THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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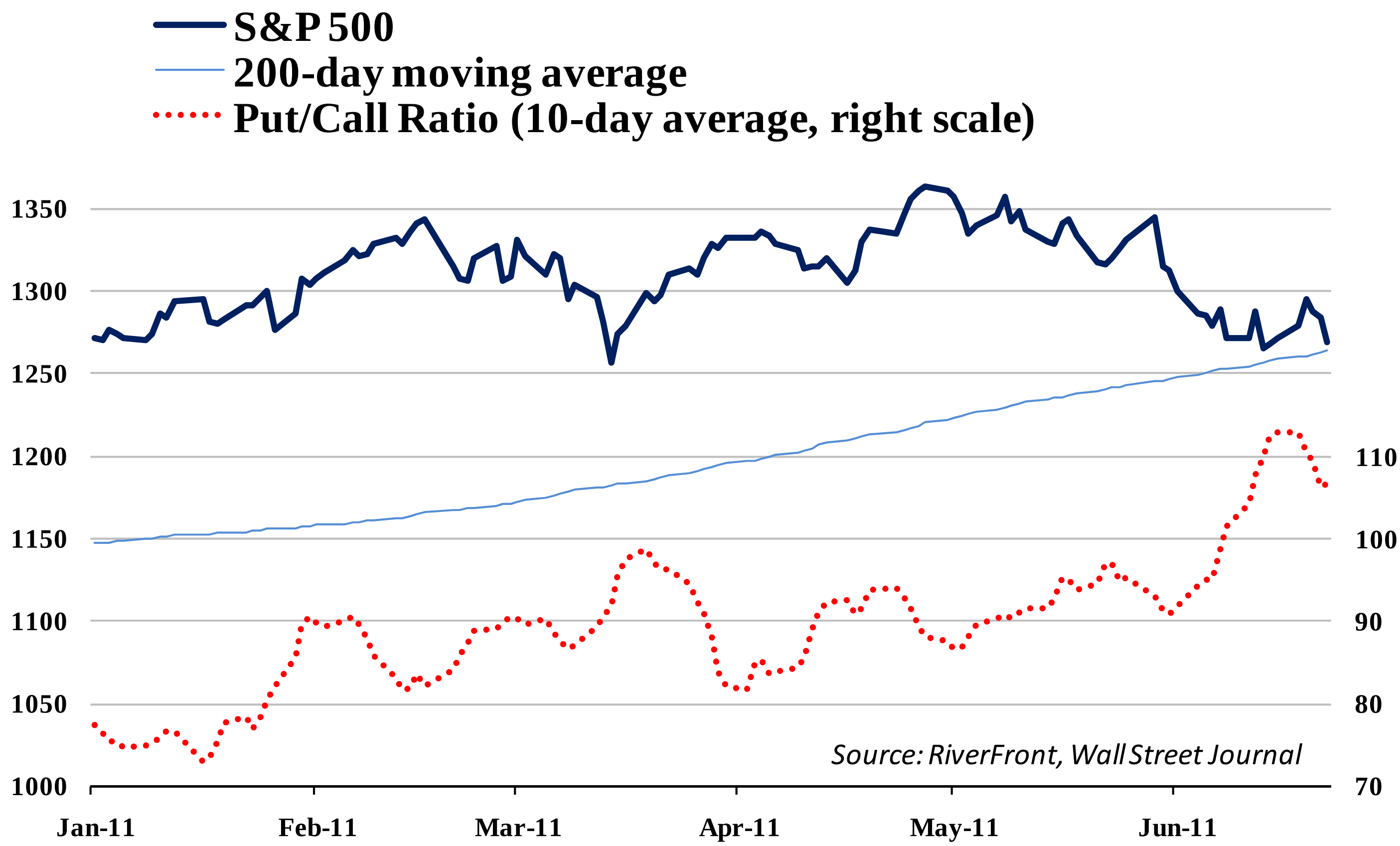
June 27, 2011

