THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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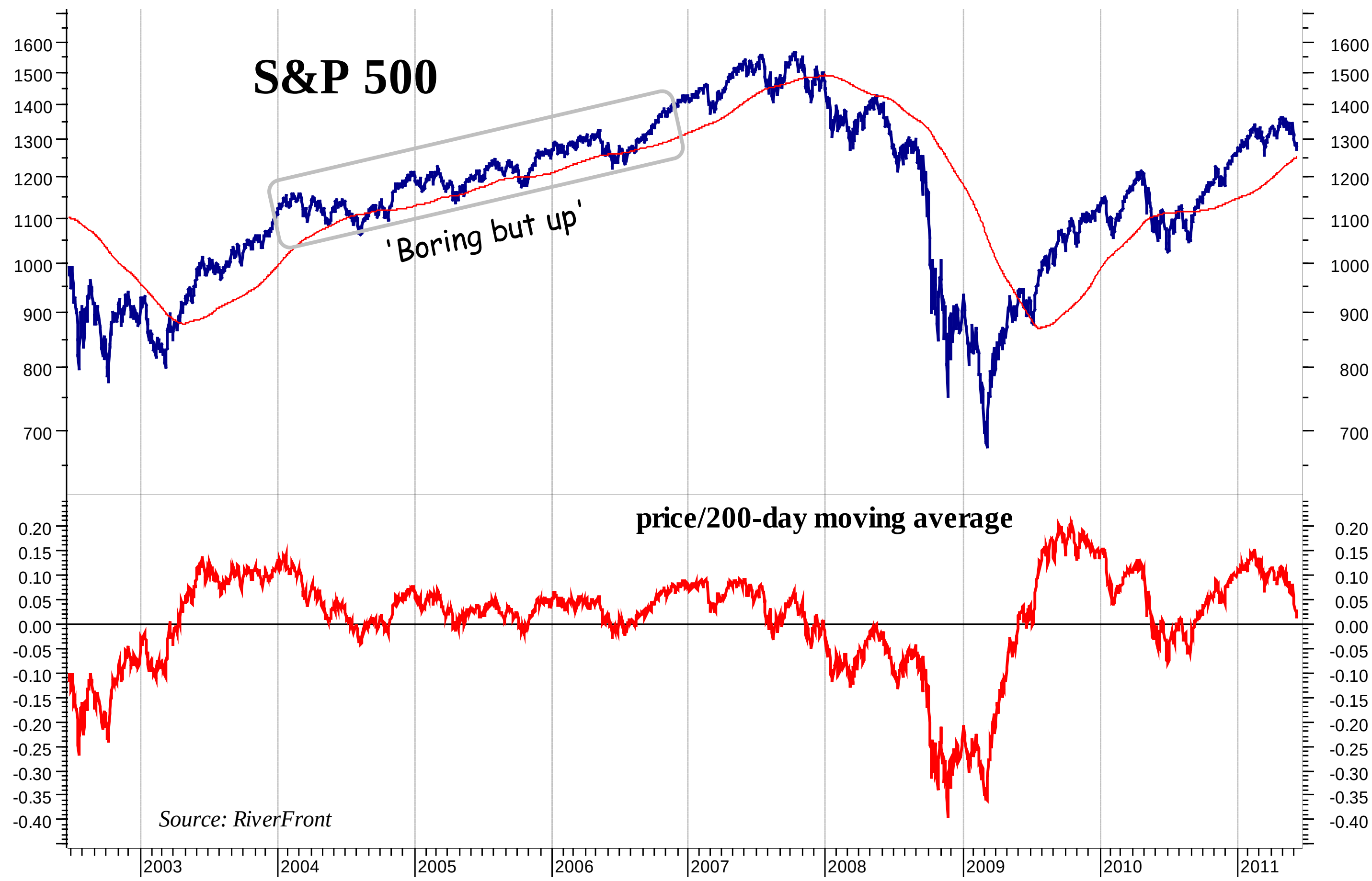
A Risk Management Strategy

