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RIVERFRONT INVESTMENT GROUP

THE WEEKLYVIEW

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It is good news that the private sector is growing strongly enough to offset government cutbacks, it is good news that the unemployment rate is coming down, and it is especially good news that all of this is happening in the context of very low levels of inflation, in our view.

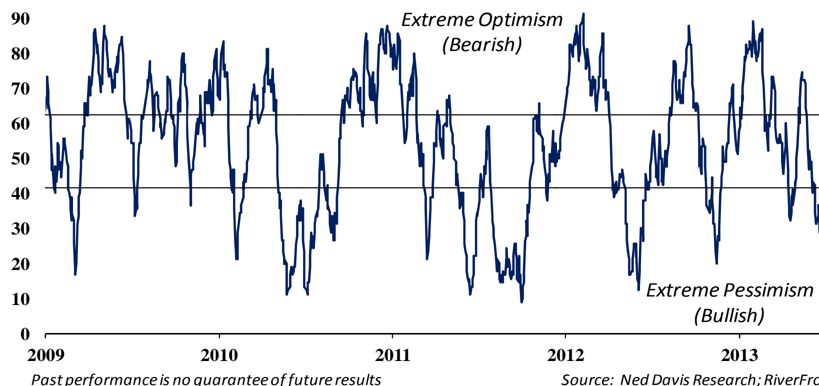
Buying the Dip in US Stocks

We believe that reducing or 'tapering' the Federal Reserve's bond purchases will ultimately be a good thing for stocks, especially since the Fed has made it clear that changes to its bond purchase program (QE3) will be "data dependent." It is good news that the private sector is growing strongly enough to offset government cutbacks; it is good news that the unemployment rate is coming down; and it is especially good news that all of this is occurring with inflation well below the Fed's target level of 2%, in our view. Except for ongoing low inflation, none of this is good news for the bond market. (see *The Weekly View* – "The Bond Investor's Dilemma: Heads You Lose, Tails You Still Lose," 6/6/13)

We think the Fed's forecasts for growth and employment are somewhat optimistic. However, we do not believe stock investors should be afraid of economic growth until growth is too strong for the Fed's liking and/or inflation becomes an issue. We believe both are years away.

Time will tell if the S&P 500's June 24th low of 1560 was the low of this correction, but we have used the recent weakness to restructure our portfolios, adding to US stocks by reducing emerging markets, high yield bonds, and cash. One of our concerns about US stocks in recent months has been that the pace of gains from last November was unsustainable and that short-term sentiment was too optimistic. Over the last month, sentiment, as measured by the Ned Davis Crowd Sentiment Polls, has fallen from extreme optimism – the daily poll, which is quite volatile (see below), fell to extreme pessimism, and the weekly poll is down to the low neutral zone. Thus, all three of our tactical rules are either positive (the trend is rising, the Fed is accommodative, short-term sentiment is extremely pessimistic) or neutral (medium-term sentiment).