Adding to Stocks – Removing Underweight

- Last week we added equity exposure to our portfolios that were underweight stocks. Seven weeks ago, with the S&P 500 at around 1340, we reduced equity exposure in our more conservative portfolios in response to both an extreme optimism reading in the Ned Davis Research Crowd Sentiment Poll and the S&P 500 stretched by 12% above its 200-day moving average. At last Friday's close, the S&P had fallen to 1268, testing its 200-day moving average, and the Crowd Sentiment Poll had reversed from extreme optimism to extreme pessimism. We believe that the 200-day moving average will provide technical support. As long as the primary trend for stocks is rising, and with sentiment now suggesting that a good deal of negative economic news is factored into stock prices, we see a tactical buying opportunity (see Weekly Chart).
- In our Conservative and Moderate Growth & Income portfolios, excess cash and short-term investment grade bonds were sold, and the portfolios' broad international equity exposure was increased. For Conservative Growth & Income, with its lower allocation to international equity, shorter time horizon, and the typical investor's lower risk tolerance, we increased equity exposure via an allocation to low volatility stocks. Our research into low volatility equity strategies has confirmed the usefulness of this asset class as an alternative for some combinations of core equity and bonds, which makes it a good tactical fit for our most conservative portfolio, in our view.
- In our Moderate and Long Term Growth portfolios, we raised our international and emerging market weightings which, coupled with a depletion of excess cash, had the net effect of increasing our equity risk exposure.
- The Federal Reserve left monetary policy unchanged at its meeting last week, but downgraded its assessment of 2011 economic growth to just below 3% from slightly above at its April meeting. Unemployment was also revised slightly higher with the Committee expecting around 8.7% by year end, while they narrowed their inflation expectation for the year to about 2.4%. In our view, this is not 'new news' but merely the Fed catching up to recent data. For its near-term outlook on monetary policy: "The Committee will complete its purchases of $600 billion of longer-term Treasury securities by the end of this month and will maintain its existing policy of reinvesting principal payments from its securities holdings. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate."
- Given the recent slowdown in economic activity reflected by purchasing manager surveys and initial jobless claims, which the Fed acknowledged, financial markets may have been hoping for a greater willingness to employ 'QE3' to counteract any slump. That the Fed appears content to let QE2 run out (but still maintain the size of its balance sheet by reinvesting maturing assets) suggests that a much more drastic downturn in economic indicators will be necessary to reengage the Fed.
- Credit Suisse downgraded Chinese banking stocks last week due to "'asset quality concerns' ... 'massive off-balance sheet financing', visible only in credit-to-GDP ratios (rather than loan-to-GDP ratios) ... 'The credit-to-GDP ratio jumped by 46 p.p. from 120% in end-2008 to 166% by Mar-11.' ... [Credit Suisse] is no longer expecting a soft landing for China, even if inflation genuinely comes down," according to the *Financial Times*. However, ISI Group also notes, and we agree that, "The Big-4 state-owned banks are the only meaningful financial mechanisms in the country, and while they have a number of problems, they aren't going anywhere... it is worth repeating that for all the problems Chinese banks have, Beijing can and will be there to prop them up in a crisis."
- Last week we wrote that losses between Greek creditors and European taxpayers were an issue; but now, with more than 50% of Greece's debt held by public institutions — European governments, the International Monetary Fund, the European Central Bank and euro zone national central banks (according to *The Economist*) — taxpayers are

increasingly on the hook, i.e. a bailout of private creditors even if there eventually is a debt restructuring. This would be analogous to mortgage debt (and foreclosed properties) held or securitized by Fannie Mae, Freddie Mac and other housing agencies in the US and amounts to a taxpayer subsidized 'backdoor bailout' of private creditors (e.g. banks). *A Tale of Two Unions*, indeed.

The Weekly Chart: Trend rising, crowd reaches bearish extreme



Our chart helps illustrate that two out of three of our investment rules – 'don't fight the trend' and 'beware that crowd at extremes' – are currently favorable and thus, we see a tactical buying opportunity for stocks. (In light of the June end of the Fed's $600 QE2, we judge our third rule, 'don't fight the Fed,' to be neutral.) The primary trend (200-day moving average, thin blue line) is rising and the S&P 500 has twice found support there so far. Investor sentiment now suggests that a good deal of negative economic news is factored into stock prices (dotted red line). The put/call ratio is a sentiment indicator that compares the number of bearish put options traded to the number of bullish call options. It is widely regarded by technical analysts as a contrary sentiment indicator since the 'crowd' is usually overly bearish when stocks reach an intermediate-term low and overly bullish when stocks reach an intermediate-term high. Put volume recently reached 113% of call volume, echoing the extremely pessimistic sentiment readings of Ned Davis Research Crowd Sentiment Poll, our principal sentiment gauge. 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 rising 200-day moving average.

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