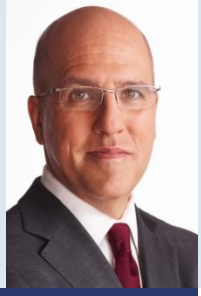

Richard Bernstein

Richard Bernstein Advisors

The REAL Great Rotation

June 2013

The REAL Great Rotation

The phrase “Great Rotation” has come to mean a sizeable shift in asset allocations from bonds to stocks. We, too, believe that stocks are likely to secularly outperform bonds, but we don’t think that is the “great rotation” about which investors should be concerned.

The most important structural investment decision facing investors is not stock/bond allocation, in our view. Rather, the REAL “great rotation” is likely to be a shift from non-US assets to US assets. Asset performance seems to be well underway, yet most investors appear totally oblivious.

We remain bullish on US equities, but continue to have concerns about emerging market (EM) equities and about non-EM companies whose growth strategies focus on the emerging markets. The standard warning signals of a bull market’s end seem nowhere in sight in the US. The Fed isn’t close to tightening too much, investors’ constant uncertainty and lack of confidence regarding the stock market suggests attractive risk premiums and good value, and there is hardly euphoria for US equities.

However, it remains startling to us that investors still seem enamored with the emerging markets despite that EM stocks have underperformed US stocks for more than five years, and that EM profit fundamentals continue to be among the weakest in the world (almost 60% of EM companies recently reported negative earnings surprises). The US is even becoming a better growth story than the emerging markets. Smaller capitalization US companies are projected to grow earnings 60% faster than are EM companies (35% versus 14% for the next twelve months).

In addition, many of the major emerging markets have serious monetary problems that make the US situation look rather amateurish. India now has the highest inflation rate among emerging and developed markets and their central bank has actually been easing monetary policy. Brazil’s President recently stated that stimulating growth was more important than was controlling inflation despite disturbing inflation trends and lack of productivity within Brazil. China’s lending policies have been so out of control that the balance sheet of the People’s Bank of China is now roughly 50% bigger than the Fed’s (see Chart 1).

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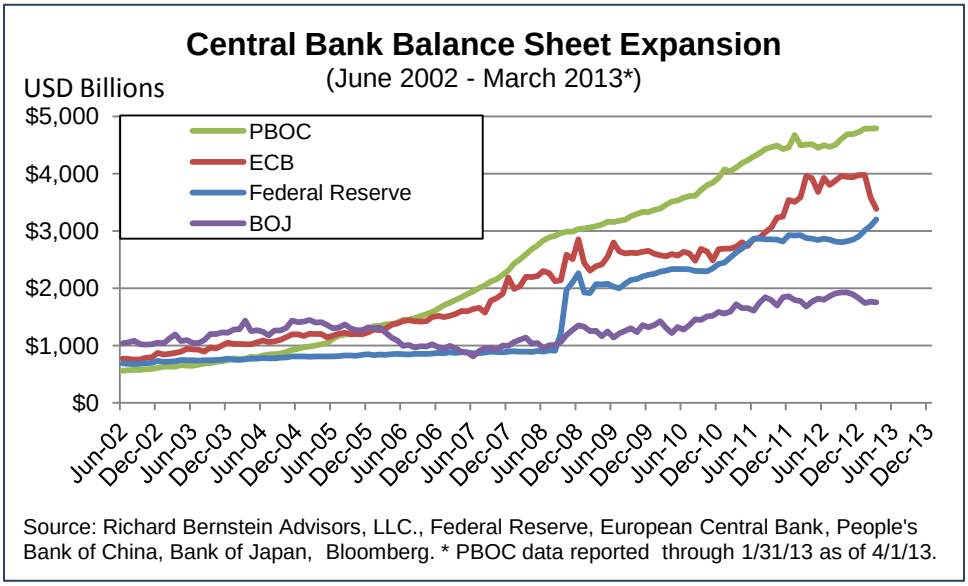
PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Chart 1:



Source: Richard Bernstein Advisors, LLC., Federal Reserve, European Central Bank, People's Bank of China, Bank of Japan, Bloomberg. * PBOC data reported through 1/31/13 as of 4/1/13.

A defensive equity rotation?

There has been considerable commentary recently regarding a "defensive rotation" within the equity market. Defensive sectors, such as Consumer Staples, Health Care, and Utilities, were the best performing S&P 500® sectors during the first quarter. Some observers believe that the outperformance of these defensive sectors suggests that the economy is slowing down and that the bull market is nearing an end.

