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SUMMARY

- The US is finally exiting the era of negative real interest rates.
- Long-term stock returns are likely to be lower going forward...but our fixed income expected returns are meaningfully better than just a few years ago.
- We think this is positive news for balanced investors, especially those needing consistent cash flow.

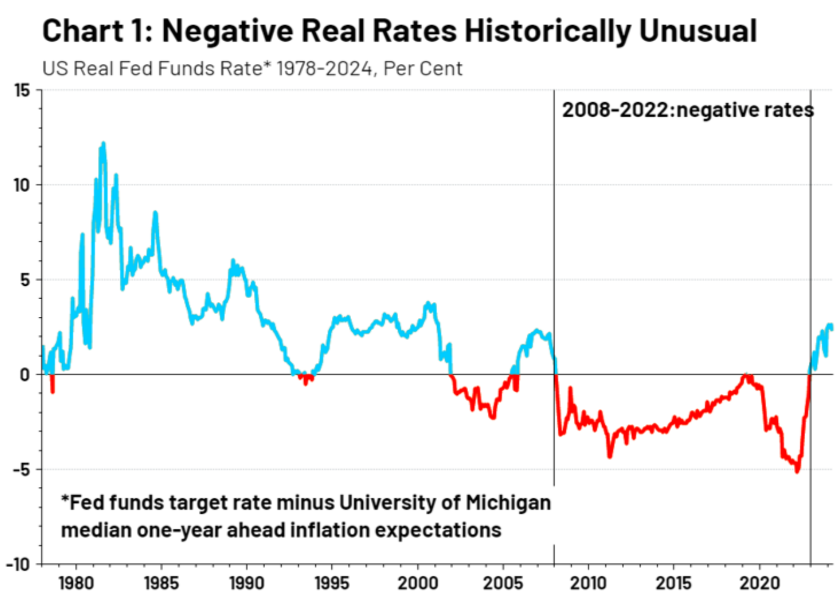
05.14.2024

Positive 'Real' Interest Rates are a Game Changer! (Part Three)

Good News (Finally) for Balanced Portfolio Investors...

(Today is the third part of a multi-part Strategic View series entitled 'Gamechangers,' in which we explore the various investment implications of a return to positive real interest rates in the US.)

Congratulations! if you have been alive longer than 15 years, you just lived through the entirety of one of the weirdest, most subtly unsettling eras in market history...and we are not referring to COVID-19, Brexit or even the Great Financial Crisis (GFC) per se. Rather, we are talking about the bizarre decade-and-a half-long period where US interest rates consistently yielded below zero after adjusting for expected inflation



Source: LSEG Datastream, RiverFront: data monthly as of April 15, 2024. Chart shown for illustrative purposes only. Not indicative of RiverFront portfolio performance.

In the US from 2008 to 2022, the Federal Reserve's fed funds 'real' target interest rate – 'real' meaning adjusted for consumer inflation expectations over the next year – was consistently negative (see red region of Chart 1). This unusual era of 'Financial Repression' was, in our view, a by-product of a Fed determined to jumpstart the abnormally low economic growth caused by a series of rolling global economic crises – the GFC, various European crises, and COVID-19 among them. These crises, in our view, were exacerbated by aging demographics in the developed world leading to excess saving and reduced risk appetite... as well as slowing growth in China and various other factors.

