From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Big Quarter for US Stocks Imposes Opportunity Cost for Holding Bonds and Cash

Stocks are often driven by changes in expectations. The first quarter of 2013 was a good example – the easing of investors' fears led to a 10.6% total return gain for the S&P 500 even though longer-term fiscal issues remain unresolved and first-quarter earnings estimates were revised lower by 1.4%. The year began with concerns about the fiscal cliff, tax hikes, the debt ceiling, and mandatory budget cuts. Stocks 'climbed a wall of worry' in our view, (see *The Weekly View*, 2/11/13) and with the better-than-expected resolution of most of the above concerns, uncertainty subsided and stock valuations rose. We believe the economic risks in the US have diminished, with the private sector now driving growth and jobs, thus offsetting contracting government spending. We expect GDP growth of 1.5 – 2% this year.

In contrast to stocks, bond (based on the Barclays US Aggregate) and cash returns were approximately zero, slowly eroding investors' purchasing power and coming with considerable opportunity cost. This reflects one of RiverFront's primary investment themes: 'safe' assets are currently overvalued and holders of traditionally safe assets are paying for the US government's excessive debt. International stocks, which returned almost 14% during the second half of 2012, took a breather – total return for the MSCI World ex-US index was 3.3% in the first quarter.

'Safe' assets are currently overvalued and holders of traditionally safe assets are paying for the US government's excessive debt.

Disappointing employment growth of just 88,000 in March (announced Friday) needs to be put in context, as the prior two months were revised higher. The monthly figures are so volatile and so often revised that we prefer to look at the three-month average, which is 168,000. This suggests a tepid employment recovery similar to last year's monthly average of 183,000. Aggregate payrolls (hours worked times hourly earnings) increased 3.9% year over year – positive but slow.

We pared back our European exposure to expand our yen-hedged Japan position to a significant overweight. Japan's central bank recently extended the range and duration of its asset purchases in a big way.

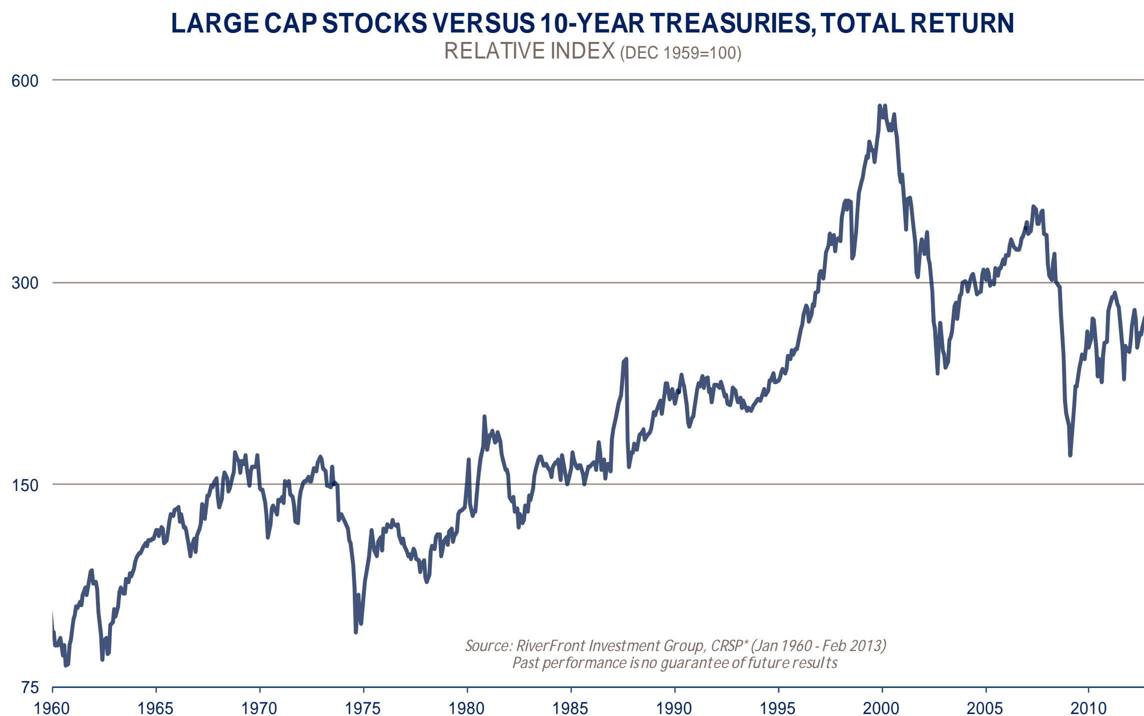
Looking ahead, US manufacturing and services purchasing manager indexes (PMIs) suggest decelerating growth for the second quarter. Earnings are being revised lower with revenues expected to be sluggish, especially as the effects of sequestration begin to kick in and Europe remains in recession. European PMIs fell further below 50, indicating a faster pace of contraction in business activity. We think sluggish growth means stock prices will continue to be supported by Fed accommodation.

After decades of economic stagnation, Japanese business activity is starting to pick up, with PMIs indicating accelerating expansion. As discussed in *The Equity View* last week, we pared back our European exposure to expand our yen-hedged Japan position to a significant overweight. One of the main reasons for this was our expectation that the Bank of Japan (BOJ) would extend the range and duration of its asset purchases (quantitative easing) in its quest to lift the Japanese economy out of deflation. Last Thursday, Japan's central bank did so in a big way, essentially committing to expand its balance sheet from the current 34% of GDP (compared to the Fed's 20% and the ECB's 28%) to more than 50% over the next two years by buying long-term government bonds, equities, and real

estate investment trusts (REITs). Although 'printing money' does not guarantee the BOJ can or will reflate, we think these asset purchases, along with expansionary fiscal policy ('Abenomics'), are creating the conditions for sustained nominal growth for the first time in two decades. So far the effects of Japan's policy has been most evident in yen weakness — directly helping Japanese exporters' earnings — and rising inflation and growth expectations, which are key to reducing Japan's massive debt load.

Unlike the BOJ and the Fed, this year the European Central Bank (ECB) has done relatively little to help the Eurozone out of recession in contrast to last year's more proactive approach. While the ECB hinted it might ease if conditions worsen, they opted not to cut rates or expand asset purchases last week, despite inflation falling below its 2% mandate and soaring unemployment. We believe the ECB will become more aggressive and provide the necessary catalyst for European markets.

THE WEEKLY CHART: STOCKS BEATING BONDS SINCE 2009



Calculated based on data from CRSP 1925 US Indices Database ©2013 Center for Research in Security Prices (CRSP®), Graduate School of Business, The University of Chicago.

In September 1981, at the end of a 30-year bear market for bonds, 10-year Treasury yields were 15.3% and the S&P 500 was at 118 with a 5.5% dividend yield. The chart shows relative total return – stocks are outperforming when the line is rising. Despite a positive environment for bonds since their bear market trough, during which 10-year Treasury yields fell to their current 1.7%, the S&P 500 has delivered roughly 70% more total return, but volatility has been significant. Indeed, the two stock bear markets of 2000 to 2003 and 2007 to 2009 wiped out all of the significant relative gains from the 1990s by the bottom in early 2009. We believe stocks have begun a sustainable trend of outperformance supported by low bond yields and reasonable stock valuations.

Past performance is no guarantee of future results. 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. 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. 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. Dividends are not guaranteed and are subject to change or elimination.

***Stocks** represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). **Bonds** represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.*