RIVERFRONT
INVESTMENT GROUP

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THE WEEKLYVIEW

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Adding to Exposure to Emerging Markets

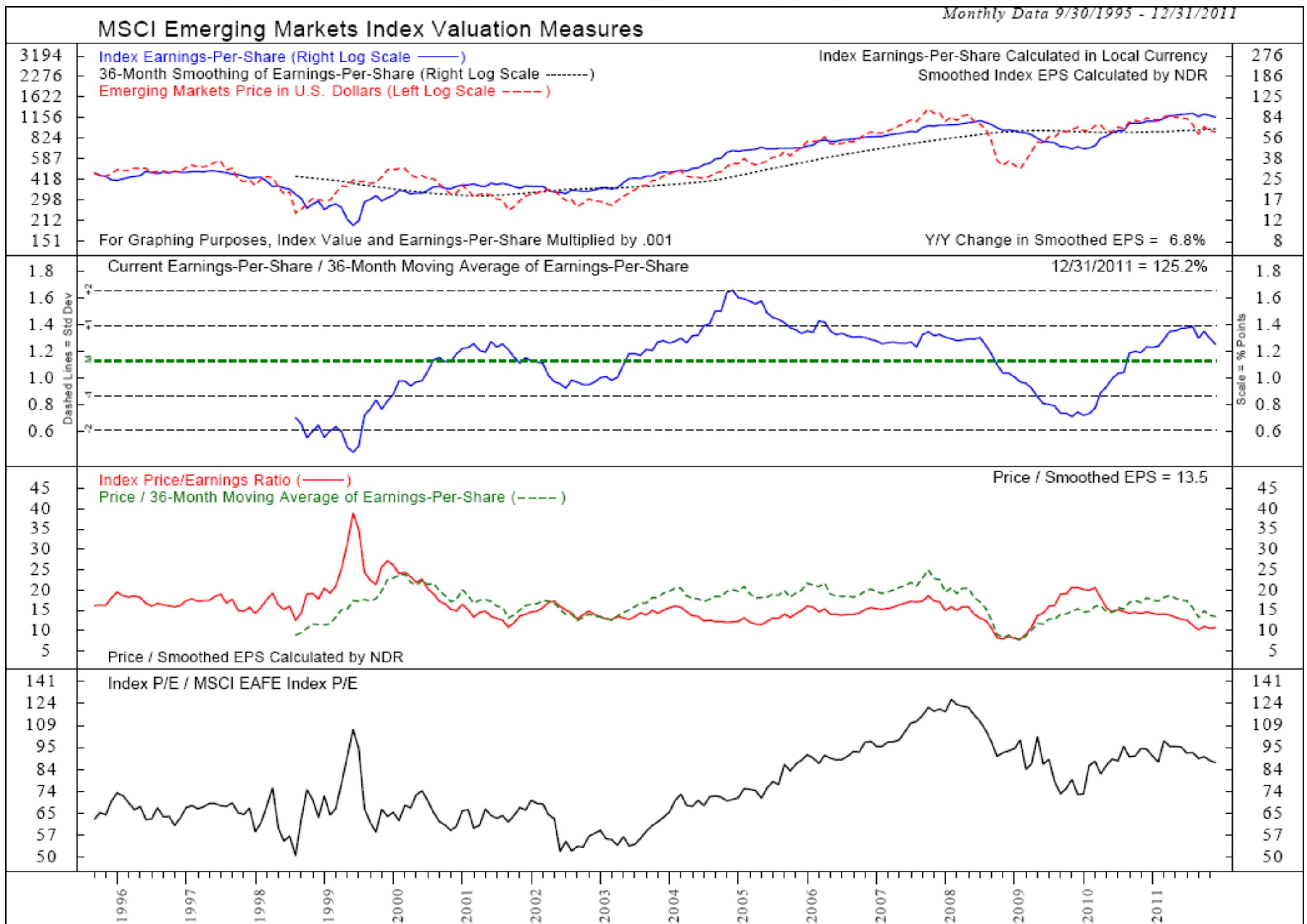
- We have increased our emerging market equity weighting to neutral from underweight. Emerging markets largely disappointed in 2011, down about 19% versus a positive 2% for the S&P 500, despite better economic and earnings growth than developed-world equities. We think the primary causes of last year's underperformance were (1) restrictive policy to rein in inflation (mostly food-related, but also from property speculation in the case of China) and (2) a general 'risk-off' attitude among investors worried about potential catastrophic consequences arising from a Lehman-like failure in Europe. These fears appear to be fading; thus, given emerging markets' attractive valuation and fundamental growth prospects, we no longer want to be tactically underweight our strategic benchmarks.

