‘Real’ News…And What We Think It Means

ROD SMYTH

CHIEF INVESTMENT STRATEGIST

We believe the economic recovery in the Eurozone is now self-sustaining and could last for years.

..We think this will lead to a multi-year rise in earnings and share prices.

A NEW CHAIRMAIN IS APPOINTED TO THE FEDERAL RESERVE:

This was important news as the chairperson of the Fed has been one of the most powerful and influential figures in the global economy. This was not surprising news as the President picked Jerome (Jay) Powell, a republican and a pro-growth ‘dove’ who has supported Janet Yellen’s cautious approach to tightening monetary policy. He was a strong favorite for the job and is a former investment banker not a PhD economist, and so is likely to be attuned to the Fed’s effect on markets. Interestingly he said in August that the lack of inflation is “kind of a mystery” He went on to say “"You would have expected given that we're getting tighter labor markets that we'd have a little higher inflation, I think that what that gives us is the ability to be patient regarding future rate hikes.”

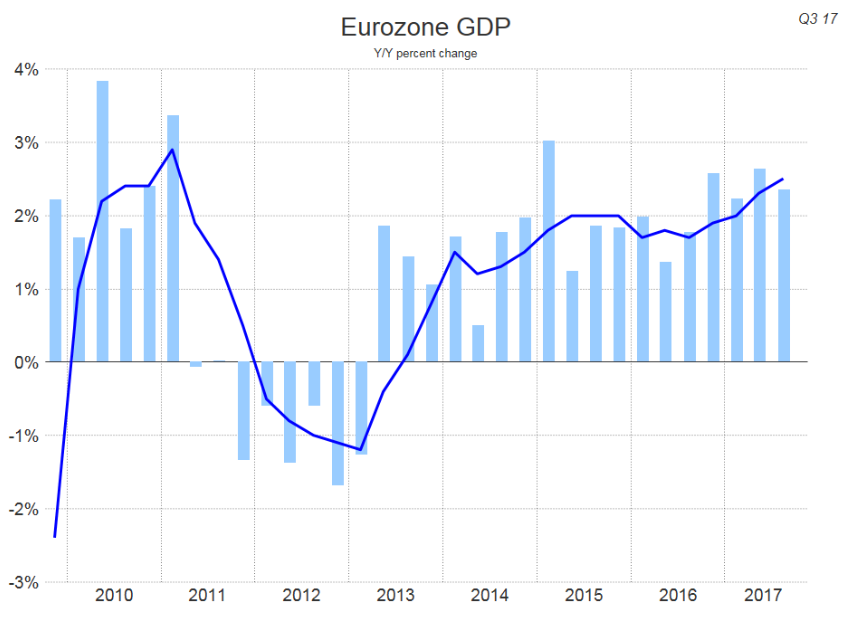
So what? Both stock and bond markets have thrived under Yellen and Powell appeared to be their preferred candidate. Powell now faces the difficult task of further unwinding the Fed’s balance sheet and guiding interest rates higher without causing the current business cycle to end. A Fed chair mystified by the lack of inflation, when combined with low interest rates and investor complacency, suggests markets could be surprised should core inflation start to climb above the Feds 2% target. We don’t think that will occur, and believe our portfolios are positioned appropriately for accelerating growth that doesn’t push inflation above the central bank’s comfort. We outlined our views in our June 19th Mid-Year Strategic Outlook.

ECB CHAIRMAN DRAGHI OUTLINES EUROPE’S PLAN FOR ITS BALANCE SHEET:

Draghi gave investors all the reassurance they were looking for last week. He said that, while the ECB (European Central Bank) is planning to reduce the size of its bond buying program, it still believes the Eurozone will need very supportive monetary policy for the next few years i.e. unlike the Fed they are still expanding their balance sheet.

So what? As our chart below shows, the Eurozone economy based on gross domestic product (GDP) has now grown for 18 consecutive quarters at around a 2% rate following their “double dip” recession that lasted about 2 years. We believe the recovery is now self-sustaining and could last for years (like the US has). We think this will lead to a multi-year rise in earnings and share prices.

