Summer Correction In Context

Rod Smyth
CHIEF INVESTMENT STRATEGIST

The bears are worried about China and an impending global slowdown/recession, while the market in general seems obsessed with the Fed's September plans. In our view, the question of whether the Fed raises interest rates by a quarter of a point in September will seem a minor footnote in history.

If we are right about global growth, the stock market is correcting because that's what markets do. We remain strategically in the bullish camp; indeed, our models have been developed to endure similarly harsh environments over a prescribed timeframe.

Over the last few weeks, the short-term technical outlook for stocks has continued to deteriorate. Additionally, US stocks have fallen less than international stocks during the correction. This has occurred against a backdrop of steady growth in the US economy and improving indicators from both Europe and Japan.

The bears seem to be in control, and momentum investors are jumping on the bandwagon of new short-term down trends. Fundamental bears have been worried about valuation for some time. Our counter-argument has been that while price-to-earnings multiples in the high teens are certainly not cheap, their earnings yields (earnings as a percentage of share price) of around 6% compare very favorably to a zero return on cash and 2 to 3% yields from high quality bonds. We also see the potential for double-digit earnings growth in the eurozone and Japan during the recovery phase of their economies. As we wrote in last week's *Weekly View,* the bears are worried about China and an impending global slowdown/recession, while the market in general seems obsessed with the Fed's September plans. In our view, the question of whether the Fed raises interest rates by a quarter of a point in September will seem a minor footnote in history.

If we are right about global growth, the stock market is correcting because that's what markets do (see Weekly Chart on the next page). If we are wrong, then there is potentially more downside to come. US stocks have not seen a drawdown of this magnitude since the summer/fall of 2011. We have thus had four benign years in the S&P 500 Index, with corrections mostly limited to 5% or less, extremely low volatility, and a few drawdowns between 5 and 10%. These years have been "equity investor heaven" by longer term historic standards, but now the bulls are being tested. We remain strategically in the bullish camp; indeed, our models have been developed to endure similarly harsh market environments over a prescribed timeframe.

In the short term, our view is the result of judgment regarding the economic and earnings cycle, and we have made our views very clear over the last few weeks. One particular concern that has been raised by advisors and clients is the price action of certain exchange-traded funds (ETFs) during the recent volatility, recalling the "flash crash" which occurred in 2010. Doug Sandler, RiverFront's Chief US Equity Officer, has extensive experience with ETFs, having used and analyzed them from their earliest days as a product. He wrote the following in the *Equity View* — "ETF Volatility: Thoughts for the Average Investor" — published last week:

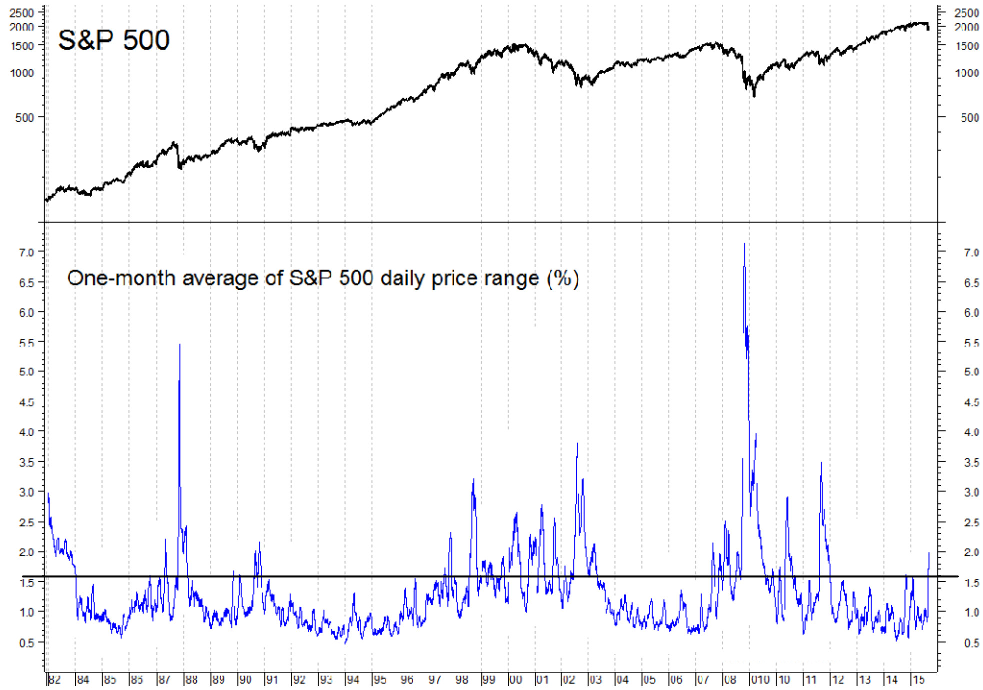
Concern: Volatile prices mean that ETFs are inefficient investment vehicles.

