THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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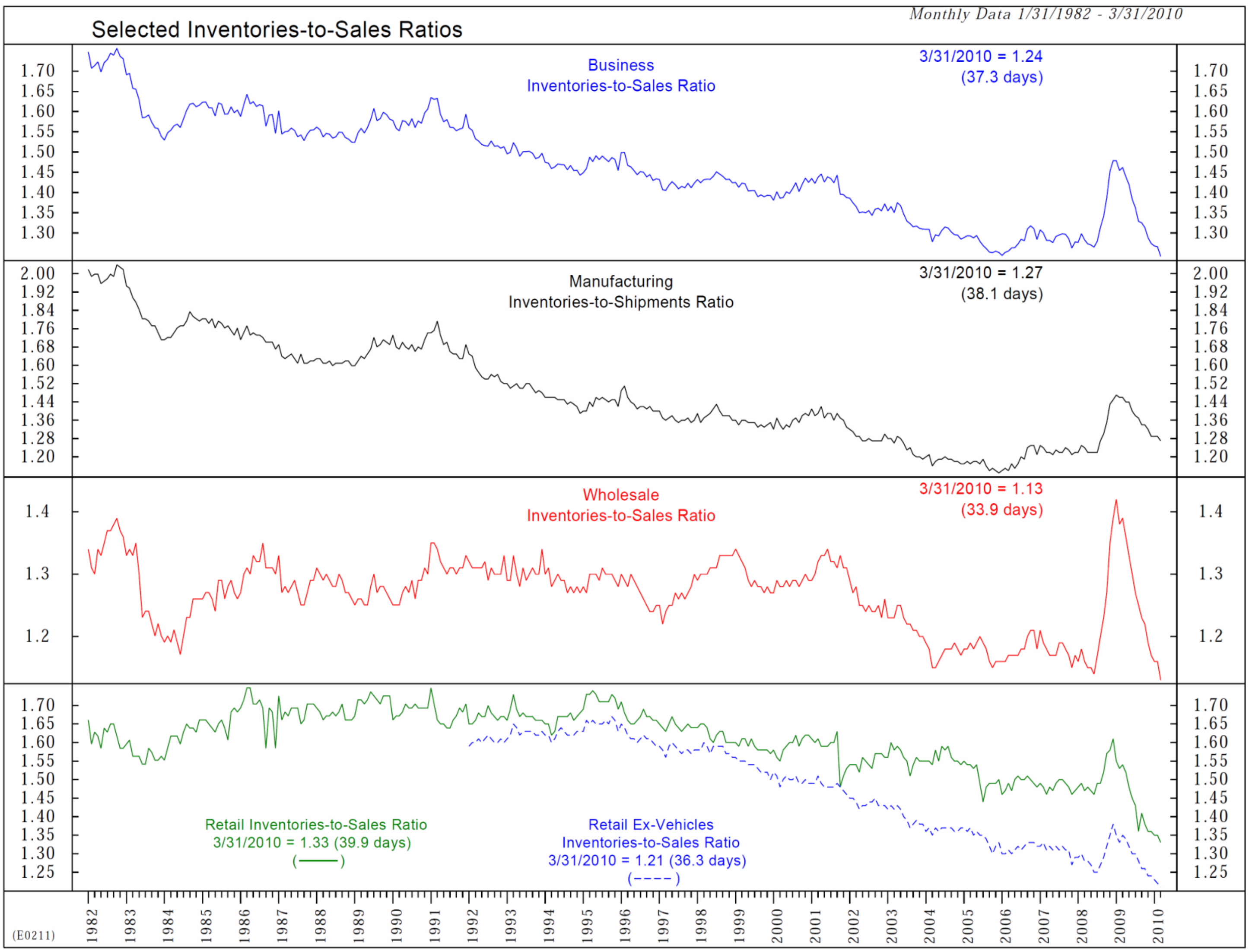
ECB follows Fed path, Euro will weaken further

