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The Crowd Hits a Pessimistic Extreme

Stock market sentiment has reached a pessimistic extreme, which has historically been favorable for stocks over the next three to six months, as we explain in more detail below. With all three of our tactical rules supportive of stocks (don't fight the Fed, don't fight the trend, beware the crowd at extremes), we have been reluctant to raise significant cash based on fears of political gridlock that we believe will prove unfounded. We expect the S&P 500 to find support in the zone between 1330 and 1370 and move higher as current fiscal cliff negotiations are successfully concluded.

As detailed in RiverFront's *Strategic View* (11/13/12), we expect the president and Congress will strike a compromise that avoids the January 1st fiscal cliff. This is because post-election changes in relative negotiating leverage and political motivations will prevent a repeat of the dysfunctional process that characterized the 2011 debt ceiling fiasco. Furthermore, continued aggressive money printing by the Federal Reserve and major policy shifts by the European Central Bank (ECB) have greatly reduced the risk of a financial crisis and therefore the potential for a 2008-style market collapse, in our view (i.e. don't fight the Fed). Thus with upside potential outweighing our assessment of downside risks, we have remained relatively neutral to our strategic benchmarks during this month-long pullback.

Of RiverFront's three tactical rules, our third rule (beware the crowd at extremes) probably requires the most discipline to apply to portfolio management decisions. Fear and greed are powerful emotions that can influence investor perceptions of the market's prospects. Rallies create a sense of optimism and worries of missing out (greed) that causes investors to chase the market higher. Similarly, market corrections, especially those that are in response to real economic or political risks, can create a sense of fear that causes investors to sell rather than risk further declines even when market valuations are attractive. Thus, when sentiment swings to either extreme of greed or fear investors have a tendency to do the wrong thing at the wrong time – buying near a market top or selling around a bottom.

