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Midyear Outlook: The Consequences of Financial Repression — 'Not Your Parent's Retirement Portfolio'

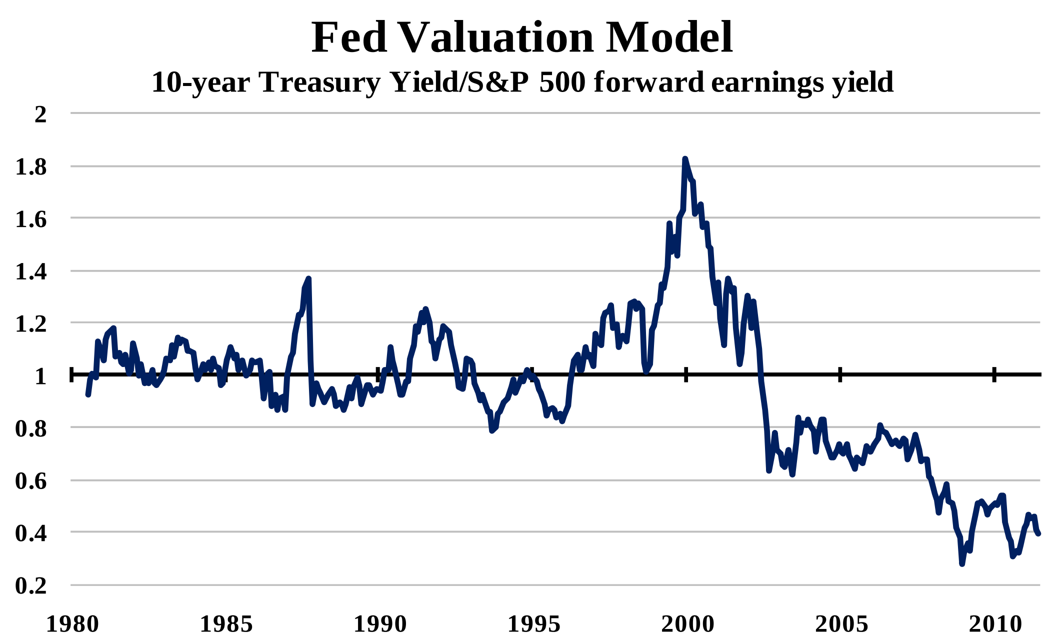
We believe that stocks have likely seen their lows for the year and will continue to rise at a modest pace, fluctuating between optimism and pessimism as the global economy 'muddles through' developed world deleveraging and emerging market inflation. Over the next six months, we expect the S&P 500 to range between 1220 to 1420 and 10-year Treasury yields of between 3% and 4%. The main risks to our scenario are:

- The developed world lapses back into a crisis from its weak links; e.g. US housing, Europe's peripheral countries, and Japan's demographics.
- China, a primary engine of global growth, is unable to smoothly transition from investment-led growth to consumption-led growth, causing a globally destabilizing slowdown.

These risks are further explored in next week's *Strategic View* publication. Our bottom line is that the current global economic cycle will extend through 2012 and provide support to earnings.

We believe that stocks are priced to deliver mid-single-digit returns after inflation for investors with 5- to 10-year time horizons and that valuations offer a 'margin of safety.' Most bonds, in our opinion, offer neither. Indeed, stocks are as cheap relative to bonds today as they were expensive 12 years ago. This is illustrated in the chart below of the so called 'Fed Model,' which compares the yield on 10-year Treasuries to the earnings yield on stocks.

