The Wall of Worry: Why we Remain Bulls

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RECOVERY IN EUROPE OFFSETS SLOWDOWN IN CHINA

Yes, we worry about China – less about its markets, and more about the evidence that growth is probably less than half the official 7 percent (see Chris Konstantinos' Weekly View from July 13, 2015: "Bear in a China Shop"). Slow growth in China is, however, more than offset for us by good news coming out of Europe and steady growth in the US. China, like Japan before it, is an export-driven economy, meaning that the slowdown from 10 percent growth to the current rate has already been absorbed by a world economy that continues to expand. Sectors that export to China (commodities, consumer brands, machinery) have already been hit hard, and we remain cautious. Michael Jones and Chris Konstantinos are visiting China in August, and we are open to learning something that will change our view. As long as the global expansion continues as a result of central banks' pro-growth policies, we think stocks will continue to deliver better returns than bonds or cash.

In the summer of 2011, the S&P 500 lost 16.5 percent of its value, falling from 1345 on July 22nd to 1124 on August 19th. Since then, the index has risen to 2100 without a pullback of more than 10 percent and with just 5 declines that exceeded 5 percent. This is shown in the bottom clip of our Weekly Chart. Reflecting that, volatility (as measured by the Chicago Board Options Exchange), which rose well above its long-term average in the summers of 2010 and 2011 and spiked recently as a result of the Greek crisis, has again died down to low levels. The Federal Reserve's pro-growth policies have been good for financial assets, especially stocks and real estate.

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Despite our positive outlook, a very real fear of a significant correction in both US and international stocks persists among a portion of our client base. While a study of history quickly reminds us that investors in stocks should always be prepared to weather a 5% –15% pullback, we do not expect that to occur. Earlier this month, Greece was the "scary headline du jour"; now, it's China. For much of 2014, the fear was centered on Ukraine, and the early part of 2013 was dominated by the US fiscal cliff. ***Bull markets climb a wall of worry***; however, our Weekly Chart shows that by the standards of 2009-2011, recent corrections have been minor. In our view, this shows the global power of central banks.

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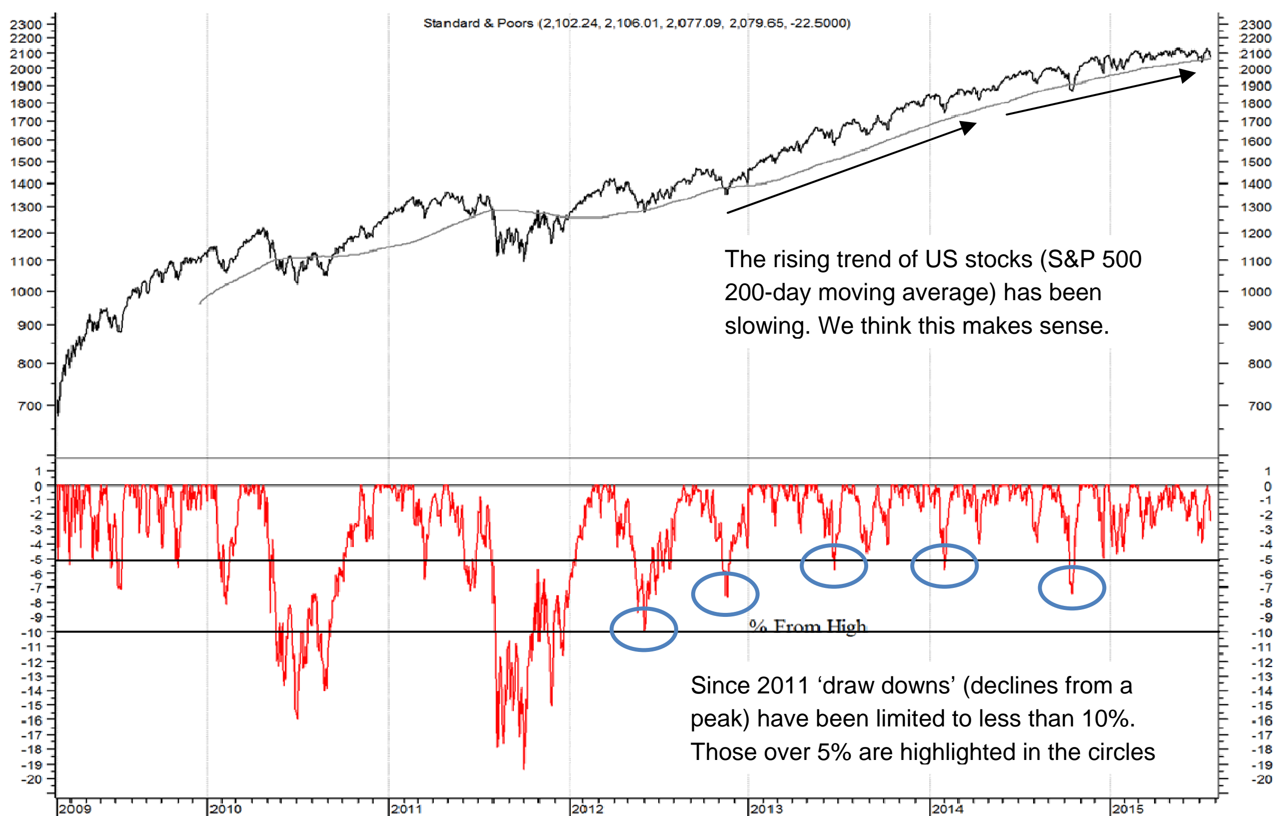
We believe sustained bear markets are primarily caused by the expectation of a decline in earnings (usually the result of a recession); or, they are caused by the bursting of inflated valuations and often follow a prolonged rise in long- and short-term interest rates. While we have gradually reduced risk strategically in our shorter timeframe portfolios, we have not made a significant tactical reduction in risk assets in four years. There are three main reasons for this decision: a low probability of recession, positive price trends, and valuations for the asset classes we own, which have risen but, in our view, are not excessive. Furthermore, we have recognized the power of 'accommodative' (pro-growth, pro-financial market) central bank policies. Both strategically and tactically, we have moved money overseas due to better valuations and more aggressive central banks. The bottom line is that we believe slow global growth means the next global or US recession is not currently in sight.

