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Global Synchronicity: Positive Earnings Mirroring Positive Economic Trends

“Synchronicity is an ever present reality for those who have eyes to see.” – Carl Jung

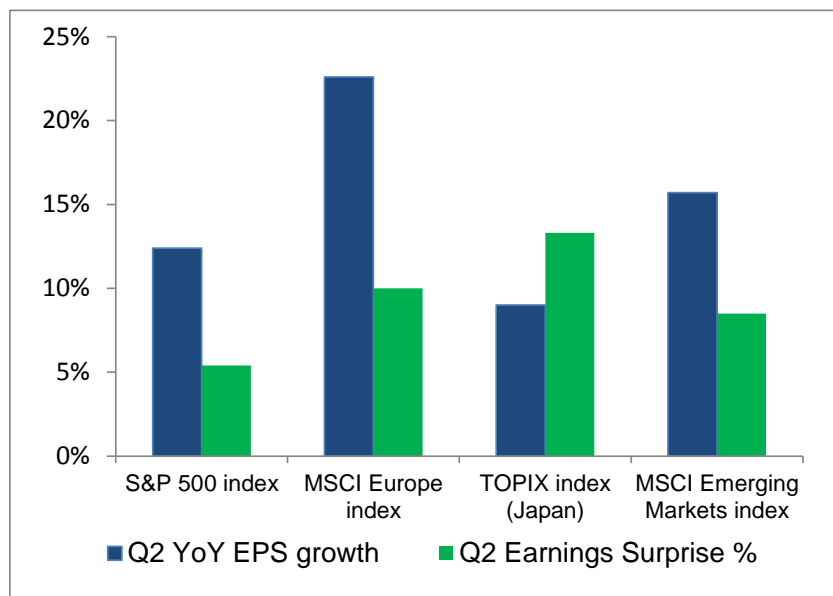
The tragedy of Hurricane Harvey has understandably dominated the US news cycle this past week. Our thoughts and prayers here at Riverfront go out to all those affected by the devastation. However, we’d caution investors about extrapolating tragedy with an inevitable economic downturn; the negative economic impact of a natural disaster is often offset by increased spending generated by the reconstruction effort. Goldman Sachs’ economists believe the direct impact from Harvey could drag Q3 US GDP by roughly 0.2 pct in Q3 (mostly due to disruption in the energy patch), but that could be largely offset by business investment.

Almost unnoticed alongside such saddening headlines, global economic growth continues to plug along. The *Wall Street Journal* (WSJ) noted two weeks ago that all 45 countries tracked by the OECD (The Organisation for Economic Co-operation and Development) were on track to grow this year, with 33 of them set to accelerate from the prior year. This synchronicity across the world has been relatively rare in the past half-century, and suggests to us a global economy that is hitting on all cylinders.

GLOBAL EARNINGS IMPROVING ALONGSIDE ECONOMIC GROWTH

Global synchronized growth is encouraging, given our view that market sentiment is driven in part by the market’s collective probability of future recessions. However, for equity investors, economic growth is primarily useful insofar as it can help drive the corporate earnings cycle, or the ‘E’ in the P/E (price-to-earnings) equation. Investors have a tendency to directly equate economic growth with earnings growth; while the two are linked, the linkages are often less direct than you might expect.

The good news today is that the strong economic growth occurring across the world is currently mirrored in solid corporate earnings-per-share (EPS) trends as well. As proof, we would point to the just-finished 2nd fiscal quarter— year-over-year earnings growth in all major regions we track was positive (see blue bars of chart to the left), as was ‘earnings surprise’ – the difference between the EPS result and the average of analysts’ expectation prior to the announcement (green bars).



Source: Thomson Reuters Datastream, Riverfront; all data in USD, as of 8/31/17

While investors have become accustomed to a growing trend of U.S. corporate earnings throughout the 8-plus year bull market, consistent growth in developed international and emerging markets has been much more fleeting. However, that appears to be changing, in our view. In all major regions of the world (Japan, Europe, US, and emerging markets), year-over-year earnings growth in calendar year 2017 is shaping up to be meaningfully positive. This is a milestone in our opinion. Our

