SHIFTING
GEARS
SHIFTING GEARS

RiverFront’s 2016 Economic Scenarios and Market Forecasts ........................................... 2

Portfolio Outlook for 2016 ................................................................. 5

US Stocks: Upside Constrained by Valuation ........................................ 6

International Stocks:
  Why We Continue to like Japan ....................................................... 10
  Eurozone: Weak Currency + ECB Stimulus = Earnings Growth .... 12
  Emerging Markets: Economies Struggling in Low Gear .............. 14

Bonds: Fed Liftoff Finally Arrives ..................................................... 17
HIGHLIGHTS

THE ECONOMY: An up-shift in global growth. We expect growth in the global economy to shift into a higher gear in 2016, as the drag from oil producers diminishes and the consumer continues to benefit from very low energy prices. We expect growth in Europe and Japan to accelerate as the decline in their currencies supports the competitiveness of their global companies and increased wages and tourism provide a boost to domestic growth. In the US, there is evidence that a 5% unemployment rate is finally allowing increasing wages. We expect growth in China to stabilize as the government increases spending on infrastructure improvements. Furthermore, we think consumer spending in China will continue to grow at a double-digit pace.

US STOCKS: We believe the bull market in US stocks will remain in place, but we only expect single-digit annual returns. We anticipate a prolonged but slow expansion, which is shifting gears as wages start to grow. This is better for economic growth than for earnings, as higher wages pressure already high margins and the strong dollar remains a headwind for global companies. We expect mid-single-digit returns from the S&P 500, as we believe current valuations put a restraint on upside potential. Within our portfolios, we currently like homebuilders and bank stocks; we recently added oil services to increase our energy holdings, which we underweighted in 2015. In contrast, we are avoiding utilities and REITS, which are highly sensitive to interest rates. We are cautious on retailers and healthcare stocks.

INTERNATIONAL STOCKS: We continue to like Japan and the eurozone, but have recently removed about half of our euro hedge. We are cautious on emerging markets. We highlight three major themes internationally. Firstly, we favor countries where central banks are aggressively promoting growth. This is most evident in Japan and the eurozone. Secondly, we recognize that these pro-growth policies have led to currency weakness, making currency hedging an important part of our strategy, albeit less so following significant declines in 2015. Thirdly, we remain underweight stock markets like Australia, Canada, Latin America and the UK, which have significant exposure to commodity producers.

We believe that fundamentals in Japan have structurally improved since Prime Minister Abe took office in late 2012. Over the course of 2015, our portfolios have evolved from being focused on exporters and having a substantial yen currency hedge, to our current position, in which the yen hedge has been largely removed, and we have a greater focus on domestic sectors. In the eurozone, we still retain a significant bias to multinational companies, but our most recent changes have oriented us more towards domestic sectors, which we believe will benefit from a broadening economic recovery. While we enter 2016 with very little exposure to emerging markets, Latin America presents an opportunity when the commodity cycle turns, as does China if its leadership embraces reform.

BONDS: Avoid longer maturities, focus on corporate bonds. The Fed has made it clear that the path of future rate increases is expected to be gradual and data dependent. This environment is more likely to result in a “rust” not “bust” end to the bull market in bonds. Our strategy is to own short-term corporate bonds, both investment grade and high yield, to deliver more income in a low interest rate world and protect portfolios from any rise in longer term interest rates.
RiverFront’s 2016 Economic Scenarios and Market Forecasts

<table>
<thead>
<tr>
<th></th>
<th>PESSIMISTIC</th>
<th>BASELINE</th>
<th>OPTIMISTIC</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROBABILITY</td>
<td>25%</td>
<td>60%</td>
<td>15%</td>
</tr>
<tr>
<td>OIL PRICES</td>
<td>$20 to $40</td>
<td>$30 to $60</td>
<td>$30 to $50</td>
</tr>
<tr>
<td>US POLICY</td>
<td>Fed forced to reverse rate hikes—back to 0%</td>
<td>Rates rise very slowly</td>
<td>Rates rise at slightly faster pace</td>
</tr>
<tr>
<td>EUROZONE POLICY</td>
<td>Political backlash against EU. UK exits EU.</td>
<td>Rates fall further below zero. QE expanded and extended.</td>
<td>Rates further below zero. QE expanded and extended.</td>
</tr>
<tr>
<td>US GDP (%YoY)</td>
<td>0 to 1%</td>
<td>2 to 3%</td>
<td>3 to 4%</td>
</tr>
<tr>
<td>STOCK MARKET RANGE (% IN LOCAL CURRENCY)</td>
<td>S&amp;P 500: -10 to -20% EAFE: -15 to -30%</td>
<td>S&amp;P 500: 0 to 8% EAFE: 10 to 15% EM: -5 to 5%</td>
<td>S&amp;P 500: 10 to 20% EAFE: 20+% EM: 5 to 10%</td>
</tr>
<tr>
<td>US 10-YEAR BOND YIELDS (%)</td>
<td>1.0 to 1.5%</td>
<td>2.25 to 2.75%</td>
<td>3 to 3.5%</td>
</tr>
<tr>
<td>US DOLLAR</td>
<td>Competitive devaluation leads to higher $</td>
<td>Modest rise vs EU, much stronger appreciation vs EM, flat versus Yen</td>
<td>Flat vs developed economies, modest appreciation vs EM</td>
</tr>
</tbody>
</table>

Source: RiverFront Investment Group

* Index definitions and important disclosure information can be found on inside back cover.

