THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Positioning for a Weak Euro, Stronger Dollar

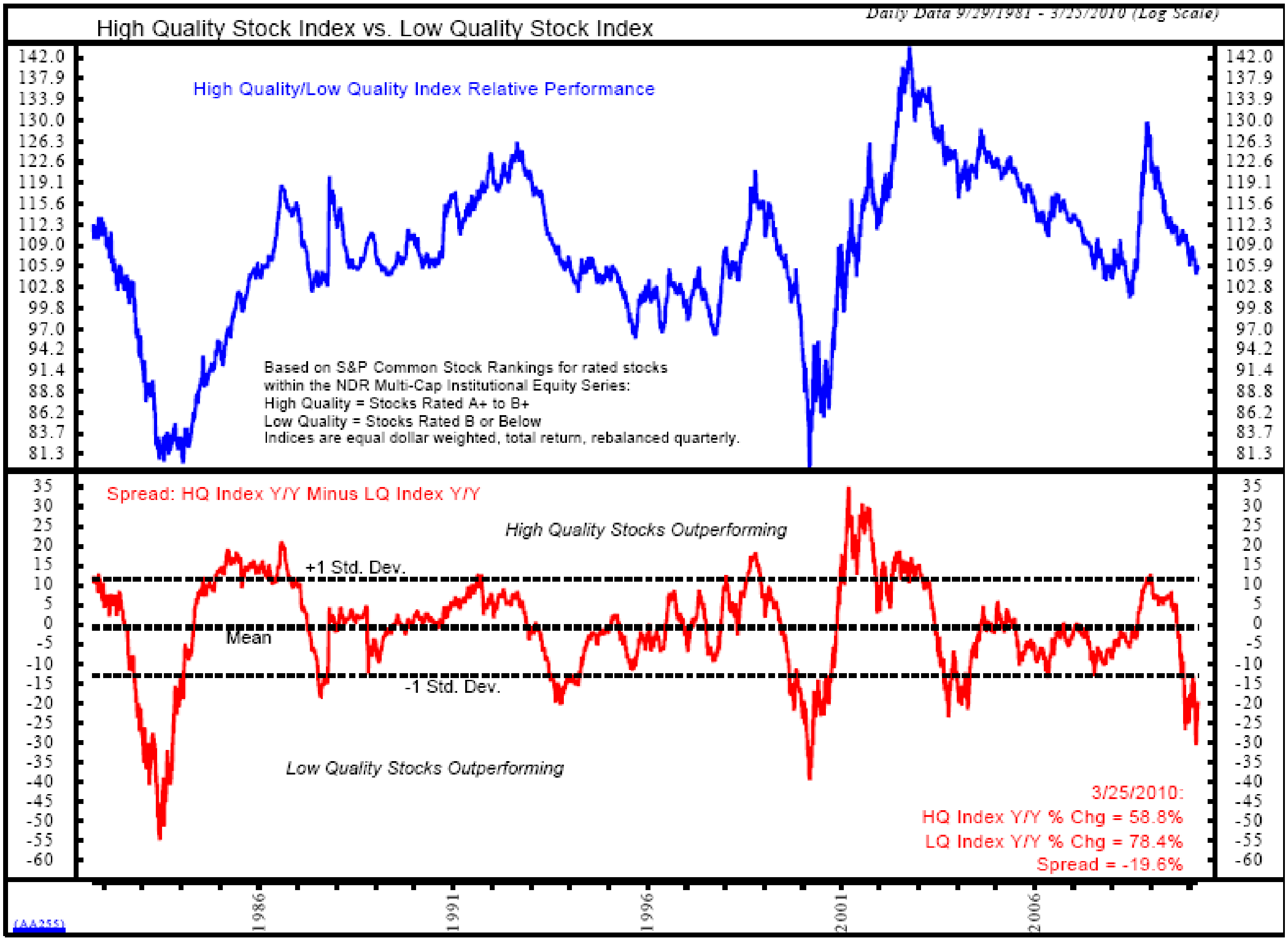
- Europe's marriage is in trouble. In a *Financial Times* article, the former Chief Executive of Barclays, Martin Taylor, likened the Eurozone to an increasingly discordant marriage between Teutonic efficiency, discipline and organization in Northern Europe, and the Mediterranean mix of siesta and the good life (our words). There is little doubt about where you might want to go for a relaxing vacation, but it is also increasingly clear who has kept their fiscal house in order (primarily Germany). Europe must now decide whether "the misery of unraveling [the euro]" will "exceed the pain of soldiering on." He concludes: "when both partners in a marriage seriously question the arrangement, divorce is only a matter of time. This is a marriage with 16 partners and domestic violence is heating up." We are not so bearish and expect the euro 'project' to survive, but we believe its members will be in counseling for some time and that this will continue to hurt its value until their economies (and politics) are better integrated.
- Last week the Europeans cobbled together an arrangement with member states and the IMF to provide Greece with loans at market interest rates in the event that they can't get funding from the private markets. The current spat is thus temporarily resolved, but the longer term issue of an incompatible marriage remains. We like BCA Research's description best: "the three currency majors [euro, yen, and dollar] are in an ugly contest, and the US dollar is suddenly not looking so bad." Having only fallen 12% from its peak late last year and with momentum now clearly negative, we think it can fall further.
- The stronger dollar has important asset allocation ramifications. Commodities (priced in dollars) which broadly matched stocks for much of last year are down for the year and have not participated in the rally over the last six weeks. We started reducing weightings to both Europe and commodities in early February. We now have no direct exposure to commodities in our Growth & Income portfolios, have cut our direct exposure in the Growth portfolios in half, and have introduced a position in the trade weighted dollar. Regarding Europe, while it represents about 70% of the international benchmark, we have only about one-third of our international exposure there. When the US is outperforming world markets, a globally diversified portfolio of stocks and commodities will typically underperform the S&P 500, and that is happening. We will consider whether we need to reduce Europe further as history shows that Europe rarely outperforms the US when the dollar is strengthening against the euro.
- Lower commodity prices also have implications for emerging markets as the energy and industrial material sectors make up 35% of the large cap emerging market index. Unlike Europe, we think emerging markets are in a secular bull market, by which we mean a multiyear period of rising prices with the potential for price/earnings (PE) expansion. Thus we are less inclined to underweight this group. However, we have started to look for ways to focus our portfolios more on the domestic growth in emerging market countries and have been increasing our exposure to smaller cap stocks which have greater concentration to domestic consumption.
- Coincident with the dollar's strength has been a sell-off in Treasury bonds driving yields back towards 4%. Ten-year yields bottomed in late 2008 close to 2% and have been flirting with 4% for nine months. Our bearish views are well known by regular readers, but a clear break above 4% would likely set the stage for a move to at least 4.5% in the coming months. Since the driver seems to be distrust of policymakers' resolve to lower deficits, and some trepidation that the Fed is ending its long-end purchases, rather than expectations of stronger economic growth, a break above 4% would probably cause the stock market rally to stall.