We think last quarter's defensive rotation within the S&P 500® points more to the problems larger multi-national companies are having because of the stronger US dollar and economic weakness abroad than to looming deterioration in the US.
As one looks beyond the S&P 500® toward more domestically-oriented universes, the defensive rotation dissipates. In other words, the defensive rotation was most widespread among global companies, and less prevalent among domestic companies.

The following three charts show first quarter sector performance for the S&P 500®, the S&P MidCap 400®, and the S&P SmallCap 600®. The S&P 500® companies generally have more foreign exposure than do the S&P MidCap 400® companies, which in turn have more foreign exposure than do the companies within the S&P SmallCap 600®.

Chart 2 shows the performance for the S&P 500® companies is indeed quite defensive. The best performing sectors in the first quarter were Health Care, Consumer Staples, and Utilities, all of which are classic defensive sectors. They are closely followed, however, by early-cycle sectors (Consumer Discretionary and Financials), which also outperformed the overall market.

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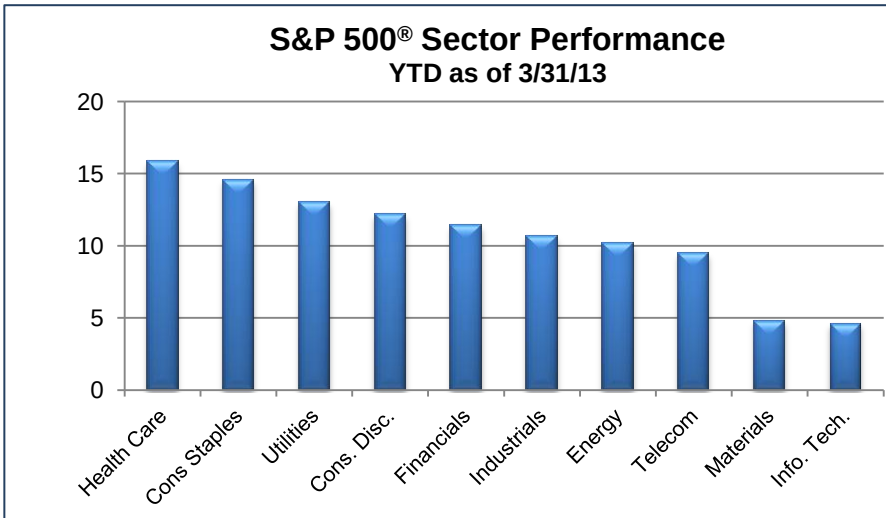
Chart 3 shows sector performance for the S&P MidCap 400® universe. Again, this universe is more domestically-oriented than is the S&P 500®, which is dominated by larger, multi-national companies. Consumer Staples and Utilities did lead mid cap companies during the first quarter, but note that Industrials crept up to third place ahead of Health Care. Thus, cyclicals performed a bit better among mid cap stocks than among larger caps.

Chart 4 depicts sector performance for the S&P SmallCap 600® universe. This universe is incrementally more domestic than the S&P MidCap 400® universe, and is considerably more domestic than is the S&P 500®. Incrementally domestic sector performance again had an incrementally more cyclical bent to it. The best performing sector was Energy, and Financials ranked third.

Technology was among the worst performing sectors regardless of size. Technology is historically the most foreign exposed sector, and the sector's consistently poor relative ranking regardless of size might similarly reflect concerns regarding non-US growth. We are not trying to overstate our case. Clearly, first quarter sector performance was less cyclical than was that in the prior quarter. However, we think a closer inspection of the data suggests that equity investors' fears might not be US-focused.

Chart 2:



Source: Richard Bernstein Advisors LLC, Standard & Poors, Bloomberg.
For Index descriptors, see "Index Descriptions" at end of document.

