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THE FIXED INCOMEVIEW

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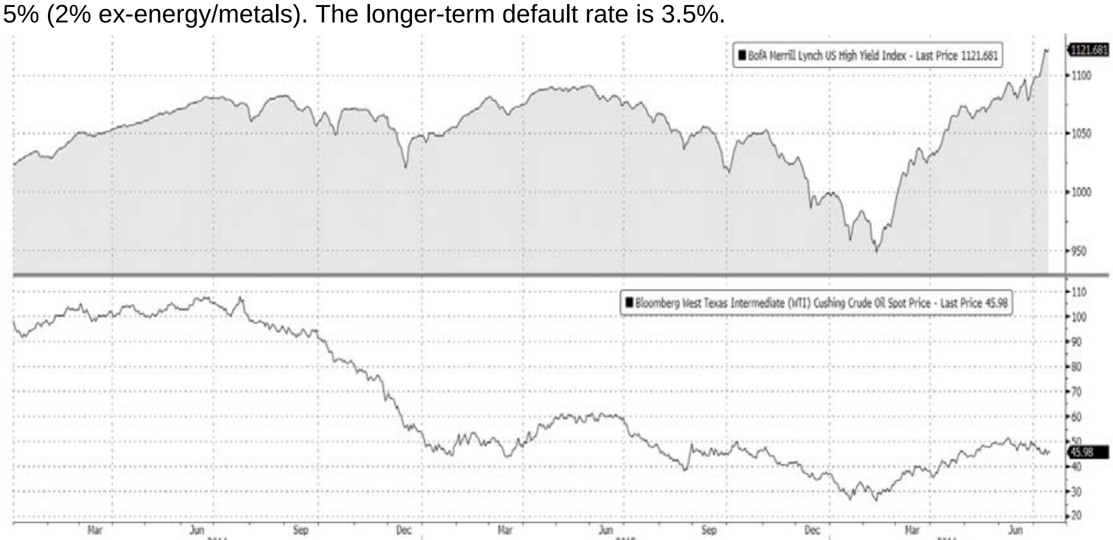
Fixed Income YTD – Everyone’s A Winner

It has been an unusual year in financial markets, as both riskier assets and less risky fixed income assets have turned in strong performances. In fact, almost every major sector of the US fixed income market has substantially outperformed the S&P 500 (see “Bond Market Returns and Yields” table on the last page), with the exception of high quality, short-term bonds. In the short term during periods of heightened market volatility, financial markets are usually driven by a risk-on (investors buy riskier assets and sell safer assets) or risk-off sentiment (investors sell riskier assets and buy safer assets). Earlier in the year, classic risk-off behavior prevailed, and Treasury yields fell 50-60 basis points (bps) while high grade and high yield corporate bond risk premiums widened about 50 bps and 200 bps, respectively.

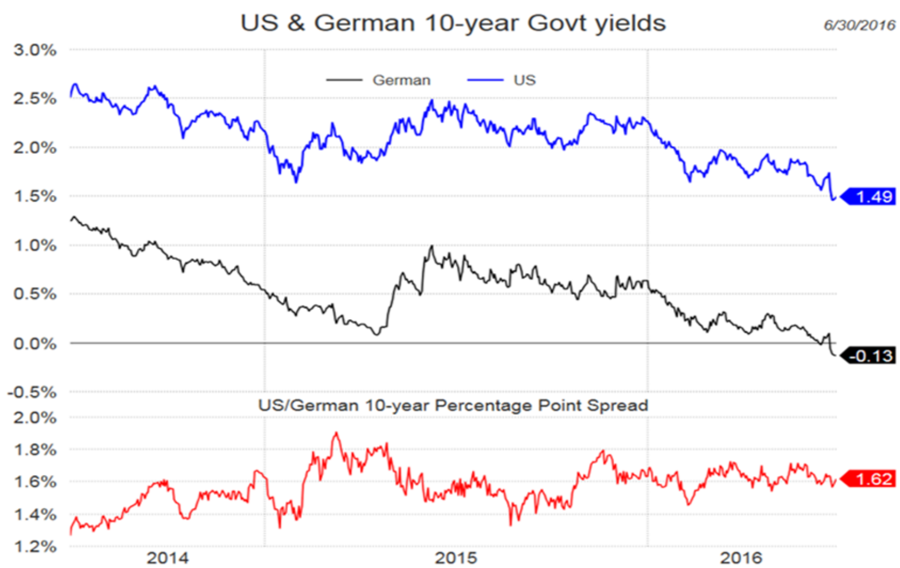
On 2/11/16, oil prices hit a bottom and risk assets overall bottomed. The subsequent rally in riskier assets since then likely had a lot to do with the rebound in oil prices. The high yield market had become more correlated to the oil market, as prices dropped from over $100/barrel in 2014 to $26/barrel on 2/11/16. Over the past decade as oil prices and drilling were booming, smaller energy companies financed much of their expansion with high yield debt, and the energy sector grew from around 9% to 15% of many high yield indices. As oil prices fell, default expectations increased for the energy sector, contributing to the fall in high yield prices. The same thing also happened in the metals/mining space (about 5% of many high yield indices), as many metals prices also collapsed. Year-to-date, 83% of default volume has been in the energy (65%) and metals/mining sectors (18%), but the rebound in oil prices to around $50 at the end of the 2nd quarter has lowered default expectations for the energy sector and overall high yield. Many energy companies have been able to benefit from the recent rebound in oil prices and market sentiment to refinance existing debt and push out maturities, issue equity, and sell assets. J.P. Morgan forecasts 2016 defaults to be 6% (2% ex-energy/metals) and 2017 defaults to drop to 5% (2% ex-energy/metals). The longer-term default rate is 3.5%.



