The Weekly View

RiverFront Investment Group

Asset Management • Investment Strategy • Advice

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S&P 500 Breakout Suggests Cyclical Bull Intact

- The S&P 500 broke out above its February and April peaks last week to 1364, the highest it's been since June 2008. We are encouraged by the breakout, which supports our view that stocks' cyclical bull market remains intact and the economy is moving into a self-sustaining growth phase. The S&P 500 has now retraced more than 62% of the October 2007/March 2009 decline, which, from a technical perspective, increases the likelihood that it will ultimately test its October high of 1565. Standard & Poors' small and midcap stock indexes, as well as the NASDAQ Composite, have already exceeded their October 2007 peaks.
- We think the S&P 500 will likely grind higher over the next few weeks; sentiment is optimistic but has yet to reach the extremes of the recent stock market peaks, based on the daily and weekly Crowd Sentiment Polls calculated by Ned Davis Research. Furthermore, the short-term market indicators we follow do not yet appear overbought to us. We expect initial overhead resistance around 1426 (an interim peak made in May 2008) which, if accompanied by optimistic sentiment extremes and overbought market internals, could mark the beginning of a summer correction.
- We do not intend to chase the S&P 500 breakout. As we wrote last week, "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." This equates to roughly a 10% downside risk/5% upside reward tradeoff, which we do not see as particularly enticing. So far this year, we have made some gains versus our benchmarks by being overweight risk assets. Thus, we are preparing to become more neutrally positioned when we think stocks have reached a multi-month peak.

Economy moving to slower pace of expansion

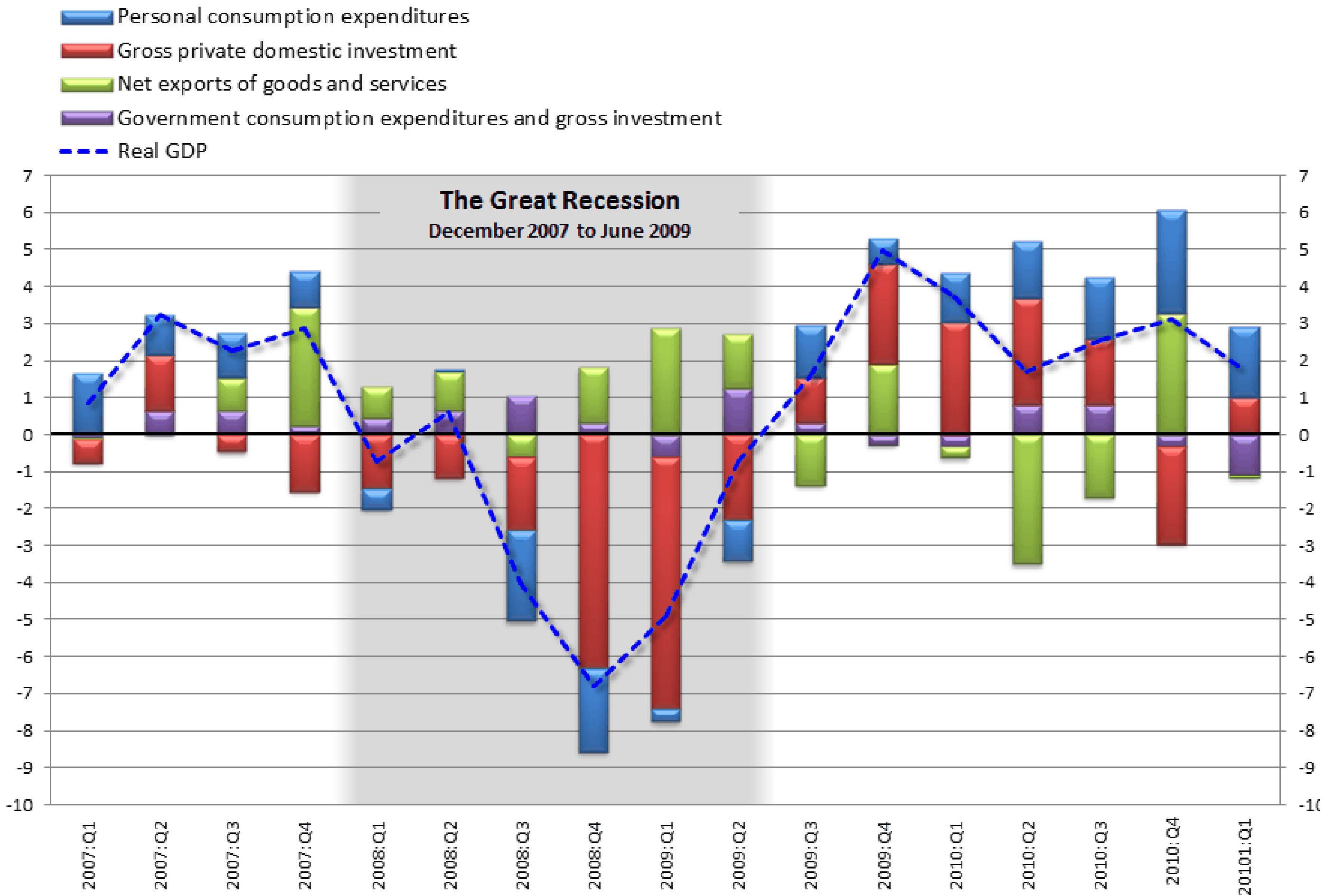
Real GDP decelerated to a 1.8% annual growth rate in the first quarter, from 3.1% in the fourth quarter of last year. We view this as evidence that higher energy prices are beginning to sap personal consumption expenditures and worsen the trade deficit, while government cutbacks have begun to subtract from GDP (see Weekly Chart). Another concern we have is that initial jobless claims, which have a good correlation with economic growth, have moved back above 400,000 a week, a level that we think indicates a downshift in growth. First quarter *nominal* GDP growth was 3.7% annualized; in other words, the impact of prices added 1.9 percentage points over real GDP, which hints at 'stagflation' although still nowhere near that which occurred in the late 1970s. As we have written previously, we believe nominal GDP growth around 6% is necessary to reduce the US' debt load (without default) over the long run.

