THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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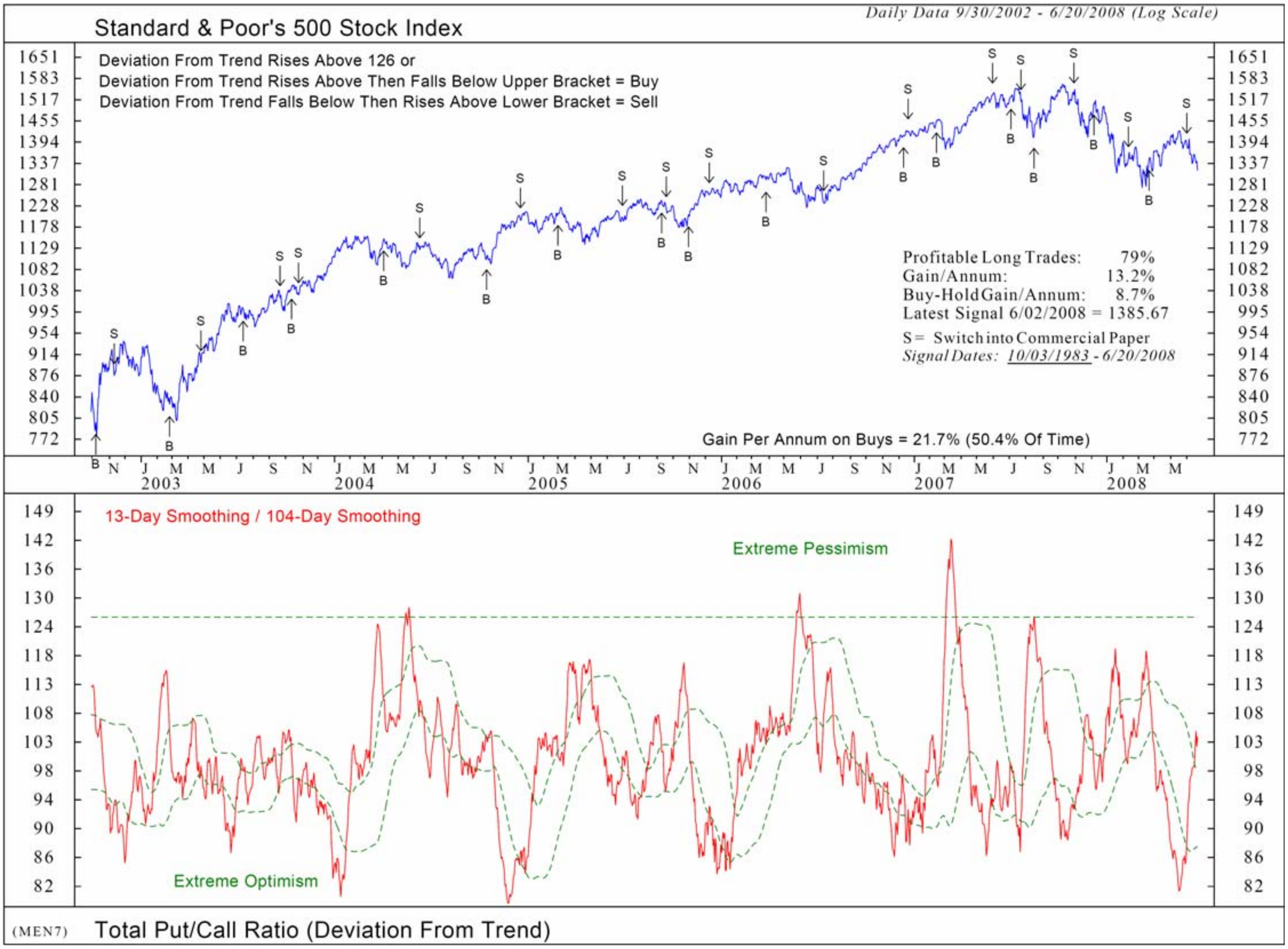
Dow Testing March Lows – Sentiment Not Yet at Bearish Extremes

