From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Gauging the Extent of a Pullback in a Cyclical Bull Market

The S&P 500 has been rising at a 38% annualized rate since the beginning of June, a pace that we do not believe is sustainable. Thus, with the S&P 500 down three out of the last four weeks and 2.5% off its September peak (a four-year high) we think investors should be prepared for a pause or correction in the stock market. There is no shortage of near-term worries for stocks: another three weeks of uncertainty regarding the outcome of the election, the US fiscal cliff, Europe's ongoing financial crisis and recession, and China's growth slowdown. However, these concerns are widely recognized and have not prevented both international and domestic stocks from having a strong year. Furthermore, the S&P 500's primary trend is rising, the Fed and nearly every other central bank in the world is accommodative, and crowd sentiment is not at an optimistic extreme. We set out levels for a normal pullback within a cyclical bull market in our Weekly Chart, but we maintain our 1500 target for the S&P 500 in the first quarter of 2013. This target is about 18 times 2013 trend reported earnings and is contingent upon the US avoiding a fiscal cliff-induced recession.

Third-quarter earnings reporting season began last week, and estimates are for a 2.6% year-over-year decline in S&P 500 quarterly earnings, marking the end of an 11-quarter streak of earnings growth, according to FactSet Research Systems. However, the S&P 500's best annualized returns usually occur when earnings are growing between -20% and 5%, according to Ned Davis Research. Paradoxically, history shows that when earnings growth is 'too fast' (above 20%) the stock market's annualized gains are disappointing. Fourth-quarter consensus earnings estimates (compiled by FactSet) are for 9.7% year-over-year growth, which seems overly optimistic to us. Thus, stocks could face some headwinds during earnings reporting season if fourth-quarter estimates are guided lower, as 'new normal' below trend economic growth persists.

We are now broadly neutral to our international strategic benchmarks. We have increased our weighting from a more defensive international positioning since the second quarter. This was motivated by compelling valuations for international markets and improving direction for policy. In addition to the ECB's stated commitments to preserve the Eurozone by backstopping the funding requirements for Italy and Spain, European policymakers appear increasingly focused on the structural adjustments that need to occur beyond austerity — increased competitiveness, labor mobility and flexibility, reduced employment costs, and higher productivity. In an October 15th CNBC interview, International Monetary Fund Director Christine Lagarde noted that "austerity upon austerity doesn't work" and that "it is fiscal policy and structural reform now that must coincide with

The S&P 500 has been rising at a 38% annualized rate since the beginning of June, a pace that we do not believe is sustainable. Thus, with the S&P 500 down three out of the last four weeks and 2.5% off its September peak (a four-year high) we think investors should be prepared for a pause or correction in the stock market.

We have increased our international weighting from a more defensive positioning since the second quarter. This was motivated by compelling valuations for international markets and improving direction for policy.

monetary policy, reforms such as tax reforms and growth policies." Our optimistic scenario for 2013, where global growth reaccelerates, assumes that conditions placed on Spain and Italy to receive ECB funding emphasize these structural adjustments rather than additional austerity measures. In our view, Lagarde's comments increase the odds that such a policy adjustment will occur.

THE WEEKLY CHART: HOW FAR COULD STOCKS FALL

Because we think the 38% annualized pace of June through October rally is unsustainable, we think the S&P 500 will break out below this trend channel (rising grey lines) and lower the trend to a more sustainable pace. The process of decelerating an uptrend typically results in a correction to major support levels. The retracement levels shown are a general guide of pullbacks that generally follow a market rally within the cyclical bull market.

- **1428**: The S&P 500 has fallen 2.5% from its September peak, reaching its 50-day moving average and the 23.6% retracement of the rally that started in June. The S&P 500 found support at the 50-day moving average (blue line in the chart) twice in July. Thus, the S&P 500 could find support at current levels and eventually continue its five-month rally.
- **1400**: Our next target around 1400 acted as support last August, overhead resistance in early May, and would also be the 38.2% retracement of the rally from June's low.
- **1370**: The maximum downside in 'typical' corrections would be between the 50% and 61.8% retracements (1352 and 1375). (Technical analysts believe breakdowns below 61.8% retracements indicate a return to at least the beginning of the rally that is being measured.) The 200-day moving average (red line) at 1370, which we regard as a significant technical landmark, is between the two maximum retracement levels and acted as support at the early June low.