THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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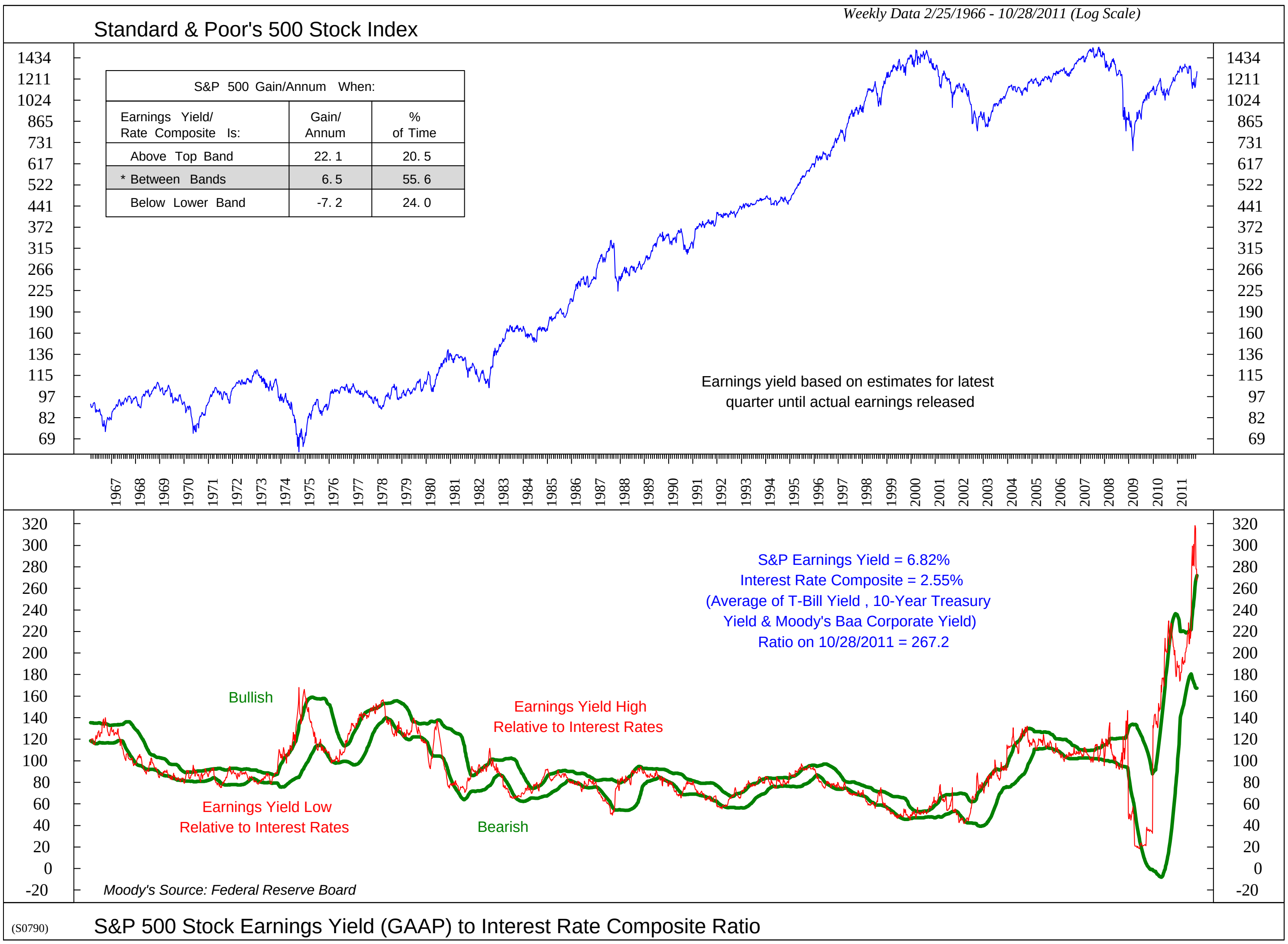
Stocks Break Out on EU Deal and Better US Data