Source: RiverFront Investment Group, Bloomberg. Data through July 15, 2016. The BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Bloomberg West Texas Intermediate (WTI) Cushing Crude Oil Spot Price uses benchmark WTI crude at Cushing, OK; and other US crude oil grades trade on a price spread differential to WTI, Cushing. Prices are on a free-board basis. It is not possible to invest directly in an index. Please see the end of this article for important disclosure information.

The chart on page 1 shows the correlation between oil prices and the high yield index value since the end of 2013. The high yield market hit a high just slightly before oil’s one year high of $61.43 on 6/10/15, and they both hit their lows on 2/11/16. The high yield market rallied 15% from its low through 6/30/16 (9.3% ytd), while the high yield energy sector was up 51% (22.5% ytd).

Despite the sharp recovery in risk assets since 2/11/16, longer-term US Treasury yields have continued to fall, hitting new lows. So far in 2016, we have had had an unusual period in which both risky and safe fixed income assets have outperformed the S&P 500. While the reaction of US Treasuries is less intuitive during this period, we believe it was driven by a combination of global macro and political concerns. In the US, decelerating employment gains during the second quarter, culminating in May's anemic 11,000 gain, raised concerns about domestic growth and reduced expectations for future rate hikes from the Fed – i.e. lower for longer. On the global front, the UK's 6/23/16 referendum decision to leave the Eurozone (Brexit) dominated headlines and added another layer of concern about weak global growth and low inflation. The ultimate impact of Brexit is uncertain, but it has raised expectations for further monetary policy action from global central banks. These concerns and policy responses from the European Central Bank (ECB) resulted in Germany joining the negative 10-year interest rate club for the first time, joining countries such as Japan and Switzerland. The large yield differential between U.S. rates and much of the higher quality developed markets may continue to drive down U.S. rates (or at least temper rate increases) as foreign buyers continue to find them relatively attractive.



Source: RiverFront Investment Group, Thomson Reuters Datastream.

Yields Still *Relatively* Attractive. Earlier in the year, short-term high yield bond yields spiked above 11.5% and intermediate corporate bond yields hit 4%, prompting us to increase our exposures to these sectors. However, yields in these sectors have since fallen to around 7% and 3% respectively, as both Treasury yields fell and risk premiums contracted. Intermediate corporate bond yields at around 2.9% are still slightly above their all-time lows of 2.76% in 2013, as spreads at around 150 are just slightly below their long-term average. Short-term high yield bonds (which have a shorter history) are now yielding just over 7%, which is well above its all-time low of 4.25% in 2014 but near its longer-term, non-recessionary average. In addition, US corporate and high yield bonds yield significantly more than their European counterparts, making them an attractive alternative for foreign investors, in our view.

Source: Bank of America Merrill Lynch. Please see the end of this article for index definitions and disclosure information. It is not possible to invest directly in an index.

SECOND QUARTER REVIEW & OUTLOOK

We have attempted to construct portfolios that out-yield the Barclay's US Aggregate Index without taking more duration risk. We have done this by focusing on investment grade and high corporate bonds, which we believe provide an attractive yield advantage over Treasuries. We have concentrated our biggest credit bets on the front end of the yield curve (short-term high yield bonds), and have taken progressively less credit risk as we move out further on the yield curve (intermediate corporate bonds, long-term Treasuries). This is because the longer duration bonds are much more sensitive to changes in both yields and risk premiums.