- We maintain our view that stocks remain in a cyclical bull market and the slowdown in global growth will be temporary. We believe that that the US economy will not return to recession in the next 18 months and that earnings growth will slow but remain positive.
- We acknowledge that 10-year Treasury yields have fallen below our 'line in the sand' of 3% – though not yet decisively – unlike the S&P 500, which closed last Friday at 1271, clearly breaking below our initial support level at 1295. We are considering two downside scenarios. We have already fleshed out the first scenario: a test and perhaps even a brief break of the rising primary trend (our usual measure of the primary trend is the 200-day moving average). This would involve a summer low for the S&P 500 between 1220 and 1250, no downturn in the primary trend, and a new high for the current cyclical bull by year end between 1400 and 1450. In this scenario, minimal defensive action is needed in our portfolios beyond what we have already done, and we think an opportunity will present itself to add to stocks when sentiment becomes extremely bearish. This is our central case, which we believe has roughly a 70% probability of occurring.
- The second scenario is a repeat of last summer: economic weakness does not reverse, but rather persists for several months; 10-year Treasury yields retest their October 2010 lows of 2.3%; and stocks fall to 1140, a 12% decline from current levels and a peak-to-trough decline of 18%. This view is currently being articulated by several prominent economic forecasters, who warn of a US recession in 2012 driven by further declines in house prices, a debt crisis in Europe and the US, more fallout from the earthquake in Japan, and a significant slowdown in China. While we currently assign this scenario a relatively low probability, it would clearly warrant additional capital-preserving investments in all our portfolios, especially the more conservative ones. We use both technical and fundamental indicators to judge if we are wrong and decide whether further risk management is required.
- In our central case, we assume that China's war chest will be sufficient to maintain growth of around 7%, but we must admit that China's policymakers worry us from a longer term perspective. Rather than allowing the yuan to appreciate as a means of solving their inflation problem, they are choosing anti-market mechanisms. First, they are subsidizing the price of electricity to consumers, which is resulting in the utility companies being unable to profitably operate due to the rise in coal prices. This will require a rise in electricity prices, a bail out for utility companies, or blackouts as the utility companies cut back to avoid excessive losses.
- Our second concern regarding China is overinvestment in recent years – newly built empty cities; bullet trains without passengers; and bad debts in the local governments, which were given growth and investment targets. Reuters recently reported that China has implemented its own version of TARP, removing 2 to 3 trillion yuan ($308-463 billion) of debt from Local Government Funding Vehicles to bail out about a third of the loans that these vehicles own. If this is China's equivalent of the US' subprime crisis, it is significant because 9 trillion yuan is about one-third of China's GDP. Unlike the US, China can easily afford bailouts as they have the equivalent of around 20 trillion yuan in reserves. The reason we have not positioned portfolios for a China crisis is because of these reserves. Finally we believe that allowing 15% wage growth to offset inflation will create a wage price spiral, which will erode China's competitiveness. As long as China can drive 20% productivity growth, it can afford 15% wage growth and export prices in yuan are not rising, but we see a big squeeze on the profitability of China's exporters.

- Two weeks ago we wrote that a compromise would likely be struck to raise the US' debt ceiling. The bond market has remained largely sanguine and, indeed, it appears a deal has been struck. According to ISI, the compromise is to raise the debt ceiling by $2 trillion in exchange for $2 trillion in debt reduction over the next ten years, mostly through spending cuts.

The Weekly Chart: Primary trend is rising but will be tested



Past performance is no guarantee of future results

The top panel of our chart shows the S&P 500 with its 200-day moving average (200 DMA) and the bottom panel shows the price relative to its 200 DMA. In the initial stage of the 2003-2007 bull market, the S&P 500 rose sharply from its March 2003 low, and remained 12% to 15% above the 200 DMA during the second half of 2003. From 2004 to 2006, stocks entered what we termed a 'boring but up' phase, rising at a steady but more moderate pace than the initial rise off the 2003 low. During this phase, the S&P 500 dipped below the 200 DMA about ten times, by magnitudes of between 1% and 4%. Our central case now is that stocks are entering another boring but up phase, during which the S&P 500 will occasionally dip below its 200 DMA. As long as declines below a rising 200 DMA are comparable to the previous boring but up episode, we see little need for excessive risk management.

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