- Investors cheered last week's EU statement because it showed policymakers reached a broad agreement to recapitalize the banking system, leverage their bailout fund, and substantially write down Greek debt. While the outlines are encouraging, the details still need to be filled in to support the rally in risk assets. Since there was a great deal of skepticism around whether a deal was even possible, we think the market responded rationally as the threat of a 'Lehman like' systemic event has been significantly reduced. The magnitude of the fear built into stocks, relative to bonds and cash, is illustrated in our Weekly Chart. The earnings yield for the S&P 500, at 6.8%, is nearly three times that of an interest rate composite of cash, 10-year Treasuries, and corporate bonds -- a 40-year high according to Ned Davis Research. The earnings yield is calculated by dividing the price by the earnings per share. It reflects the annual earnings of a company or index expressed as a percentage 'yield'.
- After Thursday's sharp rally – the MSCI All Country World Index rose more than 4% – reality returned with concerns about Italian debt, for which 10-year yields remain stubbornly elevated at 6%, an ongoing reminder that the markets will test the strength and commitment of European leaders. We do not think that write downs will end with Greece; hence the importance of a credible banking recapitalization to withstand expected losses (which we think was achieved) and a bailout mechanism with sufficient firepower to stabilize shaky credits. Although the agreed upon four-times leverage to around $1.4 trillion should be enough to calm investors, it is still unclear how this will be done — what structure it will take and who will fund it.
- US third-quarter GDP, reported last Thursday, also bolstered investor sentiment after showing acceleration to 2.5% growth led by investment spending, personal consumption, and net exports. While this report dispelled fears of impending recession, growth in 2012 will likely remain slow — particularly if budget issues remain unresolved, unemployment stays high, and home prices continue to drop. The US Department of Labor recently reported that about 2.2 million unemployed workers will lose their jobless benefits by February 2012 if they are not extended by Congress. Such a rapid drop off in income would suggest that current economic growth rates are unlikely to be sustained. Indeed, households must now dip into savings to maintain consumption levels. With spending up 0.6% in September, outpacing income growth of just 0.1%, the personal savings rate fell to 3.6%, its lowest level in four years. Without income growth or a savings cushion to draw from, household consumption (70% of the economy) will continue to stagnate, in our view.
- In contrast, developing economies' consumption could get a boost. Commodity prices have fallen enough for some developing economy monetary and fiscal authorities to consider less restrictive policies. Emerging markets have underperformed all year as authorities there have tightened policy to combat inflation (particularly for food) and rampant investment spending (of dubious value). Profits generally have come through, however, so from a valuation perspective emerging markets look attractive, in our view. Structurally, if developing countries are able to sustainably transition from being overly reliant on production and exports to more consumption-based economies (accommodated by policymakers), they could become an important source of aggregate demand growth that is currently lacking in the developed world. We believe such a transition is likely; thus, we maintain a strategic overweight to emerging markets.
- The S&P 500 rose 3.4% on the day of the Eurozone announcement and made enough technical progress that we think our six-month objective of 1360 is achievable. Thursday's rally was on about 25% greater trading volume than its recent average (volume is generally the weapon of bulls) and was accompanied by a breakout above the 200-day moving average, our proxy for the primary trend, which has flattened. Furthermore, our favorite shorter-term moving averages – the 50-day and 29-day – have turned upward; the S&P 500's breakout from our 1120-1220 box can now be viewed as decisive; and the index has retraced more than 62.8% of the July through October decline,

which suggests a test of the July high around 1350 as the next technical objective. The Crowd Sentiment Poll, produced by Ned Davis Research, is now rising from the depths of extreme pessimism and still has plenty of room to rise before reaching extreme optimism, a condition that has historically been a positive for stocks. From a timing perspective, several of our short-term market indicators have moved to overbought status, and investors should expect a pullback following the 16% rally from October's low. If the rally is to continue through year end, such pullbacks would likely find support between the 200-day moving average, currently 1274, and the top of the box at 1220. We expect continued high volatility as stocks react to incoming news from the Eurozone and the Congressional 'Super Committee' that is supposed to be coming up with budget cuts by Thanksgiving. The S&P 500's daily volatility has averaged 2.3% over the past month, down from 3.5% in August, but it is still above its 10-year average of 1.5%.

The Weekly Chart: Despite Rally, Stocks Still Reflect Extreme Caution



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