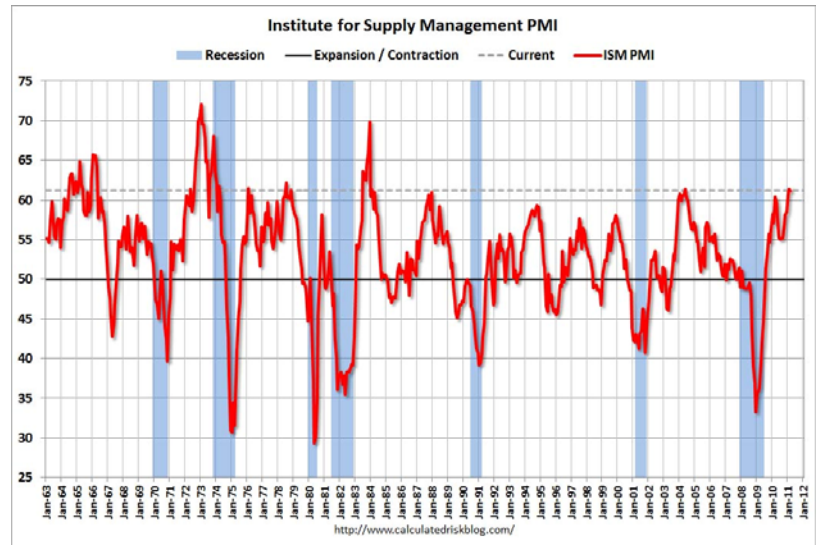




Recovery and Rebalancing

- The economic recovery is beginning to sustainably generate jobs, which we view as positive for stocks, although this means the Fed is likely to become progressively less accommodative and, eventually, restrictive. Nonfarm payrolls increased by 216,000 in February, bringing the three-month average gain to 159,000, and the unemployment rate ticked down for the fourth consecutive month to 8.8%. As we wrote previously, labor force participation continues to decline, which helps the unemployment rate, but to the extent that declining participation is a secular trend (primarily as baby boomers retire), we continue to view the unemployment rate's downtrend as consequential. Ongoing hiring is likely with economic activity still expanding at an elevated rate, as evidenced by the ISM manufacturing survey of purchasing managers, which at 61.2 in March, remains well above the 50 level that indicates expansion (see chart right, courtesy of Calculated Risk).



- Emerging markets are starting to outperform again as early indications suggest that their central banks are getting ahead of the curve on constraining excess liquidity and credit growth. We continue to believe in emerging markets' long-term growth story, which is largely contingent upon growing demand from a burgeoning middle class and supported by steady productivity and wage gains. Hence, we maintained a core strategic overweight although we have been tactically underweight given emerging countries' central bank tightening. Moreover, recent emerging markets' relative underperformance make them well positioned in our Price MattersSM context to add value for investors amid portfolio rebalancing. Thus, we are adding to our emerging markets positions.
- We are also consolidating positions in markets that are strengthening and trimming positions where momentum is waning. In particular, we are switching from Singapore to South Korea, which has been gaining relative strength and constitutes a large portion of the emerging market index. We think the passage of a free trade agreement with South Korea should provide a tailwind, although it is still wending its way through congress. In developed markets, we are switching our UK position into Canada, which has continued to lead developed markets higher and is a better beneficiary of rising energy prices, in our view.
- More broadly, we think underlying trends that support further economic and earnings growth are reemerging. These 'mega' trends, although clouded by near-term uncertainties from Japan and the Middle East, involve the ongoing shift of purchasing power to emerging market consumers, while developed market households continue to reduce debt and deleverage. This provides the backdrop for the current interest rate differentials between developed and emerging markets and the apparent 'two-speed' world for investors. While making for a challenging investment climate, we think the global economic recovery is transitioning to sustainable growth as trade patterns slowly, but inexorably, adjust and rebalance towards a more stable configuration.
- The main risk for global equities, in our view, is higher food and energy prices. Higher food prices would suggest further tightening by emerging markets' central banks, while higher energy prices sap developed market incomes

