THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Sell in May and Go Away? Maybe Not

- As summer approaches, the old trader's adage "sell in May and go away" comes to mind, and for good reason. According to Ned Davis Research, since 1950, $10,000 invested in the S&P 500 only during May 1 through October 31 would have shrunk to $6575; $10,000 invested only during November 1 through April 30 would have grown to $385,073. Last year, the adage was especially true. The S&P 500 was almost unchanged between May and the end of October – starting and finishing at around 1180 – and remained below 1100 for all of June, July, and August, with a low of 1010. Since October 31, the index is up 13% excluding dividends, based on Friday's close of 1337. For an investor with a multi-year time frame, May 2010 presented a trading opportunity, but not a strategic exit point.
- Over the next six months, our expected range for the S&P 500 is about 100 points above and below its current level – between 1230 and 1430. We think that some sort of summer correction is likely, and we may attempt to reduce equity exposure if stocks head towards the upper end of our six-month expected range, especially if sentiment becomes extremely optimistic. However, from a longer term perspective, as we wrote when we added to equities last month: "The judgment we are making is a simple one – that the events of the last month (Middle East tension and Japan's earthquake) will not derail the global economic cycle and so the drop in prices, combined with the shakeout in sentiment is a buying opportunity." In the absence of a global recession, we believe stocks both in the US and worldwide will be roughly 10% higher by May 2012.
- Risk management requires that we recognize the circumstances that could prove us wrong. At the top of our list is that social upheaval in the Middle East leads to a significant disruption in oil supplies and that prices rise beyond $120 per barrel towards the old high of $150 over the next 12 months. We think this could be enough to derail the global recovery, but we currently judge it unlikely given our views of somewhat slower global growth in the second half and uninterrupted Saudi oil production. From a technical perspective, an S&P 500 break below 1250 would be a warning signal and a break below 1220 would require some risk management.
- We must also contend with the end of the Federal Reserve's second Quantitative Easing program (QE2) by June 2011. Markets tend to react most violently to the unexpected, and the end of QE2 has been heralded by the Fed and the media for months. We think the economy's third-quarter performance is more important than the end of QE2. A year ago, the economy's pace of recovery faltered, bonds rallied, and stocks fell. So far this year, that is not happening and economic recovery has turned into economic expansion. We expect some weakening of the data as the states begin fiscal austerity programs in July and consumers react to $4 per gallon gasoline, but we do not currently expect either the economy or the stock market to correct as strongly as last summer.
- China's currency reserves recently topped $3 trillion, prompting its central bank governor to remark: "Foreign-exchange reserves have exceeded the reasonable levels that we actually need. The rapid increase in reserves may have led to excessive liquidity and has exerted significant sterilization pressure. If the government doesn't strike the right balance with its policies, the build-up could cause big risks." This has prompted speculation that China will soon allow the yuan to appreciate at an accelerated rate and/or perhaps a one-off revaluation of its exchange rate, particularly with ongoing signs of elevated inflation and excess credit creation. We would view any such yuan revaluation as a positive sign of global economic rebalancing and sustainable growth, which would be bullish for stock markets globally (for more details, please see the *Weekly View* from 4/11). In addition, China's central bank has just allocated up to $200 billion – coincidentally the amount of reserves it accumulated in the first quarter – to the China Investment Corporation (CIC), a sovereign wealth fund of the Chinese government. Besides using the funds to secure strategic access to energy and minerals, which it sees as a way to diversify away from US Treasury securities (of which it is the largest holder, excluding the Fed), "CIC has increasingly focused on offshore investments that take advantage of China's economic boom. Besides focusing on natural resources and energy, it is also