Financial Repression – Not A Victimless Crime

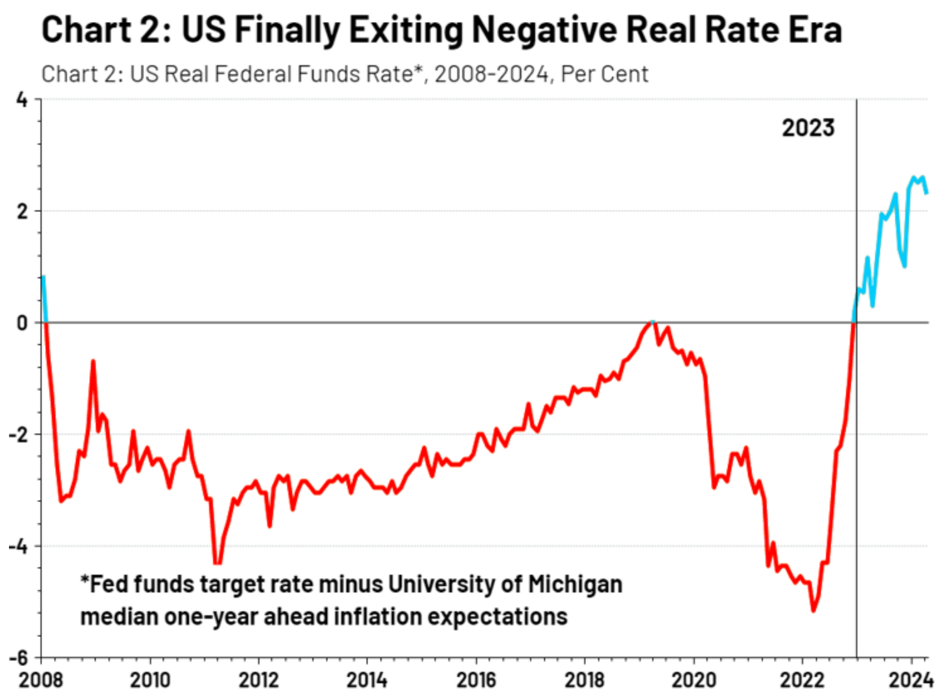
The 2008-2022 Fed had its reasons for such extreme measures, in trying to stimulate risk-taking and economic growth in an era where there was often little of either. And by some measures, they succeeded. Over this 15-year span, US large-cap stocks, as gauged by the MSCI USA index, averaged a total return of almost 11% per year. But prolonged negative real rates also, ironically, created a set of perverse incentives that encouraged excessive risk taking for businesses and investors alike.

For companies, 'negative rates forever' encouraged excess debt accumulation and investment in projects with dubious potential returns. For investors, we would argue that the recent phenomenon of 'meme stocks' and 'SPACs' (special purpose vehicles that allow firms to use shell companies to go public, while sidestepping regulatory due diligence) were by-products of this 'cheap money' era.

Real rates below zero also have potential negative implications for any entity who owes a lot of money, whether sovereign or corporate. Even though low rates make it possible to service higher levels of debt, they also ensure that debt burdens grow over time in 'real' terms, all else being equal. This is particularly a problem for the developed world, as the US, Europe, and Japan are all aging, highly indebted societies to various degrees.

Most perversely, negative real rates penalized savers and anyone on a fixed income – including pensioners, retirees, and the elderly. Negative rates of real return mean that the value of every dollar you keep under the proverbial 'mattress' - in a savings account or in cash – is losing purchasing power. To this point, over the 2008-2022 period, the average real interest rate for US 10-year Treasury securities (adjusted for consensus expectations of CPI inflation, one year forward) was -0.66%...hardly a compelling investment.

For investors who were increasingly moving towards retirement during this era, the lack of positive returns available in 'risk-free' government bonds forced them into a Faustian bargain: either own a higher percentage of stocks than financial planning frameworks recommended - and risk losing their nest egg if stocks corrected - or watch the value of their low-risk assets get eroded away slowly as living costs increased.



Source: LSEG Datastream, RiverFront: data monthly as of April 15.2024. Chart shown for illustrative purposes only. Not indicative of RiverFront portfolio performance.

Patient Exiting the ICU – Investor Implications of a Return to Positive Real Interest Rates

The good news is that the US appears to have finally emerged from the dark age of negative real rates (see blue line, Chart 2, right). Since 2022, the 'patient' is slowly emerging from the ICU, as robust US growth and strong productivity is powering the US economy (see *Weekly View* from 2.27.24, for more on the US economy). This has allowed the Fed to aggressively hike rates over five percentage points, without plunging the economy into deep recession.

The process of weaning our nation off the proverbial 'painkiller' of low rates has begun, in our view. Like any recovery, it will be uneven and spiked with periodic episodes of discomfort. One such episode was the inflationary spike caused by supply chain disruptions in the wake of the pandemic… the after-effects of which we are still dealing with today. But overall, we think the world is better off in a more normalized rate environment… and long-term investors should take note of some of the wide-ranging implications of what we believe to be a structural move back to positive real rates.

We see this new positive real rate era as having a profound effect on several of major stock and bond market dynamics. In previous weeks, we have discussed how a backdrop of 'reflation' should benefit US energy companies, Japanese stocks, and international commodity-based economies, as well as how greater investor emphasis on balance sheet strength and cash flow should benefit mega-cap technology stocks. (See Gamechangers Part One and Gamechangers Part Two).

