believe that proposed legislation will change the culture of Wall Street — or Washington for that matter — we do think it will at least usher in a period of

stability, until new financial ‘innovations’ are made and regulatory complacency (or subversion) sets in again. After all, except for a few perpetrators of the most egregious Ponzi schemes, no one has been punished and indeed many have been handsomely rewarded. To us, with the financial sector rallying 22% since early February, the lesson is clear: business as usual.

- David Orr, an old friend and former Chief Economist at First Union Bank once said “give the American consumer a dollar and they’ll spend it.” That still seems to be true as highlighted by recent retail spending figures, the strong outperformance by the homebuilding and retail industry groups and the Consumer Discretionary sector as a whole, which is the best-performing S&P 500 sector year to date, up 19.3%. New home sales in March, reported last Friday, surged 27% to a 411,000 annual rate, the second largest gain on record. We do not think such gains are sustainable, especially since these sales were likely boosted by a tax credit that is about to expire, but we are impressed that sales growth was much greater than economists’ consensus expectations of 5.5%. ISI’s surveys of retail, restaurant and airline companies have improved significantly since last year and indicate a willingness by consumers to spend. In our view, a double-dip recession in 2011 is unlikely.
- We think there are three main contributors to the resumption of consumption: 1) as stocks recover and home prices have stabilized, household wealth has risen and savings rates have declined, boosting spending; 2) the combination of foreclosure forbearance and ‘strategic defaults’ has resulted in a windfall for around six million homeowners delinquent on their mortgages; and 3) pent-up demand after a severe recession — the economic situation has stabilized enough for people to be coaxed out of their shells and not defer purchases any longer. For consumption growth to be sustained, however, we believe incomes need to rise. With real disposable personal income growth less than 1% (solid line in middle panel below), and unemployment likely to remain high, we think the burst in personal consumption expenditures since the beginning of the year (bottom panel) is likely to prove temporary and that consumption will settle at a slower pace of growth.

## The Weekly Chart: Spending supported by temporary factors



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