THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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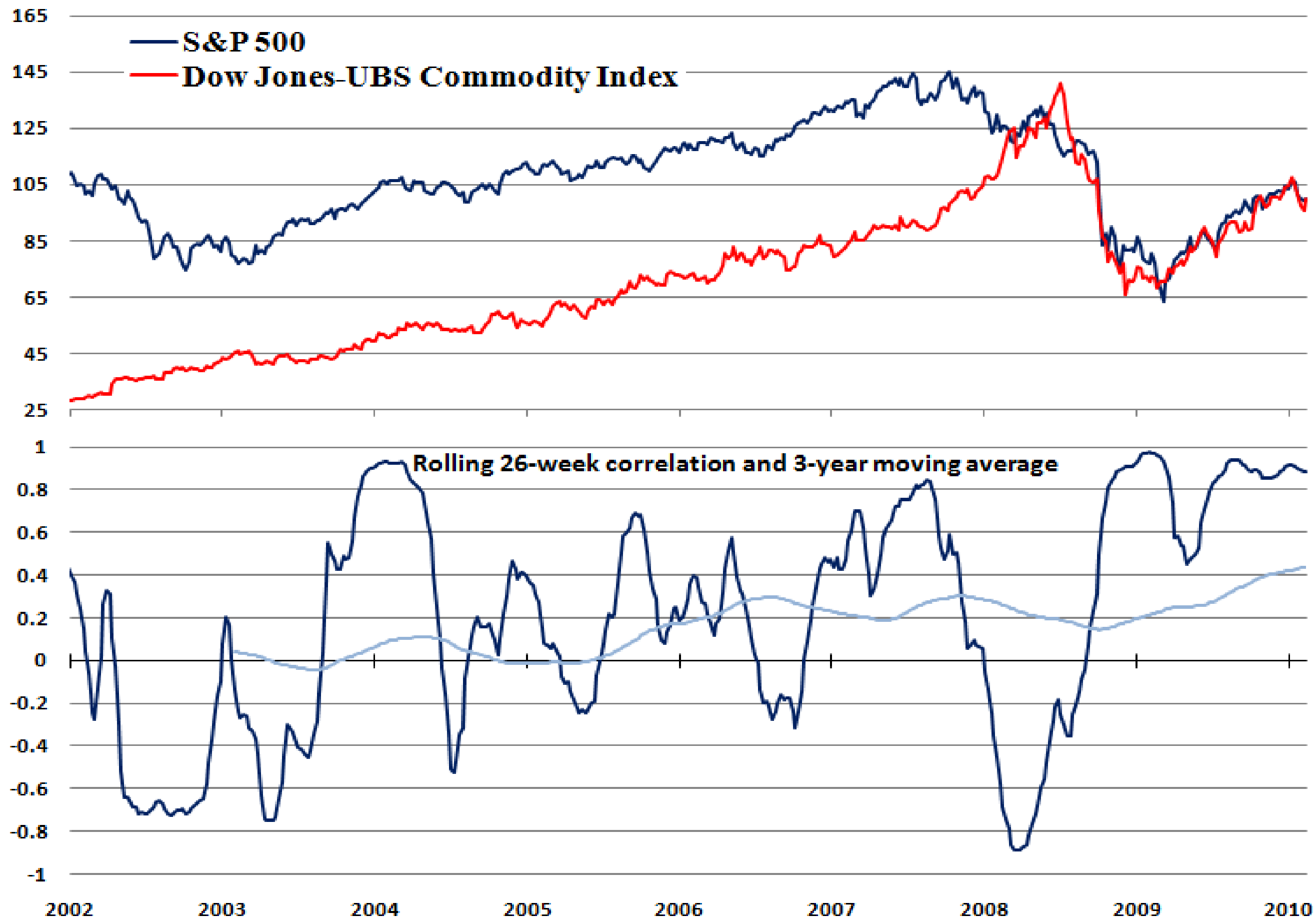
Repositioning Portfolios