The table above links our three scenarios (BASELINE, OPTIMISTIC and PESSIMISTIC) with the major policy issues that we believe will have the greatest impact on the global economy in 2016. As a result, we focus on the biggest economic blocks: US, Europe and China/Emerging Markets. Our assessment of each scenario’s probability is also shown.
Our baseline speaks to our 2016 title, “Shifting Gears,” as we believe the drivers of growth in 2016 will be different than what we saw in 2015. Firstly, we believe that there will still be a drag from the energy sector in 2016, but it will be less than was experienced in 2015. In 2015, oil companies made significant progress toward adjusting production and employment to reflect a lower price range for oil. The oil industry likely has additional adjustments to make, necessitated by OPEC’s December 2015 decision to increase production quotas despite the current oil glut. However, we believe these additional cuts in capital expenditures and employment will be less severe than those experienced in 2015. Secondly, while the benefits of lower oil prices have been seen in strong car sales, we believe the full effects will be broader in 2016, as wage gains and the full effect of low energy prices on consumer spending take hold. We believe that the impact of lower oil prices will be especially strong in Japan and the eurozone. These economies, unlike the US and emerging markets, mostly benefit from lower oil prices. In the US, rising wages should allow the nascent housing market recovery to gather momentum and help substitute for growth lost in the energy sector.

We place a high probability on our baseline scenario (60%) because we see all global policymakers seeking stronger growth. While interest rates in the US will be among the highest in the developed world, they are still very low by historic standards, and we believe they will be somewhat offset in the global economy by continued monetary stimulus by other major central banks.

In our pessimistic scenario, the global economy flirts with recession. We think the greatest risks to growth are protectionism triumphing over free trade deals and China retreating from necessary economic reform. For the US and Asia, a retreat from free trade would mean the failure to pass the Trans-Pacific Partnership. In Europe, the UK will likely have a referendum on European Union (EU) membership, and currently the outcome is uncertain. Further, Europe has a constant threat of rising anger against mainstream politics and the EU bureaucrats in Brussels, a tendency that has only been exacerbated by the tragic flood of refugees pouring into Europe. Global commitment to open trading relationships will potentially be pressured by China’s ongoing economic transition away from manufacturing and toward a service-based economy. As its economy slows, China will be tempted to delay or retreat from crucial economic reforms. A rudderless China, combined with its diminished demand for commodities, could continue to reverberate negatively across all emerging markets. We place a modest
probability on these possibilities, but recognize that free trade and a healthy Chinese economy have been linchpins of global growth.

We place a low probability on our optimistic scenario of a “deflationary boom,” but we note that aspects of this case will drive our baseline scenario, namely low inflation, wage growth and supportive monetary policy. In 2015, both the European Central Bank and People’s Bank of China embraced quantitative easing (QE) policies after having resisted such aggressive monetary stimulus for most of the post-Lehman crisis period. With these giant central banks finally embracing reflationary policies, there is some chance that the excess capacity and deflation suffered by commodity producers act to free up disposable income and fuel a boom in the service-oriented sectors of the global economy.

Our 2015 forecast of slowing earnings and a significant moderation in US stocks proved accurate, as did our view that Europe and Japan would do well in local currency terms; however, we underestimated the extent of commodity price declines and the corresponding significant decline in emerging markets. Our ranking of markets remains the same going into 2016. We prefer stocks to bonds, and we prefer Japan and the eurozone over the US or emerging markets.
Portfolio Outlook for 2016

Price Matters® forms the centerpiece of RiverFront’s methodology for estimating expected returns. Following flat returns in large cap US stocks and better returns in MSCI EAFE countries in their local currencies, the valuation gap between the two has closed. We believe that the best value is currently in international markets, in dollar terms (see charts below).

![MSCI EAFE (IN US$) REAL TOTAL RETURN INDEX](chart1)

![MSCI EMERGING MARKET EQUITIES REAL TOTAL RETURN INDEX](chart2)

Past performance is no guarantee of future results.
Source: RiverFront Investment Group, MSCI. Data for MSCI EAFE Index is from Jan 1970 through Nov 2015. Data for MSCI Emerging Markets Index is from Jan 1988 through Nov 2015. It is not possible to invest directly in an index. Investments in international and emerging markets securities include exposure to risks including currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Using a currency hedged product does not insulate the portfolio against losses.

The MSCI EAFE Index is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the US & Canada. MSCI presents the data for this index in terms of US dollars and in terms of local currencies. The left chart above reflects index data in terms of US dollars. The MSCI Emerging Markets Index measures equity market performance of emerging markets. The Index consists of 21 emerging market country indices. It is not possible to invest directly in an index.