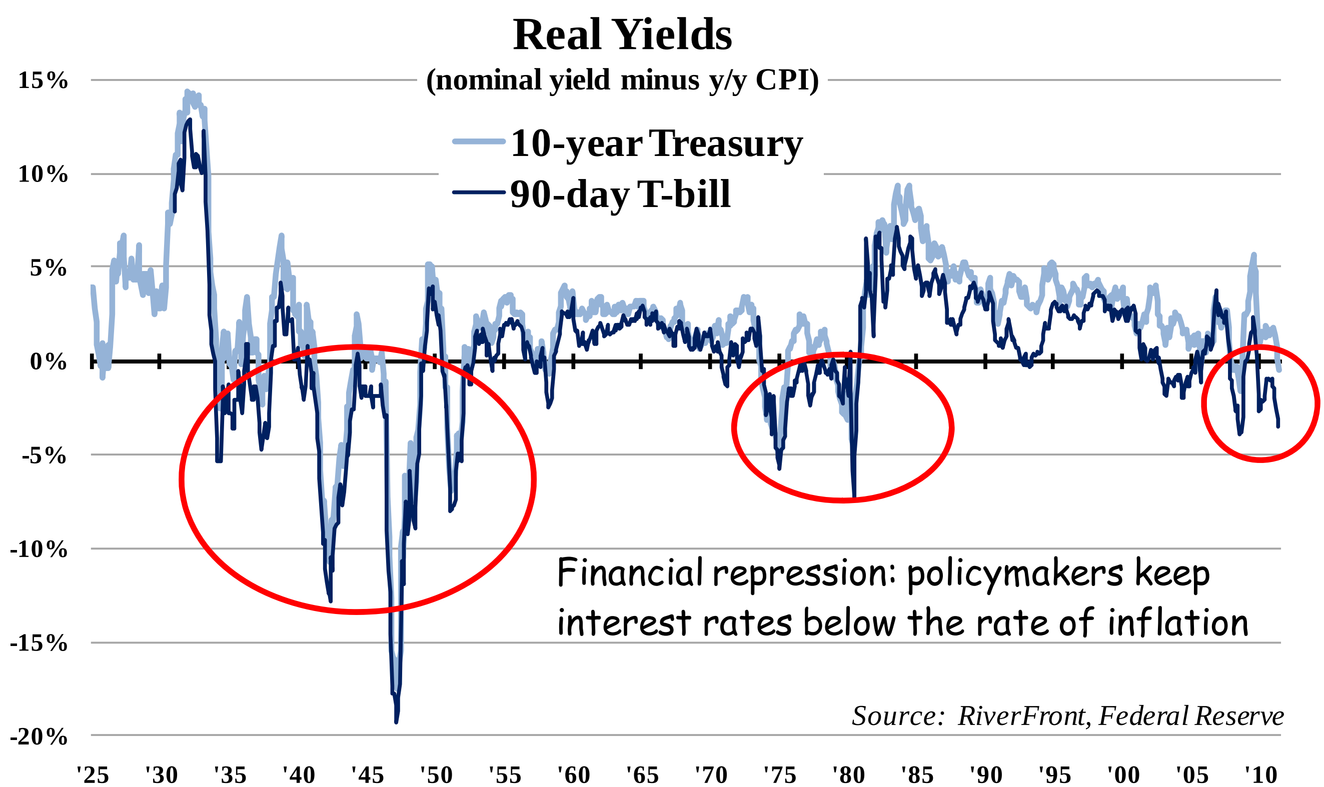
The earnings yield is simply earnings/price, and the assumption of the model is that the earnings yield should be about the same as the Treasury yield. The Federal Reserve's model worked well as a medium-term relative valuation guide in the 1980s and early 1990s but has been less effective since the late 1990s as stocks and then bonds reached valuation



Source: Ned Davis Research, RiverFront extremes. In 2000, bonds were yielding about 6.5%, roughly twice as much as stocks, implying that stocks were overvalued. Today the situation is reversed — the 10-year Treasury yield is 3.2% and the S&P 500's forward earnings yield is 7.9%. For us, the message is that Treasury notes are expensive rather than that stocks are cheap. While less useful as a tactical guide, we believe the Fed Model is still useful at extremes and explains RiverFront's defensive bond portfolio and ongoing belief that stocks and other risk assets will outperform longer dated bonds in the coming years.

Financial Repression

The Federal Reserve's policy of zero short-term interest rates and balance sheet expansion — mainly through purchasing bonds, i.e. quantitative easing — has denied investors the opportunity to lock in reasonable, low-risk, real rates of return through traditional bond purchases (QE was designed to support borrowers, both individual and corporate). This is the hand investors have been dealt — economist Carmen Reinhart recently called it 'financial repression' — and we can find no domestic, high credit quality fixed income investments that offer attractive real returns. Such investments had been plentiful for most of the last 30 years, resulting in the rule of thumb that investors at or nearing retirement should have a bond weighting equal to their age, i.e. 'your parent's portfolio.' We strongly reject this rule of thumb in today's interest rate environment.



