Doug Sandler, CFA

Global Strategist

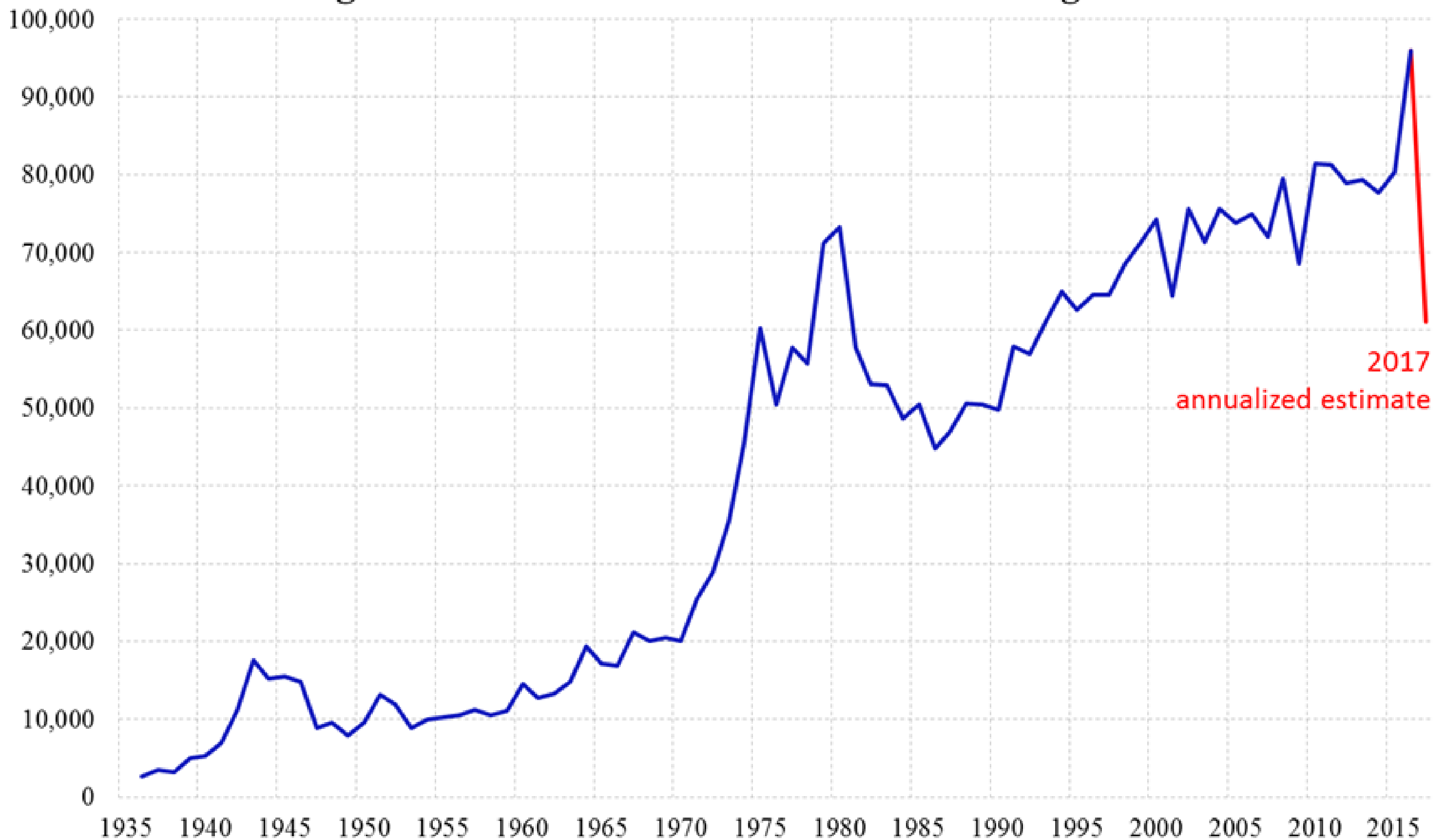
Liking International Stocks Does Not Mean Disliking US Stocks

The investment decisions of a global asset allocator, like RiverFront, are rarely zero-sum. On most occasions, our portfolios reside in the "and" world, not the "or" world. In practice, this means we own stocks **and** bonds, even though we may favor stocks. It also means we maintain exposure to US equities despite the more attractive valuations and momentum of international equities. The strategic rationale for managing our portfolios from an "and" perspective is three-fold — varying client objectives, diversification, and the recognition that we are not always right and can often be early to an investment theme. We express our preferences through our overweights and underweights relative to each portfolio's benchmark. Currently, we are overweight international equities and underweight US equities, which equates to a 33–37% US equity allocation in each of our equity-oriented globally balanced portfolios.