A "melt-up" – a move to a higher level of valuation of what we expect to be modest earnings growth – seems more likely to us than a meltdown. Judging by flows into funds, retail investors have not reduced their holdings in fixed income despite very low yields. Should they do so, because bond yields rise and/or they see better return potential from stocks, there is a case over the next 18 to 24 months for some exuberance. Our Weekly Chart shows that, as we expected, the pace of the

advance, while still positive, has already slowed significantly – a response to slowing earnings and the end of Quantitative Easing, in our view. Last week the S&P 500 closed near its primary up-trend, presenting investors with cash as an attractive entry point, in our opinion. We expect the S&P 500 to break out to new highs by year-end as investors increasingly move money into stocks and out of low-yielding bonds and cash.

Japan And Europe: Gradually Going Local. Our clear preference among global stock markets remains Japan and Europe. We recently took another important step in gradually moving our focus away from multinational companies and yen-hedging in our portfolios. We believe the yen has already experienced the majority of its weakness and that the upside and downside are now more balanced. Following this change, the majority of our Japan position is now un-hedged, and we have greater exposure to the domestic economy through increased index exposure. In Europe, we continue to believe that the euro has further downside, and its recent strength is mostly the result of risk reduction over Greece. During the first quarter, many traders and investors sold the euro and bought European stocks and bonds. These investors then reversed these positions as they reduced risk, causing them to buy the euro and sell stocks and bonds. During the Greek crisis we sought to take advantage of the weakness in European stocks and strength in the euro by buying Germany across all our portfolios and low volatility European stocks for our shorter time horizon portfolios; both on a currency-hedged basis.

THE WEEKLY CHART: THE S&P 500 FALLS TO A RISING TREND



Source: RiverFront Investment Group, Standard and Poors. Past performance is no guarantee of future results.

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. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future. In a rising interest rate environment, the value of fixed-income securities generally declines. Using a currency hedge or a currency hedged product does not insulate the portfolio against losses. 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). Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.

Stocks represent partial ownership of a corporation. If the corporation does well, investors share in the appreciation. However, if it 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.

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