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Stock Markets Rise Despite Mixed Economic Data and ISIS Threat

With recent global geopolitical events dominating the news, this is probably a good time to think longer term and remember why you decided on your preferred asset allocation. If you are a RiverFront client, it may also be a good time to remind you of the long-term risk management that is built into our timeframe-based portfolios. We have stress-tested them against challenging historical times for markets; our portfolios seek to, at a minimum, preserve your capital over the corresponding timeframes we have set.

That said, we also have a mandate to consider markets in the short term. Currently, a few indicators are showing clear messages; however, many other indicators are decidedly mixed. The commodity markets – especially oil – continue to reflect clear oversupply, and this is manifest in the recession in the industries that support their production. Consumer indicators globally, on the other hand, remain solid and stable.

While deeply saddened by the tragic loss of life in last week's terrorist attacks in Paris, we have also attempted to think through the potential economic and market implications of the events, as well as the potential implications for the refugees fleeing Syria.

For guidance, we look to the historical effects of similar attacks that are significant in scale but prove to be relatively infrequent. The al-Qaeda attacks in Madrid (2004) and London (2005) are comparable examples, as are the numerous but sporadic attacks by the IRA in England, or by the Baader-Meinhof gang in Germany (both during the 1970's and 80's). None of these events had a sustained material effect on either their economies or markets. By contrast, countries like Lebanon, Israel, Northern Ireland and, at an extreme, Syria, show that sustained frequent use of terror can alter a country's economic future. We are not experts on terrorism or counter-terrorism intelligence, but we hope and believe that the coordinated counter-terrorism measures that have so far restrained al-Qaeda's efforts will prevail against ISIS. Our short-term risk management processes will engage if markets take a less sanguine view than they did last week, as global stocks rose about 3%, in part due to the expectation of further action by the European Central Bank.

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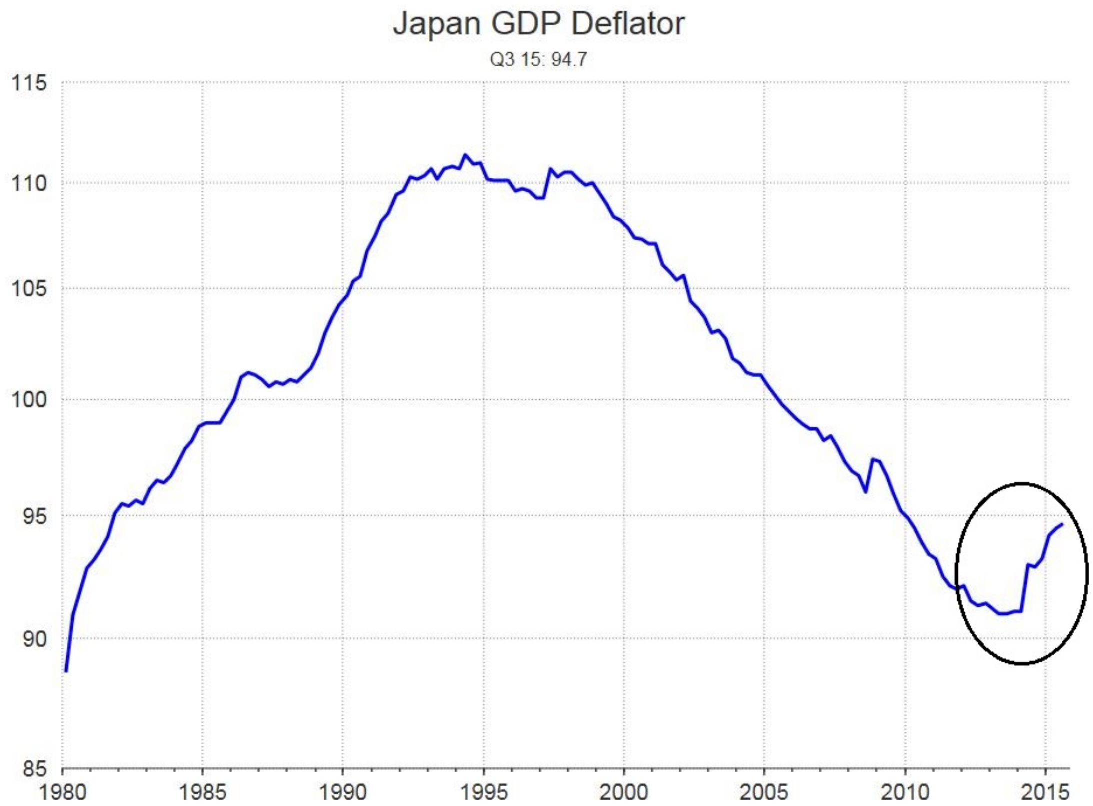
One indicator which has made a clear turnaround is the 20-year cycle of deflation in Japan. In a country with a social contract to preserve employment, deflation is devastating to corporate profits.

In the early 1990s, then Bank of Japan Governor Mieno was determined to force corporate restructuring in the wake of the collapse of housing and stock prices. He deliberately maintained interest rates above a rapidly declining rate of inflation, and in our opinion, brought about the subsequent persistent period of falling prices.

Mieno's policies were exactly the opposite of those pursued by Ben Bernanke 15 years later, and the consequences were also reversed. Savers in Japan were rewarded by falling prices and the rising purchasing power of cash, government bonds and the ever-strengthening yen. By contrast, stock investors in Japan were the unfortunate recipients of a simultaneous decline in both earnings and valuations. Since 2008, the Federal Reserve's determination not to repeat what they saw as a disastrous policy to repeat Japan's mistakes has led to cash savers falling victim to rising prices, and stock investors enjoying a vigorous bull market driven by low interest rates and record corporate profits and profit margins. We believe that Japan is set on a very different course today: one that favors stock investors over holders of cash, just as corporate costs are declining and profits are rebounding. Hence, our bullishness on Japanese stocks.

THE WEEKLY CHART: THE END OF THE ERA OF DEFLATION IN JAPAN



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

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