



Michael Jones, CFA
CHAIRMAN AND CHIEF
INVESTMENT OFFICER

Not Too Hot, Not Too Cold (with the exception of Japan)

Last week witnessed a flurry of policy announcements and economic data releases. We believe that on balance, the news from last week supports continued upward momentum in US, European and emerging market equity prices, accompanied by relatively stable interest rates. In contrast, we believe that the Bank of Japan (BOJ) has made yet another policy mistake, and absent a stronger-than-expected fiscal stimulus package, Japanese equities could give back much of their recent gains.

We have positioned our balanced portfolios for this environment by increasing our equity allocation to levels that are 1-5% over their respective benchmarks, depending on the time horizon and risk tolerance of the portfolio. We have added to US small caps and emerging markets and reduced our weighting in Japan. High yield continues to offer attractive cash flow in a world of negative interest rates, but we believe that current price levels suggest we take some risk off the table. We have, therefore, lowered our high yield weighting by 3-5%, depending upon the portfolio. This brings the cash in our balanced portfolios to between 5 and 11%, depending on the portfolio, and we are

looking for opportunities to redeploy this cash amidst the current market volatility.

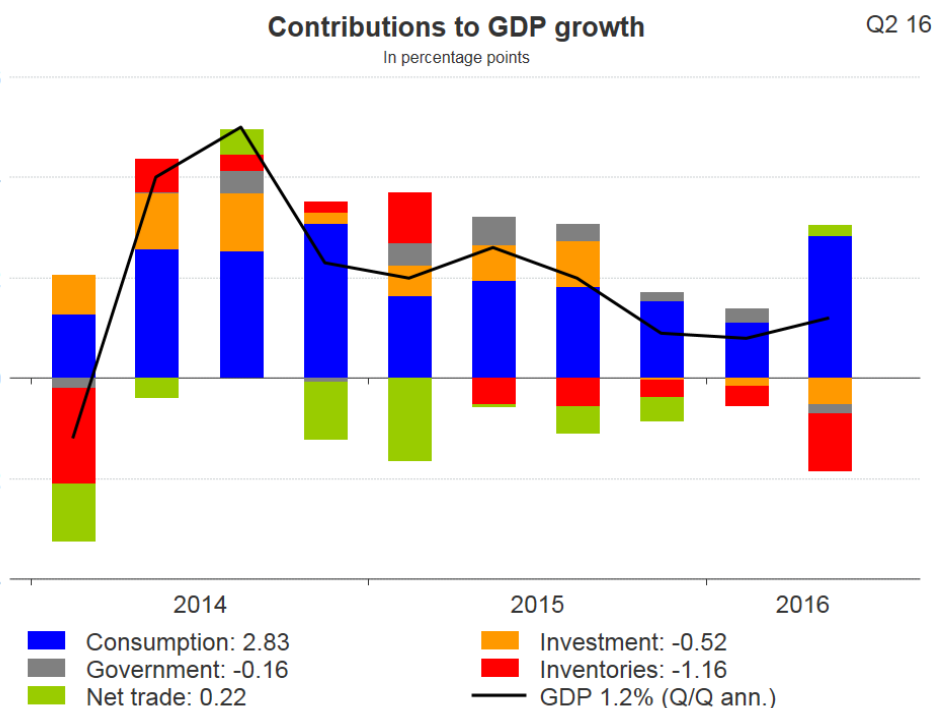
The US Economy: Stronger Than The Numbers Indicate, In Our View

The Federal Reserve's Open Market Committee met on Tuesday and Wednesday of last week, and adopted a much more optimistic tone with respect to the US economy in its July statement. The Fed noted, "Near-term risks to the

economic outlook have diminished," job gains were "strong", and consumer spending "has been growing strongly."

These comments reflected a marked increase in confidence regarding the economic outlook when compared to the more cautious tone adopted in the June statement. Strong June payroll data and the quick recovery in financial markets after the post-Brexit turmoil apparently reassured Fed officials about the economic outlook.