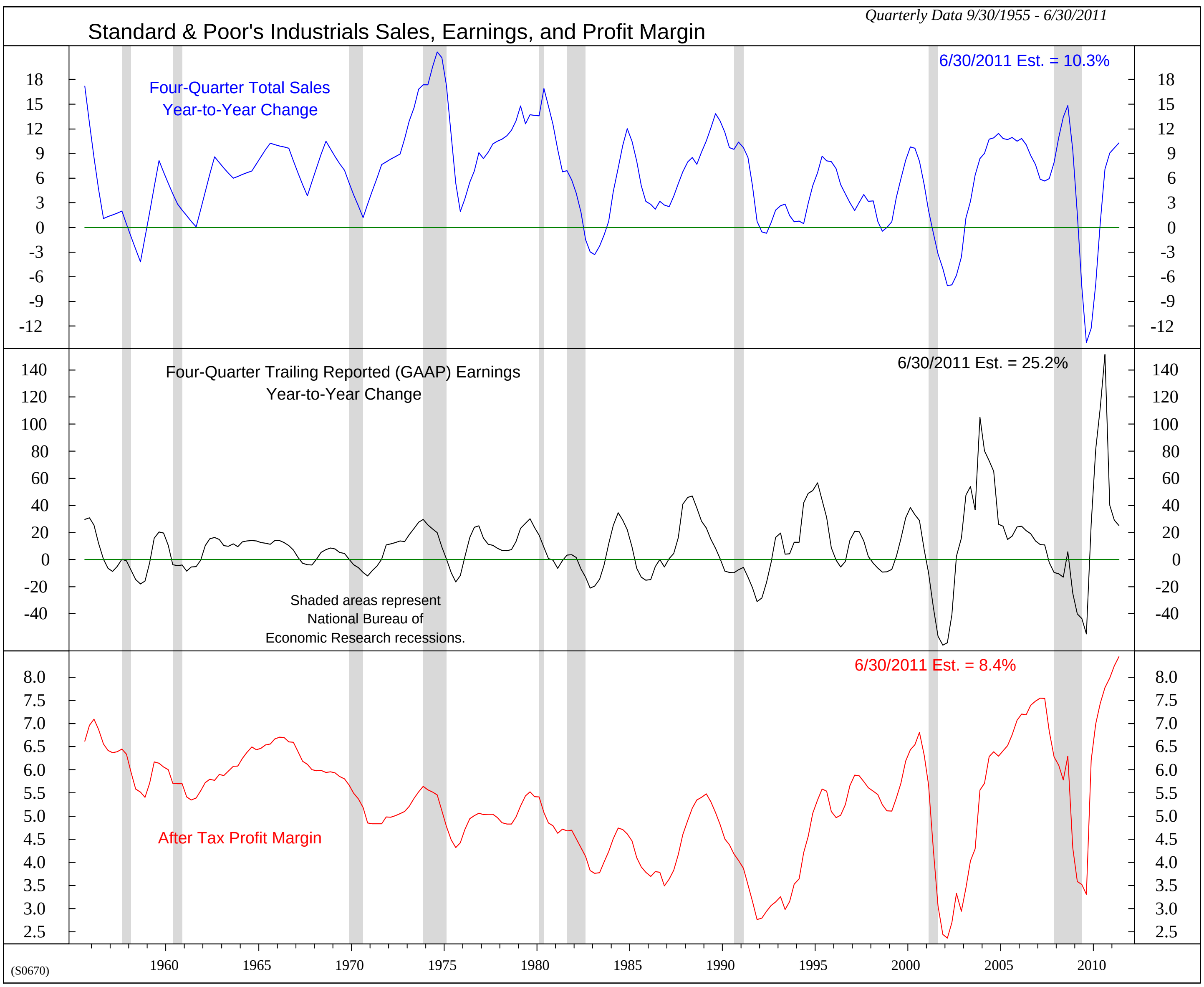
Today's retirees will live longer than their parent's generation and, in our opinion, should have significantly larger exposure to stocks and other real assets to protect against inflation and provide potential for income growth. We think their stock portfolio should seek to be less volatile, higher yielding, and have greater potential for dividend growth than major indexes such as the S&P 500. Thus, our strategic growth & income benchmarks have relatively small allocations to traditional fixed income and have increased allocations to less volatile, higher quality, higher yielding stocks. From a shorter-term tactical perspective, we concur with this strategic position because stocks with these characteristics have begun to outperform as they often do once the big cyclical recovery in profit margins has peaked, as is the case today.

We believe investors with long time horizons and/or no need for income — especially those that contribute systematically to their portfolio — should follow the traditional approach, i.e. real assets: stocks, real estate, commodity producers and occasionally commodities. We think the major difference for this investor profile is the importance of a global approach. This means owning both US and European companies with global franchises and local companies in the world's faster growing economies.

Positioning portfolios for 'muddling through'

The current economic cycle is now two years from its trough. In the early stages of economic recoveries, leadership typically comes from stocks that had been beaten down by recession and suffered the greatest change in fortune, i.e. lower quality, smaller and more cyclical. Economic cycles also have structural characteristics, where the bubble sectors in the prior expansion (technology in the late 1990s, housing/financials in the late 2000s) take longer to recover in the next up cycle. The current expansion has an unusually large 'hangover' from the previous excesses in housing and debt. This continues to dampen the recovery for the US and much of Europe, making it unlikely that US investors will enjoy the feel-good effects of a robust economy. We think the opportunity for tactically portioning our portfolios is to trade against sentiment, i.e. raising stock weightings when shorter-term pessimism builds to an extreme and reducing when sentiment gets overly optimistic.

The silver lining to this environment is that monetary policy will likely remain highly accommodative; low interest rates combined with meager wage gains and modest top-line growth should keep profit margins high even as sales and earnings growth slows (see chart below). Thus, while recognizing the risks, we expect a long recovery cycle for both the economy and the stock market.



In conclusion, our strategy has four primary components:

1. Developed world equity holdings focusing on businesses that can sustain growth in a muddle through environment due to sustainable competitive advantages
2. Low volatility, higher dividend yielding stocks as a substitute for bonds in our balanced portfolios
3. Emerging markets as a secular growth story with reasonable valuations
4. Creative alternative-income strategies with higher yields and shorter maturities

In the coming week, RiverFront's Chief Investment Officer, equity and fixed-income teams will publish midyear outlooks elaborating on these themes.

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