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# Positive Fundamentals Clash with Negative Technicals – Raising Cash Again

We just published our 2016 Outlook, which explains that we anticipate better economic growth for most developed economies (US, Europe and Japan) and a stabilization of the Chinese economy. Although the economic data released thus far in 2016 is supportive of this economic forecast (e.g. improving purchasing manager surveys in Europe and strong nonfarm payroll gains in the US), financial markets have focused on chaotic policy moves from Chinese leaders and the subsequent turmoil in Chinese equity markets. Market concerns over policy direction and growth prospects for China were augmented by troubling geopolitical developments, as North Korea detonated another nuclear bomb and Saudi Arabia suspended diplomatic relations with Iran.

*Even though the fundamental data looks consistent with our expectations for modestly higher equity markets in 2016, we have followed our short-term risk management discipline and raised an additional 5 to 7% cash across all of our portfolios.*

Managing money requires humility and good risk management, in our view. In the first ten days of 2016, the S&P 500 has fallen 6.0% and as our chart on page 2 shows, the short-term technical picture for the S&P 500 has deteriorated markedly. Thus, even though the fundamental data looks consistent with our expectations for modestly higher equity markets in 2016, we have followed our short-term risk management discipline and raised an additional 5 to 7% cash across all of our portfolios.

We did not expect markets to have such a poor start to the year, but we have been aware since mid-December that the technical picture has deteriorated. When combined with the cash raised late last year, our balanced portfolios now have between 18 and 25% in cash and very short-maturity, high-quality bonds. Further risk reduction measures will be taken if the market continues to break important technical support levels. With that said, given our fundamentally positive outlook, we will be looking for the right opportunity to redeploy the cash.

We are aware of the heightened level of investor concerns and thought it would be helpful to offer RiverFront's views on the main concerns we are hearing.

| INVESTOR FEARS | OUR RESPONSE |
|---|---|
| **China:** Lack of confidence in China's leaders, yuan devaluation, China's stock market collapse. | We agree that China's leaders have made multiple mistakes, both in regulating the stock market and creating an environment of fear among business decision makers in their crackdown on corruption. Investors are worried that these policy blunders are a sign of panic over the "true" state of the Chinese economy, but we believe that the actual source of these problems is President Xi's poor micro-management of most policy decisions.<br><br>We regard yuan weakness as an indicator of capital flight and a judgment on the leadership, but believe its biggest impact will be felt by China's Southeast Asian neighbors. We reject the importance of China's stock market as a good indicator of the economy, given that it has not been one in the past. In our view, the economic data in China has stabilized in the last 6 months. |
| **Oil:** Collapsing oil prices are indicating a potential global recession. | There is no shortage of demand for oil in our view; the problem is oversupply. That is good news for global growth in countries that consume more oil than they produce, especially Europe, Japan, China and SE Asia (i.e. a majority of the world). It is bad for oil producers, but the ultimate cure for low oil prices is lower oil prices which will eventually curb supply. |
| **Stock Bubble:** Stocks are in a bubble driven by easy money; QE has ended in the US and rates are rising. | Our work shows US stocks to be fair value and the rise in stock prices to have been justified by a corresponding rise in earnings. The Fed is determined to avoid raising rates too much. We regard eurozone and Japanese stocks as attractive since their central banks are still printing money, and we believe earnings will grow faster than the US – We do not like |

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| | emerging markets, the UK, Australia or Canada as they are too tied to the commodity cycle. |
| **US Recession?** | Friday's strong payroll data, 5% unemployment and healthy service economy simply does not support this view. There is a recession in the oil patch, but not in the economy overall. |
| **Volatility suggests instability.** | Volatility feels unusually high only in contrast to the unusually calm environment during QE. So long as a recession is not imminent, volatility reflects uncertainty and usually creates opportunity, but not until pessimism reaches an extreme. This hasn't happened yet. |

Financial markets have been more volatile over the past week and indeed the past year. Now that the Fed has ended Quantitative Easing (QE) and is starting to raise interest rates, we believe equity markets will revert to their more typical, historical pattern of volatility. Investors should recognize this volatility for what it is – normal. In our view, investors should also consider whether the passive, index-based strategies that prospered in the steady bull market of recent years will struggle in this more volatile environment. Managers with sound risk management disciplines could come to the fore as volatility presents more consistent opportunities to buy low and subsequently sell high.

## THE WEEKLY CHART: S&P 500 BREAKS DOWN


*Source: RiverFront Investment Group; FactSet Research Systems. Past performance is no guarantee of future results.*

*Important Disclosure Information:*

*Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.*

*Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.*

*In a rising interest rate environment, the value of fixed-income securities generally declines. Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.*

*Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.*

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*Index Definitions:*

*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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