RIVERFRONT INVESTMENT GROUP

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THE WEEKLYVIEW

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Risk Managing the Volatile Global Market

We believe that an essential part of our value-add for investors is a risk management process grounded in an unemotional investment decision-making process. The volatility in the markets thus far this year has put that process to the test and has underscored the importance of such a discipline. Based on signals from our Risk On/ Risk Off (RORO) model, which is heavily influenced by the 200-day moving average, we began reducing risk in November and more actively starting in January, as the trends are now clearly falling (see red lines in the charts below). Specifically, we have both raised cash and repositioned the portfolios. We have reduced exposure to broad-based international equities, thereby reducing our exposure to non-US financials. We have redeployed some of the cash raised into MLPs[1], US financials, Japanese real estate and European small caps, depending on the portfolio's time horizon.

The volatility began in early December when Mario Draghi, President of the European Central Bank (ECB), over-promised and under-delivered relative to market expectations. Volatility was further exacerbated on January 29th,when the Bank of Japan (BOJ) did an about-face in a 72-hour period by implementing negative interest rates after declaring they would not use a negative interest rate strategy. This abrupt policy reversal left investors wondering whether deteriorating economic data might have prompted such a move and how Japanese banks would cope with such an unexpected change in policy.

As we enter the final month of the quarter, we expect global markets will be range-bound as they deal with central bank policy purgatory. We believe that each of the major central banks has been struggling to communicate their message to the investing public. The most recent risk reduction trades in late February were the result of our risk models flashing warning signals which suggested below-average returns over the next three months. While we remain overweight risk assets in most of our portfolios relative to their composite benchmarks, our three rules for tactical strategy (don't fight the central banks, don't fight the trend, beware the crowd at extremes) are providing conflicting signals. With the ECB set to meet on March 10th and the BOJ and Federal Reserve (Fed) following on March 15th and 16th, respectively, we believe that markets are approaching an important inflection point and correct risk positioning is critical at this time.

As discussed in more detail below, we believe that the ECB and the BOJ are likely to provide additional monetary stimulus at their March meetings, and the Fed is likely to strike a dovish tone about future rate increases. Thus, our "don't fight the central banks" rule suggests putting more cash to work. By contrast, our RORO model, which implements our analysis of the trend and crowd sentiment ("don't fight the trend" and "beware the crowd at extremes"), is placing the odds of a positive return over the next 3 months well below the S&P 500's long-term average. For more information on the RORO process, please refer to our Risk Matters dated October 1, 2015. Although the odds of a declining market are currently about 60% according to our model, it still leaves about a 40% chance that markets are higher in 3 months. Since we remain optimistic about economic growth in the US and expect policy stimulus from the ECB and BOJ, we are carefully monitoring technical resistance levels in several key equity markets.

In the US, the Fed has seen improving data in areas such as employment, retail sales, and manufacturing Purchasing

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[1] Master Limited Partnerships (MLP) investing includes risks such as equity- and commodity-like volatility. Also, distribution payouts sometimes include the return of principal and, in these instances, references to these payouts as "dividends" or "yields" may be inaccurate and may overstate the profitability/success of the MLP. Additionally, there are potentially complex and adverse tax consequences associated with investing in MLPs. This is largely dependent on how the MLPs are structured and the vehicle used to invest in the MLPs. It is strongly recommended that an investor consider and understand these characteristics of MLPs and consult with a financial and tax professional prior to investment.

Managers' Indexes, which has helped the S&P break through the important resistance level of 1985. The improvement in this data has once again left the Fed as the single central bank with rate hikes on the table in 2016. The potential market effects of this include a stronger dollar due to investors chasing higher yields, pressure on oil prices if dollar strength is not offset by production cuts, and caps on the upside for the S&P 500 as multinationals have a tougher time selling products internationally.

Source: RiverFront Investment Group, Thomson Reuters Datastream. Past performance is no guarantee of future results.

As we move our attention away from the US into Europe, the ECB continues to face deflation or at the very least anemic inflation. As the March 10th meeting approaches, market participants will be paying close attention to Mario Draghi. We do not believe that Draghi wants to disappoint markets again. Investors expect the ECB to increase its quantitative easing (QE) program by buying more European sovereign bonds. Currently, the ECB is purchasing €60 billion per month, and it is our expectation that the program will have to grow meaningfully. Additionally, we expect the ECB to lower its deposit rate from the current negative 30 basis points. If the ECB does not deliver on investor's expectations, then we think the euro will rally and exporters in Europe will bear the brunt of the pain. Given this backdrop, we are closely monitoring the German stock market (using the DAX) to see whether it can decisively break out of the 8500 to 9900 range. Similar to signals on the S&P, our RORO model indicates that the DAX too is indicating the odds for a positive return over the next 3 months are below its long-term average.

Source: RiverFront Investment Group, Thomson Reuters Datastream. Past performance is no guarantee of future results.

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The last central bank we are focusing on is the BOJ. The BOJ surprised markets on January 29th by implementing negative interest rates without giving its banks a chance to prepare for the policy change. This move to negative rates has put pressure on Japanese banks, as their prospects for growing net interest margin are diminished in this environment. Furthermore, this move has caused the investing public to lose confidence in the BOJ because it has initiated a rally in the yen, rather than the intended depreciation. Inflation remains low in Japan, and it is our belief that the BOJ will have to increase QE by going into the equity markets and buying individual securities and exchange-traded funds (ETFs). An additional headwind for the Japanese economy is that the value-added tax on consumption is still on the table for later in the year, which could once again slow the economy. The RORO picture in Japan is no different than for the other markets we have discussed; the odds for a positive return over the next 3 months are below its long-term average. We are monitoring the Nikkei 225 after breaking out of its recent range of 15550 to 16600 last week.

Source: RiverFront Investment Group, Thomson Reuters Datastream. Past performance is no guarantee of future results.

Just as global markets remain volatile, our RORO strategy remains fluid. While our discipline rarely overrides the model's signals, we acknowledge that we must survey all available data. RiverFront's model is based on a three-month timeframe, so the verdict is still out on our most recent risk management decisions. Regardless of whether markets behave in the manner in which our models suggested, we can find assurance that our decisions are based on a process rather than on emotions during these volatile times.

Important Disclosure Information

Past performance is no guarantee of future results.

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.

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.

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.

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

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

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

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.

Index Definitions

The Standard & Poor's (S&P) 500 Index is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the New York Stock Exchange or NASDAQ.

The DAX Index is a stock index that represents 30 of the largest and most liquid German companies that trade on the Frankfurt Exchange. A free-float methodology is used to calculate the index weightings along with a measure of average trading volume.

The Nikkei 225 Index is a price-weighted equity index, which consists of 225 stocks in the 1st section of the Tokyo Stock Exchange.

It is not possible to invest directly in an index.

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