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Navigating the Central Bank Gauntlet – Taper Tantrum Lite

The European Central Bank (ECB) disappointed the markets last week (9/8) by doing basically nothing, leaving both interest rates and its asset purchasing program unchanged. The market reaction was reminiscent of a global version of 2013's Taper Tantrum, when the Fed announced it would begin to taper its asset purchases, causing U.S. rates to jump sharply and leading to a brief sell-off in risk assets. Interest rates on 10-year Government bonds in the US, Germany, and UK all jumped an average of 15 basis points (bps) since the meeting, and the S&P 500 is off over 2.5%. Rates in these countries are now up about 20-30 bps from their post-Brexit lows, as are Japan's.

These movements serve to highlight the extent that global bond, equity, and currency markets have become reliant on the actions of the major global central banks since 2008's great recession and credit crisis. Over the next two weeks, we will have regularly scheduled meetings of the Bank of England (BOE), Bank of Japan (BOJ), and the US Federal Reserve (Fed). The markets are likely to experience heightened volatility during this stretch and their actions could have a profound effect on both global bond and equity markets. However, we believe that the impacts are likely to be less pronounced than they were during the first Taper Tantrum.

Central banks have been forced to experiment with unconventional measures such as negative interest rates and large scale asset purchases, due to anemic economic recoveries and lower-than-desired inflation since the recovery took hold. These actions have led to distortions in the global bond markets, such as negative long-term interest rates (for more on this phenomenon see the 8/8/16 Weekly View, "Get Paid to Borrow – Monetary Madness?"). In addition, large scale asset purchases by the central banks have also contributed to anomalies in the Government, Corporate, and Mortgage-backed bond markets. These actions were designed to lower borrowing costs for governments, corporations, and homeowners, in the hopes of spurring economic growth, capital spending, and a gradual rise in inflation. While these actions may have helped countries to avoid another recession/deflation, most of the developed world remains mired in mix of slow growth and low/no inflation. We do not see any change in this environment in the near-term, especially for Japan and the Eurozone. We believe that the BOJ and ECB will likely have little choice but to remain accommodative, which will likely prevent US rates from approaching the levels they did during the first Taper Tantrum.

Upcoming Central Bank Meetings

Here is a list of the recent/upcoming central bank meetings that we believe are likely to have the largest impacts on markets over the next two weeks. The table on the next page summarizes the current interest rate and asset purchase programs for the major central banks.

European Central Bank – (9/8/16). Result: No change to interest rates or the asset purchase program.

Market reaction: Negative, global rates increased sharply and equity markets sold off, as detailed above. The market had been anticipating, at a minimum, an extension of its current asset purchase program beyond March 2017.

Bank of England – (9/15/16). The BOE was the first major Central Bank to begin tightening its monetary policy when it stopped its quantitative easing program in February 2010. However, in July it was forced to reverse course after the Brexit vote. The Bank is hoping to offset any negative economic impacts from the exit from the European Union.

Bank of Japan – (9/21/16). The BOJ has a long history of disappointing the markets. The BOJ is in the midst of a comprehensive review of its existing stimulus programs, but we are not optimistic that this meeting will bring material improvements. The initial optimism around the BOJ's aggressive easing moves in 2012 have largely been forgotten, as the BOJ has largely underwhelmed and disappointed the markets since. (See 5/10/16 Strategic View, "Japan's 2016 Monetary Policy- Mistakes and Missed Opportunities", for more details).

Federal Reserve – (9/21/16). The Fed has been actively jawboning the past couple of weeks to let investors know that a rate hike at the next meeting is still a possibility. The Fed enters its pre-meeting quiet period on September 13th. Investors haven't fully bought into September, as the Federal Funds Futures market is currently placing the odds for a September rate hike at 30%, a November hike at 34.5%, and a December hike at 60%. Our base case assumption is that the Fed is likely on hold until the December meeting because

of the current market volatility and the Presidential election in November.