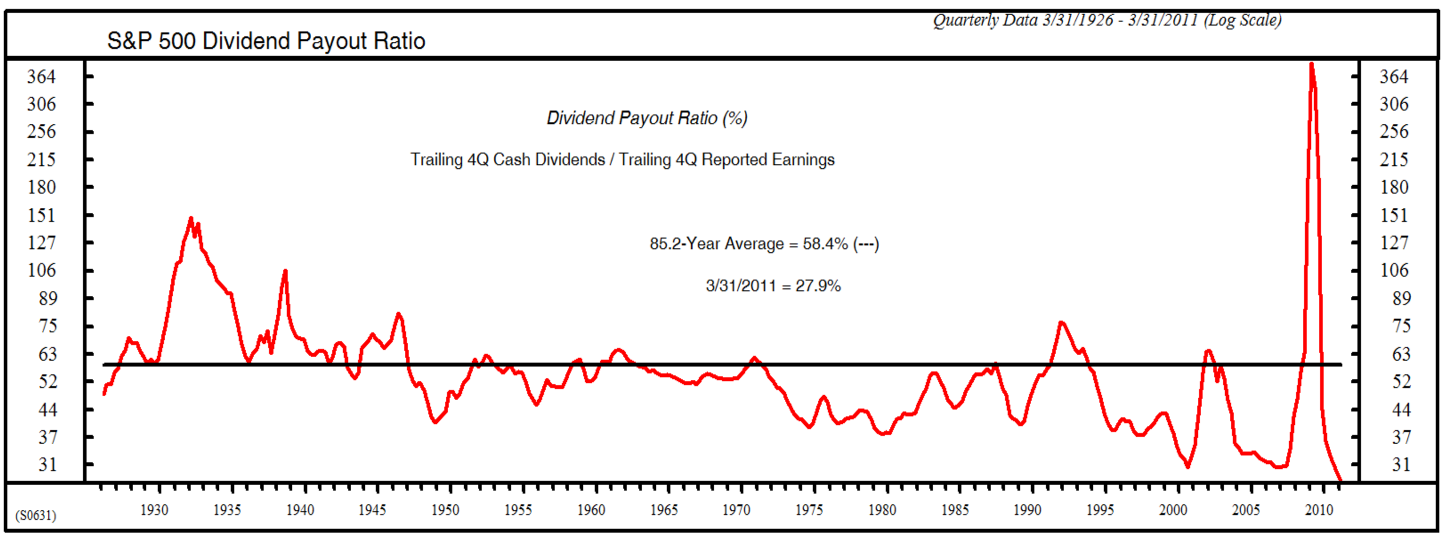
increasingly interested in investing in Chinese companies listed offshore... especially ones where they can acquire technology," according to the *Financial Times*. Furthermore, "two senior government economists have publicly said China only needs reserves of around $1,000 billion," which suggests that another $2 trillion could be freed up in this manner. Apparently, like RiverFront, China sees better opportunities than low-yielding US government debt.

Too many traders and too few investors create opportunities for investors

Veteran technical analyst Philip Roth recently commented to us that "there were few investors left in the market." Rather, daily activity was dominated by hedge funds, Wall Street brokerage firms, and traditional fund managers constrained by quarterly performance. This does not mean that there are no long-term individual investors, but he felt that there were fewer and that they accounted for little volume. To us, Phil's comments rang true and led to the following logical conclusion: There is a real opportunity to be a long-term investor, for it is the "un-crowded" investment that often yields the best returns. The S&P 500 first hit 1337 in May 1999 on the way to its record high 1527 in March 2000. It hit 1337 again in January 2001 on the way back down, then in November 2006 (up) and February 2008 (down). After a 12-year trading range like that, it is no wonder that investors have become disenchanted.

A core belief at RiverFront is that the key to long-term investment success is paying the right price, i.e., Price Matters℠. In 2011, investors can buy the S&P 500 at 1337, with trailing 12-month GAAP earnings of $84, which equates to a price earnings ratio of 16, which we regard as reasonably priced. At 16 times earnings, companies' earnings are 1/16th of the S&P 500's market value, which equates to an earnings yield (the earnings-to-price ratio) of about 6.3%, which is significantly more than government and most investment-grade bond yields .

The Weekly Chart: Dividends positioned to grow strongly



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The S&P 500's annual dividend payments are currently $23 (a 1.7% yield). As the chart above shows, this represents a record low payout ratio of below 30% and suggests a high probability of dividend growth. We think a total return of 8% to 10% seems likely for the long-term investor, with some inflation protection built into the dividend stream. Thus, from a Price Matters perspective we think true long-term investors will be rewarded. *Dividends are not guaranteed and are subject to change or elimination.*

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