The confident, almost hawkish tone to the Fed's July statement initially raised concerns that the Fed could be setting the stage for an interest rate increase as early as its September meeting, and that rising interest rates could derail the current equity market rally. These concerns were somewhat allayed by a



second quarter GDP report that was close to ideal from an equity market perspective, in our view

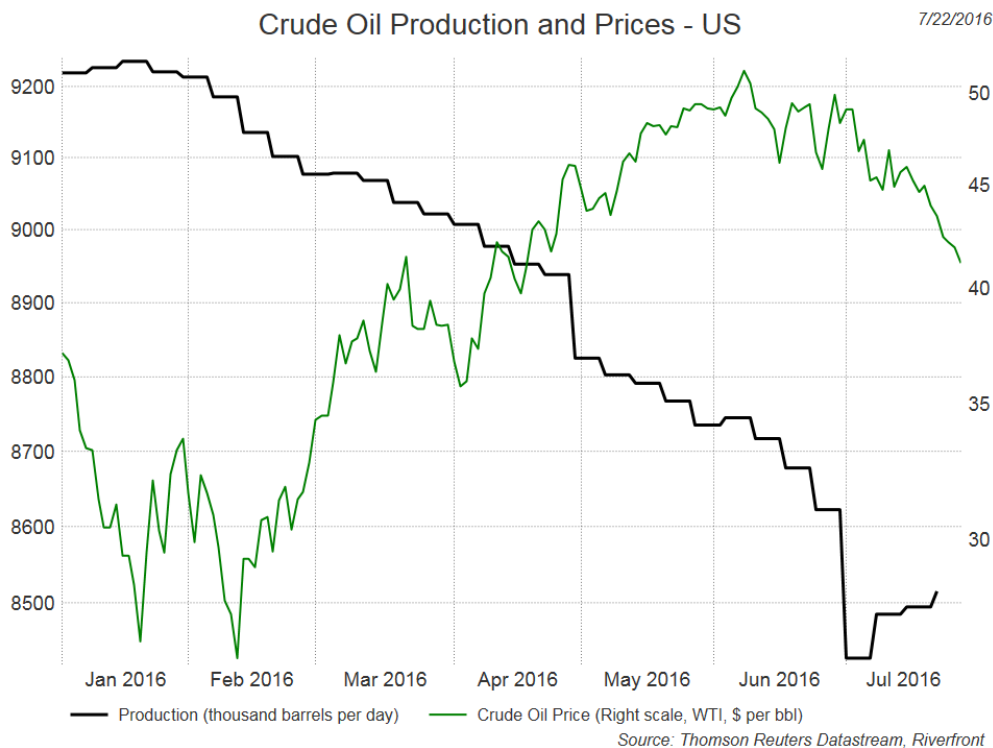
In contrast to the Fed's optimistic tone, US economic growth in the second quarter registered a very disappointing 1.2%. However, consumer spending accounts for 70% of the economy and was surprisingly strong in Q2, more than doubling its

recent rate of growth. Much of the economic weakness came from reduced inventory investment, a volatile category that tends to offset big declines with increases in subsequent quarters.

We believe the weak headline GDP figures could be a something of a “Goldilocks” – not too hot, not too cold – outcome for the equity markets. Unless July and August economic data are overwhelmingly strong, the Fed has a good excuse to delay any rate increases past September. At the same time, the underlying strength in consumer spending and expectations of an inventory rebuild may keep earnings expectations high. Stable rates and strong earnings expectations could continue to push equity markets higher.

Range-Bound Oil Markets

Oil prices fell sharply last week and may provide a “Goldilocks” environment for equity markets. When oil prices are too low, as they were in late 2015 and early 2016, sovereign wealth fund selling and fears of defaults by oil producers can destabilize financial markets. By contrast, oil prices rising too high could undermine the accelerating consumer spending that is driving economic growth in both the US and Europe.



As shown in the adjacent chart, oil prices recovered from the depressed levels seen early in 2016 largely due to declining US oil production. This drop in US production was the inevitable result of the nature of fracked oil wells - output from fracked wells tends to fall sharply after about 2 years. To maintain production levels, oil producers must bring new wells on line to offset declining output from existing wells. They will only do so if oil prices are high enough to make these new wells profitable. Oil companies are sitting on an inventory of about 4,000 drilled but uncompleted oil wells (“DUC” wells), and these DUC wells can be quickly brought into production if prices are sufficiently attractive.

For much of June and early July, oil prices traded near \$50 per barrel. Rising US rig counts indicate that a \$50 price level incentivized producers to start production on some of their DUC oil wells. Sufficient DUC wells apparently came on line to offset declining production in existing wells. The associated increase in US production combined with continued high inventory levels to put an end to the oil price rally, as shown on the chart.