Why own US stocks at all? In addition to the strategic reasons listed above, we own US stocks because they remain attractive in our view according to the "3 Cs" — **C**ondition, **C**atalysts, and **C**onfirmation.

1. **Condition:** If long-term investment success is about buying low and selling high, a critical first step for the global asset allocator is to identify those areas where conditions are "low" and those where they are "high." Our proprietary *Price Matters®* methodology ranks US stocks as only 10% above their long-term trend. We believe this could lead to returns slightly below the long-term real return average of 6.4% but well above the less than 1% real returns we anticipate for cash or bonds.

2. **Catalysts:** We are currently seeing positive readings from the three catalysts that have historically been beneficial to US equities.
    1. **Monetary:** Although the Fed is expected to raise rates for the fourth time this December and began balance sheet tapering in October, we believe the Fed is also likely to be cautious in pushing short rates much above the current rate of inflation (1.5–2%). We believe such a low-rate environment would continue to be stimulative for stocks. The US stock market has also historically performed well in the early stages of a Fed rate cycle because higher rates typically coincide with periods of rising earnings.
    2. **Macro:** World economies have found their footing as reflected by the Organisation for Economic Co-operation and Development's (OECD) recent proclamation that all 45 economies it monitors are in economic expansion for the first time in a decade. Global synchronized recoveries tend to be positive for all countries due to the additional demand for products and services, and additional profits for investments. Since most S&P 500 companies derive a substantial portion of their revenue and profits from overseas, many US companies are a direct beneficiary of global economic strength.
    3. **Micro:** US companies appear to be in good shape from both an income statement and balance sheet perspective. Going forward, earnings appear to be on pace for a second leg of growth after three years of relative stagnation. For example, according to the *Wall Street Journal,* 2017 earnings are expected to grow 5–6% over 2016. Additionally, the President's pro-business agenda, which includes lower corporate taxes, increased fiscal spending, and less regulation could also boost earnings if enacted. While there are many obstacles to turning the President's agenda into action, the current administration has already made a significant impact on reducing regulation. The chart below shows the unprecedented reduction in Federal Register pages published this year. The Federal Register is the official journal of the federal government containing government agency rules, proposed rules, and public notices.



Source: Federal Register, RiverFront Investment Group

3. **Confirmation**: US stocks are still performing well relative to cash, bonds, and commodities. The short and shallow pullbacks experienced over the past 18 months are a reflection of underlying buying demand, in our view.

Bottom line: We believe a global disinflationary boom is increasingly probable given solid growth, modest inflation, and accommodative monetary policy. This kind of environment, should it persist, could keep our US *Price Matters*® line above trend. This last occurred in the disinflationary boom from the mid-1980s to the late-1990s. For this reason, our portfolios still have a meaningful allocation to US equities despite our recent reductions to the asset class and our underweight position. Within US equities, we favor a selective approach and have reduced our allocation to simple market-cap weighted indexes. In our Global Balanced Portfolios, we also slightly favor small and mid-caps relative to large caps, and we are currently overweight the technology, financial, and utility sectors.

Important Disclosure Information

RiverFront Investment Group, LLC, is an investment adviser registered with the Securities Exchange Commission under the Investment Advisers Act of 1940. The company manages a variety of portfolios utilizing stocks, bonds, and exchange-traded funds (ETFs). RiverFront also serves as sub-advisor to a series of mutual funds and ETFs. Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.

RiverFront is owned primarily by its employees through RiverFront Investment Holding Group, LLC, the holding company for RiverFront. Baird Financial Corporation (BFC) is a minority owner of RiverFront Investment Holding Group, LLC and therefore an indirect owner of RiverFront. BFC is the parent company of Robert W. Baird & Co. Incorporated ("Baird"), a registered broker/dealer and investment adviser.

These materials include general information and have not been tailored for any specific recipient or recipients. Accordingly, these materials are not intended to cause RiverFront Investment Group, LLC or an affiliate to become a fiduciary within the meaning of Section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974, as amended or Section 4975(e)(3)(B) of the Internal Revenue Code of 1986, as amended. Disclosures continued on the following page.

Past results are no guarantee of future results and no representation is made that a client will or is likely to achieve positive returns, avoid losses, or experience returns similar to those shown or experienced in the past.

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

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.

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.

Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

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

Index Definitions

It is not possible to invest directly in an index.

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Copyright ©2017 RiverFront Investment Group. All rights reserved.

2017.194