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A Normal Pullback for the US; A Potential Turning Point for Europe

We do not believe that five-year bull market in risk assets has ended, despite global equity markets' rise in volatility and falling prices over the past six weeks. We believe:

1. The S&P 500 is enduring a typical pullback before resuming its upward climb. Investors are alarmed by the recent surge in volatility because, thanks to the Federal Reserve's (Fed's) Quantitative Easing (QE), the market has not had a normal pullback to the 200-day moving average for almost two years. We expect the S&P 500 to find support around 1870, just under its 200-day moving average, and we see secondary support around 1830 (see Chart 1 on page 2). We expect the S&P 500 to be back above 2000 by year end.

2. European equity markets' sharp underperformance versus the US over the past few weeks has been largely due to disappointment in the European Central Bank's (ECB's) policy pronouncements, vocal German opposition to any monetary accommodation, and growing fears that Europe could be the new Japan and endure a decade or more of stagnant growth and declining equity markets.

3. Markets are underestimating the potential impact of the new ECB policies based on comparisons to the Fed, rather than prior ECB policies. While Draghi's new policy initiatives are not yet as aggressive as the Fed's, he is transforming ECB policies from a significant headwind for European markets to a significant tailwind (see Chart 2 on page 3).

4. Draghi was willing to defy Germany back in 2012 when their support was critical to Europe's bailout efforts, and the ability of Greece and Portugal to borrow on the open markets has reduced dependence on German bailouts and thus Germany's negotiating leverage with the ECB. Draghi defied German opposition to implement the current more aggressive monetary policy and is likely to defy German opposition again if he deems outright QE is necessary to avoid deflation and save the euro.

5. European equity markets are far more attractively priced than Japanese markets were during their long bear market in the 1990s and 2000s. Both Price Matters® and traditional valuation disciplines suggest average equity market returns if European growth remains sluggish and double-digit returns if Europe avoids Japan's two-decade stagnation. Price Matters® puts the odds of European outperformance over the next five years at more than 80%.

6. Although momentum indicators would suggest reduced European exposure (don't fight the trend), our two other tactical rules (don't fight the Fed/ECB, and beware the crowd at extremes) support a continued overweight position. Given the attractive valuation and the fact that two of our three tactical rules are suggesting outperformance by European markets, we intend to maintain our current European exposure.

PULLBACKS ARE NORMAL, QUANTITATIVE EASING IS NOT

We believe that US equity markets are having a normal correction in an otherwise healthy bull market. The Fed's Quantitative Easing (QE) program has provided a liquidity-driven tailwind for equity markets, which has altered the "two steps forward, one step back" behavior of a normal bull market. Thus, US stocks have not had a typical pullback to the 200-day moving average in almost two years. With the Fed's QE purchases on schedule to end this month, investors will need to be prepared for periodic pullbacks to again become a normal part of market behavior.

US ECONOMIC EXPANSION INTACT

Virtually every employment indicator in the US is improving (e.g., unemployment, job openings and labor turnover [JOLTS], jobless claims) and purchasing manager surveys remain strong. Neither ISIS nor Ebola represent material economic threats to the US expansion, in our view. Thus we believe that after testing support at around 1870 or potentially 1830, the S&P should bounce back above 2000 by year end.

CHART 1 — S&P 500

Source: FactSet Research Systems; Past performance is no guarantee of future results.

EUROPE – APPROACHING A TURNING POINT

Although we are not concerned by the pullback in US equity markets, we have been surprised by the more severe declines in European equities. These declines and their impact on RiverFront's portfolios have prompted a reevaluation of our positive outlook for European equity markets. Based on a thorough review of the ECB's recently announced policies, current market valuation, earnings prospects and our technical indicators, we have decided to maintain our current overweight position. We believe investors are underestimating the positive impact of the new ECB policy direction, and that investors expecting Europe to repeat Japan's decade of market declines are ignoring the significant difference in valuation between current European markets and Japanese equities in the 1990s and 2000s.