High quality stocks and dividend growers – attractive separately and together

High quality dividend paying stocks remain among our favorite long term risk adjusted investments. From the market's low last year, however, they are up less than the S&P 500 as lower quality more cyclical stocks, which fell precipitously in 2008, have led the market. We think the economy's growth rate will peak in the second quarter and that the peak in economic momentum will result in low quality's relative strength peak.

Regarding dividends, the critical investment thesis is the mathematical power of compounding. Companies that are able to grow their dividends at 7%, will double the dividend every 10 years; and we believe this is going to be valuable to America's biggest demographic -- the baby boomers. It is estimated that a 50-year old in the US can expect to live another 25 to 30 years. Thus, a portfolio that yields 3% today and for which the dividends compound at 7% could yield 12% in 20 years, quadrupling the investor's annual income from their original investment. For an investor who reinvests the dividends for the first 10 years, the compounding effect is even greater. We think the baby boomers will eventually rediscover the value of dividends, and bid up the value of those stocks who can deliver consistent dividend growth. *Dividends are not guaranteed and are subject to change or elimination. Past performance is no guarantee of future results.*

The Weekly Chart: High Quality becoming very oversold



Quality is subjective. In the chart above, the criteria is S&P quality ratings. The underperformance of high quality is becoming extremely stretched, suggesting that a period of outperformance is becoming more likely. Additionally, as we wrote in our 2010 outlook, we believe consistent dividend growth is another, perhaps better, measure of quality. The combination -- high quality global franchise companies with a history of dividend growth -- is a theme in our portfolios and one which will likely become bigger when price momentum turns upward.

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