



Performance Shifting from Emerging to Developed

- Since November, developed equity markets including the US have outperformed their emerging counterparts. In our view this is due to a shift in the perception of relative growth rates in 2011 — developed becoming less bad, emerging less good — rather than a changing view of the longer term story. We have lowered our tactical weightings in emerging markets but still retain a strategic overweight.
- Emerging markets face a dilemma. With interest rates in much of the developed world so low, emerging markets have seen a rush of 'hot money' flow into their economies, attracted by their higher interest rates and returns. This has helped lead to economic overheating, which is increasingly reflected by asset and consumer price inflation. Governments and central banks are pursuing different paths, but nearly all are seeking to slow growth and combat inflation. In an era of global capital flows, raising interest rates is not as effective in tamping down inflation, because high rates tend to attract more money, bid up prices and destabilize economies. Since traditional policy options are constrained, many developing economies have resorted to supplemental, and at times novel, administrative measures to control capital flows. As long as emerging markets are fighting inflationary pressures, we expect relative underperformance to continue. Indeed, capital controls are often explicitly *designed to inflict pain* on sources of hot money flows. Longer term, to the extent that policymakers seek to limit boom/bust cycles and prevent asset bubbles, we believe such actions are valid and should be welcomed by long-term investors.
- Emerging markets will likely be waging an extended defensive campaign so long as interest rates in the developed world remain low. The turning point will likely be when the developed world's central banks believe they can remove policy accommodation, when economic recovery becomes more deeply entrenched with unemployment heading steadily lower. We think there are two main conditions that could hasten monetary policy tightening. The first is if China allows its currency to appreciate faster. As we wrote last week, China is having difficulty controlling inflation while simultaneously suppressing yuan revaluation. Currency appreciation would also help economic rebalancing in other emerging markets as well and provide a boost to US export competitiveness. This would help solidify the US recovery and raise employment growth, in our view.
- The second condition that could hasten monetary tightening would be a reduction of debt burdens. There is some initial progress; in the US, total credit market debt has declined for six consecutive quarters and appears to have peaked (see Weekly Chart), although it remains extremely high. The lingering debt overhang from the previous credit boom consigns the developed world to anemic growth. Central banks are unable to raise interest rates without returning the economy to recession. Part of the debt reduction process is reining in budget deficits at all levels in both the public and private sectors, otherwise debt will continue to expand. Another way to reduce debt is to restructure it. This involves principal reduction, which although painful for bondholders, shortens the resolution process, reduces uncertainty, frees up capital and allows all parties to move on to more productive endeavors. Policymakers are naturally wary of contract renegotiations and voiding obligations because debt deflation poses systemic risks and introduces its own uncertainties. To guard against this and facilitate the process of debt write downs, central banks can credibly commit to preventing deflation and also buy debt through balance sheet expansion. Under present circumstances of high unemployment and unused capacity, the Fed has concluded balance sheet expansion is worth the risk.

Developed Markets Revisited

Contrasting the US and Eurozone's monetary and fiscal responses to their debt overhangs is instructive. While both have been reluctant to resort to debt restructuring, the US has for the most part pursued a monetary approach (utilizing the Fed's balance sheet to reduce private debt burdens), while the Eurozone has focused on the fiscal side (enacting austerity measures). Debt restructuring for the weaker European countries is now being openly discussed and markets have responded positively. To be successful, we think the bondholders, specifically the major European banks, will require the European Central Bank to expand its balance sheet while they raise capital to offset the write-offs. In the US, serious fiscal retrenchment at the national level appears to have been postponed until the 2012 election, but is front and center at the state level, as we wrote about last week. We believe a crucial test of the US deficit's impact on long-term Treasury yields will come when the Fed ends its quantitative easing programs, but for states and municipalities, the risk of default or restructuring has already become apparent.

Japan's economy has stagnated over the past two decades and its stock market has been a perennial underperformer during that time. Some of Japan's substandard performance relative to other economies can be explained by its demographics — an aging, declining population (on a per worker basis, Japan actually compares more favorably). Japanese policymakers appear to increasingly

realize that ongoing structural reform is necessary to reverse their relative decline and take advantage of Asia’s rising economic dynamism and prominence. Initial change began promisingly under Prime Minister Junichiro Koizumi a decade ago, but his successors have been heretofore disappointing. With the rise to power of the Democratic Party of Japan (DPJ) in 2009, upending almost uninterrupted post-war rule by the Liberal Democratic Party, there was hope that a fresh start might be in the offing. Unfortunately, the DPJ has been mired in scandal and ineffective nearly from the beginning. Prime Minister Yukio Hatoyama resigned last summer after a no confidence vote and was replaced by finance minister Naoto Kan. While still too early to gauge his success, Kan has adopted a platform of tax reform and tackling public finances, which we find encouraging, if rather belated.