From a timing perspective, we continue to see reasons for some further euro weakness as the US raises interest rates and the eurozone lowers them. We have already removed most of our currency hedge in Japan and have begun the process of reducing our currency hedge against the euro in recognition of the significant euro decline in 2015. We plan to continue to reduce both currencies if the dollar strengthens further. Emerging markets performed poorly this year, tied to falling growth in China and continued weakness in commodities. Emerging markets currencies suffered too, exacerbating the declines for dollar investors. We expect some improvement in 2016, but emerging markets are still less attractive to us than unhedged developed international due to their greater volatility and their lack of long-term data, which gives us less confidence in the trend (see charts above). As was the case in 2015, with interest rates so low, the opportunity cost of seeking to ensure safety of principal in our more conservative strategies has increased. This can be mitigated by slightly lower stock weightings and greater use of short-maturity bonds. Furthermore, in the event of an unexpected significant decline in stocks, these more conservative strategies will have plenty of scope to increase stock weightings.
We believe the bull market in US stocks remains in place, but we only expect single-digit annual returns between now and the next US recession. If, as we expect, recession is many years away, then the risk/reward tradeoff for stocks versus bonds or cash remains compelling. We anticipate a prolonged but slow expansion, which is shifting gears as wages start to grow. This is better for economic growth than for earnings, as higher wages pressure already high margins and the strong dollar remains a headwind for global companies. The chart below highlights the difference between the service sector, which has benefitted from falling energy prices, and the manufactured goods sector, which has been hit by declining production. It shows both the absolute change in prices on the top (indexed to 100 in 2006) and the 12-month rate of change on the bottom. In 2016, we expect the services sector to continue to grow and the goods sector to be less of a drag, kicking the economic growth into a higher gear.
WHY WE EXPECT SINGLE DIGIT RETURNS FROM US STOCKS

We believe the S&P 500’s historic 6.1% earnings growth trend (as illustrated by the parallel lines in the chart below, which show different valuation multiples of trend earnings) is sustainable due to the many globally focused companies in the index. However, we do not expect earnings growth to exceed the S&P 500’s 80-year average.

Standard & Poor’s estimate for the S&P 500’s earnings per share (EPS) at the end of 2016 is about 20% above its long-term trend. Because earnings have persistently returned to trend, we calculate the price-to-earnings (PE) multiple based on forward trend earnings to gauge longer term investor optimism. This is shown in our chart below.

Source: RiverFront Investment Group, Standard & Poor’s
Past performance is no guarantee of future results.

In the stock bubble of the late 1990s when actual earnings were well above trend, investors paid 39 times trend earnings. By contrast, in 2009 investors were only willing to pay 10 times trend earnings, as earnings were well below trend and there was little optimism about recovery. Such are the swings in investor emotions. Following the S&P 500’s significant gains over the last two years, the latest price-to-forward trend earnings ratio has traded between 20 and 22 times, briefly falling below 20 times in the September 2015 selloff.

Our chart shows that valuations can change significantly through time, making them a blunt and imprecise instrument with which to make forecasts. This is why shorter term forecasting is challenging: one must not only forecast earnings, but also the multiple of earnings that investors will pay. Our baseline scenario is for stocks to rise approximately in line with trend earnings and remain between 20 and 22 times as it did this year, leading to single-digit returns over the next year.
SHIFTING GEARS WITHIN SECTORS

In the middle innings of a maturing bull market, we believe selection becomes more important:

The Obvious: Late-Stage Cyclicals

Homebuilders
We do not agree with the hypothesis floated by some that millennials are lifetime renters. The decision to buy a house may have been pushed out due to a significant recession, slower employment growth and more stringent lending standards than have been typical in normal recoveries, but our view is that these are orders delayed, not foregone. Since 1958, average home starts have been around 1.5 million units and recessions bottomed at 900,000 starts. In the most recent housing recession, starts bottomed at 500,000 and stayed at that level for 5 years. Current starts around 1.2 million still leave room for growth, in our view.

Banks
Despite a tough regulatory environment, we like banks because:

- Employment + Wage Growth = Consumer Confidence
- Low Loan Losses + Rising Net Interest Margins + Greater Regulatory Transparency = Banker Confidence
- Consumer Confidence + Banker Confidence = Loan Growth and Rising Bank Earnings

Avoid interest rate sensitives
As markets mature, rates rise, and we expect the same to be true going forward. We expect rising rates to negatively impact utilities and REITs, and we have thus avoided them in our portfolios.

The Less Obvious: We anticipate some assets to act differently this cycle, due to either a change in secular trend or extreme levels of valuation.

Telecommunication companies (telecom): less rate-sensitive in the future. Like utilities, telecom companies have traditionally been sensitive to interest rates, due to their historically quasi-regulated business and general lack of growth. Today’s telecom companies are less regulated and more dependent on faster growing wireless and data services than the slower growth of the landline business. Furthermore, there has been tremendous consolidation in the telecom arena over the past few years, which has led to a significant improvement in pricing power for the surviving companies. For these reasons, we anticipate faster than normal earnings growth and the potential for a positive revaluation of the group.

Retail: challenges ahead.
At first glance, a growing economy led by wage improvement and low energy costs should be supportive for retailers; however, we see three hurdles. Firstly, the consumer discretionary industry has been the top performing sector since the financial crisis, and thus has already priced in a lot of good news. Secondly, internet retail has hit the tipping point among consumers and has begun to take significant market share from the traditional retailers that will be difficult to offset with broad economic growth. Lastly, cost control has become an important component to the success of the retail story over the past few years, and we believe cost control will be difficult to sustain given the mounting pressure on wages that is occurring across America.
Healthcare: headwinds are strengthening.
Aging demographics have made healthcare a popular sector. The Affordable Care Act (ACA) exacerbated this phenomenon, as virtually every healthcare company benefited from a significant increase in “covered lives” with little or no additional costs. We believe the tailwind for healthcare companies following the passage of the ACA is coming to an end. While the ACA has made healthcare more available and affordable to many Americans, it has also led to consolidation among the third party payers. Essentially, more and more Americans get their healthcare from a smaller universe of agencies and companies. This consolidation has begun to tilt the power from the healthcare producers (drug, device, hospital and other healthcare service companies) to the healthcare suppliers (healthcare insurers, health maintenance organizations (HMOs), and federal agencies like Medicare). Greater power means greater pressure for pricing concessions and lower profits.