- Despite recent volatility, we still think stocks are in a cyclical bull market. As we wrote last week, our three rules for investing remain supportive: 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 excessively optimistic sentiment has been worked off (beware the crowd at extremes). Furthermore, as the first-quarter earnings season winds down, earnings and sales have generally been better than expected – actual S&P 500 first-quarter earnings are about 17% higher than the estimate was six months ago and top-line growth is 14% on a three-quarter annualized basis. The next area of support we expect for the S&P 500 is between 1100 (the 200-day moving average) and 1090 (the 23.6% retracement of 14-month bull market). In a more substantial correction, our next expectation of support is around 1010, the 38% retracement of the bull market.
- Market jitters resurfaced late last week following an initially enthusiastic reaction to the European Union/IMF $1 trillion (€750 billion) bailout package and the European Central Bank's (ECB) decision to buy debt, expand its balance sheet and engage in quantitative easing. The primary source of concern remains the same: a Greek default is unavoidable and will prompt further defaults within the Eurozone, leading to a crisis of systemic proportions. The alternative, severe fiscal retrenchment in order to maintain debt payments, appears equally undesirable because it would further curtail growth and probably lead to another recession, increasing the likelihood of default anyway. We think outright default (and systemic collapse) remains unlikely and expect a combination of debt restructuring along with government spending cuts (and perhaps some tax increases). While the scale of measures and how the burden will be shared is still unclear, we do not question the ECB's firm commitment to maintain the financial integrity of the Eurozone. Furthermore, the scope with which the ECB can expand its balance sheet is considerable, in our view.
- The Federal Reserve more than doubled its balance sheet in 2008 to help contain the spiraling debt crisis. The ECB has not used quantitative easing to the same degree as its central bank counterparts, easing only about a third of what the Fed and Bank of England eventually did. As the ECB engages in quantitative easing, its currency — the euro — is likely to continue weakening, just as the US dollar weakened when the Fed ramped up its asset purchases. Two weeks ago we wrote that we wouldn't be surprised to see the euro below $1.20 per dollar; this level is rapidly approaching. If the crisis is not arrested soon, we think the ECB will have to scale up quantitative easing, in which case $1.10 or even parity with the dollar ($1 per euro) is likely. Also like the Fed (and Treasury), we think the ECB in coordination with Eurozone fiscal authorities will have fits and starts containing the debt crisis. However, we believe they will eventually be able to meet the challenge, if only because they have no choice. Although the euro's disadvantages have become increasingly obvious, there is no viable alternative for the long-term advantages that a single currency union confers in terms of political/economic clout and competitiveness.
- Gold has been rallying as a consequence of the ECB's increasing assertiveness. While gold priced in euros has been making new highs since the beginning of the year, gold in dollars only broke out last week. Gold peaked last December just below $1200 an ounce, reached a low just above $1000 in February, and has since rallied decisively above $1200. Although we believe gold appears overvalued relative to its long-term trend, with the world's major monetary authorities likely to remain accommodative, gold will likely continue to benefit. Also, based on Ned Davis Research's Crowd Sentiment Poll for gold, the crowd is not yet overly optimistic, which suggests further near-term upside. Only when central banks begin to indicate removal of policy accommodation will gold's run likely end, in our view. Since the economic recovery remains frail amid retrenchment and system-wide deleveraging, it may not be until mid-2011 before there are rate hikes from the Fed or ECB.
- The ratio of business inventories to sales – often overlooked, but notable in our view – is at a record low (see Weekly Chart). Sales continue to grow faster than inventories, which we view as generally positive because both are still rising together. We draw two main conclusions: (1) supply chain and inventory management are contributing to productivity

and profit margins, and (2) purchasing managers seem reluctant to build inventories in light of a potential second-half slowdown. Retail sales rose 0.4% in April, the seventh consecutive monthly increase. However this was primarily due to a 6.9% increase in 'building materials + garden equipment and supplies' that we do not think is sustainable as housing activity decelerates following the expiration of the home buyer tax credit. In addition, we think the June termination of Emergency Unemployment Compensation, which has extended job insurance by about two years, will start to weigh on consumption demand in the second half. Despite the cautious outlook, the consumer discretionary sector has been leading the market for nearly a year as top-line growth has exceeded expectations and companies have maintained tight inventory management. Any significant deterioration in consumer discretionary stocks, especially if accompanied by widening credit spreads, would likely cause us to become more defensive, but for now we remain optimistic about profits and stocks.

The Weekly Chart: Inventories managed back to lean levels



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