Our Take: This concern stems from the fact that market prices on ETFs can depart significantly from the indicative or intra-day net asset value (iNAV) of the index for short periods of time during episodes of significant market volatility. While we do not dispute that this occurred for many ETFs on May 6, 2010 (The Flash Crash) and August 24, 2015, we believe that skeptics have ignored a critical fact in their rush for a sensational headline: ETFs were just one of many financial products to experience unusual temporary price volatility during these periods. Even some of the most highly regarded blue-chip stocks (i.e., General Electric [GE], Proctor & Gamble [PG], and Home Depot [HD]) and most well-known indexes (i.e., the Dow Jones Industrial Average and NASDAQ) became victims of accentuated price volatility on August 24th. Unfortunately, equity ETFs cannot be expected to perform differently from their constituents; if stocks and indexes experience unusual short-term pricing behavior during periods of extreme volatility, then ETFs should logically be expected to do the same.

Bottom Line. New products, such as ETFs, will likely always have critics who take advantage of the lack of product familiarity in the marketplace. However, as professional consumers of ETFs for nearly 13 years, we don't see the structural bogeyman that the skeptics claim is lurking in the shadows. We believe that if ETFs were significantly riskier than the underlying baskets of stocks that they represent, then they would trade at hefty discounts, since investors would require higher returns to compensate for the additional risks or inefficiencies of the structure.

Our chart this week is a concept that Bill Ryder, Director of Quantitative Risk Management, developed to help us put price fluctuation in context. We took the high and the low of the S&P 500 Index every day and then looked at it on a percentage-change basis. We then took the monthly average of the daily fluctuation to allow us to look back over a long period. In August, the average daily fluctuation from high to low was 2% (shown by horizontal line in bottom clip) — while this fluctuation is higher than anything since 2011 and high enough to indicate that some investors are worried, it is not unprecedented in ongoing bull markets. We will feel more comfortable if this falls back below 1.5%, but we should also be prepared to endure higher volatility until the outlook for the economy and earnings for 2016 is clearer.

THE WEEKLY CHART: PRICE FLUCTUATION HIGH BUT NOT UNUSUAL



Source: RiverFront Investment Group. Past performance is no guarantee of future results.

Exchange Traded Funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus and summary prospectus, which contains this and other information, can be obtained by calling your financial advisor. Read it carefully before you invest. As a portfolio manager and a fiduciary for our clients, RiverFront will consider the investment objectives, risks, charges and expenses of a fund carefully before investing our clients' assets.

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.

An ETF's net asset value (NAV) is the total value of the securities in the portfolio minus any liabilities, divided by the fund's number of common shares outstanding. The fund's price is the market value at which the fund trades on an exchange. Changes in investor demand for a particular fund may cause the fund to trade at a price that is greater (lower) than the NAV; in that case the fund is trading at a premium (discount) to its NAV. Since a fund's premium or discount to its NAV may narrow or widen, a fund's price return may differ from its NAV return.

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. Individual investors cannot directly purchase an index.

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). Any discussion of the individual securities is provided for informational purposes only and should not be deemed as a recommendation to buy or sell any individual security mentioned. Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.

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. It is not possible to invest directly in an index.

RIVERFRONT INVESTMENT GROUP 1214 East Cary Street, Richmond, Virginia 23219 TEL 804) 549-4800 RIVERFRONTIG.COM