Bond Market Returns & Yields

	12/31/15-2/11/16	2/11/16-3/31/16	1Q16	2Q16	YTD	6/10/2015	12/31/2015	2/11/2016	3/31/2016	6/30/2016	
Oil $/bbl (Spot)						$61.43	$37.04	$26.21	$38.34	$48.33	
	Total Return (%)					**Yield**					
S&P 500	(10.27)	12.95	1.35	2.46	3.84						
2-year Treasury	0.91	(0.08)	0.82	0.50	1.33	0.73%	1.05%	0.65%	0.72%	0.58%	
5-year Treasury	3.31	(0.36)	2.93	1.38	4.36	1.79%	1.76%	1.13%	1.21%	1.00%	
10-year Treasury	5.95	(1.10)	4.78	3.02	7.95	2.49%	2.27%	1.66%	1.77%	1.47%	
30-year Treasury	10.98	(1.84)	8.94	7.33	16.93	3.22%	3.02%	2.50%	2.61%	2.29%	
	Total Return (%)					**Risk Premium (bps)**					**6/30/16 Yield**
Broad Bond Mkt	2.45	0.64	3.11	2.30	5.47						1.82%
5-10 Yr Corporates	1.06	3.05	4.15	3.37	7.65	163	185	237	177	168	3.00%
1-3 Yr Corporates	0.27	0.94	1.22	1.04	2.27	83	108	147	108	97	1.57%
High Yield[1]	(5.14)	8.84	3.25	5.88	9.32	460	695	887	705	621	7.36%
BB	(3.65)	7.64	3.71	4.03	7.89	304	424	582	428	400	5.20%
B	(5.56)	8.48	2.45	5.39	7.98	471	715	900	686	633	7.47%
CCC	(9.49)	14.71	3.83	14.22	18.58	948	1653	2066	1777	1414	15.08%
HY Energy	(18.98)	26.59	2.56	19.45	22.51	649	1415	1984	1282	831	9.47%
S/T High Yield	(5.14)	7.68	2.15	6.18	8.46	524	835	1071	844	708	7.88%
Emerging Markets[2]	(0.63)	5.83	5.17	5.14	10.57	352	388	463	388	379	5.15%

Source: RiverFront Investment Group, Bank of America Merrill Lynch. The above chart is for illustrative purposes only and in no way related to RiverFront's portfolio performance. Past performance is no guarantee of future results. See next page for index definitions.

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

2. 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.

Index Definitions:
It is not possible to invest directly in an index.

- *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.*
- *Broad Bond Market is measured using the BofA Merrill Lynch US Corporate, Government & Mortgage Index, which tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market, including US Treasuries, quasi-governments, corporates, covered bonds and residential mortgage pass-throughs.*
- *5-10 Year Corporates measured using the BofA Merrill Lynch 5-10 Year US Corporate Index (defined above)*
- *1-3 Year Corporates measured using the BofA Merrill Lynch 1-3 Year US Corporate Index, which 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.*
- *High Yield measured using the BofA Merrill Lynch US High Yield Index (defined above)*
- *BB measured using the BofA Merrill Lynch BB US High Yield Index, which a subset of the BofA Merrill Lynch US High Yield Index including all securities rated BB1 through BB3, inclusive.*
- *B measured using the BofA Merrill Lynch Single-B US High Yield Index, which a subset of the BofA Merrill Lynch US High Yield Index including all securities rated B1 through B3, inclusive.*

- *CCC measured using the BofA Merrill Lynch CCC & Lower US High Yield Index, which a subset of the BofA Merrill Lynch US High Yield Index including all securities rated CCC1 or lower.*
- *High Yield Energy measured using the BofA Merrill Lynch US High Yield Energy Index is a subset of the BofA Merrill Lynch US High Yield Index including all securities of Energy issuers.*
- *Short-Term High Yield measured using the BofA Merrill Lynch 1-5 Year US Cash Pay High Yield Index (defined above).*
- *Emerging Markets measured using the BofA Merrill Lynch BBB & Lower Sovereign USD External Debt Index, which tracks the performance of US dollar-denominated emerging market and cross-over sovereign debt publicly issued in the eurobond or US domestic market.*

Important Disclosure Information:

Past performance is no guarantee of future results.

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.

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.

Yield to worst is calculated on all possible call dates. It is assumed that prepayment occurs if the bond has call or put provisions and the issuer can offer a lower coupon rate based on current market rates. If market rates are higher than the current yield of a bond, the yield to worst calculation will assume no prepayments are made, and yield to worst will equal the yield to maturity. The assumption is made that prevailing rates are static when making the calculation. The yield to worst will be the lowest of yield to maturity or yield to call (if the bond has prepayment provisions); yield to worst may be the same as yield to maturity but never higher.

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.

A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security. (bps = 1/100th of 1%)

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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.

Barclays US Aggregate Bond Index is a market-cap weighted index commonly used to track the performance of investment grade bonds in the US.

The BofA Merrill Lynch 1-5 Year US Cash Pay High Yield Index (JVAO) 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 Domestic Master Index (D0A0) follows US dollar-denominated investment grade public corporate and government debt.

The BofA Merrill Lynch 5-10 Year US Corporate Index (C6A0) is a subset of The BofA Merrill Lynch US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 10 years.

It is not possible to invest directly in an index.