In this final installment of Gamechangers series on real interest rates, we discuss major asset allocation implications of positive real rates for balanced portfolios. As a builder of dynamic, balanced asset allocation portfolios, RiverFront cares deeply about this topic…and as you'd guess, we have some thoughts. ***We see at least three major ramifications for balanced investors through the next business cycle:***

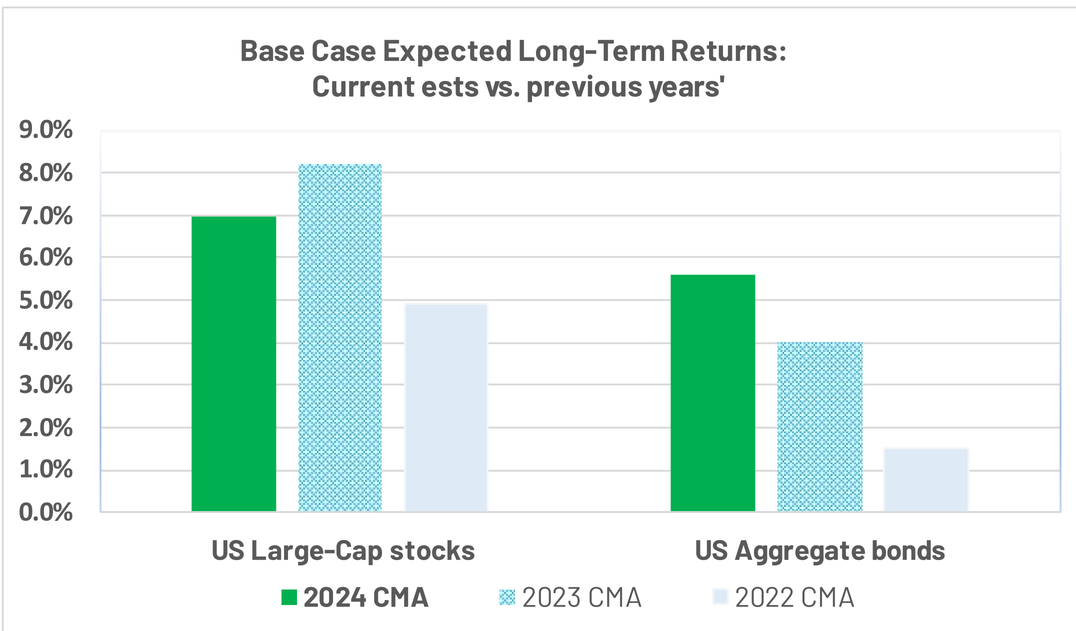
1. **Potentially Lower Returns From Stocks, with Higher Volatility…**
2. **…but with Higher Expected Returns on Fixed Income due to Higher Yields…**
3. **…Leading to Similar Expected Performance for Balanced Portfolios as before, but with Higher, More Stable Cash Flow.**

US Stock Volatility Likely to Shift Higher – and Stock Returns Likely to be Lower - Through the Next Business Cycle

In December, RiverFront released its Long-Term Capital Market Assumptions, which are meant to give our views into major asset class returns through the next business cycle (defined by RIG as roughly five to seven years). Our Base Case (which we define as the highest probability outcome, in our view) is that of a mildly 'reflationary' US economy – one with a healthy level of economic growth, but also moderately elevated inflation and real interest rates compared to recent history.

Our Base Case return assumption for US Large-Cap Stocks is down somewhat from our March 2023 forecast (Chart 3, right). This is primarily due to higher starting valuations, as markets have rallied strongly since then. Our research suggests to us that higher starting points for stock valuations can lead to lower long-term future returns. We think that lower realized stock returns will also go hand in hand with higher volatility, as volatility tends to be 'asymmetric' – meaning that volatility tends to increase more when prices fall than when prices rise by a similar amount.

Chart 3: Our Long-Term Fixed Income Return Assumptions Have Improved



Shown for illustrative purposes. Index and asset class definitions are available in the disclosures. The table above depicts RiverFront's Capital Market Assumption (CMA) predictions for 2024 as compared to 2022 and 2023 using the Base scenario. The assessment is based on RiverFront's Investment Team's views and opinions as of December 18, 2023. Each case is hypothetical and is not based on actual investor experience. These views are subject to change and are not intended as investment recommendations. The returns above are not an indication of RiverFront portfolio or product performance. There is no representation that an investor will or is likely to achieve positive returns, avoid losses or experience returns as discussed for various market classes. US Large Cap stocks data begins in 1925, US Aggregate bonds in 1985. See end of presentation for index definitions and disclosures.