Energy: underweight but we are selective buyers.
In our view, low crude oil prices and slow world growth are now well known. As oil prices have sold off towards the lows of the credit crisis of 2008, the energy sector has underperformed the S&P 500 since 2011. It is our opinion that the magnitude of the correction in crude (and related equities on a relative basis), driven by a number of well-known forces (strength in the US dollar, greater US crude production, OPEC’s decision to not support prices, etc.), could be reaching a point where our significant underweight to domestic energy equities no longer appears appropriate for our clients. In our view, it now appears increasingly likely that a “lower for longer” view on crude is finally being baked into investor expectations and management teams. Our internal analyses suggest that, within energy, the best risk/reward lies with the oil services group.

CONCLUSION
US stock volatility is here to stay. With valuations near fair value and QE over, we anticipate single-digit annual returns, with at least one 10-15% pullback.
International Stocks: We Continue to like Japan and the Eurozone, We Remain Cautious on Emerging Markets

We have three major themes internationally. Firstly, we favor countries where central banks are aggressively promoting growth. This is most evident in Japan and the eurozone. Secondly, we recognize that these pro-growth policies have led to currency weakness, making currency hedging an important part of our strategy. Thirdly, we remain underweight stock markets like Australia, Canada, Latin America and the UK, which have significant exposure to commodity producers.

JAPAN: EARNINGS MATTER MORE THAN GDP

At RiverFront, we only track the gross domestic product (GDP) of a nation to the extent that it has a causal impact on what we really care about — namely, the level and direction of corporate earnings per share (EPS). After all, as equity shareholders, that’s what we are actually entitled to—a fractional share of profits. With regards to earnings, Japan actually has a much stronger trend than its mixed GDP reading might suggest.

Despite tepid economic growth for five years, corporate earnings in Japan over the same time period have almost doubled, surpassing their previous all-time earnings peak and Japanese stocks have risen in line with earnings. One of the more obvious reasons for the strength of earnings has been the weakness in the yen generated by the Bank of Japan’s aggressively easy monetary policy. The near 40% drop in the yen versus the US dollar since late 2012 has given Japanese corporate earnings major translation gains and boosted the competitiveness of Japanese exporters. In addition, Japanese companies have been gradually cutting costs to improve productivity and focusing more on shareholder value. As corporate profits are recycled back into the Japanese economy in the form of increased capital expenditures and wages for workers (which is already starting to happen), we believed a self-sustaining “virtuous cycle” for the Japanese domestic economy will emerge. Our recent research trip to Japan reinforced these views.

In the chart to the right, the light blue bars show the quarterly percentage change in GDP, annualized, for each of Japan’s quarters since 2012 (right hand scale, in %). The three blue circles indicate recessions, defined as two or more consecutive quarters of negative GDP growth. The orange line (left hand scale) indicates the trend of aggregate corporate earnings of publicly traded large capitalization Japanese companies, and the green line (also left hand scale) represents the aggregate market value of those companies. We use the Datastream Japan-DS Market index, a market-cap weighted index of 1,003 publicly traded companies representing a proxy for the total Japanese stock market. As the chart clearly indicates, strong Japanese corporate earnings and stock market returns have occurred over the past four years, despite the mixed macroeconomic fortunes of Japan.
STRONG EARNINGS DESPITE LACKLUSTRE ECONOMIC GROWTH

CONCLUSION ON JAPAN:

Over the course of 2015, our portfolios have evolved from being focused on exporters and utilizing a substantial currency hedge to our current position, in which we have placed greater focus on domestic sectors and mostly removed the currency hedge.

<table>
<thead>
<tr>
<th>TYPICAL BEAR CASE ON JAPAN</th>
<th>OUR COUNTERPOINT</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Japan back in recession.”</td>
<td>Corporate earnings at record highs, real estate values starting to eclipse previous highs, and expanding purchasing manager surveys all suggest a stronger economy rather than a recession.</td>
</tr>
<tr>
<td>“Japan has highest debt-to-GDP levels of any developed economy.”</td>
<td>Less than 10% of Japanese debt is held outside of Japan. In addition, interest rates close to zero mean low carrying costs for debt.</td>
</tr>
<tr>
<td>“Japan’s corporate sector suffers from a terminal case of inflexibility.”</td>
<td>Japan is one of the very few economies that currently deserves to be called a reform story, in our opinion. Return on equity (ROE) for shareholders has improved consistently since Prime Minister Abe took office, and there is a high likelihood that corporate tax rates will be reduced. Potential passing of the Trans-Pacific Partnership has helped abolish “sacred cow” tariffs in agriculture.</td>
</tr>
<tr>
<td>“Abenomics has failed.”</td>
<td>Three years into the “Abenomics” experiment, core inflation is consistently above zero for the first time in 15 years, wages are increasing, Japanese corporations are generating record income, and corporate governance is improving.</td>
</tr>
<tr>
<td>“Japanese demographics are among the worst in the world.”</td>
<td>Japanese workforce productivity growth, which is among the best in the world post-global financial crisis, has helped offset the negative effects of an aging population. In addition, a credible attempt to bring educated women back into the workforce is starting to gain traction – female labor participation has increased 5% since Abe was elected.</td>
</tr>
<tr>
<td>“China’s economic slowdown will spell disaster for Japan.”</td>
<td>Actually, the Japanese economy is more correlated to developed country economies, such as the US, rather than China, in our opinion.</td>
</tr>
</tbody>
</table>
EUROZONE: WEAK CURRENCY + ECB STIMULUS = CONTINUED EARNINGS GROWTH IN 2016

