RIVERFRONT INVESTMENT GROUP

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THE WEEKLYVIEW

Raising Exposure to Risk Assets

From right to left:

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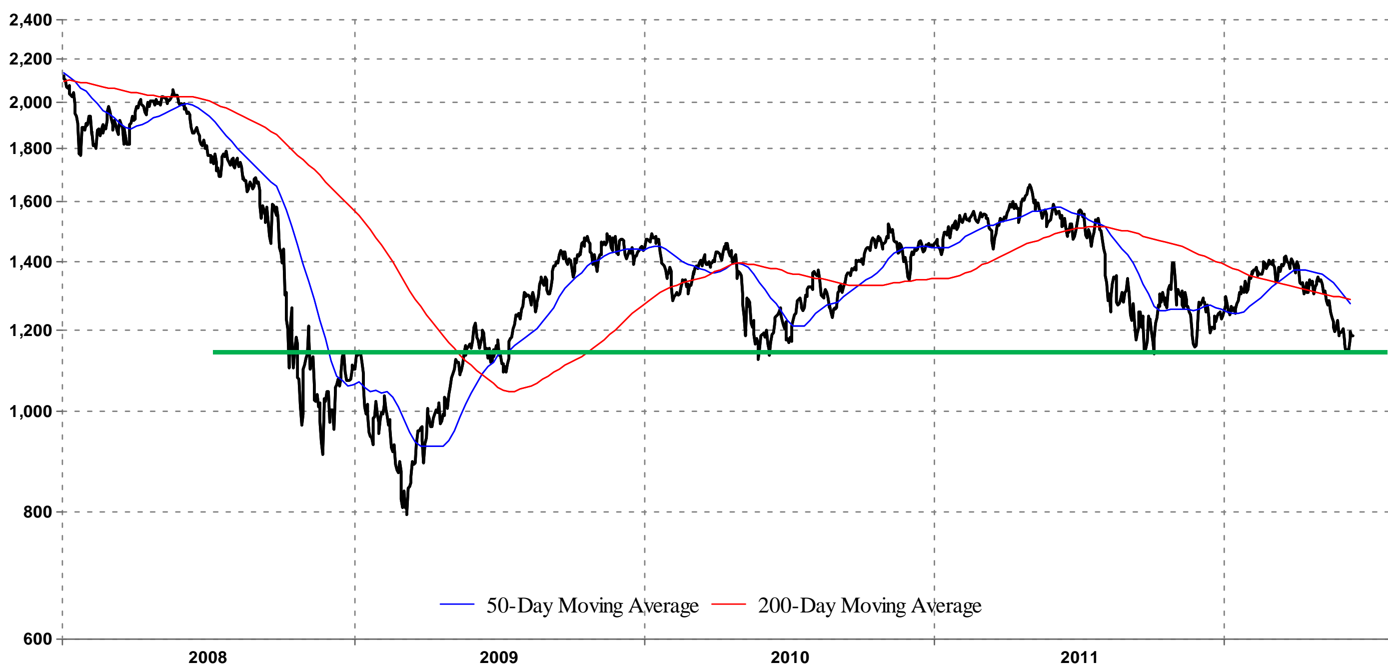
- **What we did:** Last week we continued the process of adding stocks and high yield bonds to our portfolios. We increased portfolio risk by approximately four percentage points of equity risk (beta*) in Conservative Income Builder and Moderate Growth & Income; two points in Dynamic Equity Income and Global Allocation; and five points in Global Growth (our portfolio for investors with a 10-year plus horizon). After these trades, the risk profiles of all portfolios are now roughly in line with RiverFront's strategic benchmarks, which strongly favor stocks in our balanced portfolios. **Beta measures volatility relative to a benchmark. A result greater than 1.0 implies that a security is more volatile than the benchmark; a result less than 1.0 suggests that the security is less volatile than the benchmark. Betas may change over time.*
- **Why we did it:** We believe an intermediate-term low was made early last week, with the S&P 500 testing its 200-day moving average and international markets finding support at their 2010 and 2011 lows (see Weekly Chart). We do not know if these will be the lows for the summer, but after reducing risk in April, we are returning to a more neutral position. 'Policy Purgatory' continues, but last week's rise in global equity and high yield bond prices was supported by some fundamental policy moves:
    1. Central banks and politicians from the US, Europe, Asia and Latin America acknowledged slowing global growth and the systemic risks to growth going forward. Furthermore Australia, Brazil, Vietnam and China cut interest rates, and China has been encouraging banks to increase lending.
    2. The 'Fiscal Cliff' – the prospect of significant tax increases on January 1 – was widely discussed in the US media, and some prominent Democrats argued against letting the Bush-era tax bill expire without a renegotiated substitute. Fed Chairman Bernanke, in his testimony to Congress, also stressed the short-term economic risks of a sudden increase in taxes while stressing the importance of agreeing on a long-term deficit reduction plan. Since we believe a 2013 US recession is one of the biggest concerns for global risk assets and that the fiscal cliff is one of the bigger threats to US growth, we regard the growing consensus that a deal must be reached as positive.
    3. European policy developments were mixed. The European Central Bank (ECB) left rates unchanged despite recessionary readings from most indicators. The €100 billion Spanish bank bailout is impressive in size (10% of Spain's GDP), generous in terms of its 3% rate, and comes with few strings attached. As we go to press it is unclear whether the loan will have seniority to existing Spanish government debt, which is causing Spanish 10-year yields to rise. Once again we believe Europe is being reactive not proactive. Finally, we think that in next week's Greek elections, voters who have had a month to assess the dire implications of exiting the euro will support pro-euro parties, thereby averting a disorderly exit. As demonstrated last week, European markets and the euro are at levels where good news is quickly priced in, but the risks remain high.

Different strokes for different folks: We increased our portfolios' market risk in a variety of ways. In our more conservative income and US oriented portfolios -- Moderate Growth & Income and Conservative Income Builder -- we increased risk by raising high yield bond exposure back to where it was a month ago. We also added a modest weighting in US small caps proportionately to both portfolios. Last month we reduced high yield bond exposure when yields were approximately 7.2%. Since that time, high yield bond yields have risen approximately one percentage point and are now yielding slightly over 8%. No non-US exposure was added to our two most conservative portfolios.

In our more equity and globally-oriented portfolios, we sold two defensive international positions – currency hedged international and Japan – both of which outperformed in May's sell-off, especially with the euro's weakness relative to the dollar. We reinvested the proceeds in a broad basket of Asia excluding Japan, and Europe. We are bullish on Asia long term, but we have been underweight as China's economy has slowed. We are becoming more willing to invest in Asia now that China's policy is pro growth.

Although we don't think Europe's risks have changed, prices have, with European markets in dollar terms back down to the lows of the last two summers. Furthermore the problem markets of Portugal, Ireland, Greece, Italy and Spain are now just 8.3% of the MSCI Europe index following their underperformance, whereas the UK is 36%, Switzerland is 13%, the Nordic Region is 8%, and Germany is 13%. Thus, the index now has more exposure to the successful European global franchise companies. There is a risk that we are early, but we are encouraged by extremely pessimistic sentiment regarding Europe (beware the crowd at extremes), significant technical support, and an oversold currency (the euro is down around 8% since late February and 16% from a year ago).

THE WEEKLY CHART: FALLING TREND MEETS TRIPLE BOTTOM SUPPORT



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