RIVERFRONT INVESTMENT GROUP

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THE WEEKLYVIEW

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Overseas Stimulus As Fed Ends QE

The MSCI World Index rose 3% last week (on a local currency basis) to drive October to a 1% monthly gain as both the Bank of Japan (BOJ) and European Central Bank (ECB) stepped up their policies to promote growth and combat falling inflation. We believe last week's bullish market action reflects the significance of both Japan's and Europe's monetary stimulus as the Federal Reserve ends its latest bond-buying (quantitative easing [QE]) program. However, we believe that overseas equity exposure should be on a local currency basis, because accommodative monetary policy tends to cause currency depreciation. Indeed, both the yen and euro weakened last week as the equity markets rebounded, reducing the MSCI EAFE index's gain of 3.7% in local currency to around 2.2% in US dollars. The S&P 500 rose 2.7% last week to a record high.

The BOJ announced plans to increase the size of its quantitative easing program last Friday, driving the Nikkei 225 up 4.8% to a seven-year high and the yen down by 2.6%. This increase would expand the BOJ's balance sheet by around ¥80 trillion over the next year (about $714 billion, based on current exchange rates) from ¥60-70 trillion. This equates to about 15% of Japan's annual GDP; at the peak of its asset purchases, the Fed was 'only' adding the equivalent of 6% of US GDP. Furthermore, in addition to Japanese government bonds, the BOJ decided to triple its annual allotments to Japanese stocks and real estate investment trusts as part of its new purchase program. RiverFront's portfolios are overweight Japanese stocks, and most of our exposure is on a currency-hedged basis, which means that yen weakness does not detract from performance (see Weekly Chart).

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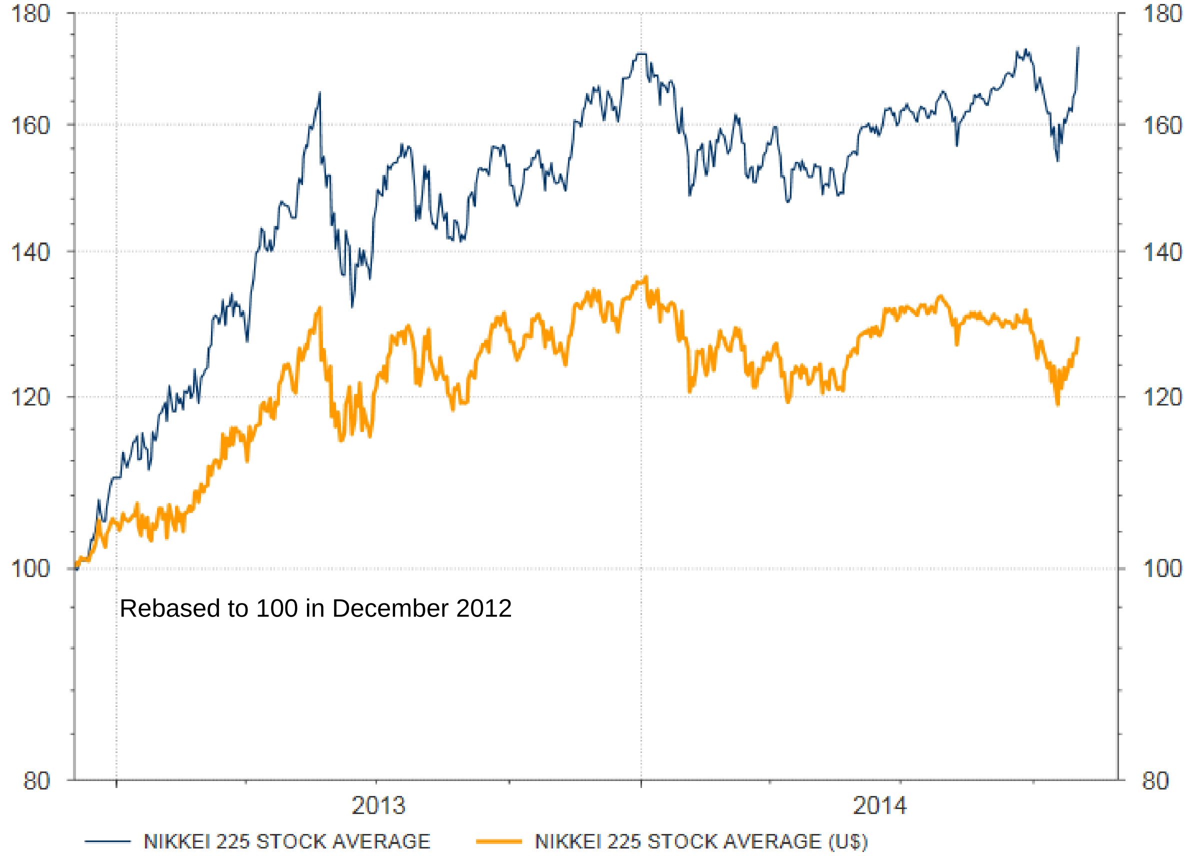
Just as the Fed is ending its balance sheet expansion, the ECB has finally embarked on a quantitative easing of its own. Thus, we are also overweight Eurozone stocks, with euro exposure almost entirely hedged out.

In Europe, the ECB announced largely benign results from its stress test of 130 banks last week, the toughest since the financial crisis. Previous stress tests have been dismissed as failing to adequately account for potential risks. Although 25 banks failed the test, with a €25 billion capital shortfall (using backward-looking balance sheet data from the end of 2013), 17 of them have already raised enough capital this year to meet requirements, and the remaining 8 only need to raise an additional €6 billion.

We believe this rigorous stress test lowers financial market uncertainty and clears the way for increased lending and investment in Europe. Indeed, the ECB's latest survey of European banks shows easing lending standards and increasing loan demand. We think this bodes well for economic and earnings growth in the Eurozone, as it did in the US several years ago. Moreover, the ECB has finally embarked on its own quantitative easing program, committing to buy around €1 trillion in asset-backed securities, covered bonds, and corporate bonds over the next two years, with the possible addition of sovereign debt. We expect the ECB to meet its goals of preventing deflation and moving inflation — currently just 0.4% year over year — back closer towards its 2% target. Thus, we are also overweight Eurozone stocks with euro exposure almost entirely hedged out.

THE WEEKLY CHART: YEN HEDGE HAS BOOSTED GAINS



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

Since Shinzo Abe became prime minister in December 2012, Japan's currency has depreciated from 82 yen per dollar to 112 last Friday. We believe this was largely due to an unprecedented expansionary monetary policy, the first 'arrow' of Abenomics. The weaker currency — one dollar now can buy more yen, hence the 'higher' exchange rate — has improved Japanese export competitiveness, boosted earnings, and raised inflation expectations; all of which have spurred Japan's stock market rally over the last two years. However, without hedging out currency movements, a stimulative monetary policy that weakens the yen would have detracted from the Japanese stocks' US dollar-denominated performance gains. As shown in the chart, a US investor who bought $100 of the Nikkei 225 in December 2012 on an unhedged basis (thick yellow line) would have a 28% gain to date, whereas on a yen-hedged basis (thin blue line) the Nikkei 225 has a 74% gain.