We Added Stocks, Reduced Cash

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Last week we decided to reinvest the cash that we had raised over the preceding two months. We chose, for the most part, to add to existing positions: Europe on a currency-hedged basis and Japan on a local currency basis. We also added to US stocks.

During the week, short-term sentiment hit a pessimistic extreme. Following Monday's decline, our indicator, which combines sentiment with the market's trend, suggested significantly better-than-average odds of stocks being higher three months from now. No indicator is foolproof, but tools like this help us to make informed decisions when emotion and volatility are high.

Our decision to add to stock weightings is not just a technical one. It comes down to a fundamental call. Namely: will the recession in the commodity industries (especially oil and industrial metals) and the slower growth in China lead to a return to recession in the developed world? We think not, but we should examine some of the questions being posed.

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We think not.

Is the decline in oil and copper prices an indication of declining demand and an impending recession? Not in our view**.** We believe that increased supply is a large driver of the decline in these commodity prices, and the resulting lower prices will help spur global growth. Ten years of rising prices encouraged significant technological progress and investment in new production. Now, lower prices are a transfer of wealth from producers to consumers, and in most countries, the benefits outweigh the costs. There is little question that the falloff in China's investments in infrastructure and urbanization has caused a decline in demand for industrial materials and machinery, but according to the International Energy Agency, China's demand for oil is growing around 3% year over year. China's recent de-coupling of its currency peg from the dollar has also caused concern. In our view, this move is China giving itself the freedom to stimulate growth now that the two economies have diverged. We see that as a good thing – it looks like smart policy.

A De-Synchronized World: we have been struck by how much the world economy has de-coupled since 2008.

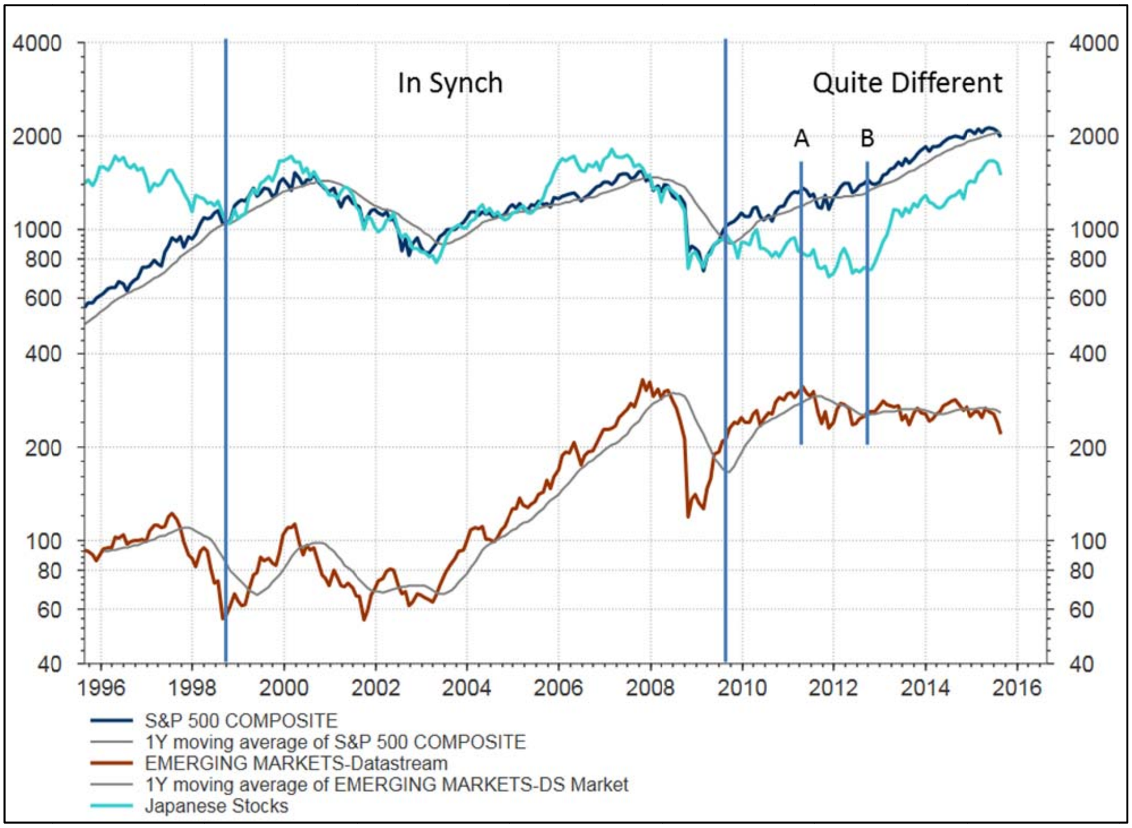
Is the fall in stock prices predicting a recession? For emerging economies, especially those tied to commodity production (the poster child would be Brazil), we agree. Emerging markets in general regained their 2008 highs in 2011 (point 'A' in our Weekly Chart, below) and have since fallen some 30%. For the developed world, the picture is very different. Price trends remain positive, and so far this looks like a correction. A pattern of lower highs and lower lows would be more worrying to us than just the sharp decline we have seen. As you can see in the Weekly Chart on page 2, the US endured more significant declines in the summers of 2010 and 2011, both of which were the markets' way of worrying about recessions which did not occur, allowing the bull market to continue. We think it is wrong to put too much weight on China's A-share market, which is mostly a vehicle for local speculation. In the face of declining growth in China, the A-share market more than doubled from last August to June; now, it has given back more than two-thirds of that advance.

Will the Federal Reserve cause a recession if they raise interest rates? This is very unlikely, in our view. It is true that most recessions are preceded by Fed tightening, but not when they are beginning to raise rates in response to an economy that is creating jobs and not producing inflation. The Yellen Fed has been very public about its desire to allow growth to continue.

A De-Synchronized World

Although markets feed off each other, especially during periods of high volatility, we have been struck by how much the world economy has de-coupled since 2008. Our Weekly Chart below attempts to show this de-coupling through the performance of the US (top dark line), Japan (top light line) and Emerging Markets (lowest line). From late 1998 after the Asian currency crises, these markets were remarkably in synch with each other as global growth forged ahead and growth in the developing world, led by China, was unprecedented. The policy response to the 2008 crisis has been very different in the major economies and regions, with the US and UK being the first to adopt aggressive monetary policies, then Japan (point 'B' on the chart below), and finally Europe. Europe was left off because it made the chart hard to read, but since 2008 its pattern has been similar to that of Japan. De-synchronization creates more opportunity for diversification and hopefully helps explain our gradual reduction in exposure to the US and the building of our positions in the eurozone and Japan. At some point (although not currently, in our view) the emerging cycle will turn, creating a buying opportunity.

THE WEEKLY CHART: RECENTLY, A DE-SYNCHRONIZED WORLD



Source: Thomson Reuters Datastream. Past performance is no guarantee of future results.

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RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

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.

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Index Definitions: Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.