We believe the eurozone is in the early innings of a positive earnings cycle. Indeed, 2015 marked the first year in quite a while in which eurozone large-cap companies out-earned their US peers—a trend likely to continue in 2016, in our opinion. This positive cycle begins with European earnings still roughly 30% below their 2007 peak and should be aided by an accommodative European Central Bank (ECB), a relatively weak euro, and low energy input costs.

THE EURO

Based on both rate differentials and relative size of central bank balance sheets, our view is that the euro will likely resume its downward trend versus the dollar at some point in 2016. We therefore continue to hedge at least part of our euro exposure relative to the US dollar. A weaker euro will boost eurozone corporate earnings and local stock markets, in our view.

Source: Thomson Reuters Datastream.
In a year dominated by ugly headlines (Greece, refugee crisis, terrorism, etc.), it is easy to lose sight of just how far ECB policy progressed in 2015. January’s QE announcement was the region’s first-ever experiment with QE and negative interest rates, a move that many had previously considered to be politically infeasible. The ECB’s December statement marks a meaningful re-commitment to easing policy, along with an implicit agreement that these policies will continue as long as needed to return inflation to more normal levels. Historical precedent with QE programs in Japan and the US strongly suggest that this expansion of QE in Europe will continue to boost earnings (see Chart below left).

WE REMAIN UNDERWEIGHT THE UK

The United Kingdom boasts a solid macroeconomic outlook and some of the largest and highest quality stocks in Europe. However, the combination of a meaningful level of energy and commodity exposure; a central bank easing cycle that’s likely near the end of its run; and a lackluster corporate earnings outlook makes the risk-reward relatively unattractive, in our opinion. In addition, political uncertainty relating to the 2016 referendum vote over continued European Union participation (likely to occur sometime in the second half of 2016) could constrain risk appetite in the first half of the year. If a UK exit were to actually occur, we would expect lasting negative market repercussions. We remain underweight the UK, as we have been for over a year.

CONCLUSION ON EUROZONE:

We expect eurozone stock markets to rise in line with corporate earnings growth in 2016, which we expect to be in the high single-digit or low double-digit range for the broad eurozone index. We continue to favor eurozone consumer-facing sectors and other global businesses, as well as selected low volatility stocks. We continue to hedge out a meaningful amount (approximately 50%) of the euro from our portfolios.
EMERGING MARKETS: ECONOMIES STRUGGLING IN LOW GEAR.

China stands at a major crossroads, where it will either reform or repeat the mistakes made by Japan. We describe the development profile of many Asian countries and highlight our beliefs about the reasons for their early success and long-term challenges in our section on the Asia Development Model (ADM) on page 16.

ASIA: THE END OF THE CHINA ‘MIRACLE’—UNDERSTANDING THE ASIA DEVELOPMENT MODEL (ADM)

Following our recent visit to the region, we believe market fears of an imminent collapse in the Chinese financial system or economy are overblown. We also believe the long-term economic and investment prospects for China depend on its leaders adopting painful reforms, which will help it transition from an export-driven economy to one led by domestic demand. China’s recently announced reform package is a start, and it could buy time for the more pervasive reforms that will eventually be required. However, opinion is sharply divided as to whether the current government has the political will to follow through with the current reform proposals. Extending bad debts by pretending they are okay and pumping up growth with fiscal and monetary stimulus should allow China to avoid a hard landing for the time being. That said, we will need to see the proposed reforms enacted before becoming more optimistic about Chinese equity markets.

South Korea is just now encountering the limitations of ADM as China attacks more and more of its export markets. We believe the country is at risk of repeating Japan’s experience of extended economic stagnation. South Korea’s small size compared to Japan and China could buy it more time to reform, but no significant reform proposals are currently under discussion. Despite attractive valuations, we do not yet see promising investment opportunities in South Korea.

India has great potential coming from its young demographic, reform-minded leadership, and demonstrated track record of growth over the last 15 years. Furthermore, India’s highly respected central bank has a firm grip on inflation, which has shielded India from some of the economic and currency volatility experienced by other emerging markets countries. As a major net importer of commodities, India will continue to benefit from low prices.

We believe, however, that the reality on the ground in India is more complicated and less rosy than the aerial view. Prime Minister Modi’s reform zeal is starting to run into political opposition, as some of the bureaucracy that he’s challenging is starting to push back. Modi’s political party lost a meaningful regional election in the fall, suggesting the honeymoon phase for Modi’s tenure is officially over. The inconvenient truth is that India’s weaknesses in infrastructure and its vast network of corruption is not easily or quickly fixed by politics and makes for a market whose sum is often less than its parts.

