THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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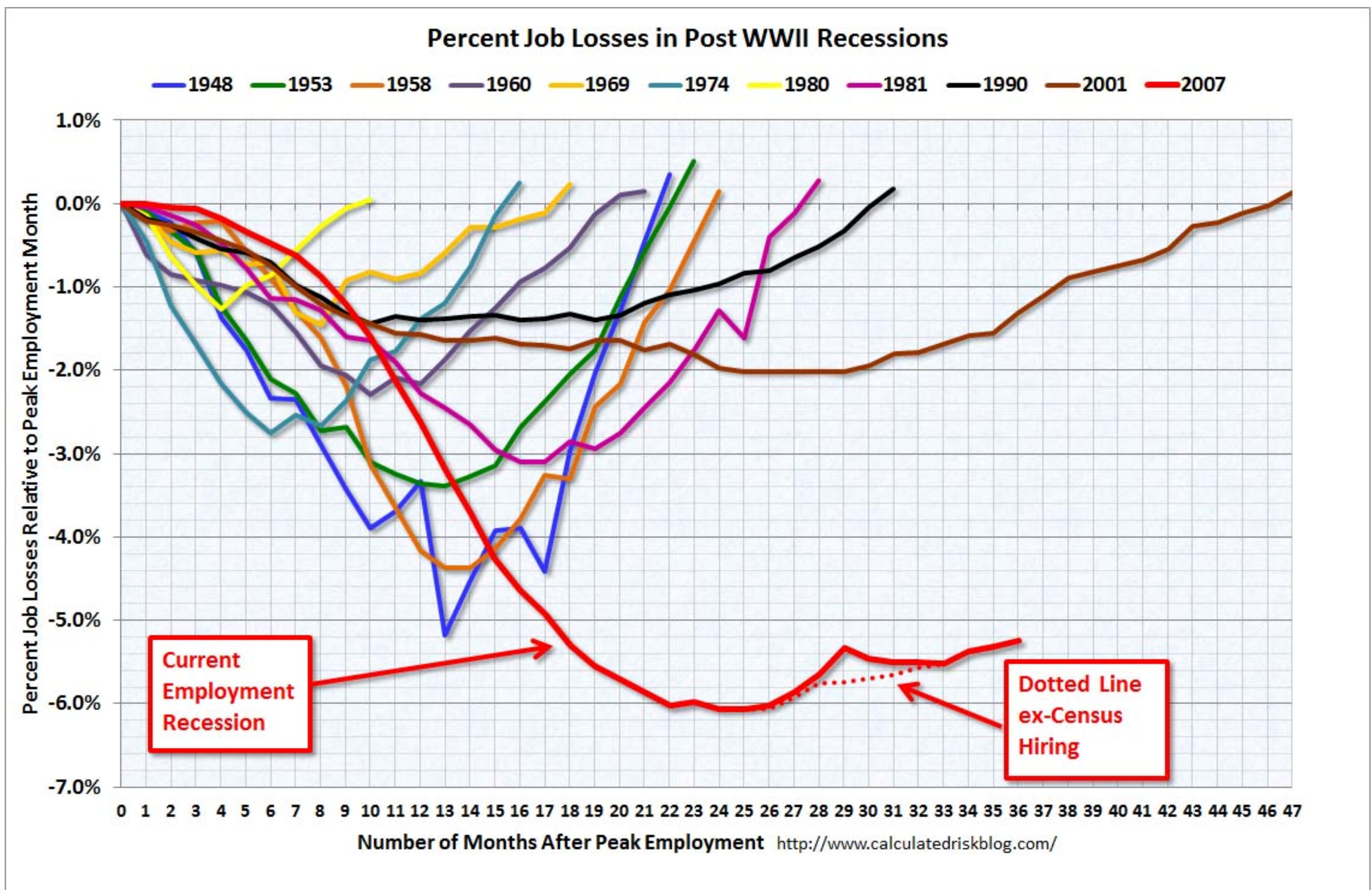
January 10, 2011