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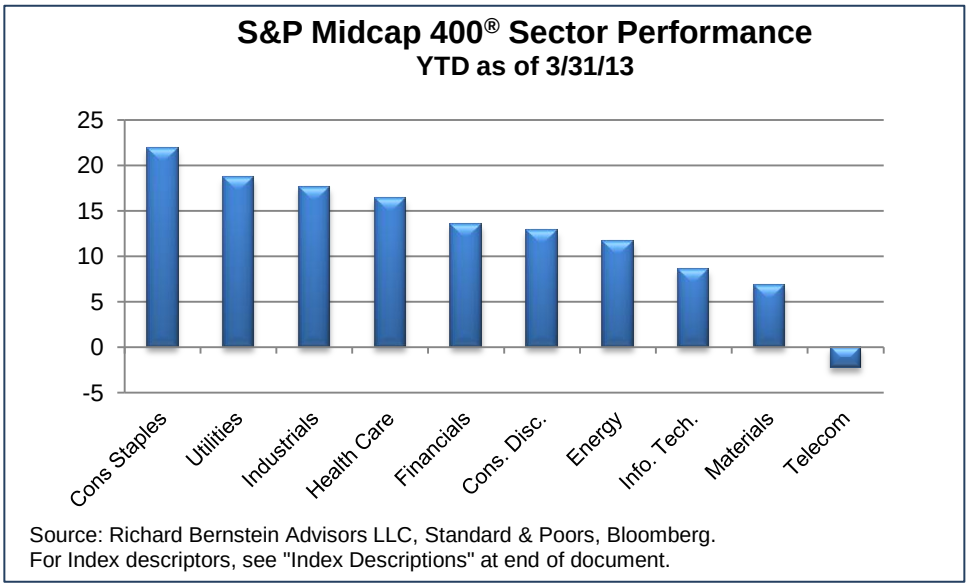
Chart 3:



Source: Richard Bernstein Advisors LLC, Standard & Poors, Bloomberg.
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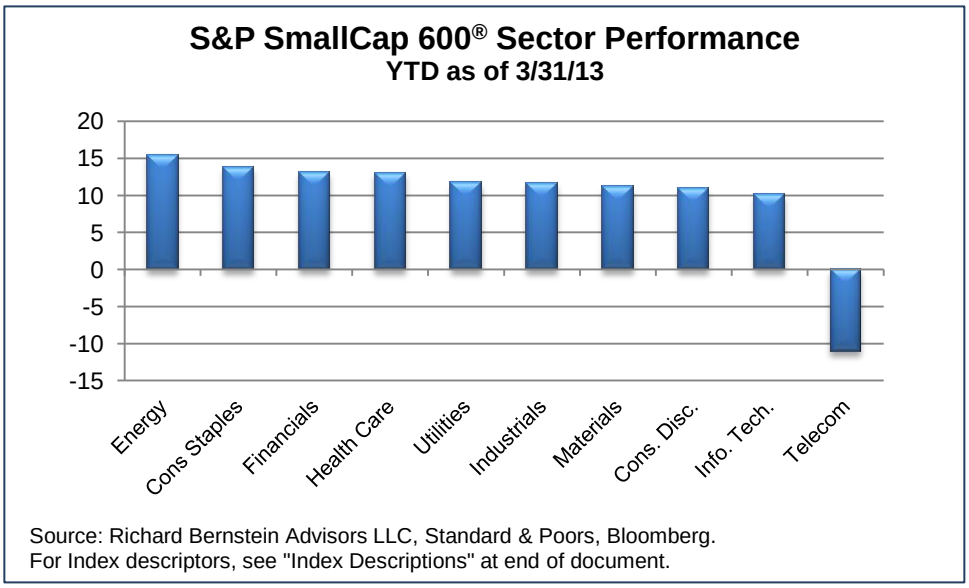
Chart 4:



Source: Richard Bernstein Advisors LLC, Standard & Poors, Bloomberg.
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Global asset performance supported the REAL "great rotation"

