THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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‘Golden Cross’ Suggests Cyclical Bull Intact

- Anticipating another dose of monetary stimulus and a Republican takeover in the House of Representatives, the S&P 500’s 50-day moving average crossed above its 200-day moving average, creating a bullish ‘golden cross’ (see Weekly Chart). A second round of quantitative easing (QE) has garnered considerable media attention since Federal Reserve Chairman Ben Bernanke affirmed its likelihood in late August. Expectations are for the Fed to announce a bond purchase program of $500 billion to $1 trillion at its November 3 meeting. With crowd sentiment on the verge of extreme optimism territory, we suspect stocks are vulnerable to a pullback given the old traders’ maxim to ‘buy the rumor sell the news.’ That said, we expect any pullback to be limited because an injection of that much liquidity would demonstrate the Fed’s determination to prevent deflation. In addition, the trend is beginning to turn upward; we view 1120 as major support for the S&P 500, the current level of the 200-day moving average.

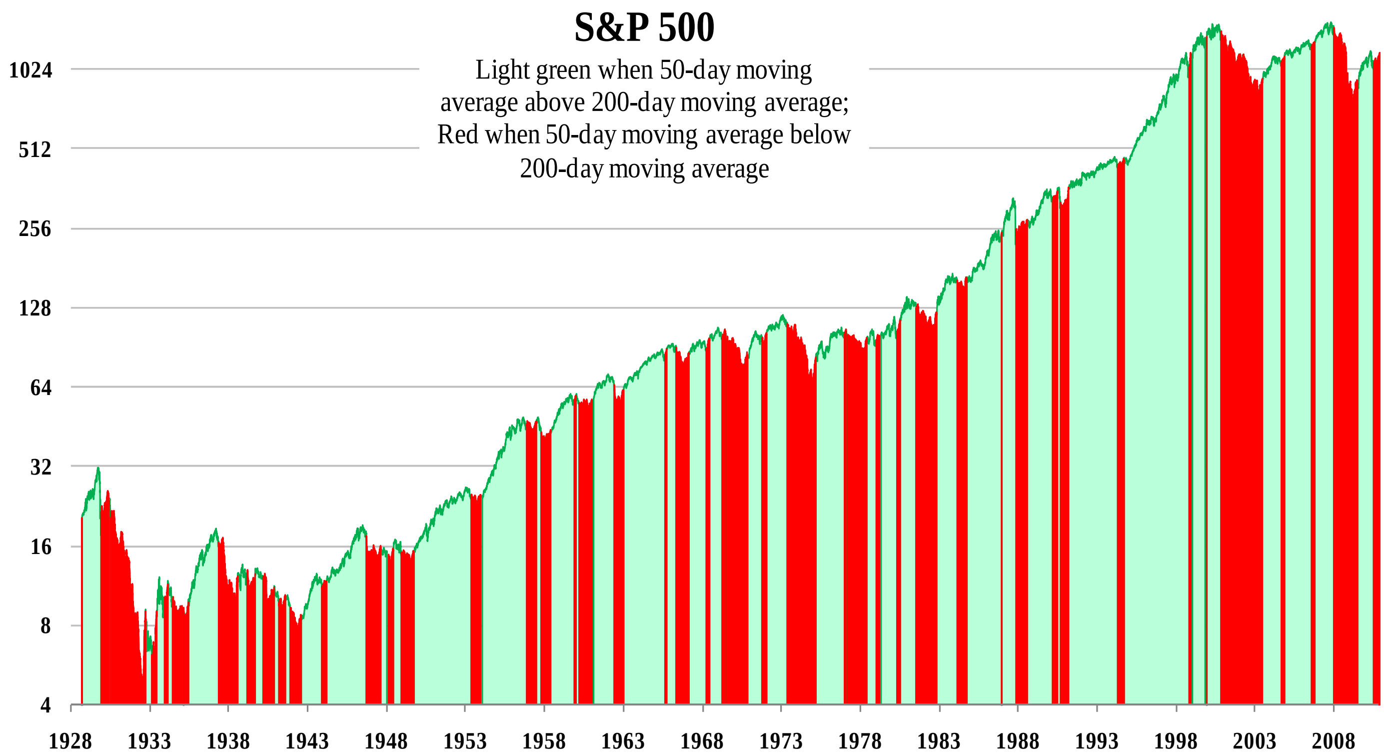
- Since QE appears widely anticipated by markets, we think earnings should figure more prominently. Third-quarter earnings and guidance have mostly met expectations so far, which we think bolsters our case for ‘boring but up.’ With S&P 500 operating earnings for 2010 expected to be around $82 and 2011 estimates north of $90, we anticipate a trading range of 1140 to 1350 next year, keeping the price/earnings (PE) ratio in the mid-teens, where it has traded for most of this year. For us the critical issue remains the ability of the global economy to generate enough growth to keep earnings expanding. Profit margins are already at high levels, making further expansion difficult and limiting earnings growth to single digits, but we believe that valuations are sufficiently cheap that a bear market is unlikely in the absence of an earnings downturn.

