RIVERFRONT INVESTMENT GROUP

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THE WEEKLY VIEW

(From right to left:)

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China Moves Away from Dollar: Good for Growth, Bad for SE Asia

Markets don't like surprises… and China's decision to execute an un-telegraphed decline in the yuan last week was a massive one. The move caused other Asian currencies to fall, as well as declines in the shares of just about any company worldwide that sells to or competes with China. We believe the move reflects the government's determination to arrest the slowdown in its economy, and, more importantly, it shows how desynchronized China's economy has become relative to the US (it has largely pegged its currency to the US dollar for the last ten years). As long as the dollar was weak, China was happy to gain competitiveness versus its trading partners, but the strong dollar of the last year coupled with the after-effects of overinvestment in 2009-2011 has caused China to want to de-couple its monetary policy from that in the US. We think China's clear determination to promote growth and allow its currency to respond to market conditions is welcome (and apparently has the encouragement of the International Monetary Fund [IMF]), but it is likely to create winners and losers.

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The execution was poorly communicated, in our opinion. Following a 2% decline last Tuesday, the Chinese government suggested that the devaluation was a "one-time" event, only to surprise markets again on Wednesday by allowing the yuan to fall a second time. While the yuan stabilized on Thursday and Friday (with help from the Chinese government), it seems like higher volatility in the currency is here to stay; it also appears that the decade-long technical uptrend in the Chinese yuan versus the US dollar is broken. This week we seek to take a step back from the noise and attempt to discern the major takeaways for global investors from this incident:

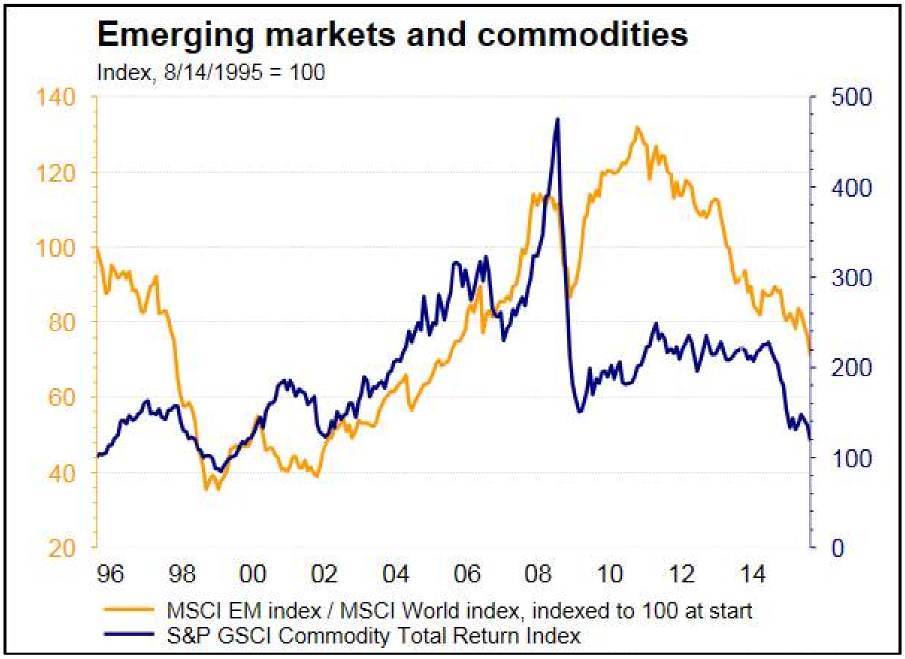
1. **We don't believe China's actions in the currency market last week will lead to a sustained risk-off trade**. Awkwardly executed as it might have been, more stimulus in any form from China (the world's second-largest economy) is a positive development for the global macroeconomy, in our opinion. Importantly, we believe China's deflationary issues may cause developed central banks (e.g., the European Central Bank, Bank of Japan, and the US Federal Reserve, and perhaps even the Bank of England) to remain accommodative longer. It might also entice other Asian central banks to ease. This could be particularly true in areas such as India, Taiwan, and Korea, which need to respond to China's devaluation in order to protect their own export interests.

2. **We remain underweight emerging markets:** Weakness in commodity prices and weakness in emerging markets economies and currencies is a highly correlated trend that began long before China's most recent actions, and one we think will continue to persist (see The Weekly Chart, below). *Therefore, we remain underweight emerging markets, as well as commodity-producing countries and currencies in our portfolios.* While we have been underweight in emerging markets stocks in general for quite some time now, our preference within emerging markets has consistently been towards Asia rather than Latin America, Africa, or Eastern Europe. Part of the reason for our preference was that we believed Asian currencies would experience less volatility than other emerging currencies in light of rising interest rates in the United States. China's actions, which have been interpreted by some as the start of an "Asian currency war," have caused us to question this working thesis. We expect Southeast

Asia in particular to be negatively affected, as some of their economies appear to us to be the most imbalanced. We still believe that certain emerging Asian equities have attractive long-term valuation characteristics, but we acknowledge that realization of this value may be some time in coming due to greater uncertainties about China's current economic malaise and currency plans in light of this. *We therefore lowered our exposure to Asia last week.*

3. **We see this as an opportunity to buy European equities on yuan-influenced weakness**: Another by-product of China's surprise devaluation has been to create significant downward pressure on European equities and upward pressure on the euro. *We expect both effects to be short-lived; thus, we used the recent sell-off as an opportunity to increase our overweight positioning in European assets across the growth-oriented RiverFront portfolios*. First, sales and earnings growth for European exporters in the first two quarters of this year were strong, even as China's macro indicators have been significantly slowing. This suggests to us that improving growth in other areas of the world could potentially more than offset a slowing China. Moreover, the magnitude of the move in the yuan relative to the euro is not large enough to meaningfully change trade dynamics yet, in our opinion. To put things in perspective, China's currency fell approximately 4.5% against the euro last week, a drop in the bucket compared to an approximate 40% rise against the euro in the last 10 years.

THE WEEKLY CHART: EMERGING AND COMMODITIES LINKED



Source: Thomson Reuters Datastream, RiverFront Investment Group, data as of 8/14/2015. Past performance is no guarantee of future results.

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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.

Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared with the 2015 strategic allocations for each portfolio, as opposed to compared with the portfolios' composite benchmarks.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Index Definitions: MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. MSCI World Index is a stock market index of 1,500 stocks of all the developed markets in the world, as defined by MSCI. The index includes securities from 24 countries but excludes stocks from emerging and frontier economies. S&P GSCI® Commodity Total Return Index is an index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. Individual components qualify for inclusion in the S&P GSCI® on the basis of liquidity and are weighted by their respective world production quantities. It is not possible to invest directly in an index.