Unfortunately, by our measures India’s corporate earnings appear to be running out of steam after a strong couple of years coinciding with Modi’s election. Compounding the issue is premature excitement around the Modi regime that has left India’s equity markets at pricey valuations relative to both global counterparts as well as India’s own history. We are currently cautious, looking for an opportunity to buy at more attractive prices.
LATIN AMERICA: PULLED DOWN BY WEAK COMMODITY PRICES.

We avoided Latin America in 2015, which proved to be a good decision as a Standard and Poor’s index of the 40 largest companies has fallen over 25% (in dollar terms) through mid December. As we noted last year, the largest Latin American countries are all significant commodity producers, and falling commodity prices creates a vicious cycle for them: it causes their currencies to weaken, thereby increasing the repayments on their dollar-denominated debt, and consequently raising fears of default which causes interest rates to rise. Equally, rising commodity prices creates a virtuous cycle. Both scenarios are shown in the chart below, which illustrates the relative performance of Latin America to the US, overlaid with commodity prices.

Tactically, Latin America is on our watch list for 2016, especially countries like Chile, Peru and Mexico, but we will need greater confidence that commodity price declines are largely over. Brazil’s political situation continues to concern us deeply, as the current government’s policies have been very detrimental to both the economy and shareholders, especially for companies with some state ownership.

CONCLUSION

While we enter 2016 with very little exposure to emerging markets, Latin America presents an exciting opportunity when the commodity cycle turns, as does China if its leadership embraces reform.
APPENDIX: THE ASIAN DEVELOPMENT MODEL (ADM) — ULTIMATELY A VICTIM OF ITS OWN SUCCESS

For the past 20 years, China has enjoyed strong economic growth and rapid industrialization. The success of their economic development model, often referred to as “Capitalism with Chinese Characteristics,” has lifted hundreds of millions of Chinese citizens out of poverty. China’s combination of top-down economic direction and selective market incentives has been extolled as a potentially superior alternative to Western-style free market capitalism.

We believe that China’s development model is nothing new and simply represents the latest implementation of the development model pioneered by Japan many decades ago. Every economy that has embraced this economic system (Japan, Taiwan, South Korea, China, etc.) initially enjoyed economic progress similar to that which has been achieved by China. However, we believe most countries that embrace this development model eventually fall victim to its inherent flaws. These fundamental flaws surface more quickly in large economies like Japan, and they can lead to excessive debt and a long period of economic stagnation. Aggressive reforms can theoretically prevent this outcome, but in practice the political alliances encouraged by ADM have created insurmountable barriers to change.

As summarized in the table, the key aspects of ADM are:

- The government targets key industries for development and protects these companies with trade barriers and suppression of domestic competition.
- Targeted industries are supported with an unlimited supply of low interest loans.
- In exchange for these benefits, targeted industries maximize exports and employment instead of profitability.
- Workers are pulled from farms and put into factories.
- Domestic consumption is suppressed to create a surplus for export.

China hit the limitations of ADM faster than Japan or South Korea because of its much greater population. In response to decelerating export growth, China has executed a series of policies that appear eerily similar to those of Japan in the early 1990s (real estate bubble, infrastructure binge, “extend and pretend” approach to bad debts). We believe, however, that just as extend and pretend allowed Japan to avoid a Lehman-style financial crisis, China has taken that risk off the table for the next few years. China’s growth has decelerated sharply as real estate investment fell much faster than infrastructure could be increased, but growth should stabilize in 2016 as infrastructure spending comes online.
Bonds: Fed Liftoff Finally Arrives—

RATE INCREASES LIKELY TO BE MEASURED AND GRADUAL. FEW ATTRACTIVE OPPORTUNITIES—VALUATION FAVORS SELECT AREAS OF CREDIT; KEEPING MATURITIES SHORT

Returns in the higher quality sectors of the fixed income market have been disappointing this year, with the broader indices up slightly less than 1%. Treasury yields fell sharply on a couple of occasions throughout the year, due to extraordinary central bank actions in Switzerland and collapsing commodity prices. However, these drops were quickly reversed, and the 10-year US Treasury yield is virtually unchanged year-to-date while the 30-year yield is up slightly.

FED OUTLOOK

The Federal Reserve refrained from raising rates until its last meeting of the year on December 16th, due to low inflation and disappointing global growth. The Fed has made it clear, however, that the path of future rate increases is expected to be gradual and data dependent. In addition, slow global growth and low or negative rates in Europe and Japan are likely to keep rates in the US from rising sharply, and the equilibrium real rate (excluding inflation) may be lower than its historical average. This environment is more likely to result in a “rust not bust” end to the bull market in bonds. Over the past 15 years, investors have witnessed the end of long bull markets in both US equity markets and real estate. While the timing hinges on the magnitude of global growth, current global bond yields are set up for either a prolonged period of low returns (the best case in our view - rust) or outright negative returns (bust). Subtracting inflation only makes the outlook worse. In our view, this is a time for managing risks and trying to preserve purchasing power, not a time to chase price momentum.

