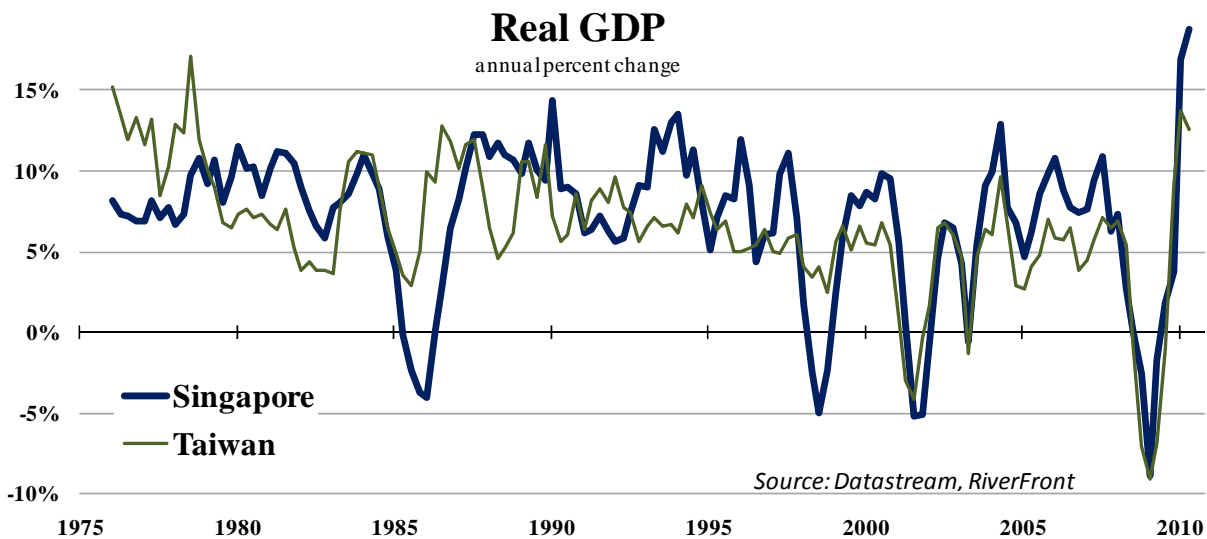




# As the 'Good' Outperforms, We Inspect the 'Ugly'

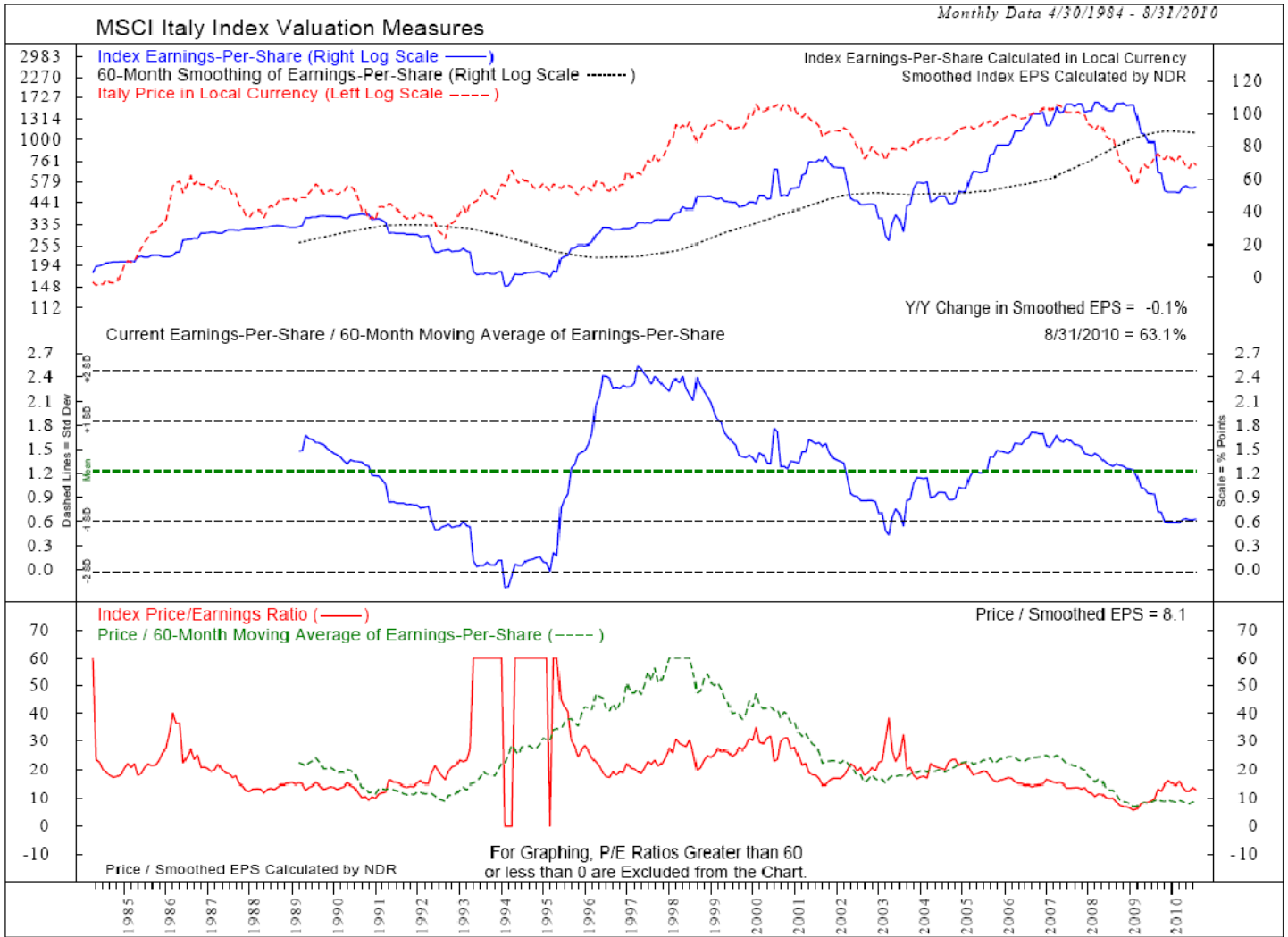
As we continue to worry about economic growth in the US and Europe, we are encouraged that growth is very strong in many Asian economies. We highlight Singapore and Taiwan below, both of which have recently reported double-digit GDP growth. We are overweight Singapore, where the stock market last week broke out to a new post-2008 high in dollar terms, demonstrating that not all markets are stuck in a trading box.



Along with Singapore, we see strength in small cap emerging market stocks, especially in the consumer sector. Developing-world domestic demand, unencumbered by excessive debt, has resumed robust growth. In our Midyear Outlook we described developing countries and those that benefit from this growth as 'the good.' From a valuation perspective emerging markets are not selling at a premium to developed markets, so we maintain significant exposure – roughly a quarter of our equity weightings. *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. Small cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.*



## Weekly Chart: Italy: Much of the 'ugly' news is known



© Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.

We selected Italy as an example of an economy with significant problems but where prices reflect a lot of bad news, in our view. The top panel shows a local currency index of the Italian stock market, the index's reported earnings per share and a five-year moving average of those earnings, which smoothes their cyclical nature. Earnings doubled during the 10 years from 1998 to 2008 and then collapsed. Unlike the US, earnings have not yet recovered, which we view as fundamentally 'ugly.' The middle panel shows the amount that actual earnings are above or below their average, giving a sense of the cycle. Earnings are currently depressed, and so we think earnings risk is low. The bottom panel shows two price-to-earnings (PE) ratios: price to actual earnings and our preferred valuation measure, price to smoothed earnings (the 5-year moving average). This was a good warning that stocks were not as cheap as they might have appeared in 1996 to 1999 and again in 2006 and 2007, since the PE on smoothed earnings was much higher. Today Italian stocks are selling for 8.1 times smoothed earnings, suggesting they are cheap by historic standards. We are not currently invested in Italy, but will watch the share price momentum of the 'ugly' economies carefully for signs that the bad news is discounted.

*Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • www.riverfrontig.com  
 Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236*

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.