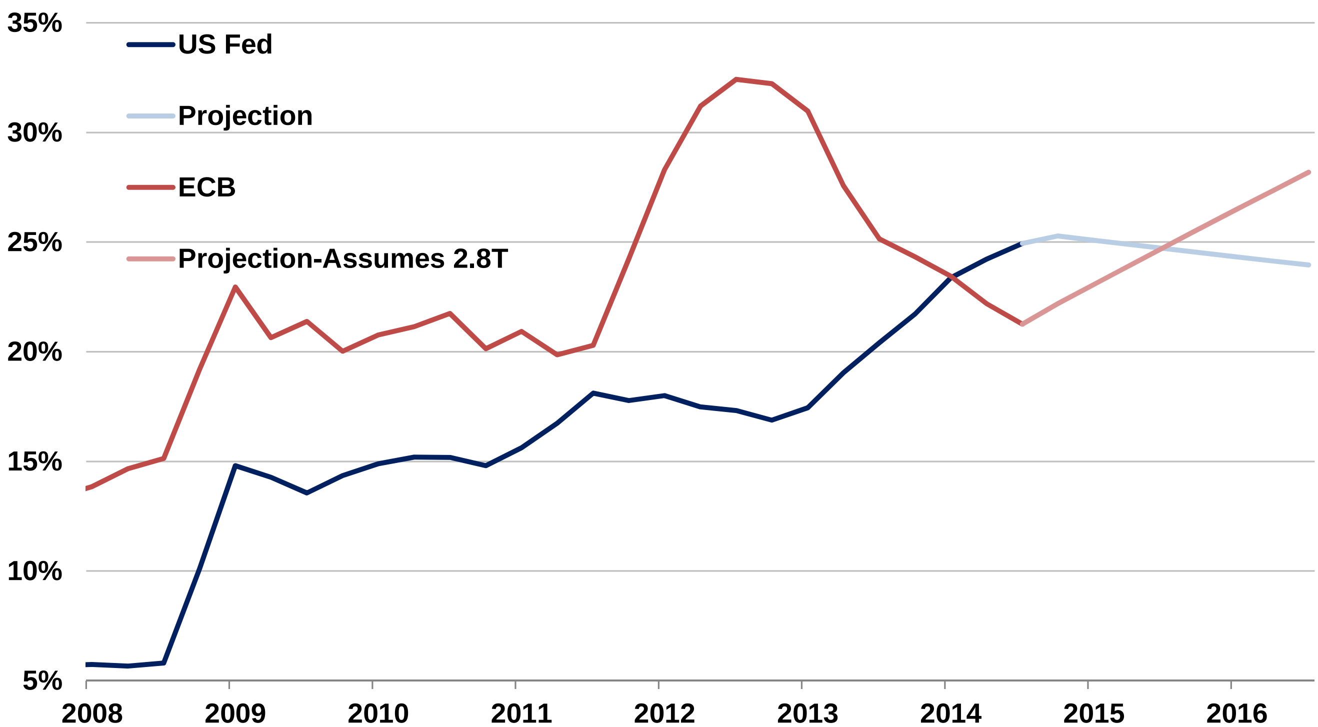
DON'T FIGHT THE FED (OR THE ECB)

After beginning his tenure with a series of bold moves (doing "whatever it takes" to save the euro), ECB President Mario Draghi has been largely inactive for the past two years. His earlier policy moves, especially an offer to purchase potentially unlimited amounts of sovereign debt in the troubled periphery of Europe, allowed borrowing rates in these highly indebted economies to plummet. Even Greece and Portugal have returned to public markets for their borrowing needs and are no longer dependent upon Germany-funded bailouts.

Draghi's initial efforts helped pull the Eurozone economy out of the freefall it experienced during the "Hoovernomics" (tight monetary and fiscal policies despite economic weakness) years of 2010 to 2012, but his inaction for the past two years has caused the ECB's balance sheet to shrink by one-third, from about 32% of GDP to less than 22%. This "unprinting" of euros drained liquidity from the European economy and financial markets, somewhat offsetting the positive impact of lower borrowing costs in the periphery. Worse still, the supply of euros shrank just as the Fed's QE policies were sharply increasing the supply of dollars (see Chart 2), forcing the euro up from about 1.20 to the dollar to more than 1.40 at its May 2014 high. The overvalued euro put additional downward pressure on economic growth and corporate earnings across the euro bloc.

Draghi's long period of inactivity has recently ended. The ECB has taken interest rates negative (essentially forcing banks to make loans) and committed to expand its balance sheet and the supply of euros through purchases of asset backed securities (ABS). Financial markets reacted poorly to these policy pronouncements, mainly for three reasons. First, investors were disappointed that Draghi did not commit to a more specific target for these purchases (he indicated that the balance sheet would return to the size seen "at the beginning of 2012," which could be anywhere from €2.5 to €3.1 trillion). Second, QE purchases of

CHART 2 — CENTRAL BANK BALANCE SHEET AS A PERCENT OF GDP



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

sovereign debt have yet to be approved (the sovereign debt market is much larger than the ABS market, and therefore would allow a much more aggressive expansion of the ECB's balance sheet). Finally, vocal German opposition to these policy moves renewed fears that Germany might prevent an effective monetary policy response to Europe's economic problems.