Eurozone Economic Recovery Looks Self-Sustaining in Our View



Source: Thomson Reuters Datastream, RiverFront

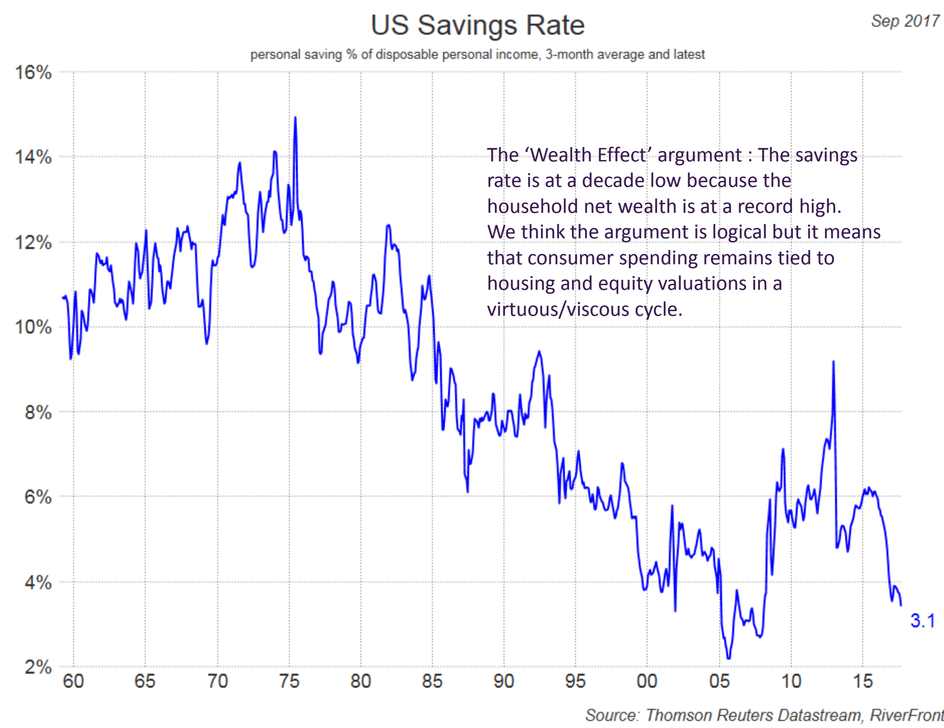
HOUSE REPUBLICANS UNVEIL THEIR TAX PLAN; SENATE RULES MEAN CHANGES ARE ALMOST CERTAIN:

Recently agreed 2018 House budget resolution rules do not allow a tax bill to add more than 1.5 tril over the next 10 years. The House bill passes that test according to the nonpartisan Joint Committee on Taxation. The problem comes after the year 2027, when it fails the “Byrd rule” test in the Senate by continuing to add to the deficit, and thereby allowing the Democrats to block the bill. The Senate releases its version this week, which may involve phase outs of key tax benefits, similar to the Bush tax cuts of 2002 which reverted to pre tax-cut rates in 2012 and forced a compromise between House republicans and President Obama in early 2012.

So What? We think this will be a messy process. The main contents of the tax plan: lower corporate taxes, taxation on overseas corporate profits, a broad based tax cut, and the abolition of the estate tax came as no big surprise to investors, who like us are in “show me” mode until a bill hits the President’s desk that he will sign. *We think* ***failure*** *to pass a tax bill would likely trigger a market correction* (it has been widely expected and helps explain the 20% gain in stocks since last November). ***Failure seems unlikely to us***, because it would be politically disastrous for the Republican Party, in our view. We expect a tough negotiation, and some changes to get 50 votes in the Senate.

US CONSUMER CONFIDENCE IS CLOSE TO RECORD HIGH LEVELS, THE SAVINGS RATE RETURNS TOR PRE-CRISIS LOWS:

Despite geopolitical turbulence, surveys of consumer confidence are hitting cyclical highs and the savings rate has returned to multi-decade lows. As we explain in the chart below, we think the savings rate has been affected by the ‘wealth effect’.



So What? High levels of confidence, like low volatility is a ‘condition’ which we believe is not a predictor of returns, but which often limits them and so we believe the pace of US stock returns will slow. In our view the best returns often occur when consumers and investors are anxious and become less anxious as we have witnessed in the US since 2008 and more recently overseas. We urge our clients to prepare for a return to higher (more normal levels) of market volatility, but not to alter their strategic allocations.

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.

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

The comments above refer to generally to financial markets and not RiverFront portfolios or any related performance.
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.