

Outlook 2017 Highlights: Passing the Baton

Below are the highlights from our 2017 Outlook. The entire report is available on our website at www.riverfrontig.com.

THE ECONOMY: In 2017, we anticipate a series of changing economic and market drivers – baton passes – across the global economy. Monetary stimulus (i.e. central banks, money printing, low interest rates) has been the primary support for the global economy over the past six years, as gridlock in Washington and debt burdens internationally precluded other stimulus efforts. In 2017, we believe that monetary policy will pass the baton to both structural (i.e. tax and regulatory reform) and fiscal (i.e. Congressional budgets) stimulus policies from the new Trump administration and in Japan. Europe is expected to benefit from more modest fiscal stimuli, while China continues to pull every stimulus lever available. We predict that corporate tax cuts and fiscal stimulus could produce strong earnings growth in the US; however, these growth drivers are likely to be partially offset by a stronger dollar and shifts in political momentum from globalism to populism/protectionism. Our baseline forecast, therefore, assumes higher growth, higher inflation, and higher interest rates in the US.

US EQUITIES: RiverFront sees a positive environment for US equities in 2017, with tax reform, deregulation, and fiscal stimulus supporting corporate earnings. That said, US stocks have risen sharply since the election, so we believe this good news is largely priced into US equity markets. As a result, we expect US stock returns to be positive but below the long-term real average of 6.5%, with accelerating earnings growth being somewhat offset by higher interest rates and the resulting pressure on equity market valuations. Within US stocks, we see a baton pass from defensive sectors to more cyclical ones. We believe that financials stand to benefit from faster loan growth, potentially improving profit margins, and a more favorable regulatory environment under the incoming administration. We also think smaller and more domestically focused companies will benefit from a strengthening domestic economy. We are cautious on those companies that we call “safety stocks”, which have done well in an environment of falling interest rates and investor caution. Many of these are in the consumer staples, healthcare, utilities and telecommunication sectors.

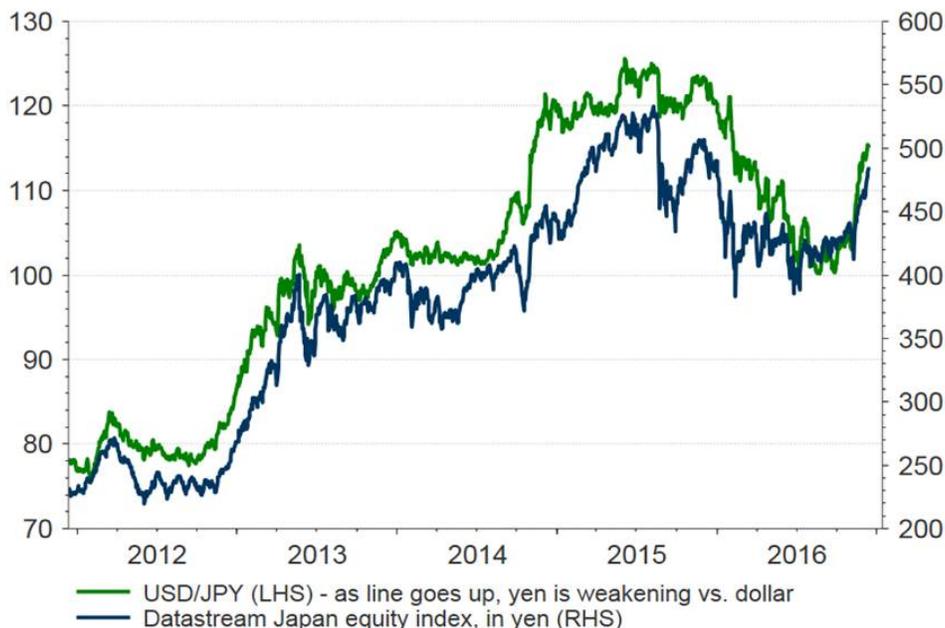
INTERNATIONAL: Developed international equities remains the most attractive equity asset class based on our Price Matters® valuation metrics, and its poor performance in 2016 has increased its relative undervaluation. Based on investor outflows, 2016 may be regarded as the year that investors “threw in the towel” on Europe. And yet, despite its political backdrop, the Eurozone generated positive economic momentum in 2016, with unemployment, though still elevated by pre-crisis standards, continuing to hit multi-year lows and manufacturing surveys recently hitting multi-year highs. We think the disconnect between economics and political sentiment presents an opportunity, and that corporate earnings and share prices could surprise to the upside in 2017. We are less optimistic about the UK, where we think the benefits of a weak currency are already widely recognized, but the reality of Brexit has yet to be felt. Navigating Japan was challenging in 2016, and the local market, which responds favorably to a weaker yen, fluctuated with a volatile currency. This price volatility masked steady progress in corporate return on equity (ROE) and other positive structural reforms. We believe the Bank of Japan has regained credibility and control over the yen; as a result, we are increasingly optimistic about Japan’s equity market prospects (see Weekly Chart).

The first three quarters of 2016 offered a brief respite from the emerging world’s five-year bear market. Ultimately, however, rising interest rates over the summer, followed by an unexpected US election result and dollar strength once again sparked emerging market weakness. We think emerging markets offer the potential for good long-term value but also for high near-term volatility, depending on China’s economic trajectory in the era of “Trumponomics.” We start 2017 underweight emerging market stocks relative to composite benchmarks, but will be watching policy, interest rates and currency fluctuation in both the US and China for clues for when to reengage.

FIXED INCOME: The global bond market’s transition from fear of deflation to fear of inflation is the final baton pass we believe could occur in 2017. We believe that the US bond market is likely to face substantial stimuli in an economy already close to full employment, a year-over-year increase for energy prices, bank deregulation that could

increase the velocity of money, and potentially inflationary import restrictions. Candidate Trump called for more aggressive Federal Reserve interest rate hikes and, if inflation increases as we expect, President Trump may get his wish. Against this backdrop, we recognize that when Treasury yields rise, fixed income assets tend to struggle. We therefore favor shorter maturities to mitigate the effect of rising rates and high yield corporate bonds, in which default risk could benefit from an improving economy.

WEEKLY CHART: JAPANESE STOCKS RISING WITH US DOLLAR



Source: RiverFront Investment Group, Thomson Reuters Datastream. Past performance is no guarantee of future results.

We recently added to our holdings in Japanese stocks on a currency hedged basis in the belief that the yen will continue to weaken against the dollar, boosting Japanese earnings in yen terms. Our chart above shows that Japanese stocks have tended to move up and down in tandem with the dollar/yen relationship since 2012, and that the recent strength of the US dollar has coincided with Japan's rising stock market.

Important Disclosure Information:

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.

Strategies seeking higher returns generally have a greater allocation to equities. These strategies also carry higher risks and are subject to a greater degree of market volatility.

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.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

Low risk assets have typically have been defined as being in the Staples, Healthcare, Utilities, and Telecommunications industries.

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