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Japan’s Nikkei Breaks Above a 20-Year Barrier

Stockmarket records are being broken all over the place. The Dow Jones last week closed above 25,000, the Nasdaq Composite above 7,000 and the S&P 500 above 2700, all new record highs. US indices eclipsed their 2000 and 2008 highs several years ago (the Nasdaq was the most recent with the breakout occurring in late 2016). By definition, bull markets must make new highs even though one of them will eventually be a top. Our study of historic price momentum finds that new highs mostly confirm bull markets and are a bullish short-term (3-month) indicator when the primary trend is rising, even if sentiment gets stretched to the upside.

Impressive as these milestones are, we want to draw attention to the other side of the world where, the flagship Nikkei 225 index just crossed 23,000. For 20 years, the Nikkei 225 has been unable to break sustainably above the 20,000 barrier, failing to break it in the cyclical bull markets ending in 2000 and 2007, and being turned back once more in 2015. We are overweight Japanese equties in our asset allocation portfolios, and have been excited about the structural changes implemented by Prime Minister Abe since his first election victory in December 2012 – when the Nikkei was around 9000. For us, there was an important technical milestone in 2014 when the index broke above the pattern of lower highs, described by the red downtrend line on the graph below. The decisive break above the blue horizontal resistance line is technical confirmation of a new secular uptrend, in our view. Because valuations in Japan are below world averages and we think Japanese companies will continue to grow earnings and place increasing importance on shareholder return, we remain optimistic about future returns.

THE NIKKEI 225 BREAKS DECISIVELY ABOVE 20,000

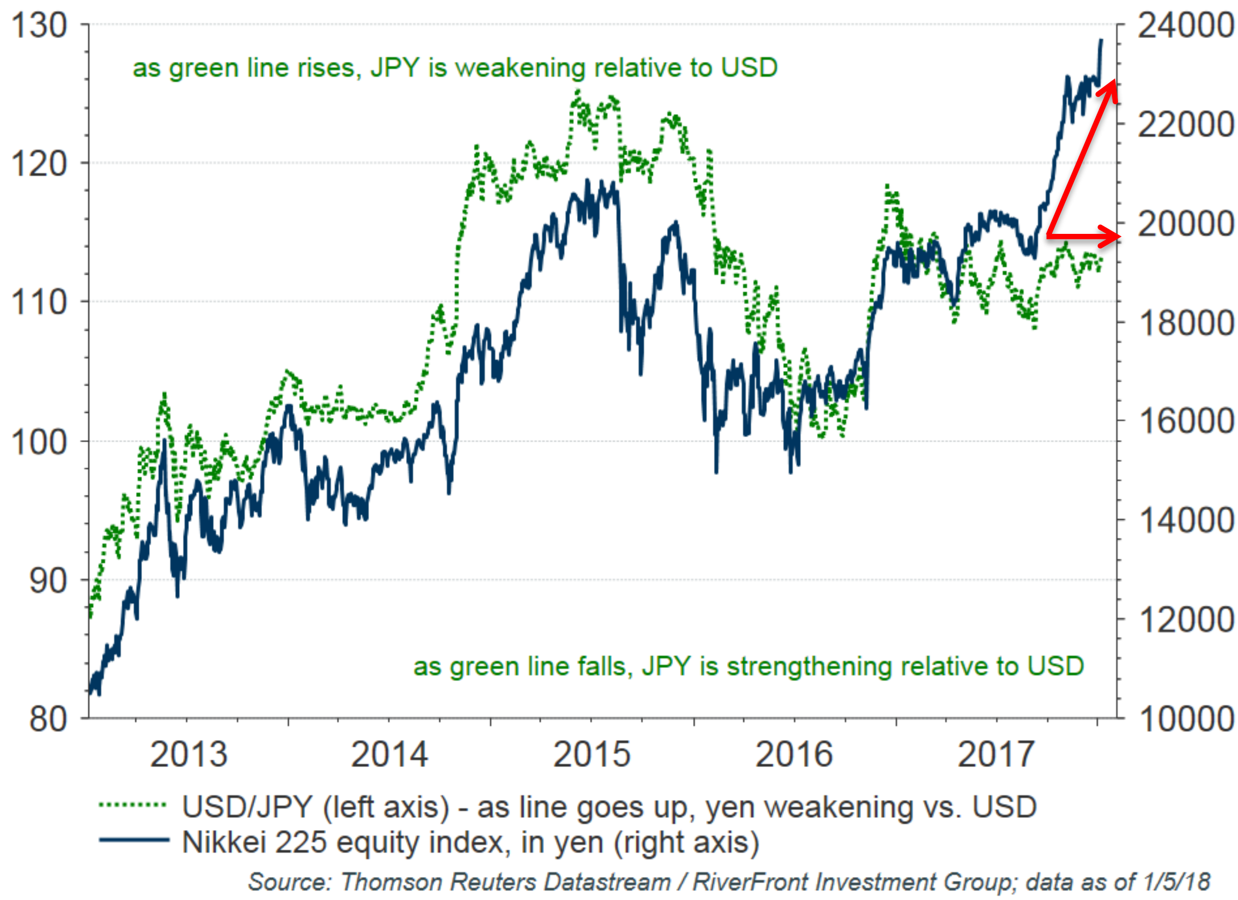
Source: Thomson Reuters Datastream, RiverFront; data as of 1/5/18

Shown for illustrative purposes only. Past performance is no guarantee of future results. You cannot invest directly in an index.

BREAKOUTS ARE GENERALLY A POSITIVE SIGN

When an investor knowingly pays a price that is higher than at anytime in the past 20 years, they are making a statement about the future. We think this statement is a recognition that earnings have grown three-fold since 1998, when Japanese stocks were much more expensive than other world markets. In other words, Japanese companies have delivered earnings growth over the last 20-years despite a challenging local economic environment. Today, Japanese companies , as measured by MSCI, are priced at 14.5x 2018 estimated earnings, compared to the S&P 500 at 18.5x; this is a remarkable discount by historical standards (source: Datastream, I/B/E/S). We think there is potential for this valuation gap to narrow, given Abe's recent renewed mandate for reform and our belief in Japan's ability to continue to grow earnings.

RECENTLY THE NIKKEI HAS MANAGED TO DE-COUPLE FROM THE YEN



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One challenge for US investors since Abe's election has been that, until 2017, the Nikkei's gains have come alongside a declining yen. Weakening the Yen was a pillar of Abe's policies to stimulate growth, corporate profits and inflation. Investors were happy to buy Japanese stocks when the yen was weakening, but not when it strengthened from mid 2015 to late 2016 (In our chart, as the line goes up, the yen is weakening). As the arrows show, in 2017 and early 2018, the Nikkei's gains have come during a relatively stable period for the yen. We think this reflects increasing investor confidence in the sustainability of profit growth from both domestic and overseas demand.

See next page for important disclosures

Important Disclosure Information:

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Index Definitions:

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.*

Nikkei 225 Stock Index *is a stock market index for the Tokyo Stock Exchange (TSE)*

Dow Jones Industrial Average Index -- *measures the stock performance of thirty leading blue-chip U.S. companies.*

Nasdaq:*The first electronic stock market listing over 5000 companies. The Nasdaq stock market comprises two separate markets, namely the Nasdaq National Market, which trades large, active securities and the Nasdaq Smallcap Market that trades emerging growth 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.*

It is not possible to invest directly in an index.