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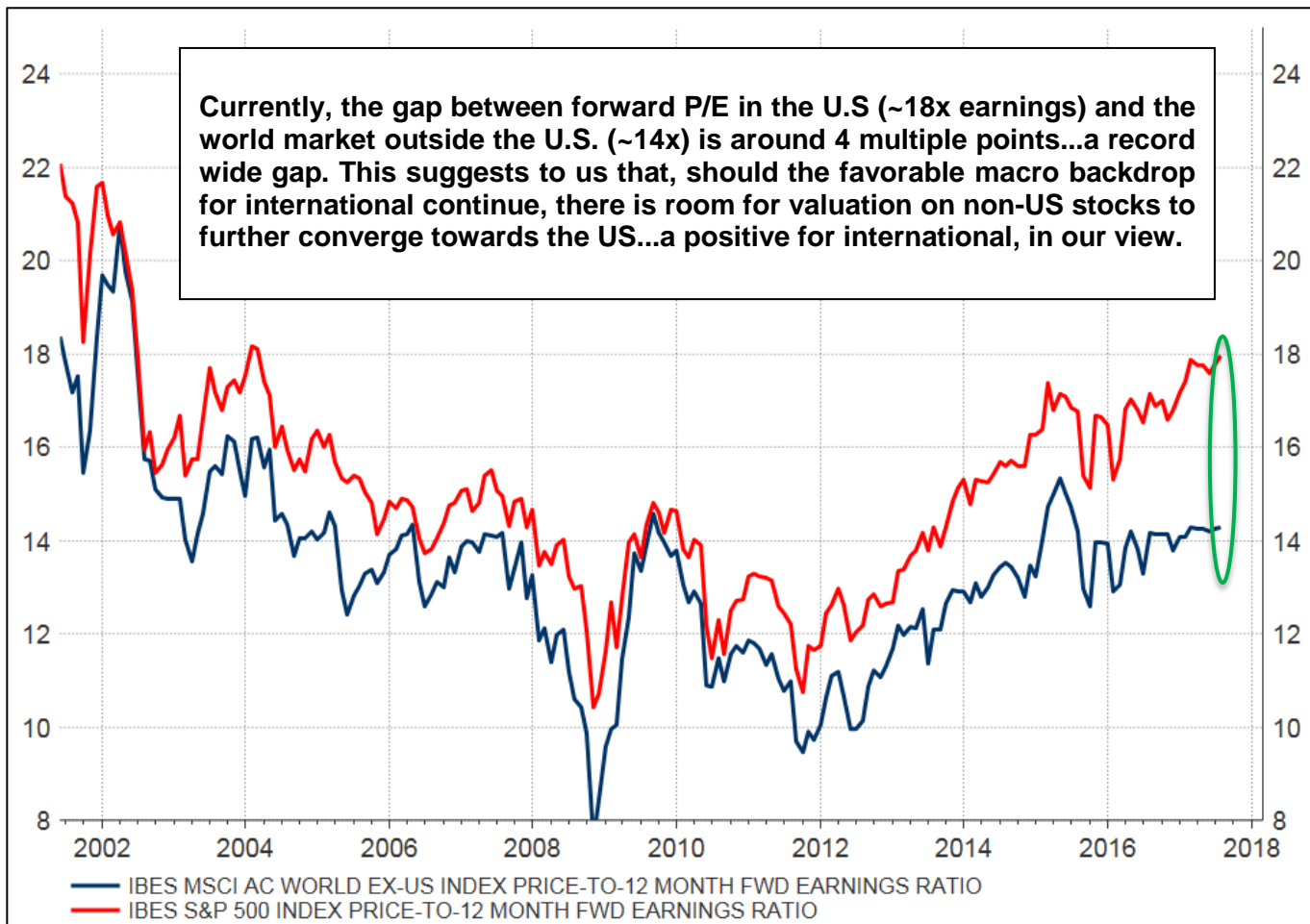
belief in the sustainability of this positive earnings trend in international markets is strengthened in part because the 'top line' (revenue growth) in most areas is growing as well, suggesting that the positive bottom line trends we are seeing are being driven by actual improving business trends and not just 'financial engineering' (moves like share reduction, cost cutting, and/or aggressive accounting treatment). This is consistent with an economy in secular rebound mode, with business and consumer confidence continuing to improve – something we've written about earlier this year in areas like the Eurozone and Japan (see *Weekly View*, dated 7/24/17 for more on this).

WE BELIEVE THE RALLY IN INTERNATIONAL STOCKS RELATIVE TO THE US IS SUSTAINABLE

We get a lot of questions about the sustainability of the year-long relative rally in international markets relative to the US – i.e., has the international rally come too far, too fast? We think not. While the recent USD weakness has perhaps slowed the ascent of FX-driven earnings boosts for international, the strengthening of Eurozone and emerging market currencies represents a lowering of the political and economic risks associated with them...an overall positive for their equity markets. We also believe that European and Asian central banks will remain generally accommodative; a stance that seems confirmed last Thursday by the continued low inflation rates across the Eurozone and Japan.

In addition, relative valuation for international appears attractive, in our view. Riverfront's *Price Matters*[®] long-term asset allocation discipline suggests that positive mean reversion potential over the next 5-10 years is much stronger outside of the US than within it. More conventional valuation metrics also appear attractive on a relative basis, in our view; looking a 12-month forward P/E ratio at the MSCI All-Country World Ex-US index, we are currently at the largest valuation gap between US and non-US markets in the 15+ years of data to which we have access.

CHART OF THE DAY: VALUATION IN INTERNATIONAL STILL VERY REASONABLE COMPARED TO THE US



Source: Thomson Reuters Datastream, Riverfront; all data in USD, data from 06/01/2001-08/31/17

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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.

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

RiverFront's Mean Reversion Optimization process incorporates Price Matters[®] asset class assumptions to quantitatively simulate potential outcomes of combining asset classes based on probability and historical data. It is based on the concept of mean reversion, which is the tendency of a variable to converge on an average value over time.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Index Definitions:

You cannot invest directly in an index. Past Performance is no guarantee of future results.

Standard & Poor's 500 Index (S&P 500) measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market.

MSCI Emerging Markets Index measures equity market performance of emerging markets. The index consists of 23 countries representing 10% of world market capitalization.

MSCI Europe Index measures the equity market performance of the developed markets in Europe. The MSCI Europe Index currently consists of 16 developed market country indices.

The **Tokyo Price Index (TOPIX)** is a metric for stock prices on the Tokyo Stock Exchange (TSE). A capitalization-weighted index, TOPIX lists all firms that have been determined to be part of the "first section" of the TSE, a section that organizes all large firms on the exchange into one group. The second section pools all of the smaller remaining companies.

MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 developed markets (DM) countries (excluding the US) and 23 emerging markets (EM) countries.

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