- Emerging market inflation is beginning to subside along with global growth as a result of policymakers' 2011 tightening strategy. We believe policy is changing. In our *Weekly View* on 12/13/2011, we wrote: "Emerging markets have begun to selectively ease monetary policy as inflation appears to be leveling off and global market strains have intensified." For example, Chinese money supply has reaccelerated to 17% year-over-year growth in December from 13% in October (its lowest level in a decade). Money supply growth has historically been highly correlated with the Chinese equity market, and we think the bottoming and renewed acceleration will be reflected in better stock performance. Money supply growth in other major emerging markets, such as India and Brazil, is still decelerating, but this should allow policymakers to become less restrictive. This means that one of our three rules -- Don't fight the Fed (or equivalent central bank) -- is turning positive for emerging markets with investors no longer 'fighting' their central banks and/or their fiscal authorities.

- As for the threat from Europe, investors seeking to diversify internationally and raise their risk weightings remain concerned about further Greek haircuts (also known as 'private sector involvement') and 10-year Italian bond yields still near, but back below, 7%. However, the immediate funding concerns for European banks seem to be diminishing as the European Central Bank's (ECB) long-term refinancing operations have lowered overnight interbank rates, which have been causing severe stress in the financial system. Perhaps most encouraging is that under its new, President Mario Draghi, the ECB has demonstrated a willingness to greatly expand its balance sheet (now on par with UK and US central bank balance sheet expansions), which we would view as a signal of its commitment to 'do what it takes' to provide liquidity and maintain financial stability. With the probability of a Lehman-like event greatly reduced, we believe investors can now venture further out onto the risk curve. The caveat is that global economic growth still remains fragile and subject to policy error — hence our Outlook 2012 emphasis on *Navigating Policy Purgatory*.

- While European markets are very attractive from a valuation perspective and have probably discounted much of the economic recession and earnings downturn we see in 2012, we remain underweight. Our chief concern from a relative-return perspective is the euro, which we think has further to fall. Europe is likely to remain 'balance-sheet constrained' for quite some time amid deleveraging and painful structural adjustments that will limit recovery, similar to the US experience over the last few years. On the other hand, emerging markets generally do not have the same constraints, remain cost competitive globally, and have higher growth prospects than the developed world due to rising incomes and consumer demand from a burgeoning middle class. Thus we continue to devote a relatively large strategic weight to this asset class, particularly in our growth portfolios.

THE WEEKLY CHART: ATTRACTIVE PEs BOTH ABSOLUTE AND RELATIVE



The top panel of our Weekly Chart from Ned Davis Research shows that prices in the MSCI Emerging Markets Index (dashed red line) have led earnings (solid blue line) consistently throughout the period shown . Thus, if global recession is avoided in 2012, as we expect, then earnings are unlikely to fall below their three-year moving average (dotted black line), which should allow emerging markets to bottom near current technical support and valuation levels. As shown in the third panel, the price/earnings ratio fell below 10 during the 2008-2009 global recession and is now hovering just above that level on trailing earnings (and 13.5 on a smoothed basis), which we think leaves room for multiple expansion should the earnings outlook stabilize and/or improve. Finally, emerging markets remain at a discount to developed international equities (bottom panel). The historic discount that prevailed from 1996 – 2004 was understandable in light of political risks and currency crises; however, as these issues have been addressed in the emerging world and are now challenging the developed world, we think relative emerging market valuations will rise (as in in late 2007 – early 2008) given lower debt and higher growth. Thus we think the recent dip is a buying opportunity.

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. The MSCI EAFE Index measures the equity market performance of developed markets, excluding the US & Canada. The index consists of indices from 22 developed markets.. It is not possible to invest directly in an index. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future. 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.