From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

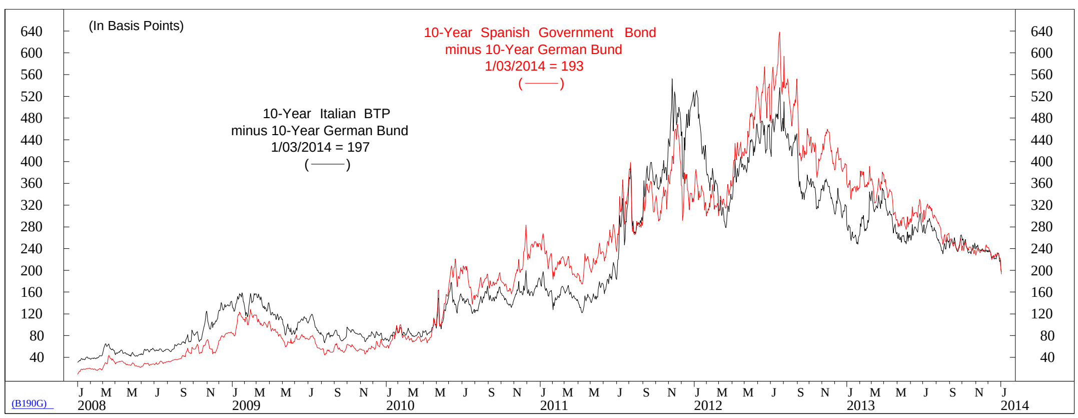
Ken Liu
GLOBAL MACRO STRATEGIST

Eurozone Benefits From Restructuring

Portugal, Ireland, and Greece (PIG) went through massive financial upheavals over the last few years, but for the Eurozone as a whole the major problem areas have been Spain and Italy, which comprise 27% of the Eurozone versus 5% for 'PIG' combined. So while smaller 'peripheral' countries have had an impact on the perception of vulnerability and caused financial shocks in the Eurozone, they do not represent the potential systemic risks posed by Spain and Italy.

Fortunately, financial panic has eased substantially since July 2012 when European Central Bank (ECB) President Mario Draghi pledged to do "whatever it takes" to preserve the euro. So far this has amounted to almost €500 billion in loans to Spanish and Italian banks (which in turn have purchased their own sovereign debt). The consequent decline in borrowing costs and perceived risk is illustrated in the chart below, which shows 10-year Spanish and Italian yields making three-year lows relative to German bunds.

10-year Spanish and Italian yields have been making new lows relative to German bunds — a measure of decreased borrowing costs and perceived risk.