- On Friday, the Dow Jones Industrials closed below 12,000 flirting with its March 10th closing low of 11,740. While we focus most of our attention on the S&P 500, we think it is noteworthy when widely followed indexes approach important technical levels. In contrast the NASDAQ, small and mid cap indexes are roughly 10% above their March lows. Examining the reasons for this, we make the following observations:
    - There have been considerable differences in sector performance from the March lows, with the notable winners being Energy, Materials, Utilities and Technology. The Financial sector leads the list of underperformers which includes Consumer Discretionary, Consumer Staples, Healthcare and Industrials. Sectors most exposed to the US consumer/housing/credit cycle are clearly the weakest.
    - Within the Energy sector, mid and small caps are up 40 to 50% year to date versus 5% for large caps, which explains much of this year's outperformance by small and mid cap indexes. Small and mid cap energy stocks are more responsive to movements in oil prices. We are underweight small caps due to our concerns about the economy, but have been overweight the energy sector in our small and mid cap portfolios. We have recently reduced this Energy weighting slightly.
- We have three main investment rules: "Don't fight the Fed, don't fight the trend and beware the crowd at extremes." Having been supportive of stocks since last August, the Fed is now neutral, hamstrung by the weakness of the dollar and the rise in inflation expectations. Sentiment is becoming bearish (a plus from a contrarian perspective), but has not reached the bearish extremes that would give us strong conviction that the month-long decline is over (see The Weekly Chart). The primary trend remains the market's biggest negative as it is clearly declining. We see considerable technical support for the S&P 500 between Friday's close of 1318 and around 1270, the March and January lows. On balance, we expect these levels to hold in the coming weeks followed by a rally that will, once again, test the primary downtrend.
- For a rally to be sustained, we believe there must be some relief from current oil prices to avoid further economic deterioration. While there is evidence of the tax rebates temporarily supporting retail spending, much of it is simply being used to offset the high cost of food and energy. We still feel the recent pace of rising oil prices is ultimately unsustainable and that a correction is overdue, but we respect the power of the current trend.
- Last Friday, China raised prices (reduced subsidies) on gasoline by 17%, diesel (18%), jet fuel (25%) and electricity (5%) – a positive development in our view. CIO Michael Jones argued last week in *The Strategic View* that the removal of subsidies by developing economies is critical to lower oil prices. Consumers in those countries have been shielded from surging energy prices and so energy consumption has not fallen as it has in unsubsidized developed economies. The problem is that China's desire to continue to manage the process gradually means that the magnitude of the change may not be sufficient. Oil prices dropped over $3 dollars following the announcement from China, only to rise again as militant attacks shut down production at an offshore Shell oilfield in Nigeria.
- Last week we wrote that developing country governments and central banks "so far have not made the tough choices." With the partial removal of energy and power subsidies by China (and other developing economies) governments are beginning to make hard decisions that entail short-term costs, with an eye towards the long-term benefits they provide, namely sustainable growth. For emerging markets this may entail a period of higher inflation and slower growth. First, removal of subsidies directly raises prices for consumers while imposing costs that are likely to limit economic activity. Second, this is likely to be a gradual process since developing country governments want to avoid economic shocks that

threaten recession and social upheaval. A few countries such as Brazil and Mexico are taking proactive monetary policy measures – maintaining positive real rates and allowing their currencies to strengthen – but the majority are not. Although tighter monetary policy and currency strength implies slower economic growth, we believe countries that enact such policies will be more stable and healthier in the long run.

The Weekly Chart: Sentiment has room to become more pessimistic



Past performance is no guarantee of future results

The Total Put/Call Ratio, from Ned Davis Research, is a sentiment measure based on the volume of all stock options traded (including both index and equity options) on all major exchanges. Put/call ratios track the activity of options traders who have a history of being wrong at extremes. To account for the volatility caused by changing lists of available options and a data bias resulting from the growth of complex option strategies, the put/call ratio is smoothed (averaged) and uses "volatility bands" to help identify extremes. The smoothed ratio rising above its moving upper band suggests that pessimism is excessive. The ratio reached an extreme optimism low in mid-May, when the stock market peaked, but has further room to rise before reaching a level of extreme pessimism that would give us conviction that the month-long decline has ended.

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