SUMMARY TABLE:

Central Bank	Current Policy Rates	Last Change in Policy Rate	Remaining 2016 Meetings	Current Asset Purchasing Program	Latest QE Change
Federal Reserve	Federal Funds Rate: 0.25% to 0.50%	Raised 0.25% on 12/16/15	9/21, 11/2, 12/14	Reinvesting principal payments from its agency debt and mortgage-backed securities in agency MBS and rolling over Treasury securities at auction.	Unchanged
European Central Bank	Main Refinancing Rate: 0.0%	Cut from 0.05% on 3/10/16	10/20, 12/8	Asset purchases of 80 billion euros/month (\$90 billion) until March 2017	Unchanged
	Deposit Rate: -0.40%	Cut from -0.30% on 3/10/16			
Bank of Japan	Policy Rate Balance Interest Rate: -0.10%	Cut from 0.0% on 1/29/16	9/21, 11/1, 12/20	Buying 80 trillion yen/year of Japanese Government Bonds (JGB). Purchasing about 90 billion yen/year of Japanese real estate investment trusts (J-REITs). Purchasing about 6 trillion yen/year of exchange-traded funds (ETFs). Maintain commercial paper and corporate bonds amount outstanding at about 2.2 trillion yen and 3.2 trillion yen, respectively.	Increased purchases of ETFs to 6 trillion yen (from 3.3 trillion yen) at 7/29/16 meeting
Bank of England	Official Bank Rate: 0.25%	Cut from 0.50% on 8/4/16	9/15, 11/3, 12/15	Purchasing an additional 60 billion pounds of UK government bonds (to 435 billion pounds). Purchasing up to 10 billion pounds of UK corporate bonds.	Expanded the purchase of UK government bonds by 60 billion pounds. Initiated purchase of 10 billion pounds of UK corporate bonds

Source: RiverFront Investment Group, Bloomberg. Please see below for important disclosure information.

Fixed Income Portfolio Positioning

Duration/Yield Curve: We have recently sold the remaining long-term Treasuries from our balanced portfolios, lowering their durations. The duration of the fixed income portion of our balanced portfolios is significantly less than their benchmark (by 1-3 years), and they have negligible exposure to the longer end of the yield curve (10+ years).

Credit Overweight: The portfolios continue to be heavily overweight investment grade and high yield corporate bonds, with no Treasury bonds in our balanced portfolios. Risk premiums on corporate bonds (unchanged) and high yield bonds (widened 3 bps) both held in reasonably well after the ECB disappointment. The more recent contraction in investment grade corporate bond spreads (17 bps) since Treasury yields bottomed on 7/8/16 has helped to offset the 30 bps rise in Treasury yields, while high yield spreads have tightened an additional 78 bps.

Yields/spreads on both corporate and high yield bonds have fallen significantly since their February highs, and we no longer view their valuations as “cheap”. The yield on corporate bonds has fallen to 2.9% from 3.7% since 2/11/16 and is now only about 30 bps above its pre-Taper Tantrum low of 2.6% (5/2/13). Corporate bond spreads are currently 140 bps, just slightly below the long-term average of 158 bps, and well above its recent low of 106 bps in 2014. We believe that spreads are likely to tighten further, as long as the economy remains relatively healthy, which we believe it will, helping to offset a potential further increase in Treasury yields. At current valuation levels, however, corporate bonds are unlikely to continue to generate positive returns if Treasury yields rise significantly, as they did during the first Taper Tantrum. We believe that US rates are unlikely to approach the level they did during 2013, as the much lower yields and anemic growth/inflation in Europe and Japan are likely to limit potential increases there. Any increase in the US yield advantage versus Europe/Japan will only make US bonds more attractive to foreign investors.

The yield on high yield bonds has fallen to 6.4% from around 10% on 2/11/16, well above its pre-oil collapse low of 4.8% in June 2014, but near its 5-year average. High yield spreads are currently 510 bps, also near its 5-year average and well off its pre-oil collapse low of 355 bps in June 2014. We believe that spreads have room to tighten further as long as oil prices and the economy remain relatively healthy, as we expect. High yield bonds sold off during the last Taper Tantrum in 2013 and prices are likely to be more volatile during this period of interest rate uncertainty.

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.

Mortgage-backed securities are subject to prepayment and extension risk ; as such, they react differently to changes in interest rates than other bonds. Small movements in interest rates may quickly and significantly reduce the value of certain mortgage backed securities.

(See next page)

Important Disclosure Information (continued):

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 portfolios' composite benchmarks.

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%)

Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices.

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