THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu

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We Remain Stock Bulls

- The stock market had a memorable day last Thursday. At one point the S&P 500 was down more than 8.5% before closing down 'only' 3.2%. The most volatile action occurred in a short period of time. The S&P 500 fell from 1130 at 2:35 PM to 1066 and was back to 1130 a little after 3 PM. Although the market had been down for most of the day — primarily due to concerns of contagion effects from the Greek crisis — the afternoon roundtrip was apparently the result of computerized trading gone wild. Additionally, judging by the strong upward moves in the yen and the US dollar, leveraged investors that had borrowed in these carry trade[1] currencies were frantically unwinding their positions. We do not think the cyclical bull market has ended and our sense is that this market drop has set up a buying opportunity. This is because the primary trend is still rising (don't fight the trend), the time horizon that the Federal Reserve will remain accommodative has likely lengthened (don't fight the Fed), and the optimistic sentiment we wrote about two weeks ago has diminished somewhat (beware the crowd at extremes).
- We have been braced for a stock market reaction to the Greek crisis since February when we wrote 'Raising the Risk Level to Elevated' (*Weekly View*, 2/22/10). When stocks started to falter 10 days ago we expected initial support for the S&P 500 at around 1150. While the decisive break below 1150 has raised our concern of something more than a typical correction, we see enough technical evidence to argue against the end of the cyclical bull market: The S&P 500 remains above its rising 200-day moving average — our gauge of the primary trend — currently at 1096. The S&P 500's late-April peak was at a resistance level where pullbacks often occur; in this case the 62% retracement of the 2007-2009 bear market (see Weekly Chart). As may also be seen in our chart, in the context of the 83% surge from the March 2009 lows, last week's decline is minor. A typical shallow retracement is about 23.6% which, based on the year-old bull market, would be around 1090. Given the strength of last week's market decline, we recognize the possibility of a more substantial correction, which could reach around 1010, the 38% retracement of the bull market. We also think current valuations still support the cyclical bull market. Last week's chart showed that from 1991 to 1995 the S&P 500 traded between 16 and 18 times one-year forward trend reported earnings. We think it will travel in that range again until earnings turn down again and, even after last week, the S&P 500 remains within the range.
- Over the last several weeks, we have been raising cash by reducing international exposure — mostly because of troubles in Europe, tightening monetary policy in emerging markets, and overly optimistic sentiment — in anticipation of a market pullback and a desire to redeploy that cash domestically. Although the pullback has been more severe (and compressed in time) than we expected, we remain fundamentally and technically bullish and think the S&P 500 could still hit 1300 this year. As the market recovers, we expect micro cap stocks to outperform, and we initiated a small position late last week. Small cap stocks (typically $300 million to $2 billion in market capitalization) have outperformed this year, but we have been reluctant to overweight them given their elevated price to earnings ratio, currently about 19 on a 12-month trailing basis. Micro caps ($50 to $300 million), on the other hand, have performed in line with small caps and yet are more attractive on a valuation basis at about 15.
- From a fundamental perspective, although we expect second-half economic growth to slow, we think the US will avoid a double-dip recession and earnings growth will likely continue into 2011, driving the bull market to new cyclical highs. We think key economic data reported last week supports this view: US job growth accelerated for the fourth consecutive month in April and surveys of global manufacturing activity indicated ongoing expansion. To turn bearish, we would need to believe that Europe's problems can depress the global economic cycle enough to reverse the current upswing in earnings. We think this is unlikely.
- US employment improved markedly as payrolls increased by 290,000 in April and were revised higher by 121,000 for the prior two months. Excluding government hiring and census workers, private payrolls increased by 231,000. Job creation was broad-based: along with ongoing gains in health care services and temporary work, the leisure & hospitality and manufacturing sectors also had strong employment growth. In addition, aggregate hours worked continued to hook up, indicating improvement not only in how *many* people are working, but in how *much*. Unemployment rose to 9.86% from 9.75%, slightly marring an otherwise healthy jobs report. This was not a big surprise as the labor force (those searching for work) rose faster than new hires. Higher unemployment helped suppress average hourly earnings growth, which fell to 1.6% from a year ago, a new low. While slowing wage and income growth doesn't help consumption, it does suggest that corporate profitability remains high (increasing the likelihood businesses will continue hiring), inflation subdued, and the Fed accommodative. All together, it looks like the jobs engine is finally firing up, which had been a missing element in the economic recovery, and which we believe is key to its sustainability.