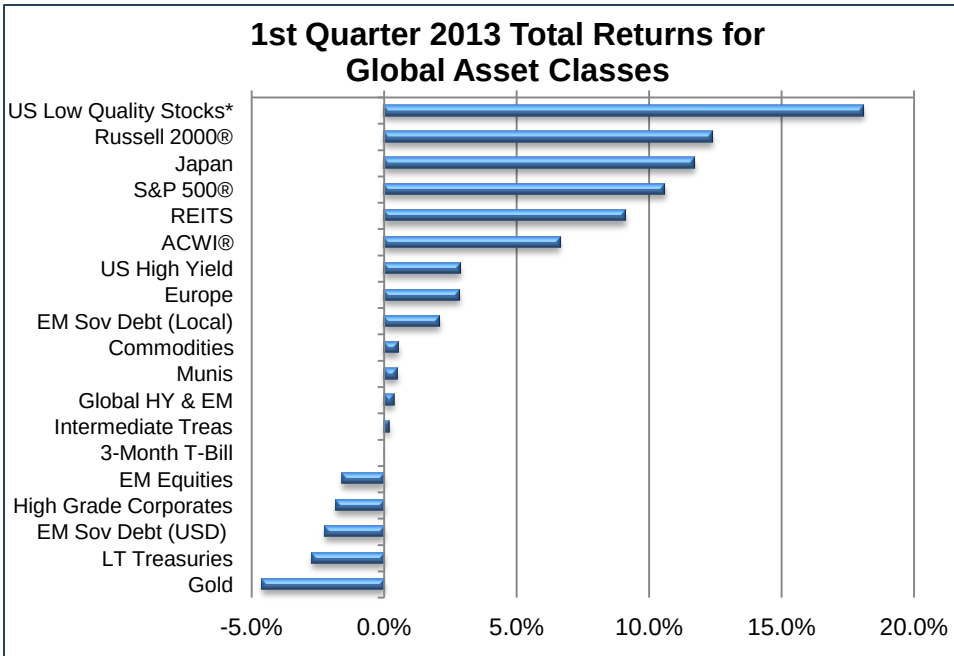
Global asset class performance during the first quarter seemed to support our notion of the REAL "great rotation". Chart 5 shows first quarter performance for a broad range of global asset classes. Interesting, the best performers were US low quality stocks, which tend to be the most economically sensitive group of stocks within the US market. Smaller stocks, here depicted by the Russell 2000® Index, finished second.

It is hard for us to see how the market is forecasting that US economy is in jeopardy when the stocks that are typically the most sensitive to the domestic economy, namely lower quality and smaller stocks, led global asset performance. By contrast, EM equities, those perhaps most sensitive to the global economy, finished toward the bottom of the performance derby.

The same performance comparison was evident within the global debt markets. US high yield outperformed EM debt both in local currency and in US dollars. If the outlook for the US economy was indeed worse than that for the global economy, then one would expect economically-sensitive US bonds (i.e., US high yield) to underperform bonds more sensitive to the global economy (i.e., EM debt).

Moreover, if the US economy were indeed going to materially weaken, one wouldn't expect to see long-term US treasury bonds near the bottom of the list. The performance comparison between lower quality stocks, smaller company stocks, high yield bonds, and treasuries is rather startling given the consensus view that the US economy is teetering on the brink of another recession.

Chart 6:



Source: Richard Bernstein Advisors LLC, MSCI, Standard & Poors, BofA Merrill Lynch, Bloomberg. For Index descriptors, see "Index Descriptions" at end of document. *Price return perfomance on US Low Quality Stocks.

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The REAL "great rotation" continues

US stocks have been outperforming emerging market stocks for more than five years. Yet, few investors seem to recognize that a "great rotation" is underway from global equities to US equities. In some cases, the US is even a better growth story than are the emerging markets.

The consensus seems to be that the US economy is on the brink of a serious slowdown. However, both asset class performance during the first quarter and US sector performance among domestically-focused companies do not support that consensus view. It is true that defensive stocks led larger capitalization US performance, but that performance appears to be tied to larger companies' exposure to Europe and emerging markets.

The REAL "great rotation" seems intact and on-going.

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INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

S&P 500® Standard & Poor's (S&P) 500® Index. The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

S&P MidCap 400® : Standard and Poor's MidCap 400® Index: The S&P MidCap 400® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the mid-sized companies of the U.S. stock market.

S&P SmallCap 600® : Standard and Poor's SmallCap 600® Index: The S&P Smallcap 600® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the small cap segment of the U.S. stock market.

Sectors/Industries: All sector/industry references in this report are in accordance with the Global Industry Classification Standard (GICS®) developed by MSCI Barra and Standard & Poor's. The GICS structure consists of 10 sectors, 24 industry groups, 68 industries and 154 sub-industries.

Russell 2000® : Russell 2000® Index. The Russell 2000® Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

MSCI ACWI®: MSCI All Country World Index (ACWI®). The MSCI ACWI® is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of global developed and emerging markets.

MSCI EM: MSCI Emerging Markets (EM) Index. The MSCI EM Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of emerging markets.

MSCI Europe: MSCI Europe Index. The MSCI Europe Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of developed European markets.

