RIVERFRONT INVESTMENT GROUP

August 13, 2012

THE WEEKLYVIEW

From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

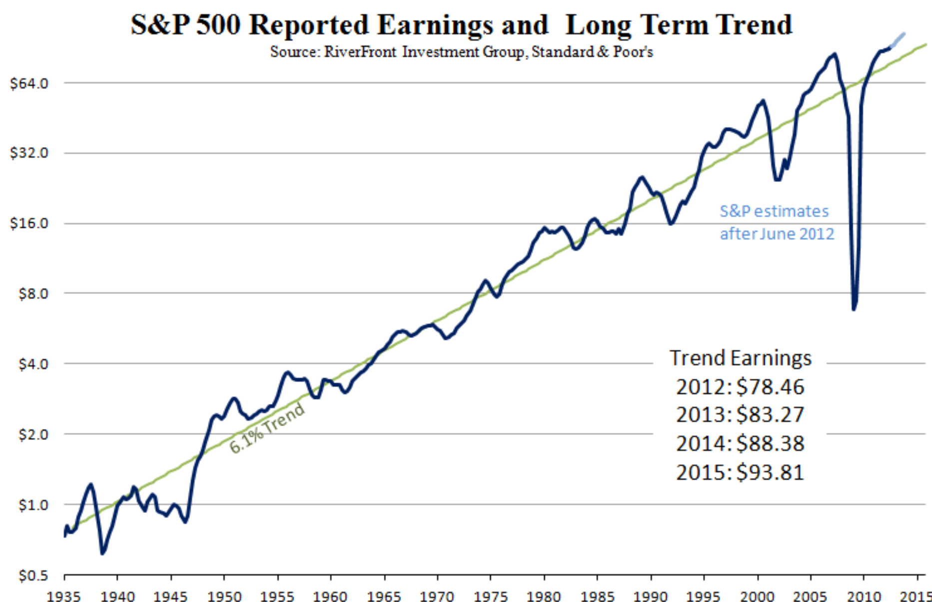
Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Key Fundamental and Technical S&P 500 Levels

1330 – 1410	16 to 17 times 2013 trend earnings	**Our current view of the trading range for the next two months, assumes no recession in 2013. We are buyers on dips.**
1500	18 times 2013 trend earnings	Target upside in next nine months if recession is avoided
1250	15 times 2013 trend earnings	Fear of global recession, but recession ultimately avoided
1140	14 times 2013 trend earnings	If global recession in 2013 occurs
1500 – 1650		**Two- to three-year target range based on 2015 trend earnings**

Our long-standing methodology for assessing valuations builds in the recognition that earnings are cyclical. It also acknowledges that the cycle has been remarkably consistent in the period since 1935, oscillating around a roughly 6% trend. The fact that the trend of earnings and the trend of US nominal GDP have been very close was first pointed out to us by Ned Davis Research and makes intuitive sense, in our view. Revenues for a broad basket of companies, like those represented by the S&P 500, are likely to be some function of economic growth. Reported earnings and their long-term trend are illustrated in the chart below.



Past performance is no guarantee of future results.

We would suggest several things:

1. Current reported earnings are around 20% above trend.

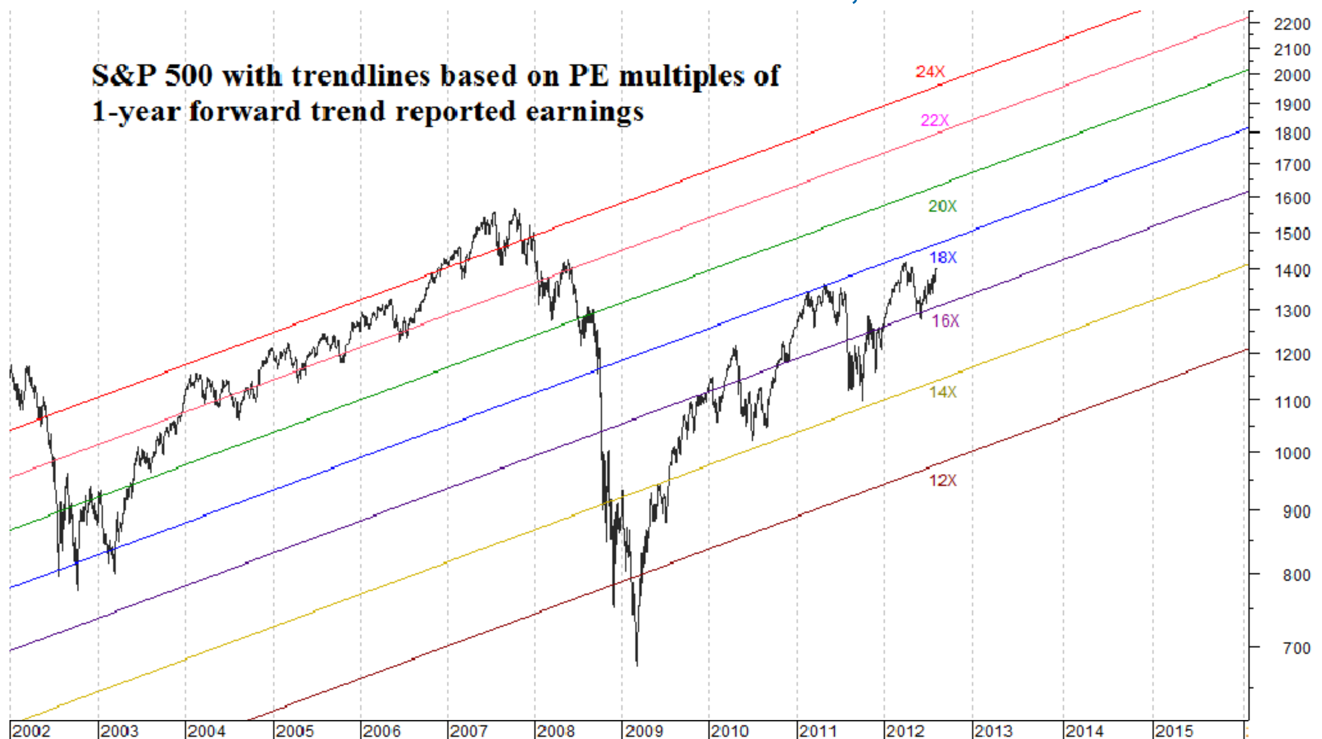
2. The recovery from the Great Recession has been V-shaped, and earnings have exceeded the 2008 peak. We believe this shows the global nature of current earnings and the excellent performance of US management.

3. The 1970s was a better period for earnings growth than the 1980s – nominal growth drives earnings and dividends.
4. Both actual and trend earnings have doubled since 2000; thus, the lost decade was a function of valuation.

Turning to stock markets, what matters is the multiple of earnings, or price-to-earnings (PE), that investors are willing to pay. Bull and bear markets are driven as much and often even more by PE multiple changes than by the earnings themselves. The fact that the average PE for US stocks has been between 15 and 16 times trend and actual earnings for more than a hundred years misses the very crucial point that it has been as low as 8 and as high as 30 just since 1970. Historians will know that high levels of inflation in the 1970s led to earnings growth above trend but also led to PEs falling below 10x, and thus to a secular bear market. Once inflation was tamed in the 1980s, PEs rose and the secular bull market resumed. A rule of thumb that developed during the period between 1970 and 1995 was "inflation + PE = 20," and we think that rule is still valid today. Only in the late 1990s "bubble" have we ever seen investors willing to pay up to 30x trend earnings. We believe the poor performance of stocks in the last 12 years owes more to the starting value, i.e., the PE multiple of trend earnings, than to any other factor, a point we argued in "Defending the Trend," a *Strategic View* we published on August 2nd.

In the chart below, we take the trend earnings from page one and draw lines representing different PE multiples to illustrate how the S&P 500 price index moves in regimes based on confidence about the future and competition from the yields on cash and bonds.

THE WEEKLY CHART: 16 – 18X FOR STABLE GROWTH, 14X FOR RECESSION FEARS



Source: RiverFront Investment Group, Standard & Poors; past performance is no guarantee of future results.

During the early 2000s recession, stocks fell to 18x trend earnings, recovering to trade in a 21 to 23 range between 2004 and 2007 in what we described at the time as '***boring, but up.***' Starting in 2010, despite lower long- and short-term interest rates, stocks have had a much more volatile range of 14 to 18x, falling to 14x in the summers of 2010 and 2011 as fears of crisis and recession peaked only to return to 18x as those fears proved unfounded. The levels we set out on page one are all important technical levels, in our view, but also tie into different multiples of trend earnings, which encourages us to believe that this is a good valuation framework. **We would be buyers on dips and regard the upside and downside at current levels fairly balanced on a one-year view.**

Dividends are not guaranteed and are subject to change or elimination. Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future. The Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.