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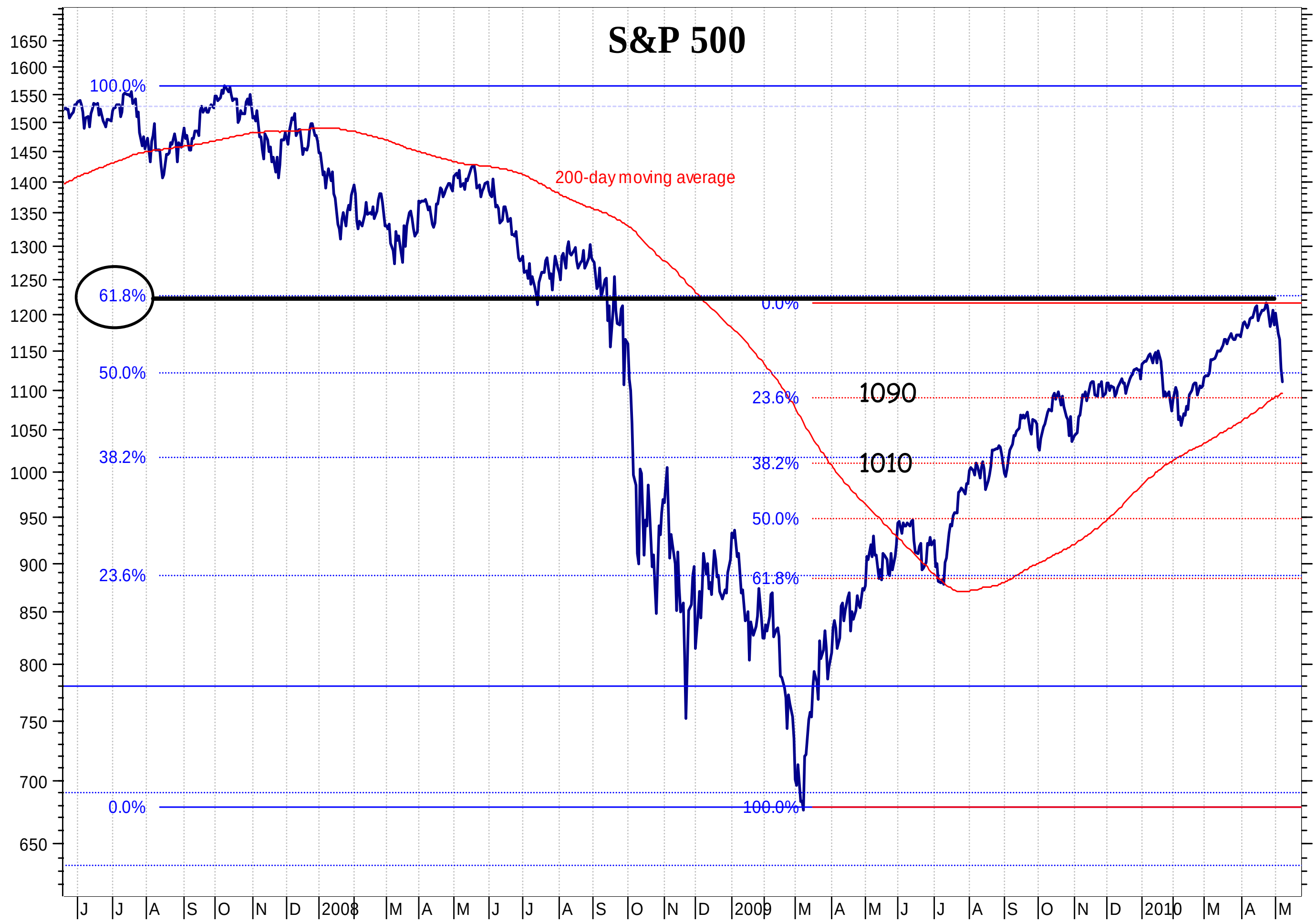
[1] *"Carry trades" involve investors borrowing overseas at low rates to fund portfolio strategies that attempt to take advantage of the wide "spread" between carrying cost and available yields and returns.*

- The Institute for Supply Management (ISM) manufacturing index rose to 60.4 in April, indicating robust expansion. Moreover, the new orders component rose to 65.7, suggesting a strong start to the second quarter. The ISM's non-manufacturing index remained unchanged at 55.4, still in expansion territory above 50, but implying that the service sector does not have quite the same momentum as manufacturing. Overall, however, the purchasing manager surveys point to ongoing expansion of business activity. Furthermore, every country that conducts purchasing manager surveys has levels above 50 except for Greece. While financial contagion cannot be ruled out, timely data shows no evidence of transmission of economic weakness.
- Last week we mentioned that the European Central Bank (ECB) said it would accept Greek debt as collateral despite rating agencies' decision to downgrade it below investment grade. This was the prelude for the ECB's weekend announcement to conduct "interventions in the euro-area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments, which are dysfunctional." Imagine if the Treasury borrowed on behalf of the Fed, which then used the funds to buy, for example, California's municipal bonds. Recall that it took 'quantitative easing,' the Fed's outright asset purchases and massive expansion of its balance sheet (along with the stress tests and forced bank recapitalizations), to calm the financial storm last year. Ultimately, government had to demonstrate that it stood behind the banking system, however flawed, even to the extent of essentially taking over the mortgage market. While not exactly analogous, we believe the ECB today is in a similar predicament with respect to its weaker member states and is now willing to use the power of its printing press.

The Weekly Chart: A shallow retracement in a cyclical bull



Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • www.riverfrontig.com
Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236