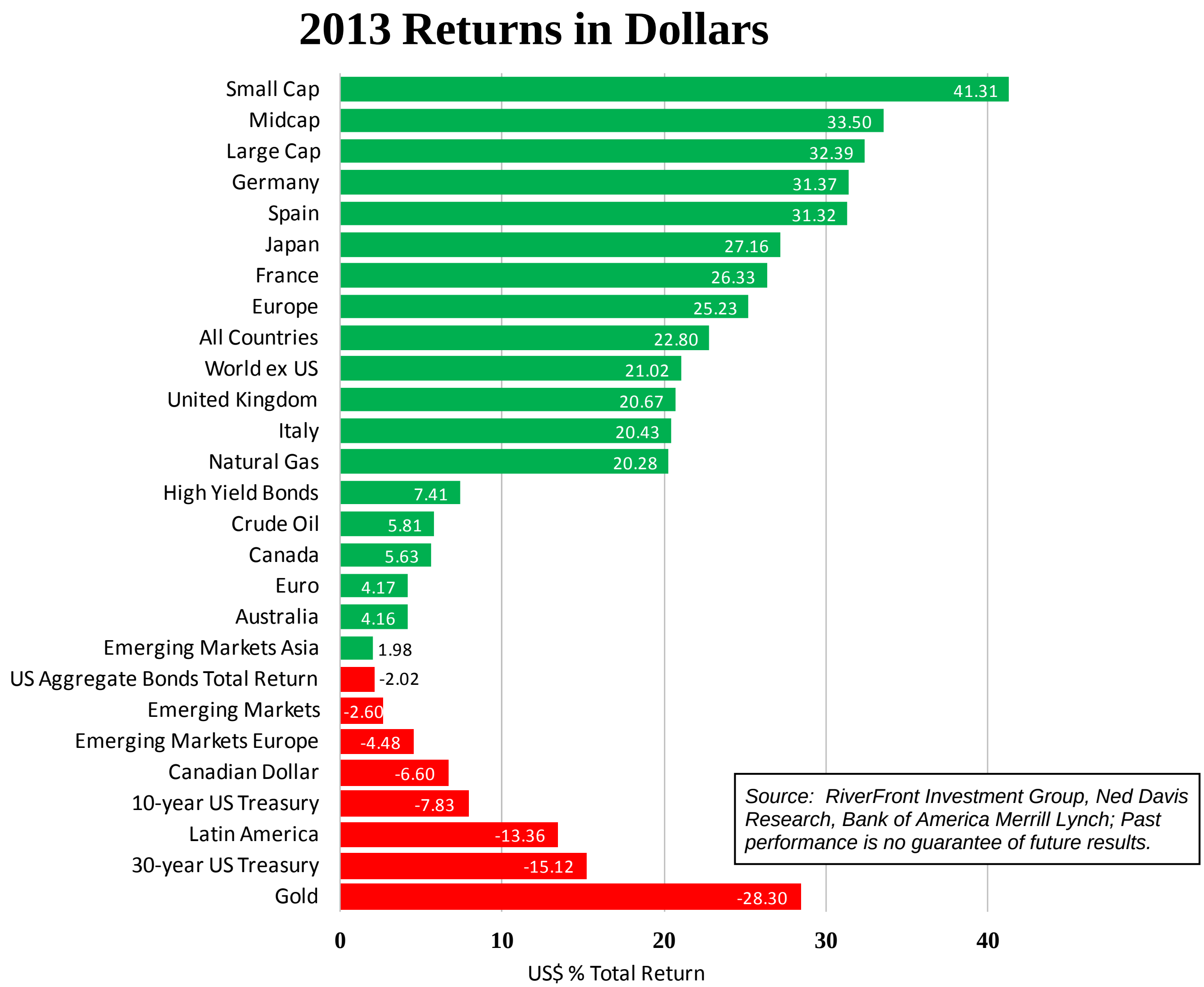


The ECB's loans came with conditions that required spending cuts. While painful, the result has been lower budget deficits, wages, consumption, and imports; and increased labor flexibility. The benefits have been current account surpluses (the broadest measure of trade), low inflation, and increased competitiveness especially in countries like Spain, which has been most aggressive in implementing reforms. We believe that these 'structural adjustments' set the stage for sustainable economic growth and fiscal stability, hence our overweight to the region. Financial markets recognized these improvements in 2013, as shown in our Weekly Chart.

Although 'structural adjustments' have been painful, they set the stage for sustainable economic growth and fiscal stability, hence our overweight to the region.

We believe that earnings need to grow in order to justify the price gains of last year, but the strategic combination of below-trend prices — Price Matters® — and the tactical improvement in purchasing manager indexes (PMIs), which tend to lead earnings, suggests the Eurozone should outperform over the coming quarters. Indeed, Eurozone PMIs for manufacturing rose in December to their best levels in three years, suggesting ongoing expansion in business activity.

THE WEEKLY CHART: STOCKS TRUMP BONDS



In his book, *Being Right or Making Money*, Ned Davis makes the case that accurate forecasting is not a prerequitise for making money, and he highlights the importance of investment disciplines and flexibility. In our view, 2013 demonstrated the value of these insights. In December 2012, we forecast the direction, but not the magnitude of global stock gains. Furthermore, we did not expect emerging markets to underperform. Nonetheless, our willingness to overweight higher risk assets (when we judged the price was attractive enough to compensate for the risk) appears to have been beneficial for our portfolios, and our price and momentum disciplines kept us invested.

For an asset allocator with a broad mandate, last year's opportunities for success or failure covered a wide range, as illustrated in the chart above. The single most helpful insight from RiverFront's Price Matters® discipline, in our view, was a preference for stocks over bonds. Within bonds, our discipline indicated a strong preference for credit (especially high yield) and short maturities. We also avoided commodities and underweighted commodity sensitive markets such as Canada, Latin America and sectors such as utilities and energy.