Fundamentals Drive Technicals

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In our view, fundamentals drive stock prices; not the other way around.

For example in 2011, the last time a technical "death cross" occurred, investors were very worried about the prospects for global growth. On that occasion, the stock market's fears were proved unfounded and the bull market resumed.

2008 was the opposite, and highlights one of the most successful occasions of a pure momentum strategy.

As long as we feel that the fundamental picture is unlikely to deteriorate next year (our current view), we will remain close to the strategic allocations that we believe are optimal for the different timeframes that each of our portfolios targets.

On September 8th, we wrote that the technical situation in the stock market had deteriorated markedly. During September, stocks staged a minor rally, retracing half the losses, only to return to the lows. From a momentum perspective, the fact that the 200-day moving average (what we refer to as the primary trend) has turned down is a caution flag, and our risk management team has been watching on high alert to see if the early September lows will hold. Friday's nonfarm payrolls, which clearly disappointed market expectations, initially caused stocks to sell off, but a meaningful turnaround occurred during the day, with international markets outperforming a strong US market. We think the reason for the turnaround was anticipation of further policy easing by the eurozone and Japan, who have the most scope to do so.

Much has been made of the fact that the 50-day moving average has fallen through a declining 200-day average, known in technical circles somewhat dramatically as a "death cross." This occurred at the end of August, and on September 1, the S&P 500 closed at 1913, below where it closed last Friday and about 10% below the May 2015 peak.

Technical analysis can be viewed as the study of price behavior in the belief that the stock market is a leading indicator of the economy, and we respect the messages it sends. However, as we will try to demonstrate through two recent examples, fundamentals drive stock prices; not the other way around.

In 2011, the last time a death cross occurred, investors were very worried about the prospects for global growth. The S&P 500 had fallen from a high in April and was down some 13% by the time the death cross occurred in mid-August. The lowest weekly close was down another 4% just one week later. There was then a six-week period where the lows were tested several times, and the market finally recovered strongly in early October, surpassing the previous high in March of 2012. The "all clear" signal, when the 50-day moving average crossed back above the 200-day, did not occur until February 2012, close to the old highs. On that occasion, the stock market's "technical" fears were proved wrong by the "fundamental" continuation of economic and earnings growth.

2008 was the opposite, and in our view it highlights one of the most successful examples of a pure price momentum strategy. Although a strict interpretation of the death cross did not occur in December 2007 as the 50-day broke down through a 200-day that was not falling, an investor following a momentum discipline would likely have sold in January 2008, some 10% below the all-time high and missed the pain of the declines, reentering well off the lows in 2009 but well below where they had sold.

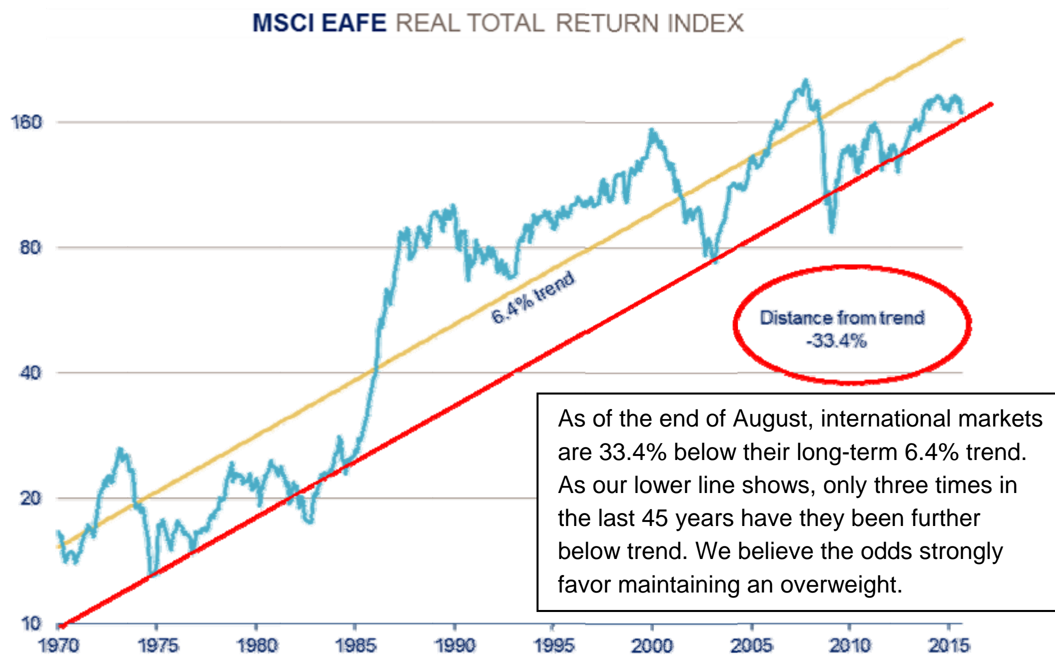
The clear difference between the two examples is what subsequently occurred to the global economy and earnings. In the first case, positive fundamentals reasserted themselves, in the second the fundamentals continued to deteriorate ultimately leading to the "great recession" of 2008/2009. Also very important, in our view, was that stocks were above trend in 2008 and below trend in 2011, and central banks were tightening in 2008 and easing in 2011. Today, US large cap stocks are slightly below trend and international stocks are almost as far below

trend as they were at the lows in 2008 (see Weekly Chart, below). Central banks are still aggressively promoting growth, and we do not expect a decline in global earnings or the global economy in 2016.

We acknowledge that we did not predict the slowing in US growth that has occurred in the third quarter, especially the poor employment report announced last Friday. In our view, the combination of the global recession in the materials and energy sectors; the persistence of slowing demand from China and other developing economies; and uncertainty about the future path of growth all justify the decline we have seen in stocks. So far, earnings in the US have stagnated, with estimates coming down to a flat year for 2015, but that includes a 60% decline in the earnings of the energy sector. Meanwhile, earnings in the eurozone and Japan have continued to grow. Thus, the decline in stock prices mostly reflects uncertainty about the future. We feel differently. We expect the benefits of low oil prices to continue to boost the consumer and a continued recovery in housing. We also expect continued earnings growth in Europe and Japan as they benefit from competitive currencies and the recently announced fiscal and monetary stimulus in China to stabilize and boost growth.

As long as we feel that the fundamental picture is unlikely to deteriorate next year (our current view), we will remain close to the strategic allocations that we believe are optimal for the different timeframes that each of our portfolios target. As mentioned earlier, we do have a risk management plan as part of our discipline and have set levels that would cause us to raise some cash. It is our hope and belief that these levels will not be breached.

THE WEEKLY CHART: INTERNATIONAL MARKETS WELL BELOW TREND



Source: RiverFront Investment Group, MSCI. Data from Jan 1970 through Aug 2015. Past performance is no guarantee of future results. The MSCI EAFE Index measures the equity market performance of developed markets, excluding the US & Canada. The index consists of indices from approximately 22 developed markets. It is not possible to invest directly in an index.

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***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.*

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