Short-term corporate bonds have performed relatively well given their inherent yield advantage versus Treasuries, approximately matching the return of the broader bond market indices despite the headwinds of rising short-term rates and widening risk premiums. In contrast, the high-yield sector has underperformed significantly despite continued low defaults and positive economic growth, largely due to the collapse in the energy and basic industry sectors (especially metals and mining). These two sectors together comprise 23.7% of the Bank of America Merrill Lynch US High Yield Master II Index and, as our table shows, their returns have been sharply negative. Returns and weightings are as of December 11, 2015. The bright spot in the high yield market has been in the shorter-term, highest quality (BB) sector, where returns have been on par with the high grade, broad market indices.
We believe the risk/reward of buying long-term bonds continues to look poor, since intermediate-term yields are basically unchanged. Buying 10-year Treasuries at current yields in the hope that yields might fall sharply is essentially purchasing very expensive portfolio insurance. The post-World War II range of yields shows that yields are near all-time lows. This presents an asymmetric risk profile—yields can rise significantly more than they are likely to fall (see chart to the right). We have sought instead to add value through short-term credit risk, basically clipping the incremental yield premium on short-maturity corporate and high-yield bonds. Short-maturity (1-3 year) investment grade corporate bonds currently yield about 2% with durations of about 2 years. In contrast, the broader bond market indices are yielding about 2.5% but have durations of almost 6 years. Short-maturity (1-5 year) high-yield bonds are yielding over 9% and have durations of about 2.5 years. We believe, however, that investors must be selective about taking credit risk, focusing on higher quality companies with strong cash flow and liquidity profiles.

We continue to believe that investment success in this challenging interest rate environment will require a flexible, tactical approach to managing fixed income portfolios. Historically, equity and real estate holders who did not sell during bear markets eventually saw their portfolios fully recover; bond investors have not been so fortunate. Even when a bond portfolio ultimately recovered its nominal value following a bear market, its losses relative to inflation were permanent. Thus, fixed income investors may have an even greater need for tactical risk management strategies than equity investors.

*The Bank of America Merrill Lynch US High Yield Master II Index is a commonly used benchmark index for high yield corporate bonds. It is administered by Merrill Lynch. The Master II is a measure of the broad high yield market, unlike the Bank of America Merrill Lynch BB/B Index, which excludes lower-rated securities.*
EXTREMELY LOW RATES = POOR RISK/REWARD

RIVERFRONT INVESTMENT GROUP
OUTLOOK 2016

THE ART & SCIENCE OF DYNAMIC INVESTING.

10-Year US Treasury Yield
In Percentage Points

Source: RiverFront Investment Group, Federal Reserve. Data through 11/30/2015. Ending value 2.22%.

Past performance is no guarantee of future results.

RIVERFRONT’S TACTICAL APPROACH TO FIXED INCOME

Tactical fixed income management requires the flexibility to significantly alter the maturity structure of a portfolio. Maturities can be shortened when there is an overwhelming risk of rising rates and lengthened during periods of perceived interest rate and price stability. Additionally, RiverFront’s tactical mandate permits substantial variation in credit quality and currency composition, encompassing a wide spectrum of fixed income markets.

Our flexible approach contrasts sharply with common fixed income portfolio practice, which typically restricts managers to a narrow range of maturities, sectors, and/or credit quality.

RiverFront’s Price Matters® process for estimating potential returns and downside risks is the primary driver of our fixed income strategy. With interest rates near record lows, our Price Matters® calculations indicate a very high probability that longer maturity bonds will lose money relative to inflation over the next ten years, similar to the level of overvaluation equities reached at the end of the 1999-2000 technology bubble. Therefore, we are prepared for an extended period of poor returns from fixed income investments, and our current strategy is primarily focused on capital preservation.

TWO STRATEGIES TO COMPENSATE FOR LOW YIELDS AND LOW POTENTIAL RETURNS

The challenge presented by a short-maturity bond strategy is that short investment grade bonds have low yields and potential returns are low. We are currently using the following strategies to help us compensate.
Allow Bonds to Mature

First, unlike typical bond funds or exchange-traded funds (ETFs), we do not manage our fixed income portfolio to a constant maturity. Instead, we can allow our bonds to mature or purchase target date ETFs that also have set maturity dates. A 3-year bond that has aged into a 2-year bond is typically priced at a lower interest rate. This provides a modest price appreciation that adds incremental return to the yield as the bond “rolls down” the yield curve.

An added benefit of allowing bonds to mature is that bonds get less risky as they approach maturity. This offers some protection from rising interest rates but will be especially important in our high-yield positions, where we place a strong emphasis on minimizing defaults.

Short-Maturity High-Yield Bonds

Short-maturity high-yield bonds are the second and, in our view, more powerful augmentation to our strategy. As our chart shows, this strategy has not worked over the past two years, as yields on high-yield bonds have risen sharply. However, from a valuation standpoint the case has become more compelling, as risk premiums have approached levels normally seen heading into a recession, which we do not have as our baseline forecast. Defaults remain below their historical average but are likely to rise over the next couple of years due to higher expected defaults in the energy and metals sectors. With yields on short-maturity high-yield bonds now significantly higher than those on longer maturity bonds, we find them more attractive as we believe they have lower interest rate and credit risk. However, given heightened risk and suspect liquidity, we believe investors need to be very selective in this space and would be best served by choosing an experienced manager.