Entering a 'Risk Control' Zone

- The S&P 500 has been rising at a 42% annualized growth rate since last July and although we expect earnings growth to be robust, we do not believe this pace of appreciation is sustainable, especially with weekly crowd sentiment at its most optimistic extreme in more than three years. A pullback by the S&P 500 to at least 1250 from its recent high of 1278 appears likely in our view, with further technical support around 1220, where it initially broke out last December. With upside probably limited over the near term, we think the current environment is in a 'risk control' zone, which means that investors should take the opportunity to pare weaker, underperforming investments to make room for higher conviction or 'alpha-generating' assets when the market finds support.
- Nonfarm payrolls increased by 103,000 in December — below consensus expectations for around 150,000 — but upward revisions in the prior two months added 70,000 jobs, bringing the fourth quarter average to 128,000 a month, suggesting that the employment situation continues to improve. Average monthly job growth for all of 2010 was 94,000. However, the economy still has over *seven million less jobs since employment peaked* before the recession despite the recent improvement. If the rate of job growth doubled to around 200,000 per month (or 2.4 million per year), it would still take a few years for employment to return to 2007 levels even while overall population growth continues apace. Federal Reserve Chairman Ben Bernanke began his congressional testimony last Friday by stating that, "The economic recovery that began a year and a half ago is continuing, although, to date, at a pace that has been insufficient to reduce the rate of unemployment significantly." While the unemployment rate did fall four-tenths of a point to 9.4%, much of that was due to a decline in labor force participation (discouraged workers drop out of the calculation) which we would not view as particularly healthy. Indeed, the Bureau of Labor Statistics (BLS) is expanding its category for the long-term unemployed from two to five years to better track longer durations of unemployment. Currently, workers without jobs for six months or more comprise over 44% of the unemployed. The average duration of unemployment rose from 33.9 to 34.2 weeks and will likely move higher when the BLS starts including those unemployed over two years.
- The upshot of Bernanke's testimony is that with full employment years away at best, monetary policy will likely remain accommodative (with the important caveat that inflation expectations stay subdued) as the Fed continues to expand its balance sheet through quantitative easing. Some critics of the Fed point to rising commodity inflation as evidence that monetary policy is too loose, but unless this translates into consumer price inflation, these accusations are likely to fall on deaf ears. Given that labor is the primary cost of business in the US (representing approximately 70% of total unit costs) we believe rising commodity prices and other producer price inputs are more likely to erode margins than translate into higher inflation. Most measures of annual changes in the general price level are hovering at or below 1%, with pricing power for consumer-facing businesses limited by household incomes that are stagnant due to high unemployment. Bernanke also noted in his testimony that, "long-run inflation expectations have remained stable; for example, the rate of inflation that households expect over the next 5 to 10 years, as measured by the Thompson Reuters/University of Michigan Surveys of Consumers, has remained in a narrow range over the past few years. With inflation expectations stable, and with levels of resource utilization expected to remain low, inflation is likely to be subdued for some time." Even more sensitive measures of inflation expectations such as the bond market's assessment of 'five-year forward' inflation — implied five-year inflation rates five years from now — are still below 3%; we would not be overly concerned unless they approached 4%.
- As we wrote almost a month ago, the rise in bond yields over the last couple of months has been largely due to rising growth expectations. This was corroborated by global purchasing manager indexes (PMIs) and the national Institute for Supply Management (ISM) surveys released last week, which both accelerated to six-month highs in December. The global PMI rose 1.1 points to 55, while the manufacturing ISM increased 0.4 to 57 and the non-

manufacturing ISM was up 2.1 to 57.1. The ISM levels have historically correlated with 3.3% real GDP growth and ongoing earnings expansion. High ISM levels have also corresponded with rising bond yields and we expect 10-year Treasury yields to test 4% in 2011. However, any rise in bond yields much above 4% is likely to be naturally self-limiting. With yields more than 4%, 30-year fixed mortgage rates would likely be pushing 5.5%, taking a further bite out of home prices, which have already been declining since the summer of 2010. Moreover, rising Treasury yields might also snuff out the nascent recovery in commercial real estate and pressure municipal bond yields. Given the precarious finances of state and local government, this could result in greater cutbacks (or local tax hikes), possibly undoing much of the 'second stimulus' recently passed at the federal level. In short, the more that bond yields rise, the more likely it is that economic growth will slow and, in turn, bond yields will fall again. This dynamic will likely continue until overall debt levels — business/property, household, and government — fall enough for the economy to withstand higher interest rates without going back into recession. We believe this process could take several more years but the faster private sector recovery and hiring takes hold, the easier it is to see economy-wide deleveraging and the quicker interest rates should normalize.

The Weekly Chart: Employment improving, but still well below pre-recession levels



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