At the Federal Reserve's first-ever press conference following its meeting last Wednesday, Fed Chairman Ben Bernanke reiterated their view that the end of quantitative easing in June "is unlikely to have significant effects on financial markets or on the economy... we have communicated what we're planning to do and that the markets have well anticipated this step [and that] what matters primarily for interest rates... is not the pace of ongoing purchase, but rather the size of the portfolio that the Federal Reserve holds." Indeed, with 10-year Treasury yields still only at 3.3%, there appears to be little concern in the market. In contrast, Bernanke did express concern over "the long run unsustainable deficit," which he considers a "top priority," saying: "If Congress and the administration are able to make credible commitments to cutting programs or... changing the fiscal profile going forward over a long period of time, that is the most constructive way to address what is in fact a long-run problem."

We think that the deceleration in US growth, a still-anemic job market, and medium-term inflation expectations that remain 'well anchored' all suggest that the Fed will likely keep its interest rate policy 'lower for longer.' With most of the rest of the world tightening policy (notably excluding Japan), the US dollar is making multi-year lows against many of the world's currencies, particularly in Asia, Europe, and commodity-exporting countries. While positive for US manufacturers, which benefit from a lower US dollar, the erosion of purchasing power for foreign goods has a negative impact US consumption, which comprises the bulk of the US economy. We think this is one reason that the Fed is choosing to end quantitative easing, because the costs are starting to outweigh the benefits of accommodation.

Moreover, the rise of gold and silver prices to record levels is signaling that the US dollar as a reserve currency 'store-of-value' is being questioned (such as by major dollar holders like China). We believe this as a sign that, for US living standards to be maintained, debt-based consumption needs to decline relative to business investment, production, and exports. Hence we continue to view US stocks (where corporate profitability is expected to have achieved record levels in the first quarter) as more attractive than US debt.

The Weekly Chart: Growth slowing…



The chart above (courtesy of dshort.com) shows the annualized quarterly growth rate of real GDP (dashed line) and the percentage point contribution of its components (colored bars): consumer spending (blue), business investment (red), trade (green) and government spending and investment (purple). Adding together the bars equals the dashed line. Note that consumer spending comprises about 70% of GDP so when the blue bar is positive, overall GDP growth tends to be positive as well. Also note that the depths of Great Recession occurred when credit dried up and business spending caused a disproportionate fall in economic growth. Now with the recovery in hand and economic growth transitioning to expansion, the challenge is to maintain growth as government support (fiscal and monetary) is withdrawn. We believe this has to be led by business investment and trade, not consumer spending.

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