THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Testing Levels; Beware the Crowd at Extremes

- A week of disappointing key economic data has driven the 10-year Treasury yield to test our 'line in the sand' at 3% (see *The Weekly View*, 5/23/11). Likewise, the S&P 500 closed last week at 1300, just above initial resistance we have identified at 1295. Interestingly, Ned Davis Research's (NDR) sentiment index for bonds now reflects 'extreme optimism' (a bearish sign – see Weekly Chart), while their daily crowd sentiment poll for stocks has just dipped into extreme pessimism (a bullish sign). If the economic data only shows temporary weakness, then we expect an eventual S&P 500 breakout above 1350 and believe 1450 is achievable in the next 12 months. If there is another month of weak data, then we should be prepared for further short-term downside, and we would expect a 'decision box' trading range to form between 1220 and 1350. Similar to last year, we expect summer weakness to be temporary as we believe the current global expansion is sustainable and will lead to higher corporate earnings and share prices.
- We first adjusted portfolios on May 6th, bringing the more conservative portfolios back to a broadly neutral allocation to risk assets. On May 24th, we sought to raise the quality and lower the beta[1] of all the portfolios by increasing our weighting in securities with a record of consistent dividend growth. We therefore believe we are positioned for temporary weakness and are looking for the opportunity to raise stock weightings. Should the economic weakness become more persistent than we expect, we will have to weigh a risk asset reduction against the possibility of further stimulative action by policymakers. *Dividends are not guaranteed and are subject to change or elimination.*

Economic growth slowing

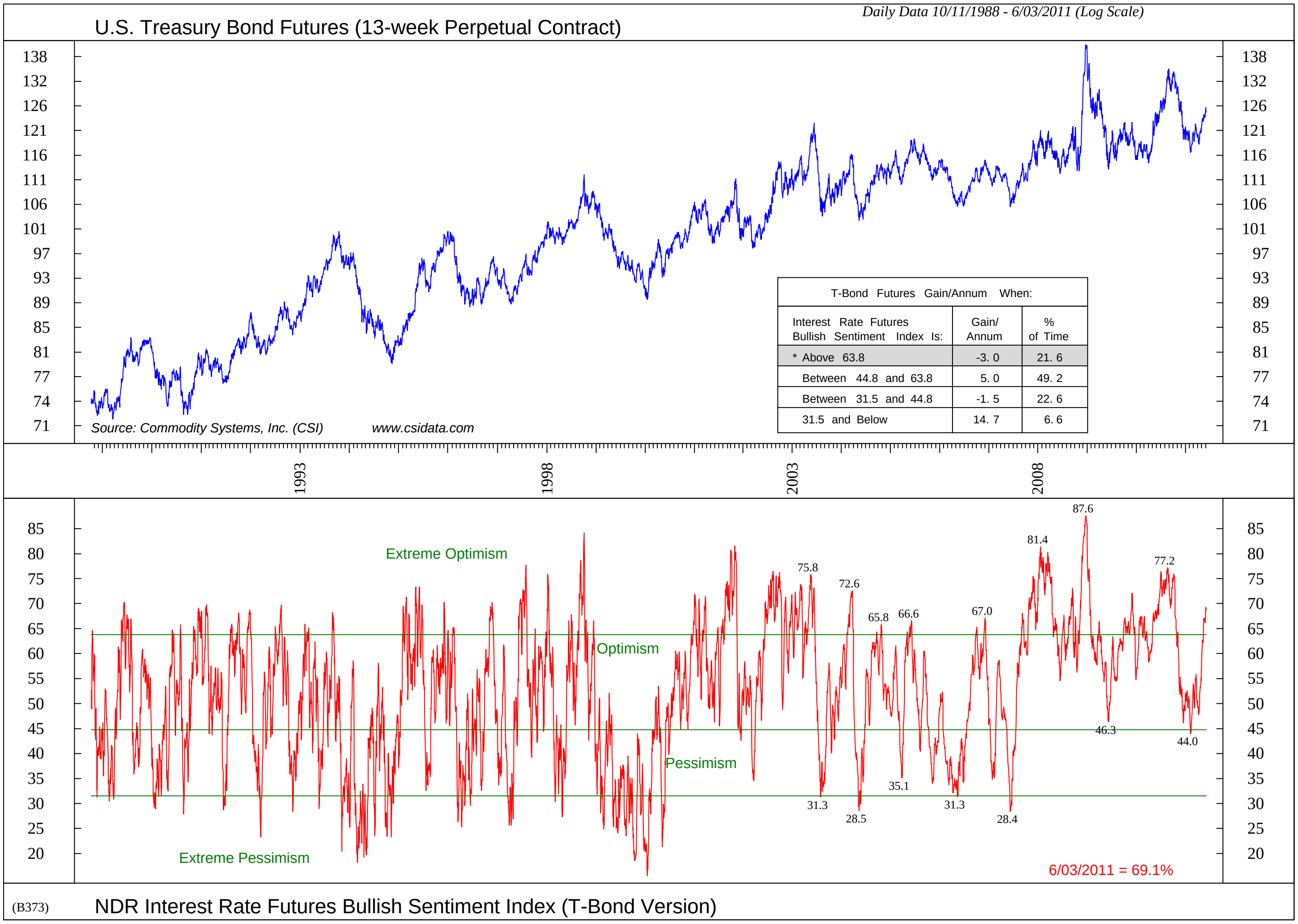
The economy has hit a soft patch. This was evident in weaker-than-expected May data from the purchasing manager index (PMI) for manufacturing and the employment situation report. With government budget cuts likely on the way, especially at the state and local levels, and Federal Reserve balance sheet expansion (QE2) over at the end of the month, growth (and inflation) estimates are being ratcheted down. The Institute for Supply Management (ISM) manufacturing PMI fell 6.9 points to 53.5 in May. While above 50, thus indicating ongoing expansion, it does imply a sharp deceleration in business activity. In particular, the new orders component fell 10.7 points to 51, suggesting barely any future growth. The ISM non-manufacturing PMI fared better, rising 1.8 points to 54.6, and reflects business activity in the services sector that represents the bulk of the economy.