- In the last few weeks we have commented several times on the legal storm brewing in the banking sector regarding foreclosures. However RiverFront’s fixed income team believe a bigger issue for banks is ‘put-backs’: “Put-backs are when banks are forced to repurchase mortgages (at face value) that were sold to investors or repackaged into mortgage backed securities (MBS) because of irregularities in the original underwriting of the mortgage or the improper servicing of the mortgage after its origination.” Their conclusion is that “the mortgage put-back issue could result in large losses for the major US money center banks and that their equity, bond and preferred securities prices are likely to see heightened volatility for the next several quarters” (please see *The Fixed Income View,* 10/22/10). We are significantly underweight banks in our equity portfolios.

- Last week we wrote about China’s central planning committee’s preparations for its next ‘five-year plan’ to be unveiled in March. As expected, the committee asserted their desire to boost consumption as a percentage of GDP, which we view as encouraging over the long term. One promising proposal that emerged from Yi Gang, the Deputy Governor of China’s central bank, is to reduce their current account surplus — currently more than 5% — to under 4% over the next three to five years. This implies less reliance on exports for growth and greater imports, reducing trade tensions with developed economies. Of course, much depends on translating words into action, but given the current level of global scrutiny, we expect China to adhere to their stated goals.

- For the second time within a month, Brazilian monetary authorities raised taxes on foreign fixed-income investment by two percentage points to 6%, signaling their strong intention to continue fighting dollar depreciation versus Brazil’s currency, the *real*. We expect them to keep raising taxes if the *real* continues to strengthen, hence we believe upside is limited. As a result we sold our position in the *real* and anticipate redeploying funds into higher-yielding sovereign debt in currencies where central banks are less intent on fighting a ‘currency war’.

The Weekly Chart: July's 'Death Cross' gave a false signal



Past performance no guarantee of future results *Source: RiverFront Investment Group*

Last July, we showed this chart to illustrate the historical significance of times when the 50-day moving average (DMA) crosses through the 200 DMA for the S&P 500. At that time, the S&P 500's 50 DMA crossed below the 200 DMA, generating a bearish 'Death Cross' signal. We made the point that, **like any price momentum tool, this indicator gives false signals more than half the time. Its effectiveness is that false signals produce small losses whereas good signals have captured all significant trends.** The last few months have neatly illustrated our point; an investor who used this signal as a risk management tool over the summer would likely have incurred small losses. We are happy to report that the "all clear" signal from this indicator — the 'Golden Cross' — occurred last Friday. The golden cross is given when the 50 DMA crosses *above* the 200 DMA.

For a long-term perspective on these technical signals, our chart illustrates periods where the S&P 500's 50 DMA has been above (light green fill) or below (red fill) the 200 DMA beginning in 1928. The 50 DMA crossover has done a good job of staying on the right side of longer term trends, in our view, but it is not the most timely indicator – for example, from the March 2009 low it did not signal 'buy' until late June, by which time the S&P 500 had already risen 31%. Furthermore, we still expect overhead resistance around the top of our decision box (1220), especially since the S&P 500 has risen at an annualized trend rate of about 70% since early September, which we view as an unsustainable pace. If it encounters resistance at the top of the box and pulls back, we see initial support for S&P 500 at around 1140 and then at the 200-day moving average, currently at 1120 — thus offering another opportunity to add equity exposure. However, last week's Golden Cross supports our view that stocks will transition from the sideways decision box to a rising trend channel where the slope is likely to be modest (a 5% to 7% annualized rate); in other words 'boring but up.'

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