THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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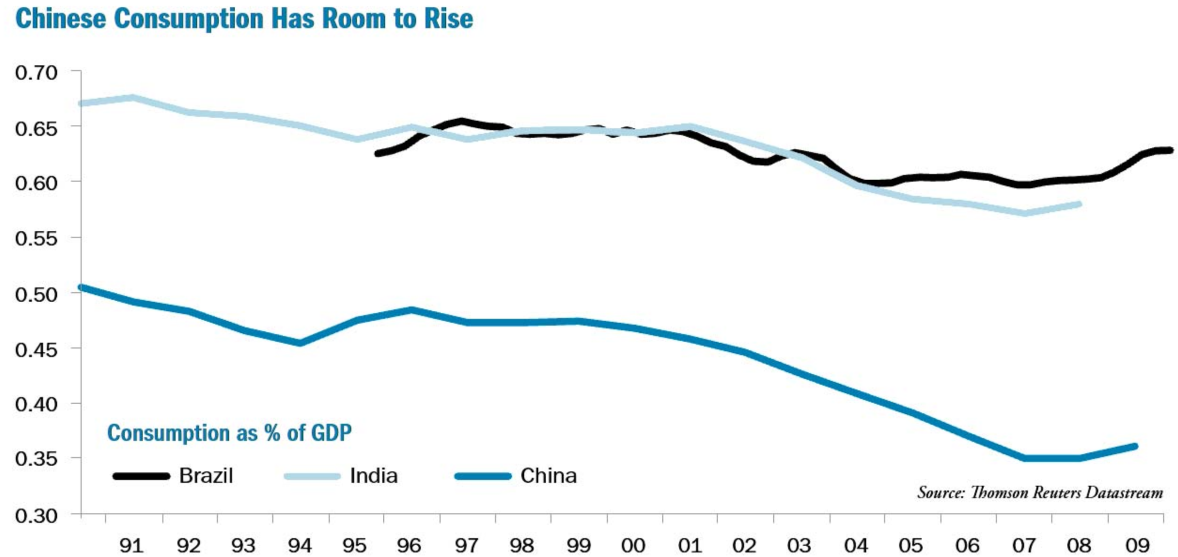
Midyear Outlook Highlights – *Investing in a Tripolar World: The Good, the Not So Bad, and the Ugly*