NDR Daily Crowd Sentiment Poll



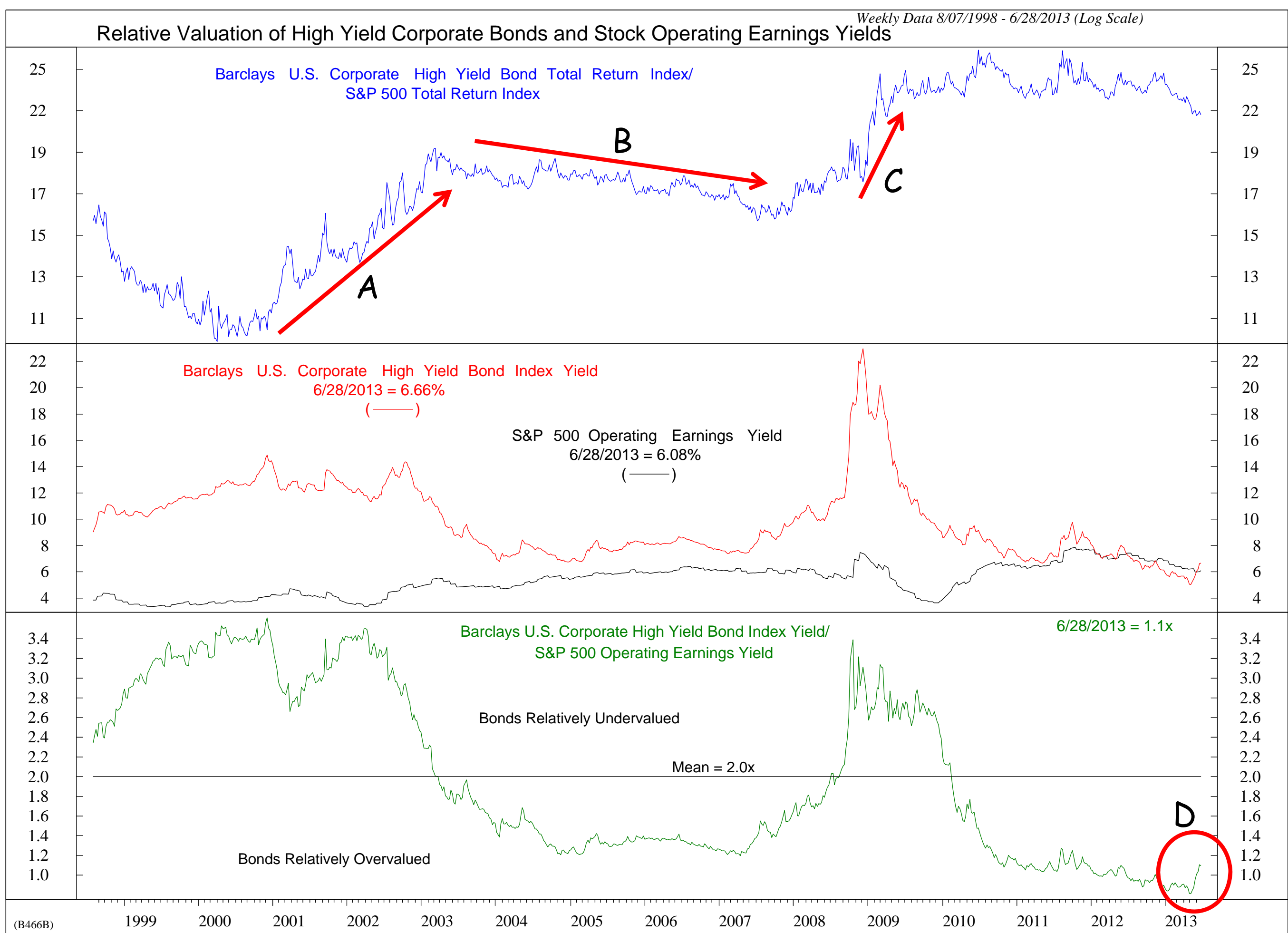
Past performance is no guarantee of future results *Source: Ned Davis Research; RiverFront*

We think conditions are less favorable for emerging markets, as we have written over the last couple of weeks. The main risk to reducing our emerging market exposure right now is that the sector has fallen so far (down more than 11% since early May) that we expect both an absolute and a relative bounce. To mitigate this, in addition to swapping from emerging markets to the US, we raised our US weighting further by reducing cash.

High yield overvalued versus stocks: We reduced our high yield bond exposure significantly over the last six months, moving into a combination of stocks and shorter-maturity high yield bonds and bank loans. We further reduced high yield last week, adding to US stocks. This is a *relative* call. The chart below shows three things: the top panel shows the relative performance of high yield bonds versus stocks (high yield bonds are outperforming when the line is rising), the middle panel shows the yields, and the bottom panel shows high yield bond yields relative to stocks' earnings yield.

High yield bond were undervalued in the late 1990s through early 2000s with double-digit yields compared to the S&P 500's earnings yield of around 4%. (The earnings yield is earnings divided by price.) As a result, they outperformed stocks through 2003 (labeled A in the chart). In the mid-2000s high yield bonds became relatively overvalued and consequently underperformed (B). In 2008, high yield rates spiked to more than 22%, setting up relative outperformance in 2009 (C) and then performed in line with stocks until 2013. Currently, the ratio of high yield rates to the earnings yield is near a record low 1.1 (D), with high yield bonds yielding about the same as stocks. We find stocks more compelling at current valuations.

THE WEEKLY CHART: HIGH YIELD BONDS ARE AT RELATIVE VALUATION EXTREMES



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