- We reduced our aggregate position in commodities, partly in anticipation of changes to our strategic benchmarks, and have used the proceeds to establish a position in the equally-weighted S&P 500 and small-cap emerging market stocks. We have also lowered exposure to developed international stocks, particularly in Europe, and raised our weighting to high-quality large cap domestic stocks with a history of dividend appreciation.
- Commodities have been highly correlated with stocks over the last couple years at around 90% (see Weekly Chart), which diminishes their diversification benefits and lowers their strategic advantage in portfolio construction. In addition, China is tightening policy to tamp down resurgent inflation, which we believe will likely decrease marginal demand for commodities over the intermediate term, while the US dollar appears to be bottoming against most major currencies, thus undermining reflation trades, of which commodities have been a prime beneficiary. Current momentum could carry the dollar index — now just below resistance around 81 — into the upper 80s. Fundamentally, we remain bullish of the commodity demand story (especially from emerging markets) over the long run, but because of decreased portfolio diversification benefits, intermediate-term demand risks and the potential for additional dollar strength, we have reduced exposure.
- With the proceeds from the commodity sale we are adding exposure to the equally-weighted S&P 500, which we believe provides a more favorable mix of sectors and stocks than the benchmark, market-capitalization weighted S&P 500. While the equally-weighted S&P 500 has 'beta' relative to the benchmark — underperforming during the bear market and outperforming in last year's subsequent 65%-plus rally — in this year's correction it has not underperformed at all, which we believe is indicative of underlying strength. We think one of the main reasons is the equally-weighted S&P 500's relatively higher consumer discretionary exposure. Although we remain concerned about consumer spending this year as households continue to deleverage amid high unemployment, consumer discretionary companies have generally done an admirable job of managing inventory and controlling costs during the downturn. With higher operating leverage, slight increases in revenue should translate into disproportionately greater profits for the sector, even with the tepid economic growth we expect.
- Small-cap emerging market stocks have corrected by 10 to 15% since their mid-January peak (depending on the index), but have since found support just above their 200-day moving averages. Fundamentally, we are bullish on emerging markets given their growing clout in the global economy (they are on track to surpass developed markets in GDP over next few years), their generally more fiscally responsible government and their competitive trade positions. While predominantly export oriented, we believe emerging markets will likely transition towards consumption-based growth as more and more citizens join an already burgeoning middle class. As this transition occurs, we think small-cap emerging market stocks will increasingly benefit from their greater sensitivity to consumer demand within their own countries. With small-cap emerging market stocks finding technical support and weighed against their long term opportunity, we think the risk-reward is currently sufficient to initiate exposure.
- Despite recent successful debt sales in Greece and Portugal, investor anxiety over potential sovereign defaults in Europe has failed to dissipate. Because of the uncertainty overhanging Europe (and the consequent euro weakness/dollar strength) we are underweight the region. Until fiscal clarity improves and/or a credible bailout materializes — for *all* vulnerable members of the Eurozone — we expect underperformance to continue. On the other hand, even amid an uncertain outlook (and, perhaps, *because* of it) one of our favorite groups, high-quality dividend growth stocks, are outperforming. From a valuation perspective, we think such stocks remain inexpensive relative to their low-quality, dividend cutting peers.

The Weekly Chart: Commodities currently provide little diversification benefit



Source: RiverFront, FactSet *Past performance is no guarantee of future results*

One of the main arguments for including commodities in portfolios is that they have historically had low (and often negative) correlation with stocks. However as our chart illustrates, the correlation has risen. The top panel shows the S&P 500 and the DJ-UBS Spot Commodity Index, both recalibrated to 100 as of February 12. As may be seen, these indexes have tracked each other closely since late 2008. This is evident in the rolling 26-week correlation shown in the bottom panel (dark line), currently 88%. The light line in the bottom panel – the three-year average of weekly correlation – also shows an increasing trend of longer-term correlation between stocks and commodities. We think the two main reasons are (1) increased investor adoption of commodities as an asset class, and (2) the tendency of risk assets to become highly correlated in times of crisis. Thus, for now, we see reduced diversification benefit from commodity exposure.

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