We believe investors are underestimating how profoundly Draghi has changed the direction of European monetary policy and overestimating the influence Germany can exert over future policy initiatives. No matter what the ultimate size of the ECB's balance sheet, the projected balance sheet size shown in Chart 2 illustrates that over the next few months ECB policy will switch from unprinting money and balance sheet contraction (a significant market headwind) to printing money and balance sheet expansion (a significant market tailwind). We think it is foolish to fight a determined central bank.

THE ECB'S STRATEGY MIGHT PROVE EVEN MORE AGGRESSIVE THAN THE FED'S QE INFINITY

During Draghi's October 2 press conference, reporters repeatedly asked for a specific target for the ECB's balance sheet. Instead of clarifying his response, "the size it had at the beginning of 2012," Draghi used these questions as an opportunity to reiterate that the goal is not a specific target for the ECB's balance sheet. Rather:

> *The ultimate and the only mandate that we have to comply with is to bring inflation back to a level that is close to but below 2%. I think that's the ultimate yardstick by which we will measure the success of the present measures and any other measures that we may take in the future.*

Investors hoping for a specific balance sheet objective instead of targeted inflation rate have forgotten that the Fed's QE Infinity program was similarly driven by a specific economic objective – an unemployment rate below 6.5% (later revised to 6.0%) – rather than a balance sheet target. Neither the Fed nor the ECB can predict how much money printing will be required to achieve their goals, but the US experience suggests that inflation may prove harder to change than unemployment. By committing to continue balance sheet expansion until inflation approaches 2% from its current 0.3% level, Draghi will likely have to be more aggressive than the Fed.

GERMANY HAS A VOTE, NOT A VETO

Jens Weidmann, the head of the Bundesbank and Germany's representative at the ECB, strongly opposes Draghi's balance sheet expansion plans, raising fears that Germany will again impose Hoovernomics on Europe.

We believe that Germany held an effective veto over ECB policy during 2010 and 2011, as their support was desperately needed to bailout Greece, Ireland, and Portugal. Despite Germany's negotiating leverage, Draghi defied the Bundesbank in 2012 when he pledged to do "whatever it takes" to save the euro and offered to buy sovereign debt issued by the euro bloc's weaker countries. This implicit credit guarantee worked so well that Draghi never had to buy any sovereign bonds. Greece, Ireland, and Portugal have all returned to public debt markets for their financing needs and are no longer dependent on German assistance.

Draghi was willing to defy Germany back in 2012 when their support was critical to Europe's bailout efforts, so his willingness to defy them now that their negotiating leverage is reduced should not be a surprise. If the current set of policy initiatives does not show fairly quick results, we believe Draghi will again override German objections and implement outright QE through purchases of sovereign debt. He has promised to make a decision on QE in "months not years," and his track record gives us no reason to doubt him.

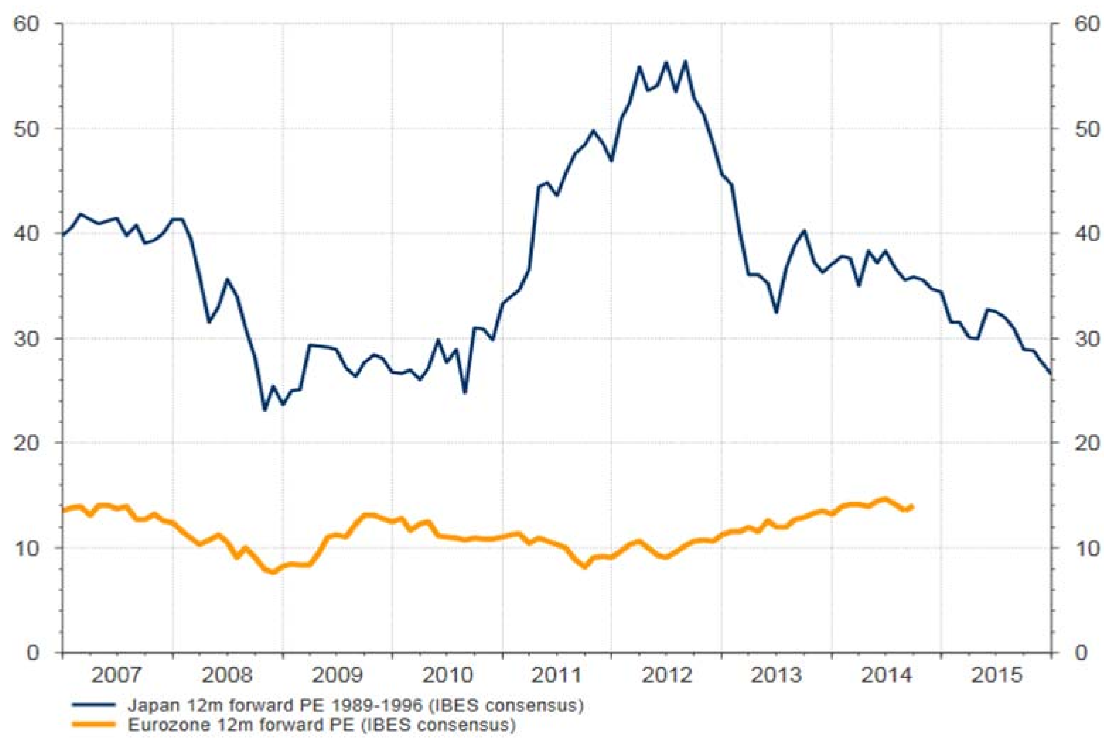
EUROPE IS NOT JAPAN (AT LEAST WITH RESPECT TO STOCKS)