We think balanced investors – and particularly ones who care about income – should consider using a portion of their portfolio to invest in alternative yield strategies that can turn higher realized stock volatility into higher income. The discussion of these strategies is outside the scope of today's piece – please reach out to your financial advisor for more information.

This higher stock volatility also suggests to us that active portfolio management – especially one with disciplined tactical shifts and risk-management processes - will be a useful portfolio feature in a world where you can't just 'set it and forget it.'

With the help of a financial advisor, a professionally crafted retirement plan can be tailored to investors' needs and risk tolerances. We think a focus on portfolio construction, risk management, transparency, and consistent communication are critical elements in giving financial advisors and their clients the peace of mind to stick with the agreed plan.

Even as our Stock Forecast Moves Lower, our Assumptions for Fixed Income Returns Have Moved Higher with Higher Interest Rates

In contrast to our stock assumptions, our long-term forecast for an aggregate of US bonds is meaningfully higher than just a couple of years ago (see Chart 3, page above). This is a function of meaningfully higher yields, which should equate to higher total returns if held to maturity. With the Fed's uber-aggressive hike cycle of 5 and a half percentage points from 2022-2023, interest rates have quickly 'normalized' back towards something approximating average historical yields.

These higher rates suggest to us that higher structural bond yields can start compounding earlier in our forecast horizon, leading to meaningfully higher aggregate total returns. Despite the near-term uncertainty for bond prices due to Fed policy, we think bonds have reasserted themselves as a more compelling long-term portfolio return source for one of the first times since the 'Financial Repression' era started. This is a major positive for balanced investors, in our view. Below we demonstrate why, using a simple example.

An Example of Why 'Normalized' Asset Allocation is Good News, In Our View

We can demonstrate this with a simple theoretical model, keeping the numbers simple for demonstration's sake. We continue to believe in the benefits of diversification and cannot help noticing that the long-term risk/return prospects for a balanced portfolio look more attractive to us than they have in a long time. This is in part due to the significant rise in interest rates, and the fact that, over the last 12 months, 10-year Treasury yields have averaged above 4% for the first time since 2007. Importantly, we believe the starting yield of a bond is the key determinant of a bond's return over time.

Table 1: Returns Needed From Stocks to Attain Portfolio Return Objective

	50/50 Portfolio Return Objectives			
Starting Bond Yield	5%	6%	7%	8%
2%	8.0%	10.0%	12.0%	14.0%
3%	7.0%	9.0%	11.0%	13.0%
4%	6.0%	8.0%	10.0%	12.0%
5%	5.0%	7.0%	9.0%	11.0%
6%	4.0%	6.0%	8.0%	10.0%
7%	3.0%	5.0%	7.0%	9.0%

If bonds yield 5% (Blue Row),
and the portfolio return objective is 6% (Yellow Column),
stocks need to return 7% (Green Box)

This is only intended as an illustration and is not a reflection of any RiverFront portfolio. Current yields are quoted as an example and are subject to change. All investments carry a risk of loss and there is no guarantee that a portfolio will reach its investment objectives. Importantly, diversification does not guarantee a profit or protect against a loss. You cannot invest directly in an index. The illustration above is provided as a mathematical Illustration and does not include all return scenarios. It Is not an indication of any RiverFront portfolio or performance and does not take into account other important factors to consider including fees and expenses.

Diversified (or 'balanced') portfolios, broadly speaking, generate returns from two main asset classes: Equity and Fixed Income. Equity investments generate portfolio performance via the rise (or fall) in the investment's price and any dividends that the investment pays. Fixed Income investments generate enhanced portfolio income for the portfolio via their yields. In an environment where bond yields have risen dramatically, there is less performance required from the equity portion of a diversified portfolio.

To demonstrate how a diversified portfolio performs, let's look at a mathematical example using current data. If an investor is seeking an annual portfolio return from a diversified portfolio and is willing to accept some additional risk from the bond portion of the portfolio above that of a Treasury Bond, the Bloomberg US Aggregate Bond Index (or 'Agg'), which includes corporate and mortgage bonds, is yielding around 5% as of May 11, 2024. **Because this yield is higher than in previous years,**

the returns required from stocks to meet one's portfolio goals in this example are significantly lower than before. This is especially true for the bulk of the 'Financial Repression ' era, when 10-year Treasury Note yields remained largely below 3%.

