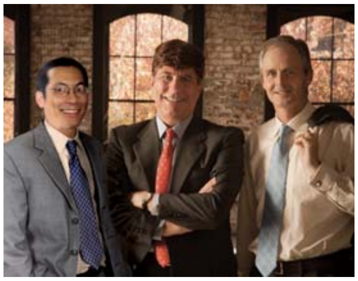
S&P 500 Testing Key Initial Support



From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

- The S&P closed at 1295 last week, 8.7% below its early April high. So far this pullback is in line with our expectations. The 70.7% bullish peak in investor sentiment on March 19th prepared us for a pause in strong first-quarter performance for stocks (beware the crowd at extremes). As we wrote in the March 26th weekly, “we think that stocks will have either a sideways consolidation period or a correction of 5% to 8% to work off the optimistic sentiment.” **We positioned our portfolios for this correction and so have the cash to deploy when we perceive the opportunity is right.** We regard 1295 as significant initial technical support for the S&P 500. The next step is judging the quality of the rebound off this support level. If the rebound falters and support is broken, we would look to 1260, which is just below the 200-day moving average, as a critical support level.
- **We closed out our gold position last week, two months after initiating a 1% position in our growth portfolios and increasing our weighting to 2% in our more conservative portfolios**. We raised our gold exposure late in March as a hedge to our risk assets, expecting it to help reduce our portfolios’ overall risk profile given gold’s historical ‘safe haven’ attributes and hedge against negative real interest rates (see *Weekly View*, 3/26/12). At that time we thought that gold’s three-week pullback was temporary and that the uptrend would resume – this has not happened. We have always acknowledged that gold is a momentum asset, so we thought it was important to honor the 1550 stop level that we set at the time of purchase. That break came last Wednesday when gold hit an intraday low of 1527. Since gold prices are moving much more in line with risky assets (such as the S&P 500) than they were a year ago, we have invested the proceeds into US equities, an asset class we prefer longer term.
- **We have been underweight international equities, especially Europe, since late last year and recently reduced our exposure further.** The Eurozone continues to face structural challenges that could potentially take years to resolve -- e.g., 17 sovereign nations with their own electorates, taxing/spending authorities, and bank regulations; combined with inflexible labor forces that face global competition. The disadvantages of a common currency without common political institutions are now readily apparent and are placing enormous strains on the European Central Bank (ECB). The latest concerns are the ongoing deposit outflows from Greek banks and the potential for contagion in Spain that could overwhelm existing bailout commitments. The range of possible responses — from default and liquidation, breakup and devaluation, to further central bank balance sheet expansion and nominal reflation — heighten the uncertainty.

- The existing bailout mechanism, the European Financial Stability Facility, is set to transition in July into a permanent rescue funding program called the European Stability Mechanism (ESM) with a €500 billion lending capacity. Between ECB liquidity provision and ESM loss absorption — some policymakers have suggested using ESM funds to directly recapitalize banks — we think institutional authorities stand ready to backstop the banking system to prevent systemic failure (see *Strategic View* 5/14/12). If bailout funds are required, the focus turns to what level of regulatory oversight, management shakeup, and/or 'private sector involvement' will be demanded in return.
- Institutional reforms will ultimately be necessary to maintain the long-term integrity of Europe's currency union, but disruptive short-term economic adjustments may prove too onerous for political stability. In this highly uncertain environment, investors have sought relative safety, driving US, UK, and German government bond yields down to record lows (following Japan's interest rate path). Unlike the Bank of Japan though, we do not believe the Fed, the Bank of England or the ECB will passively tolerate deflation, but economic conditions and inflation expectations may have to deteriorate further before there are more aggressive policy responses. We think that if measures of inflation expectations fall significantly below 2%, the Fed will likely pursue further monetary stimulus, as they did in 2009, 2010, and 2011.

THE WEEKLY CHART: S&P 500 TESTS INITIAL SUPPORT AT 1295

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