An overriding fear holding back European equity markets, in our view, is the possibility that Europe could be the new Japan and endure a decade or more of economic malaise and declining equity markets. We hope that European policy makers have learned from Japan's mistakes (except perhaps the Germans) and will follow more enlightened economic policies. However, European equity markets are far more attractively priced than Japanese equity markets of the 1990s and 2000s. As shown in Chart 3 below, European markets are currently trading at less than 15 times depressed earnings (European earnings are less than 70% of pre-crises levels). By contrast, Japanese markets traded at more than twice this valuation level throughout its crises years in the 1990s and 200s. Price to earnings (PE) ratios of 30 to 40 represent bubble levels of valuation and have historically produced poor equity market returns, irrespective of the economic environment.

Developed international stocks are more than 25% below trend, based on RiverFront's Price Matters® framework, a magnitude of undervaluation typical of markets during economic recession. Thus, European stocks are already priced for continued economic weakness and could provide reasonable returns, even if their economies remain in recession. In that scenario, their markets are likely to remain at a recessionary 25% below trend but rise at the long-term trend rate of return (between of 6% to 7% above inflation). If Europe escapes Japan's fate and avoids a prolonged economic stagnation, returns could be far greater as equity markets revert back toward their long-term trend.

In contrast, US large cap stocks are relatively close to their long-term trend. Historical periods that began with European markets approximately 25% cheap to US alternatives have resulted in European outperformance 88% of the time over a five-year horizon, and the odds of outperformance have been 60% even over one-year periods. Thus, from both absolute and relative perspectives, Price Matters® argues for a continued overweight position in Europe.

CHART 3 — POST-CRISIS PE RATIOS: 1990S JAPAN VERSUS CURRENT EUROPE



Source: Thomson Reuters Datastream; past performance is no guarantee of future results.

PORTFOLIO STRATEGY IMPLICATIONS

One of RiverFront's most difficult balancing acts is between our long-term Price Matters® strategies and our tactical adjustments based upon our three rules (don't fight the Fed, don't fight the trend, beware the crowd at extremes). This tension is especially prevalent when improving technical conditions prompt a significant allocation to an undervalued market, only to prove a head fake as relative momentum turns negative once again. Selling the position and locking in a loss in these situations is painful because the long-term outlook for the asset class is favorable.

Fortunately, we do not have to rely only on relative technical momentum when making this decision with respect to Europe. The other two components of our tactical discipline support our Price Matters® framework and argue for maintaining our overweight in Europe. First, as detailed above, we believe the market has misinterpreted monetary policy in Europe, and that in the coming months European financial markets will benefit from a significant surge of liquidity due to an expanding ECB balance sheet (don't fight the Fed/ECB). Investor sentiment as measured by our tactical model is as depressed as it has been in the past 30 years. Thus, beware the crowd at extremes dominates don't fight the trend and suggests potential for a significant relative bounce in European markets over the next several months.

With both valuation and tactical disciplines favoring European exposure, we intend to maintain our current weightings in these markets. The composition of our portfolio holdings may change to take advantage of opportunities we see in specific countries or the euro. As always, we have a risk management plan in place should events and the market reaction continue to disappoint.

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