With prices back around \$40, we expect very few DUC wells to come on line in the coming months. US production will resume its precipitous decline as more and more existing wells pass their 2-year peak production period. We believe that the large inventory of DUC wells makes the US the “swing” producer in oil markets. We predict that US production will increase as prices rise toward \$50 and will decline as prices fall back into the low \$40’s. If this prediction is correct, oil prices could remain in a Goldilocks range of around \$35 to \$55 per barrel, a price range high enough to avoid destabilizing financial markets yet low enough to keep global consumer spending on track.

Europe – Solid Consumer Recovery and Improving Political Environment (For the Time Being)

Economic releases in Europe indicate that consumer spending continues to fuel a modest but sustainable 2% rate of growth. Brexit’s negative impact on growth appears to have fallen primarily on the UK economy. Furthermore, we were pleasantly surprised by Prime Minister Theresa May’s quick consolidation of power and the apparent success of her initial

negotiating overtures to the European Union (EU). These developments increase the odds of the UK achieving a smooth reentry into the EU trading bloc, in our view.

A final piece of good news for European equities came late on Friday from the European Central Bank's bank stress test results. Only one Italian bank, Banca Monte dei Paschi di Siena, was required to raise additional capital and the company announced a privately funded recapitalization plan. Although the ECB's stress test has again been criticized for being too lenient, the positive results allow Italy to avoid a politically perilous government bank bailout and may reduce, for the time being, fears of additional political instability in Europe.

Japan: Another Missed Opportunity

Last week, the Bank of Japan (BOJ) continued its 2016 pattern of indecisive, ineffective policy responses. By refusing to provide material additional monetary accommodation, the BOJ has potentially undermined both the efficacy and even the size of the Prime Minister Abe's soon-to-be-announced fiscal stimulus package. As expected, the BOJ shied away from aggressive policy responses that might help address Japan's large debt burden, such as "helicopter money" (funding government expenditures with printed money) or swapping existing BOJ holdings for long maturity zero coupon bonds. However, investors were shocked that the BOJ did not help finance the proposed stimulus package by increasing the size of its quantitative easing bond purchase program.

The BOJ's lackluster monetary stimulus response places a substantial burden on the Abe government's proposed fiscal stimulus package. The size and composition of the stimulus package must be sufficient to offset the economic drag of a stronger yen (a result of the BOJ's repeated policy mistakes). However, absent more forceful BOJ support, investors may discount the long-term economic impact of yet another debt-driven fiscal stimulus package. Thus, Japanese financial markets face two risks in the coming weeks – disappointment over the size of the fiscal package and potential skepticism that any amount of fiscal stimulus can work in such a debt-burdened economy.

Outlook and Portfolio Positioning

We see an economic environment offering a "not too hot, not too cold" combination of strong consumer spending, range-bound oil prices and a Fed likely to defer interest rate increases until overall economic growth definitively improves. We believe that an extended period of low and stable interest rates will continue to support higher equity prices in the US, Europe, and emerging markets, and that equity markets would be equally welcoming of modest rate increases if accompanied by undeniably stronger economic growth. In our view, earnings expectations for Q3 are likely to build on better-than-expected Q2 results across all these regions and continued strength in US and European consumer spending. Japan may be the lone exception to this outlook, as proposed fiscal stimulus must be sufficient to offset a string of policy mistakes by the BOJ.

In light of this outlook, we have positioned our balanced portfolios to be overweight risk assets, with 1-5% overweight positions in equities (depending upon the investor's time horizon and risk tolerance) augmented by a significant allocation to high yield bonds. We see US large cap equities as offering the lowest potential risk in the global equity markets, but also the lowest potential returns based upon our Price Matters[®] valuation framework. We have, therefore, boosted our US allocation primarily through small cap equities, an asset class that we believe in this environment will compensate for additional short-term volatility with higher long-term potential returns.

We maintain a substantial allocation to developed international equities, with a large overweight in the eurozone offsetting underweight positions in the United Kingdom and Japan. After the disappointing BOJ decision, we have sold additional Japanese positions and used the proceeds to go overweight emerging markets. Emerging markets offer attractive valuations based upon Price Matters[®] and could benefit from continued stable interest rates in the US.

On the bond side, we have reduced our high yield weighting by 3-5% depending upon the time horizon and risk targets of the portfolio. High yield bond prices soared along with oil prices as fears of substantial oil company defaults receded. With yields approaching multi-year lows and oil prices retreating, we believe most of the appreciation in high yield bonds is behind us. High yield continues to offer attractive cash flow in a world of negative interest rates, but current price levels suggest we take some risk off the table. *(See page 4 for important disclosure information.)*

Important Disclosure Information:

Past performance is no guarantee of future results.

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