Clarifying Our 'Policy Purgatory' Strategies

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- The S&P 500 found technical support around 1290 last week, above its rising 200-day moving average (our gauge of the primary trend), while investor sentiment became more pessimistic. With the Fed still supportive, the S&P 500 down about 7% from its April high to its rising primary trend and the excessive optimism of late March worked off (see Weekly Chart), we are looking for opportunities to buy stocks. This is especially true in our longer term strategies, i.e. Global Growth, Global Allocation and Dynamic Equity Income. We optimize our strategic allocation in these portfolios for a seven year (GA and DEI) and ten year (GG) horizon. We currently hold some excess cash in these portfolios, due primarily to our underweight position in non-US equities, where the primary trends are falling.
- Our portfolios with shorter terms and a greater mandate to protect principal, i.e. Conservative Income Builder and Moderate Growth & Income, hold higher levels of cash (in excess of 10%). Furthermore, we reduced non-US weightings to bare bones levels of 5% and 9% respectively in late March/early April. Thus, although these portfolios are significantly overweight US equities, they also have buying power.
- The prospects of policy mistakes that could lead to recession in 2013 — a modest probability in our view — is restraining us from aggressively increasing our risk exposure, especially in the shorter time frame portfolios. We estimate that a 2013 recession would cause global stocks to fall another 10% to 15% but would also bring about significant policy responses that could return prices to about current levels.
- The three primary risks in order of likelihood in our view are:
  - The ECB fails to become a major buyer of European sovereign debt
  - The US fails to deal with the expiry of the Bush tax cuts
  - Chinese growth slows below government targets of 7% – 8%

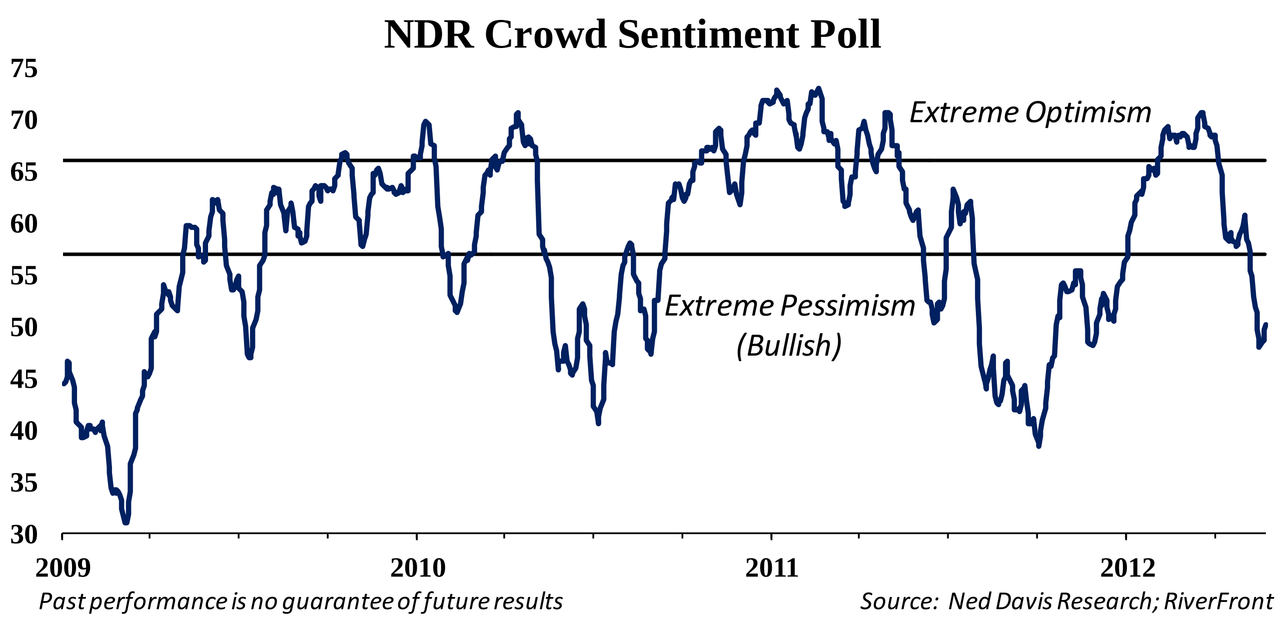
Europe: Eurozone countries do not have the ability to borrow as a collective. However, Germany can borrow (at record low rates), as can the forthcoming European Stability Mechanism (in limited fashion). In our view, the European Central Bank (ECB) has the only balance sheet big enough to potentially alleviate further turmoil in Europe. The ECB is providing emergency liquidity assistance of about €100 billion to Greece's central bank according to the *Financial Times*. There is currently no sign that this lifeline will be cut off, and we expect funding to continue through the June 17th elections, but if ECB funding stops after the elections then Greece will likely be forced into a disorderly exit.

With financing difficulties still brewing for other 'periphery' countries, we believe the ECB will be reluctantly compelled to backstop Europe's banking system, which holds substantial amounts of sovereign debt. We cannot see any other solution, but then, we have been waiting for Europe's policymakers to reach this conclusion for well over a year. We hope that the obvious failure of current policies to reduce deficits and the growing frustration of voters now makes ECB support more likely. As part of a workable solution, we believe major bank recapitalizations (as in the US) are needed, overseen by a unified banking authority/regulator. Furthermore, some form of a euro-wide deposit insurance scheme is likely needed to prevent bank runs, reinforcing the argument for a single bank regulator.

The Fiscal Cliff: We expect more investor focus on the expiry of the Bush-era tax cuts as the presidential campaign moves into high gear and next year's 'fiscal cliff' approaches. We expect a compromise and a long-term budget deal following the elections and, if necessary, the extension of the Bush tax cuts until a deal is reached. Investors will likely anticipate higher taxes and may therefore bring forward capital gains into 2012. Should US politicians fail to produce a deal, the potential rises for a mild US recession in 2013. Since all parties know this, logic suggests a deal, but the fear of failure is likely to weigh on the markets.

Chinese growth: Of the three threats to markets, this one currently seems the mildest to us. Commodity prices have already reacted to slower Chinese growth. While a major acceleration in growth seems unlikely to us, so does a significant slowing.

THE WEEKLY CHART: BEWARE THE CROWD AT EXTREMES



Currently at 50% bullish, NDR's Crowd Sentiment Poll is in the extreme pessimism zone, which has historically been a contrarian bullish environment for the S&P 500. After three weeks in extreme pessimism, we think the sentiment poll suggests the chance of a short-term bounce for the S&P 500, which is down about 6% in May. However, since sentiment has not reached the depths usually coincident with market lows (roughly between 30% to 40% bullish) we do not think sentiment is extreme enough for a definitive buy signal.