When rates are extremely low, stocks must deliver much higher returns to carry a balanced portfolio. The math is simple on a sample portfolio made up of 50% bonds and 50% stocks. For example, if one has a 6% return objective and bonds can return 5%, then stocks only need to return 7% over time (see example in Table 1, page above) to meet that objective. But when rates were much lower, as they were during 'Financial Repression', the onus was on stocks to produce much higher returns. The table further illustrates different scenarios of what equity return would be required, given varying starting bond yields, in order to meet a stated portfolio objective.

Having the fixed income portfolio of a balanced portfolio carry a larger percentage of the overall return is beneficial to the typical balanced investor, in our view. **This is in large part because a much higher portion of bond total return historically is made up of consistent quarterly cash flow (in the form of quarterly coupon payments) than it is for stocks (via dividends).** Thus, inherently the cash flow portion of the portfolio return tends to be more stable and consistent, which can be helpful for investors who rely on their portfolios to fund some or all living expenses.

We believe this difference in total return component composition is the reason that the inherent total return volatility of bonds historically is much lower than that of stocks. Across a long-term data set (1926-2023 for US large-cap stocks, as represented by the top decile by market capitalization of CRSP's US Total Market Stock Index, and 1976-2023 for the Bloomberg US Aggregate Bond Index), we calculated 'standard deviation' (the measure of dispersion of a dataset around a mean; a higher number represents higher volatility of returns) for various asset classes. **For US large-cap stocks, the standard deviation was approximately 15%; for the Agg, it was much lower at around 2% (source: CRSP, Bloomberg, Riverfront).**

Conclusion: The End of Financial Repression is a Return to More 'Normalized' Asset Allocation

The end of negative real interest rates – aka the 'Financial Repression' era – is good news for balanced investors, in our view. During the Financial Repression era, balanced investors were increasingly forced to move to a higher allocation of stocks, which resulted in greater portfolio volatility. Now, we believe bonds can do more of the 'heavy lifting' to achieve the investor's long-term portfolio return and cash flow objectives. **Getting more of your total return coming from fixed income coupons should reduce the volatility of investors' quarterly cash flow – crucial for many balanced investors on a fixed income, who often rely on portfolio yields to help defray living expenses.**

Chartered Financial Analyst is a professional designation given by the CFA Institute (formerly AIMR) that measures the competence and integrity of financial analysts. Candidates are required to pass three levels of exams covering areas such as accounting, economics, ethics, money management and security analysis. Four years of investment/financial career experience are required before one can become a CFA charterholder. Enrollees in the program must hold a bachelor's degree.

All charts shown for illustrative purposes only. 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.

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.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issue. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

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

Bloomberg US Aggregate Bond Index measures the performance of the US investment grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than one year.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 610 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

Definitions:

Treasury bond yields (or rates) are tracked by investors for many reasons. The yields are paid by the U.S. government as interest for borrowing money via selling the bond. The 10-year Treasury yield is closely watched as an indicator of broader investor confidence. Because Treasury bonds (along with bills and notes) carry the full backing of the U.S. government, they are viewed as one of the safest investments.

The federal funds rate is the rate banks charge each other for lending their excess reserves or cash. Some banks have excess cash, while other banks might have short-term liquidity needs. The fed funds rate is a target rate set by the Federal Reserve Bank and is usually the basis for the rate that commercial banks lend to each other.

The term cash flow refers to the net amount of cash and cash equivalents being transferred in and out of a company. Cash received represents inflows, while money spent represents outflows.

Small-, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

Mega cap is a designation for the largest companies in the investment universe as measured by market capitalization. While the exact thresholds change with market conditions, mega cap generally refers to companies with a market capitalization above $200 billion.

Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation.

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.

The CRSP U.S. Total Market Index is comprised of more than 3,500 constituents across mega, mid, small and micro capitalizations. The Index represents nearly 100% of the US investable equity market. The CRSP Cap-Based Portfolio Indices Product data tracks micro, small, mid- and large-cap stocks on monthly and quarterly frequencies. This product is used to track and analyze performance differentials between size-relative portfolios. CRSP ranks all NYSE companies by market capitalization and divides them into ten equally populated portfolios. Alternext and NASDAQ stocks are then placed into the deciles determined by the NYSE breakpoints, based on market capitalization.

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To review other risks and more information about RiverFront, please visit the website at riverfrontig.com and the Form ADV, Part 2A.