Although its government debt is among the highest in the developed world, Japan’s household and corporate sectors are flush with cash (invested in low-yielding Japanese government bonds). If that can be unleashed — perhaps by lowering corporate taxes and encouraging the shutdown of unprofitable ‘zombie’ institutions — savings could be drawn down and spending increased. This would help the economy break out of deflation, which we think is key to unlocking substantial value. After years of underperformance, Japan’s relative performance has stabilized over the past two years. We think the time for a big underweight to Japan has passed.

The Weekly Chart: US debt is falling but has further to go

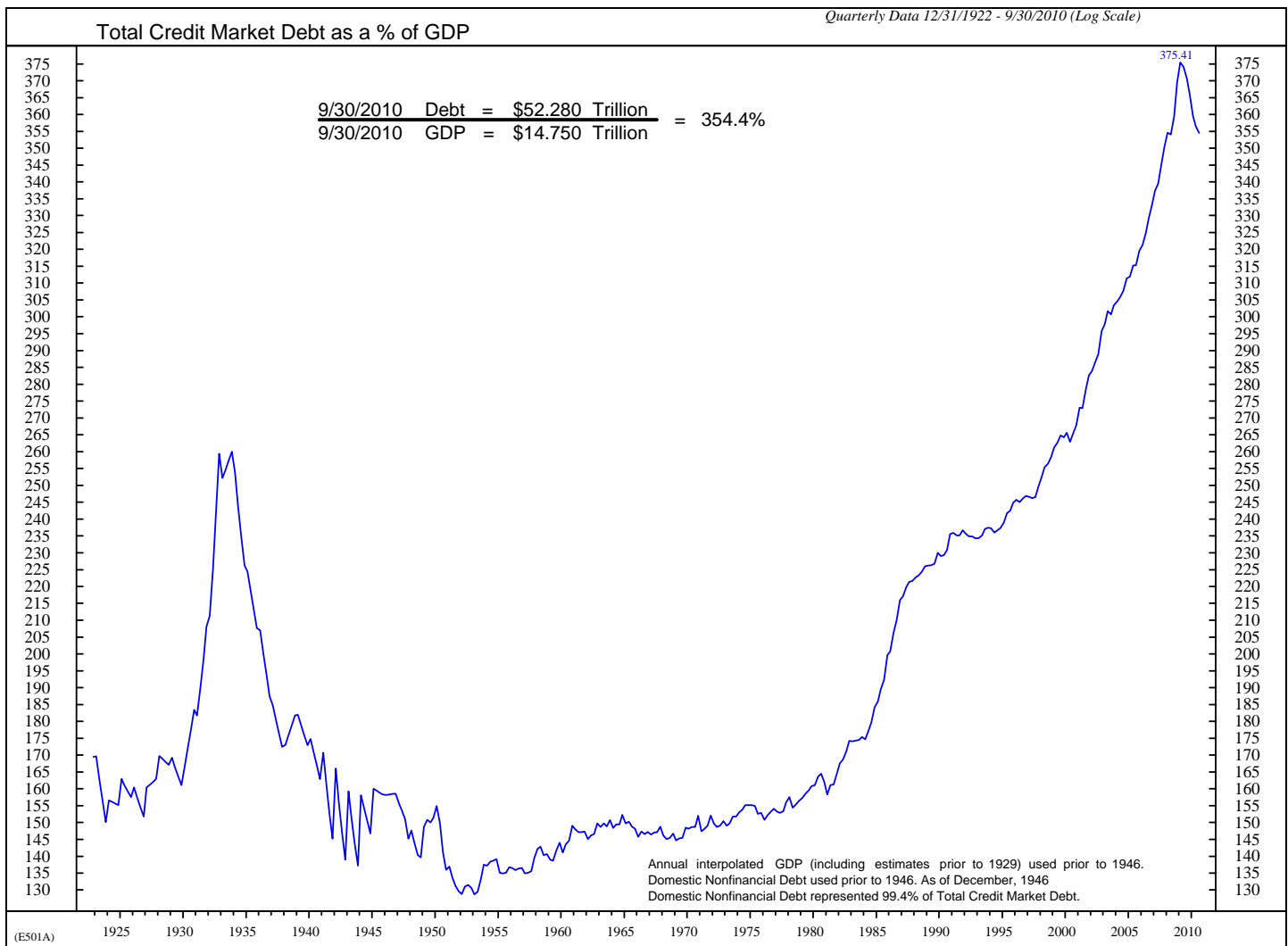


Chart courtesy of Ned Davis Research

Past performance is no guarantee of future results

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