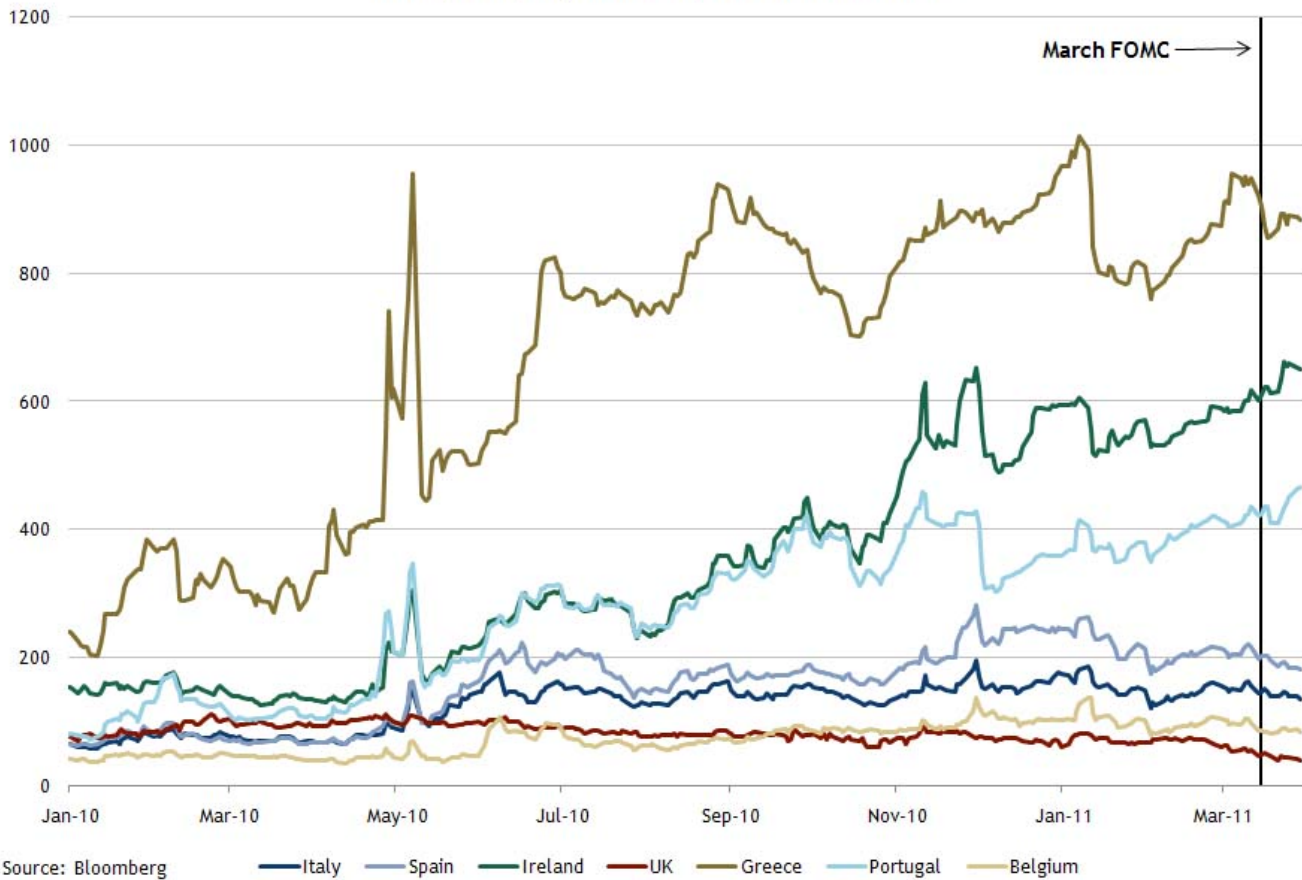
and prolong the deleveraging process. Initial signs indicate that food prices are peaking as overheated emerging market economic activity is reined in and as farmers increase plantings in response to price signals. Energy prices also appear contained, with oil remaining below \$120 a barrel, above which we would become more worried about the impact on the stock market. Interest rate risk is also a concern, but government bonds continue to benefit from safe-haven buying and the US dollar's still dominant reserve currency status despite unease about long-term deficits. Although the end of quantitative easing in June should remove a major buyer of US debt, we still expect 10-year Treasury yields to remain below 4%, particularly with home prices continuing to decline nationally amid state cutbacks.

- The recent differentiation among European sovereign credit spreads is another reason for cautious optimism, in our view. In particular, Spanish and Italian credit spreads are narrowing, in contrast with Greece, Ireland, and Portugal. We think this may be because although the size of the problem has been identified, markets are now deciding how to be acceptably allocate the losses, especially among banks, which in some cases could require major recapitalizations and ongoing restructuring from subordinated bondholders. We think that sovereign credit differentiation from this perspective is a good sign that although the jam remains formidable, it's at least beginning to clear ahead.

The Weekly Chart: Sovereign credit differentiation becoming more evident

European Bond Spreads

Basis points, 10-year bond spread to German bonds



Source: Bloomberg

Italy Spain Ireland UK Greece Portugal Belgium

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