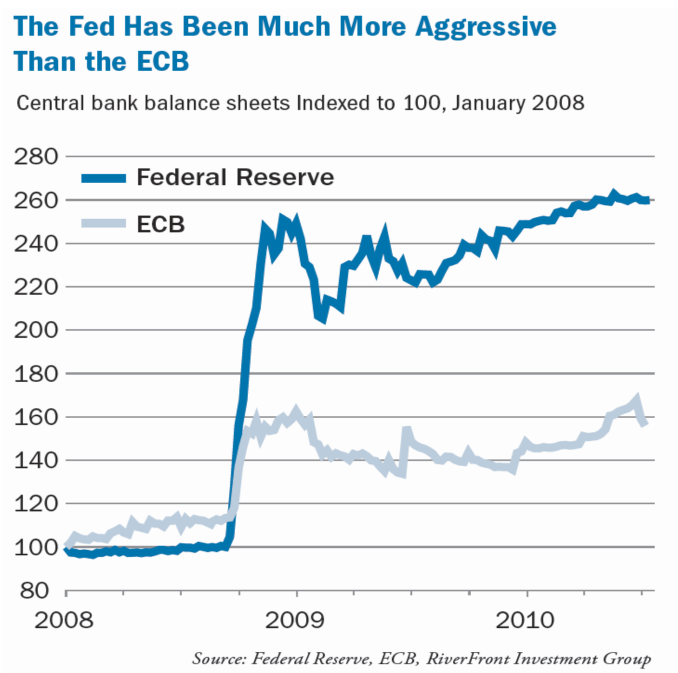
- We divide the global economy into three distinct blocks, each characterized by different economic policies and growth prospects. Many emerging economies (mostly in the Far East and Latin America) are enjoying robust recoveries. They are raising interest rates and using other policy levers to slow growth and prevent inflation. We expect these 'good' economies to continue their strong growth over the coming year, as low debt levels, modest labor costs and potential for accelerating domestic consumption appear to be insulating them from the problems plaguing developed economies. Conversely, we believe that many European countries and Japan face the 'ugly' consequences of unsustainable debt levels and uncompetitive work forces.
- The US and the UK, while having debt levels similar to Europe, have highly flexible economies, relatively productive work forces and aggressive, independent central banks. Germany has sound fiscal policies and high productivity, but is too intertwined with the rest of Europe to completely escape their fiscal and economic problems. We expect painfully slow growth in these 'not so bad' countries, thus avoiding a double-dip recession.
- We think the fundamental issue for US stocks is whether earnings growth will continue through 2011. Given our view that the US economy will avoid a double-dip recession, we remain cyclical bulls with a 2011 target of 1280 for the S&P 500. With the unusually wide range of views about the path of economic growth, we think the S&P 500 will remain in a 1000 to 1200 'decision box' until the outlook becomes clearer.
- The recent volatility in stocks, combined with the decline in Treasury yields, has presented a challenge to our optimistic outlook. If we are wrong and 2011 is a year of falling earnings, then we think the S&P 500 will fall to a range between 850 and 950. In addition to worries over US growth, two other concerns stand out: the growth slowdown in China and a return to recession in Europe. We believe policymakers' decisions will significantly impact the outcome. We are fairly confident that China can reignite their economy should growth slow too much, but we believe European policymakers' choice to cut spending and raise taxes, without offsetting monetary accommodation, makes a return to zero growth likely for Europe.
- We have positioned portfolios for slower developed economy growth, while expecting China, India and Brazil to achieve their potential as developing economies. This would involve a rapid expansion of middle class consumers and needed infrastructure driving demand. We believe this demand will create profit growth for both local companies and global companies that have invested in the facilities and branding to achieve appreciable market share for their products. Thus we own a mixture of high-quality global franchise companies and emerging markets. We have reduced our exposure to domestically-oriented US companies and largely eliminated exposure to southern Europe and Japan.
- The significant (0.9 percentage point) decline in 10-year Treasury yields during the first half of 2010 surprised us. This decline, along with widening risk premiums, made long-term Treasuries the best performing major asset class, next to gold, in the first half of 2010. We expect higher yields in the second half and thus zero to negative returns from Treasuries; with 10-year Treasury yields below 3%, a yield increase of just 0.2 percentage points would be enough to produce a negative total return for the second half of the year. To maintain a benchmark exposure to low-risk assets, we own short-maturity corporate bonds and cash. Within Fixed Income, we think high-yield bonds remain attractive. We believe that spreads could tighten as fears of a double-dip recession begin to recede. In addition, the high-yield index currently yields over 8.5% and in a world of 0% short-term rates will once again begin to look attractive as risk aversion recedes, in our view.

The full version of RiverFront's Midyear Outlook is available at www.riverfrontig.com.

Outlook Charts: China versus Europe



With Chinese personal savings rates recently exceeding 30%, a rise in consumption from less than 40% of GDP currently to a more typical 60% for emerging markets like Brazil and India seems achievable (see chart above). Such a consumption boom in the Chinese economy could drive the global economy for the next decade. However, while China's transition toward consumption-led growth is being built on a sound foundation (rising wages), thus far much of the wage gains have gone to savings.



Europe's short-term prospects appear dim. Current fiscal austerity plans might be more palatable if the European Central Bank (ECB) was as aggressive in providing monetary stimulus as the Federal Reserve has been for the US – the Fed responded to financial strains by printing more than $1.7 trillion. The ECB's response to similar financial strains caused by overly indebted European countries has been far less aggressive, as illustrated in the chart on the left. While the 'PIIGS' (Portugal, Ireland, Italy, Greece and Spain) might be eager for more aggressive monetary accommodation to mitigate the pain of fiscal austerity, Germany is enjoying a rapid recovery thanks to its success tapping into the Chinese market. As Europe's largest economy and the primary source of funds for Europe's bailout plan, Germany has tremendous influence on ECB policy and is strongly resisting aggressive monetary accommodation as potentially inflationary.

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