CONCLUSION

At current interest rates, our portfolios are avoiding longer maturities and focusing on both investment grade and high yield corporate bonds.
RiverFront’s Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

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.

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.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

Small, Mid, and Micro Cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

There are special risks associated with an investment in real estate and Real Estate Investment Trusts (REITs), including credit risk, interest rate fluctuations and the impact of varied economic conditions.

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.

In a rising interest rate environment, the value of fixed-income securities generally declines.

High yield securities are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

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

ETFs are subject to substantially the same risks as those associated with the direct ownership of the securities comprising the index on which the ETF is based. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index. ETFs typically incur fees that are separate from those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

Exchange Traded Funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus and summary prospectus, which contains this and other information, can be obtained by calling your financial advisor. Read it carefully before you invest. As a portfolio manager and a fiduciary for our clients, RiverFront will consider the investment objectives, risks, charges and expenses of a fund carefully before investing our clients’ assets.

RiverFront Investment Group, LLC, is an investment advisor registered with the Securities Exchange Commission under the Investment Advisors Act of 1940. The company manages a variety of portfolios utilizing stocks, bonds, and exchange-traded funds (ETFs). Any discussion of the individual securities that comprise the portfolios is provided for informational purposes only and should not be deemed as a recommendation to buy or sell any individual security mentioned.

RiverFront is owned primarily by its employees through RiverFront Investment Holding Group, LLC, the holding company for RiverFront. Baird Financial Corporation (BFC) is also a minority owner of RiverFront Investment Holding Group, LLC and therefore an indirect owner of RiverFront. BFC is the parent company of Robert W. Baird & Co. Incorporated (“Baird”), a registered broker/dealer and investment adviser.

Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.

RiverFront’s expectations and outlook discussed in this piece are based on information that is currently available to us, and in no way are a guarantee of how our strategies, the markets, or specific securities will perform in the future.

Published on December 24th, 2015 | © 2015 RiverFront Investment Group, LLC. All Rights Reserved. Past performance is no guarantee of future results.

INDEX DEFINITIONS

It is not possible to invest directly in an index.

The 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.

The MSCI EAFE Index measures the equity market performance of developed markets, excluding the US & Canada. The index consists of indices from 22 developed markets.

The MSCI Emerging Markets (EM) Index measures equity market performance of emerging markets. The index consists of 21 emerging market country indices.

The Bank of America (BoFA) Merrill Lynch 1-5 Year Cash Pay High Yield Index is a subset of the BoFA Merrill Lynch US Cash Pay High Yield Index including all securities with a remaining term to final maturity less than 5 years.

The BoFA Merrill Lynch 1-3 Year US Corporate Index is a subset of The BoFA Merrill Lynch US Corporate Index including all securities with a remaining term to final maturity less than 3 years.

INVESTMENT
Tia Abrams
tabrams@riverfrontig.com
Tim Anderson, CFA®
tanderson@riverfrontig.com
Rebecca Felton
rfelton@riverfrontig.com
Rob Glownia, CFA®
grlownia@riverfrontig.com
Adam Grossman, CFA®
agrossman@riverfrontig.com
Scott Hays
shays@riverfrontig.com
Michael Jones, CFA®
mjones@riverfrontig.com
Chris Konstantinos, CFA®
cekonstantinos@riverfrontig.com
Deva Meenakshisundaram, FRM
dmeenakshisundaram@riverfrontig.com
Kevin Nicholson, CFA®
knicolson@riverfrontig.com
Bill Ryder, CFA®, CMT™
bryder@riverfrontig.com
Doug Sandler, CFA®
dsandler@riverfrontig.com
Rod Smyth
rsmyth@riverfrontig.com
Sam Turner, CMT™
sturner@riverfrontig.com

SALES & MARKETING
Kate Atwood
katwood@riverfrontig.com
Ben Clarke
bclarke@riverfrontig.com
Bart Farinholt
bfarinholt@riverfrontig.com
Tyler Finney, CIPM®
tfinney@riverfrontig.com
Brian Gaertner, CIMA®
bgaeartner@riverfrontig.com
Brian Glavin
bglavin@riverfrontig.com
Beth Johnson
bjohnson@riverfrontig.com
Jim Martin, CIMA®
jmartin@riverfrontig.com
Stuart Porterfield
sporterfield@riverfrontig.com
Sean Quigley, CIMA®
squigley@riverfrontig.com
Pete Quinn
pquinn@riverfrontig.com
Brad Wear, CDFA®, CFS®
bradwear@riverfrontig.com
Kathy Wommack
kwommack@riverfrontig.com

TECHNOLOGY & INNOVATION
Marc Cheatham
mcheatham@riverfrontig.com
Shane McNamee
smcnamee@riverfrontig.com

COMPLIANCE, OPERATIONS & TRADING
Willene Bellamy
wbellamy@riverfrontig.com
Ellie Perkins
eperkins@riverfrontig.com
Karrie Southall, CIPM®
ksouthall@riverfrontig.com
Sam S. Turner
turner.sam@riverfrontig.com
Will Wall
wwall@riverfrontig.com

ADMINISTRATION
Karen Basalay
kbasalay@riverfrontig.com
Heather Houser
hhouser@riverfrontig.com
Diane Mann, CPA
dmann@riverfrontig.com
Lora Scott
lscott@riverfrontig.com
Wendy Smailes, PHR
wsmailes@riverfrontig.com