RIVERFRONT INVESTMENT GROUP

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THE WEEKLY VIEW

From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Climbing the Wall of Worry

Dysfunction in Washington, DC, slow growth on Main Street, and record highs on Wall Street do not seem to make sense, and worried investors have been reluctant to move out of bonds and cash. We think a logical explanation reconciles these disconnects: stocks like low interest rates and stable earnings growth (see Weekly Chart). Furthermore, recent decisions made in Washington, DC, have made a 2013 recession unlikely. A well-known Wall Street adage claims that a bull market, especially in its early stages, 'climbs a wall of worry.' In other words, as long as investors are worried and their fears are built into stock prices, then stocks can rise as some of those fears prove unfounded. We have recently expressed our view that the pace of stocks' advance over the past three months will slow, especially since some short-term sentiment measures are extremely optimistic (*Weekly View*, January 28th). We remain fully invested.

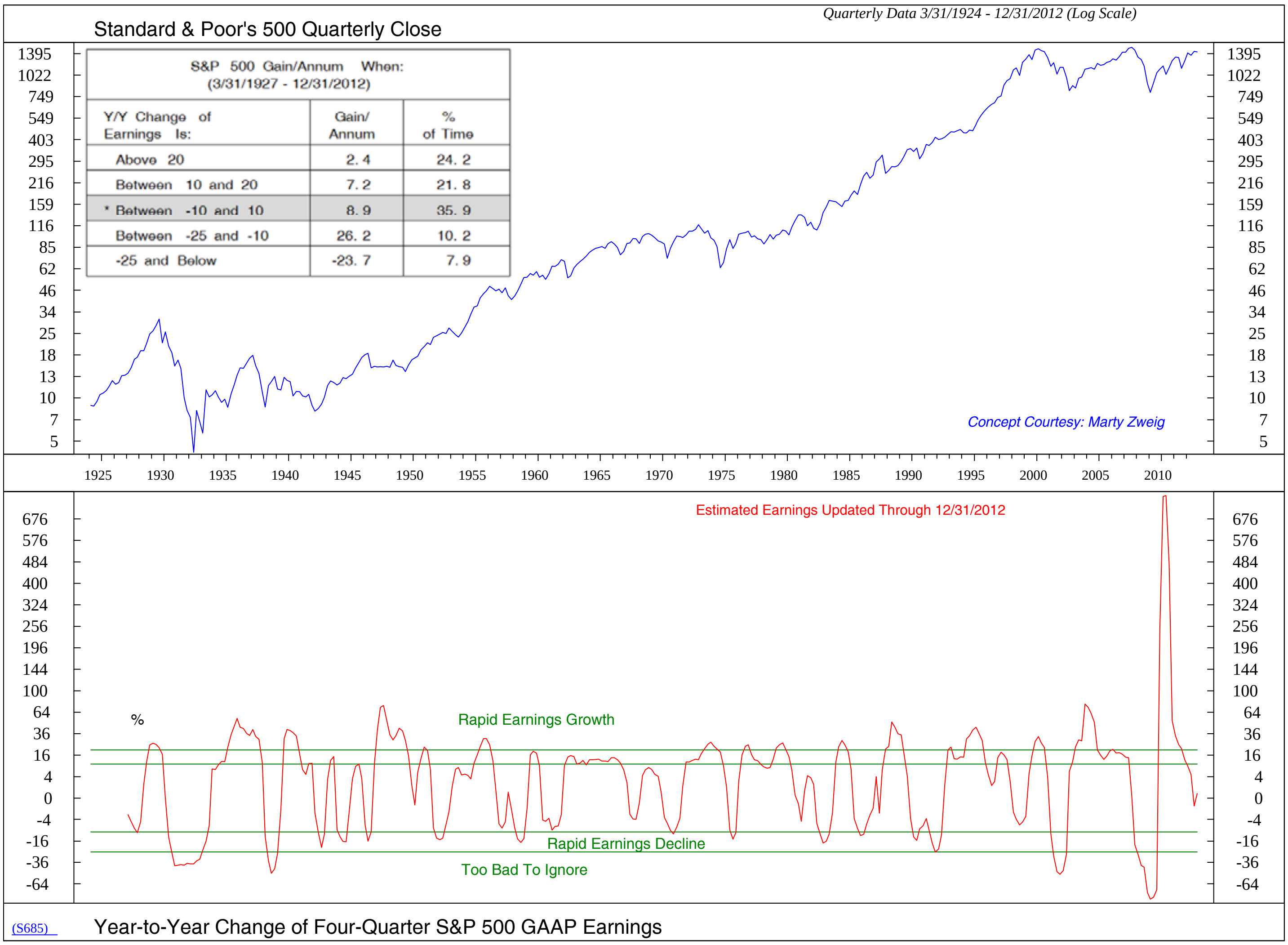
Washington, DC, is probably investors' greatest worry. Everyone is aware of the record high US debt and the absence of agreement on how to rein it in. The fiscal cliff dominated the news in the fourth quarter of 2012, then came the debt ceiling, and now the sequester (mandated spending cuts). Markets are an expression of investors' collective views and feelings, so when the fiscal cliff tax issue was resolved and the outcome was 'less bad' than feared, stocks rose and bonds fell. When the Republicans decided not to make the debt ceiling an issue, the same happened. We expect the March 1st sequester to occur. However, to put the sequester in perspective, the cuts in the 2013 fiscal year will be around $85 billion whereas the recent Hurricane Sandy spending bill is $59 billion, according to the *Wall Street Journal*. Washington has no serious plans to cut spending, which means the Fed will have to continue to fund the deficit as long as unemployment is above 6.5%, inflation remains quiescent, and borrowing costs are low. This should worry bond and cash holders more than stockholders, in our view.