MSCI Japan: MSCI Japan Index. The MSCI Japan Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of Japan.

Gold: Gold Spot USD/oz Bloomberg GOLDS Commodity. The Gold Spot price is quoted as US Dollars per Troy Ounce.

Commodities: S&P GSCI® Index. The S&P GSCI® seeks to provide investors with a reliable and publicly available benchmark for investment performance in the commodity markets, and is designed to be a "tradable" index. The index is calculated primarily on a world production-weighted basis and is comprised of the principal physical commodities that are the subject of active, liquid futures markets.

REITS: THE FTSE NAREIT Composite Index. The FTSE NAREIT Composite Index is a free-float-adjusted, market-capitalization-weighted index that includes all tax qualified REITs listed in the NYSE, AMEX, and NASDAQ National Market.

3-Mo T-Bills: BofA Merrill Lynch 3-Month US Treasury Bill Index. The BofA Merrill Lynch 3-Month US Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. The Index is rebalanced monthly and the issue selected is the outstanding Treasury Bill that matures closest to, but not beyond, three months from the rebalancing date.

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INDEX DESCRIPTIONS cont'd:

Long-term Treasury Index: BofA Merrill Lynch 15+ Year US Treasury Index. The BofA Merrill Lynch 15+ Year US Treasury Index is an unmanaged index comprised of US Treasury securities, other than inflation-protected securities and STRIPS, with at least $1 billion in outstanding face value and a remaining term to final maturity of at least 15 years.

Intermediate Treasuries (5-7 Yrs): The BofA Merrill Lynch 5-7 Year US Treasury Index
The BofA Merrill Lynch 5-7 Year US Treasury Index is a subset of The BofA Merrill Lynch US Treasury Index (an unmanaged Index which tracks the performance of US dollar denominated sovereign debt publicly issued by the US government in its domestic market). Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $1 billion. including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

Municipals: BofA Merrill Lynch US Municipal Securities Index. The BofA Merrill Lynch US Municipal Securities Index tracks the performance of USD-denominated, investment-grade rated, tax-exempt debt publicly issued by US states and territories (and their political subdivisions) in the US domestic market. Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule, and an investment-grade rating (based on an average of Moody's, S&P and Fitch). Minimum size requirements vary based on the initial term to final maturity at the time of issuance.

High Grade Corporates: BofA Merrill Lynch 15+ Year AAA-AA US Corporate Index. The BofA Merrill Lynch 15+ Year AAA-AA US Corporate Index is a subset of the BofA Merrill Lynch US Corporate Index (an unmanaged index comprised of USD-denominated, investment-grade, fixed-rate corporate debt securities publicly issued in the US domestic market with at least one year remaining term to final maturity and at least $250 million outstanding) including all securities with a remaining term to final maturity of at least15 years and rated AAA through AA3, inclusive.

U.S. High Yield: BofA Merrill Lynch US Cash Pay High Yield Index. The BofA Merrill Lynch US Cash Pay High Yield Index tracks the performance of USD-denominated, below-investment-grade-rated corporate debt, currently in a coupon-paying period, that is publicly issued in the US domestic market. Qualifying securities must have a below-investment-grade rating (based on an average of Moody's, S&P and Fitch) and an investment-grade-rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long-term sovereign debt ratings), at least one year remaining term to final maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.

EM Sovereign: The BofA Merrill Lynch US Dollar Emerging Markets Sovereign Plus Index
The BofA Merrill Lynch US Dollar Emerging Markets Sovereign Plus Index tracks the performance of US dollar denominated emerging market and cross-over sovereign debt publicly issued in the eurobond or US domestic market. Qualifying countries must have a BBB1 or lower foreign currency long-term sovereign debt rating (based on an average of Moody's, S&P and Fitch). Countries that are not rated, or that are rated "D" or "SD" by one or several rating agencies qualify for inclusion in the index but individual non-performing securities are removed. Qualifying securities must have at least one year remaining term to final maturity, a fixed or floating coupon and a minimum amount outstanding of $250 million. Local currency debt is excluded from the Index.

US Low Quality Equities: **The BofA Merrill Lynch MLQS C&D Index.** The BofA Merrill Lynch MLQS C&D Index is designed to represent the performance of US companies with the lowest quality rankings based on the S&P Common Stock Rankings. The indices are equal-weighted and rebalanced monthly.

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