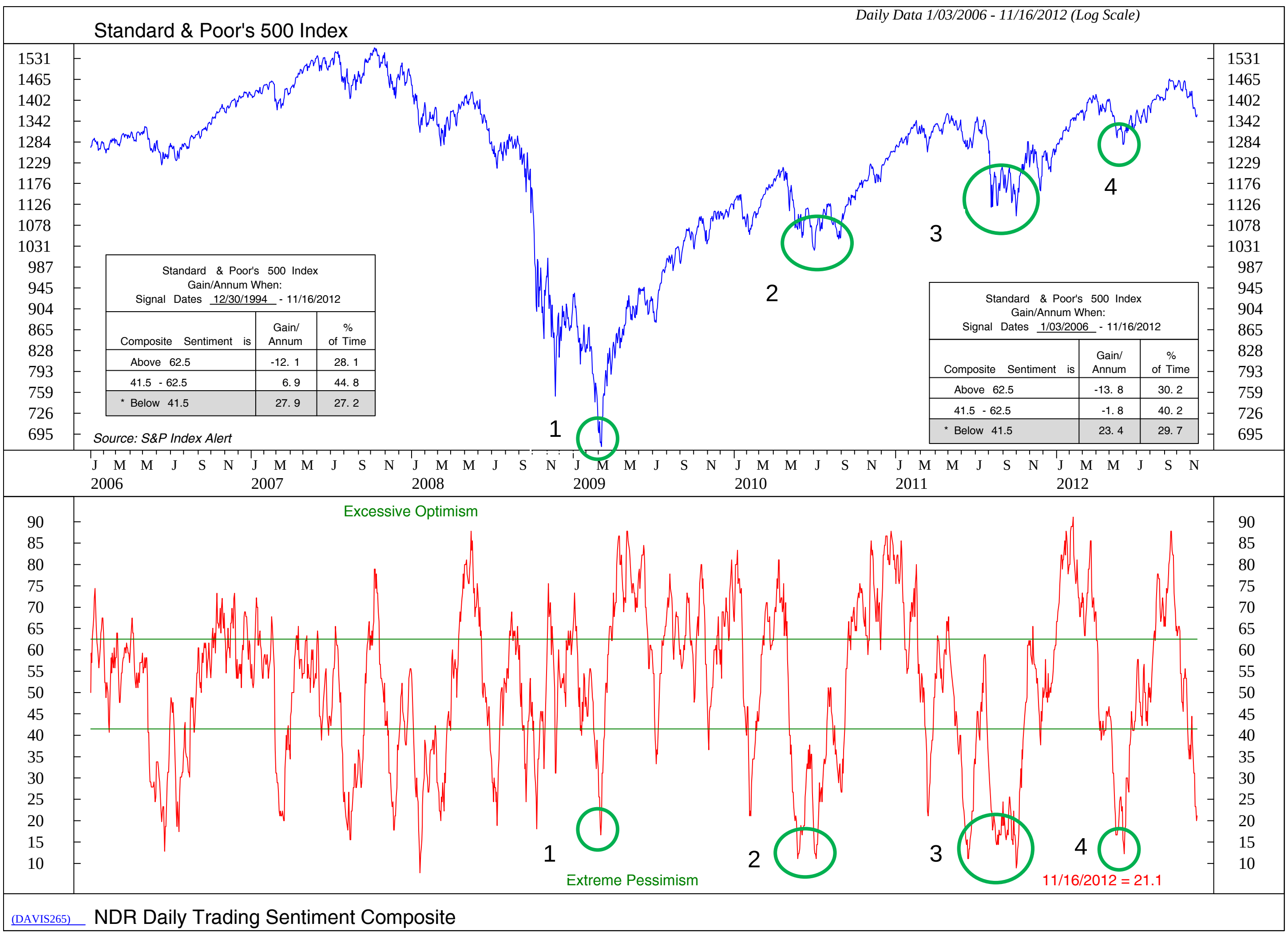
To guard against such emotionally driven investing, RiverFront quantifies investor sentiment using the crowd sentiment polls developed by Ned Davis Research (NDR). NDR's weekly sentiment poll uses surveys of investors to identify intermediate-term swings in investor psychology, while the daily sentiment composite incorporates technical market indicators to measure shorter term sentiment swings. We have quantitatively analyzed 30 years of sentiment data from these two indicators. From this analysis we have calculated how the odds of market gains or losses change based upon the degree of investor optimism or pessimism. This assessment helps us avoid trading on short-term trends when sentiment levels suggest vulnerability to a sudden and sharp reversal. In other words, our 'beware the crowd at extremes' rule is intended to help us avoid the all too human mistakes of buying at peaks and selling at bottoms.

For example, political uncertainty and the recent market pullback has left investors bearish and inclined to sell; historically, however, similar degrees of extreme pessimism suggest an 81% probability of making money over the next three months. NDR's daily sentiment composite fell below 21% bullish last week, a level of pessimism that has occurred 77 times since 1985. Following these periods of extreme pessimism, the S&P 500 rose 81% of the time in the subsequent three months, compared to a 67% probability of positive returns for all three-month time periods. As importantly, those 77 historical periods posted a 6.5% median return for the S&P 500, more than twice the 2.8% median for all three-month time periods.

As with all market indicators, trading according to the daily sentiment composite is not a guarantee of success. An 81% historical success rate means that 19% of the time the S&P 500 continued to fall after pessimism reached an extreme. These historical periods of continued market declines after the sentiment indicator fell below 21% tended to coincide with financial or geopolitical crises (e.g. Lehman Brothers, 9/11). These unexpected crises validated existing levels of market fear and prevented the normal bounce back from a market overreaction. With the ECB's recent offer of "unlimited" support for Spain and Italy, we believe that the risk of Lehman Brothers-type financial crises has been greatly reduced.

The chart below tracks changes in the S&P 500 on top of changes in the NDR's daily sentiment poll. The numbered circles correspond to recent times when both market sentiment and the S&P 500 bottomed at the same time. Visual analysis of the data confirms our quantitative conclusions: as sentiment reaches a bearish extreme, markets tend to bottom and then move higher, while extreme bullish sentiment tends to mark a market poised for a correction.

THE WEEKLY CHART: THE CROWD AT BEARISH EXTREMES IS BULLISH FOR STOCKS



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. 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. 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.