European Issues Resurface

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- The S&P 500 fell back to its 50-day moving average at 1376 last week, after peaking two weeks ago at 1420 and following an extreme optimism peak in Ned Davis Research's Crowd Sentiment Poll one month ago (see Weekly chart). Last week we made the case that stocks should weather a moderation of corporate earnings growth expectations. The catalyst for the recent decline has been signs of distress in the sovereign debt yields of the 'PIIGS' (Portugal, Italy, Ireland, Greece, and Spain), especially Spain, whose 10-year Treasury is up to 6%. This has prompted a slight reduction in the international weighting of our most conservative portfolios to lower overall risk exposure. We trimmed our UK position because of its heavy financial, energy, and materials exposure, which has contributed to its underperformance year to date. **We are currently underweight Europe, especially the PIIGS.**
- Spanish bank stocks have been leading the decline internationally, with US financials and European markets in general following in sympathy. Along with the issue of whether budget targets can be achieved, there are also questions about bank solvency. In the US, expectations have started to rise regarding the Fed potentially extending its 'operation twist' program (perhaps including MBS [mortgage backed securities] purchases) and/or maintaining its zero-interest rate policy through 2015. We think the Fed stands ready to do whatever it can to prevent growth slowing too much. **With no end yet in sight for financial repression (interest rates held below the inflation rate) we are maintaining our position in gold** (see *Weekly View*, 3/26/12).
- Along with central banks' support, we think global rebalancing is essential to prevent deleveraging from developing into debt deflation. Fortunately, there are signs this is beginning to occur. For example in China, the *Wall Street Journal* reported: "Consumption contributed 76% of first-quarter GDP growth, well above 52% in 2011 and an average of 42% over the last decade. Investment's contribution to Chinese GDP made an offsetting fall, down to 33% from 54%." Real estate dragged and exports faltered, bringing year-over-year GDP growth to 8.1% — a slowdown by China's standards. We think the transition to consumption-led growth in China (and away from export-oriented investment and property development) is positive for rebalancing trade and sustaining more modest global growth.
- The US appears to be undergoing its own positive 'structural adjustment' towards rebalancing its economy. As ISI Group's Nancy Lazar has asserted for more than two years, the US is undergoing a manufacturing and energy 'renaissance.' If the US can lower its oil dependence (e.g. through natural gas production) and trade deficit as a result of global demand for US products and

services — with a workforce and industries tooled to meet that demand — then the US is well positioned to outperform as it retires debt and boosts savings/investment. Meanwhile, other regions (notably Europe and China, the US' main economic rivals) face major institutional restructuring. Hence, **we remain fundamentally bullish about the US' earnings prospects and expect S&P 500 current correction to find support between 1250 and 1340.**

THE WEEKLY CHART: THE CROWD HIT AN EXTREME ONE MONTH AGO

Standard & Poor's 500 Composite Index

Daily Data 12/01/1995 - 4/10/2012
(updated weekly on Wednesday mornings)

NDR Crowd Sentiment Poll is:	S&P 500 Gain/Annum When: Gain/ Annum	% of Time
Above 66	-9.7	18.4
* 57 - 66 from Above	-3.0	14.2
57 - 66 from Below	15.2	20.7
57 and Below	10.1	46.1

Source: S&P Index Alert

Extreme Optimism (Bearish)

4/10/2012 = 63.0

Extreme Pessimism (Bullish)

(S574A) NDR Crowd Sentiment Poll -- Transitional Mode Basis

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The 70.7% bullish peak in investor sentiment on March 19 preceded the S&P 500's peak by two weeks and made us alert for a pause in stock's strong first-quarter performance. This was the same level of bullishness that accompanied the S&P 500's April 2010 peak, which was followed by a 16% decline. As we wrote in our March 26 weekly "We do not expect that much of a pullback this year because central banks have been pushing down global short-term interest rates significantly for the past six months (don't fight the Fed), unlike 2010 and much of 2011 when global short rates were rising. Thus we think that stocks will have either a sideways consolidation period or a correction of 5% to 8% to work off the optimistic sentiment." If we are correct, we expect the decline in the sentiment poll to stop in the neutral or upper pessimistic zone and then start to rise.

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