We have written that higher energy prices, central bank tightening in emerging markets and fiscal retrenchment in the developed world would slow global growth. Indeed, the global manufacturing PMI has decelerated to levels seen last summer, before the Fed committed to renew quantitative easing. This decline also reflects recent substantial supply-chain disruptions from Japan's earthquake and nuclear incident. As Japan recovers, we expect industrial production to rebound. Additionally, the downshift in global economic growth has dampened demand for energy and commodities, with prices remaining below their recent highs. Oil prices have stabilized around $100 a barrel since early May, and we think this will help consumer confidence and keep the global manufacturing PMI in expansion territory into 2012. As we wrote last week, weaker commodity prices increase the likelihood that the end of emerging market central bank tightening is closer. After all, a contraction in world GDP would not be in the interests of emerging markets, and would likely lead to a policy reversal.

Nonfarm payrolls rose only 54,000 in May although, excluding government cuts, private payrolls increased by 83,000. Furthermore, the prior two months' employment gains were revised downward by a net 39,000, bringing the three-month average to 160,000 a month. Meanwhile, the unemployment rate ticked up to 9.1%, off its March low of 8.8%. The slowdown in hiring impedes the pace of economic expansion, particularly since any housing market recovery must be fundamentally underpinned by job growth. In this regard, one of the broadest measures of employment health – aggregate weekly payrolls (combining hours worked with earnings) – continues to rise 4% year over year, which translates into real disposable income growth of 1.7%. In summary, we expect economic expansion to continue; but with credit still constrained as households deleverage, we think it will be tough for real GDP growth to exceed 2%.

While declining mortgage rates have likely helped, they have not been enough to stem the decline in home prices nationally. The Case-Shiller home price indexes through the first quarter have continued to display month-to-month declines, hitting new cyclical lows in the process. Affordability, especially for low-end homes, has greatly improved as a result, and rents have firmed (helping investment demand), but with a glut of inventory still on the sidelines (as foreclosures have ramped up) we expect housing supply to continue weighing on prices. Moreover, this will continue to place pressure on banks as the number of households in negative equity situations escalates (currently about a quarter of all mortgages). The silver lining for financial markets is that the Fed is likely to maintain ultra-low interest rates for a longer period of time and could potentially become even more accommodative if economic conditions continue to deteriorate.

The Weekly Chart: Bond holders – beware the crowd at extremes



Past performance is no guarantee of future results

NDR's Interest Rate Futures Bullish Sentiment Index (lower clip in the chart) is designed to highlight swings in investor psychology for Treasury bonds. This indicator measures the percentage of advisory services that are bullish on interest rate futures by using a weighted combination of various measures of advisory sentiment. As the table within the chart shows, US Treasury bond futures have had a -3.0% annualized return when bullish sentiment was above 63.8. While the current reading is 69.1, the chart shows that sentiment has often peaked at higher levels before bond prices begin to fall.

1. Beta measures a portfolio's volatility relative to a benchmark. A result greater than 1.0 implies that the portfolio is more volatile than the benchmark; a result less than 1.0 suggests that the portfolio is less volatile than the benchmark. Betas may change over time.

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