Submerging Markets

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Emerging markets (EM) peaked relative to the world in 2011, following two strong years in 2009 and 2010. RiverFront lowered its strategic EM weightings significantly at the end of 2012 and 2013. Our strategic allocations are underweight EM (with zero exposure in our conservative portfolios). Year to date, EM is down 2.6%, while the S&P 500 is down 0.3% and developed markets (DM) are up 2.3% (9.6% on a currency-hedged basis). The one semi-bright spot in EM is Asia ex-Japan — up 1.35% for the year (source: MSCI).

We think the reasons to be underweight EM are clear. EM shows a high degree of correlation with commodities and, inversely, with the US dollar, as our Weekly Chart shows. In other words, EM tends to underperform when commodity prices are falling and the US dollar is strengthening. While these correlations hold for EM generally, the impact on the various regions within EM can differ, which is why we remain overweight Asia ex-Japan.

We think the reasons to be underweight EM are clear. EM tends to underperform when commodity prices are falling and the US dollar is strengthening, as is currently the case.

Latin America (mostly Brazil, Mexico, and Chile) and Emerging Europe (Russia, Turkey, and Poland) are heavily dependent on commodity production, particularly oil. Lower oil prices have not only depressed earnings but have proven to be politically destabilizing. This has raised risk premiums in these markets, which also feeds back into currency weakness. Given their degree of underperformance over the past few years, it is tempting to bottom fish, but because of concomitant earnings deterioration, valuations remain near ten-year averages and are not that attractive.

Asia (China, South Korea, Taiwan, and India), in contrast, are net oil importers and benefit from falling energy prices. Furthermore, many of their largest companies export to the US and are thus helped by a strong dollar, which effectively makes their products cheaper for American buyers. Thus, Asia ex-Japan is the only EM region with earnings and stocks near record highs, whereas Latin America and Eastern Europe remain well below peak levels. Valuations in Asia ex-Japan remain near average levels; while we do not expect major currency depreciation among Asian nations, we think they are feeling pressure to weaken their exchange rates. Therefore, while Asia ex-Japan is our favorite among EM, we prefer DM overall (especially on a currency-hedged basis).

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At some point EM — Latin America and Eastern Europe in particular — will again outperform. However, at a minimum, we think that will probably be when: (1) Federal Reserve monetary tightening is ending; (2) the US dollar stops appreciating; and (3) commodities find a bottom. We think it is premature for all three.

China

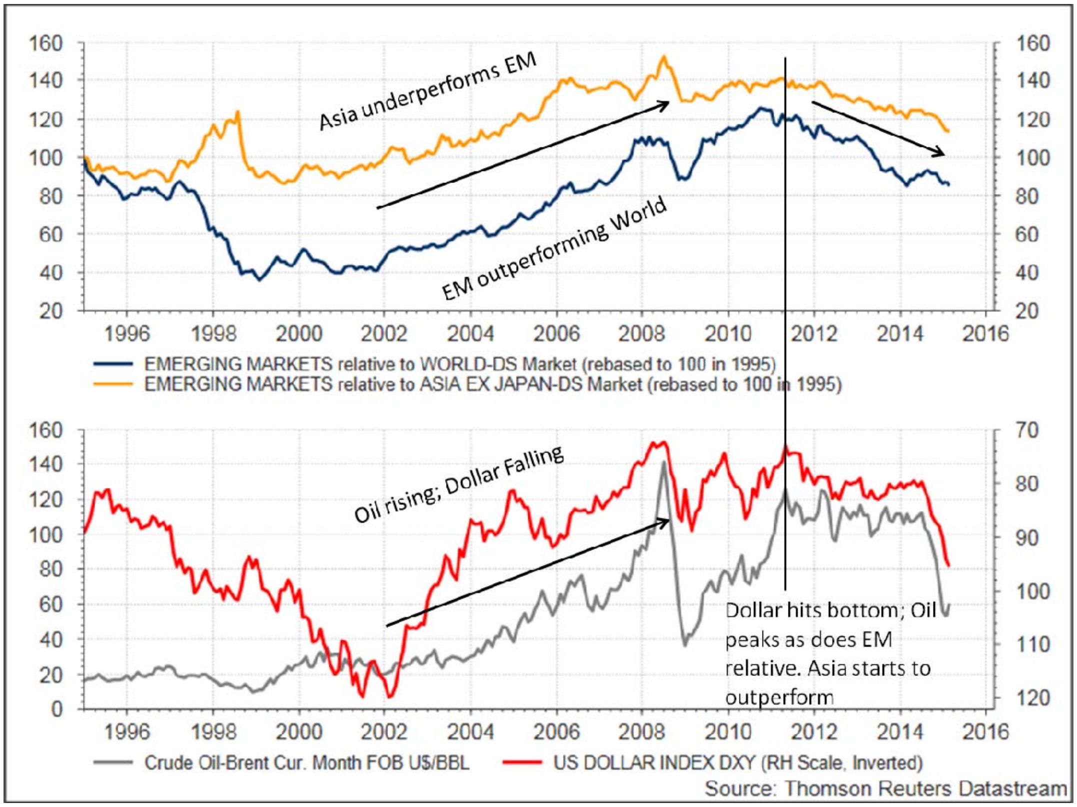
China's economy is not only the largest in EM, but second or third in the world depending on whether you count the European Union as a whole. Its stock market capitalization is also the largest in EM, but it is still small compared to the US ($5 trillion versus $22 trillion) or Europe ($11 trillion). China's economic growth is slowing notably, while at the same time its leaders are trying to rebalance towards more service-led growth and away from heavy industry. This slowdown and transition is part of the reason why commodities prices have fallen so far, given China's large imports and consumption of basic materials over the years.

We see two major challenges for China:

1. Chinese credit growth through its 'shadow banking' system rivals the US' in the lead up to the 2008 Global Financial Crisis. Indeed it was the GFC that prompted China to prime the credit pumps in the first place.
2. Chinese capital outflows, perhaps fueled by a widening 'anti-corruption' drive, appear to be accelerating; Goldman Sachs estimates $72 billion left the country in the third quarter of 2014 and $91 billion in the fourth.

We do not think these two issues are enough to derail China's economy, but we do believe the risks to a 'hard landing' have risen. To their credit, Chinese authorities seem aware of these problems and have already introduced 'targeted' fiscal stimulus, eased monetary policy considerably (with more likely to come) and promised structural reforms to better allocate capital, all while having plenty of foreign exchange reserves to back these initiatives and clean up any accidents that may occur. However, as Chinese Premier Li Keqiang said recently: "Over the past year we have faced more difficulties and challenges than anticipated, [but] with downward pressure on China's economy building and deep-seated problems in development surfacing, the difficulties we will encounter in the year ahead may be even more formidable than those of last year."

THE WEEKLY CHART: EM TRACKS OIL & DOLLAR; ASIA BUCKS THE TREND



Past performance is no guarantee of future results.