Main Street: Purchasing manager indexes (PMIs) recently reported for January continue to indicate expanding US and international business activity for both manufacturing and services sectors. Moreover, the new orders and employment subcomponents also indicate ongoing improvement both in the US and globally, suggesting that policy uncertainty is increasingly abating. For example, the US services PMI employment index (representing about 80% of domestic jobs) reached a seven-year high in January. We doubt companies would be hiring if the business environment and sales outlook were deteriorating.

Discoveries by the energy industry over the last few years are another reason for Main Street optimism, as advances in horizontal drilling and 'fracking' techniques allow access to formerly unreachable oil and natural gas deposits. Indeed, the US exported record amounts of petroleum products in December, and crude oil imports were the lowest in almost 16 years. This reduced the trade deficit much more than expected, and fourth-quarter GDP will likely be revised upward to show positive growth. In the long run, growing domestic energy production increases the US' energy security and lowers its trade deficit. As manufacturing relocates back to the US, attracted by lower energy costs, we think the trade deficit could conceivably be eliminated over the next several years. As an added bonus, US carbon emissions are at the lowest levels since 1994, largely as a result of power plants switching to natural gas from coal.

Wall Street: We see several differences in 2013 that could help stocks avoid the 'sell in May' declines that occurred in 2010, 2011, and 2012: Policy purgatory, with respect to monetary policy, ended during 2012 as almost all of the world's central banks, now including Japan, committed to potentially unlimited monetary accommodation with the Fed's latest quantitative easing program having no end date. Chinese growth appears to be picking up, easing concerns of a hard landing, and Europe's financial conditions are greatly improved, as evidenced by gains of about 50% for European financial stocks since last summer's lows. In the US, housing and employment are strengthening together, and budget issues could be resolved by May. ISI Group points out that National Association of Homebuilders' data shows six consecutive months of increasing employment, housing permits, and home prices for 259 out of 361 metro areas; 17 months ago only 12 metro areas had such improvement.

THE WEEKLY CHART: SLOW EARNINGS GROWTH HAS USUALLY BEEN A GOOD THING



Y/Y Change of Earnings Is:	Gain/ Annum	% of Time
Above 20	2.4	24.2
Between 10 and 20	7.2	21.8
* Between -10 and 10	8.9	35.9
Between -25 and -10	26.2	10.2
-25 and Below	-23.7	7.9

Past performance is no guarantee of future results.

Stocks' earnings growth has slowed significantly. Coming out of the 2008-2009 'great recession', the S&P 500's reported earnings growth hit unprecedented levels, as shown in our chart. Earnings contracted by 0.55% last September, are expected to have grown just 1.16% in 2012 and estimates for the first quarter of 2013 indicate growth of 0.86%. However, as can be seen in the table within the chart, earnings growth above 20% has not historically produced the best price returns for the S&P 500. The table shows that when earnings growth has been between -10% and 20% – which has occurred 57.7% of the time since 1924 – the S&P 500 has risen at an annualized rate of between 7% and 9%. This is in line with our current forecast.

RIVERFRONT INVESTMENT GROUP
1214 East Cary Street, Richmond, Virginia 23219 TEL 804) 549-4800 RIVERFRONTIG.COM