Dovish on the Fed, Bullish on Japan

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We think December's weak job gains of 74,000 versus consensus expectations for around 200,000 was likely a 'one off' and does not portend economic weakness. Losses in such areas as construction, transportation, and warehousing appear weather related, while more real-time indicators like jobless claims and the purchasing managers indexes (PMIs) for employment suggest ongoing labor market improvement.

The three-tenths of a point drop in the unemployment rate to 6.7% requires further examination, in our view, since the Federal Reserve's *current* threshold to consider raising interest rates from the 'zero lower bound' is 6.5%. The recent expiry of emergency unemployment compensation is likely to reduce the unemployment rate further in the next few months as more people drop out of the work force. While this could be seen as raising the probability that Fed raises rates this year, we still expect the first rise in rates to be in 2015 or later. The Fed recently said that "it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the Committee's 2% longer-run goal."

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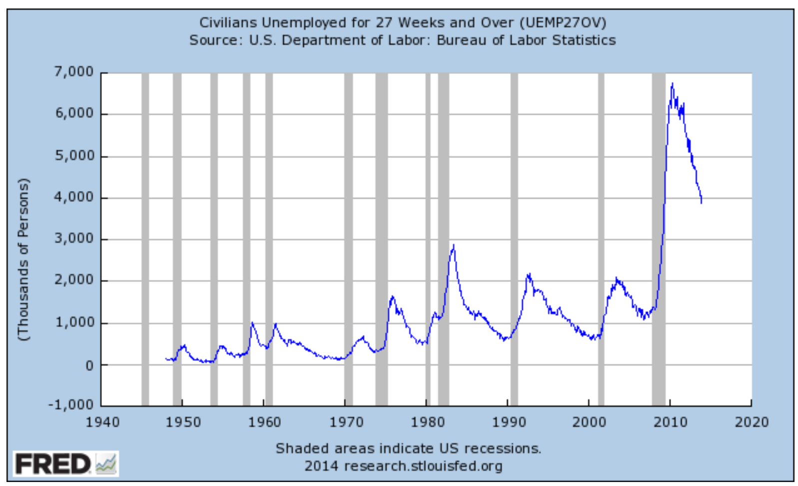
The unemployment rate is just one of many indicators the Fed monitors to determine whether the overall health of the labor market has improved enough to warrant tightening. Newly confirmed Fed Chairman Janet Yellen has emphasized the plight of the long-term unemployed as a key consideration in keeping monetary policy extraordinarily accommodative. As shown in the chart on the right, those unemployed for over 26 weeks are still far above normal (although substantially lower since the end of the Great Recession).



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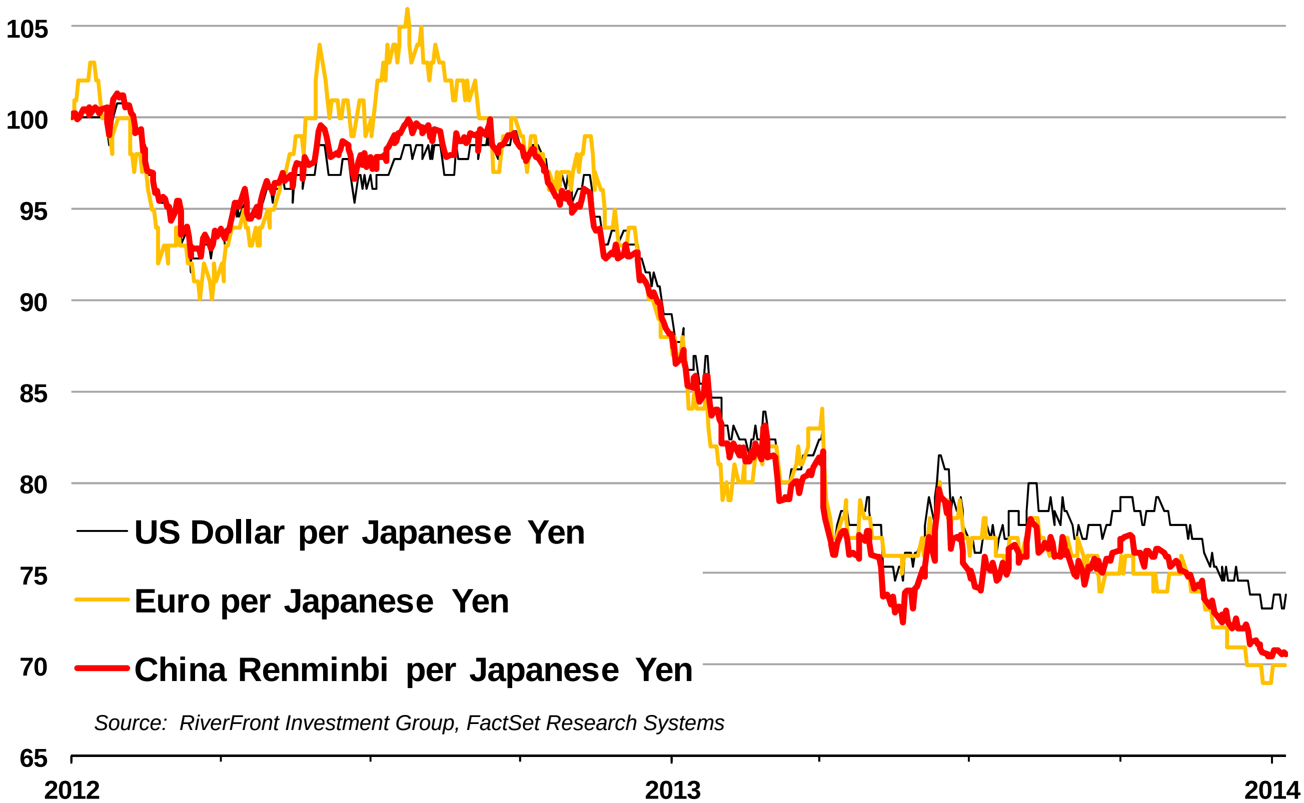
We expect stocks to continue outperforming bonds in an environment of monetary accommodation, economic expansion, earnings growth, inflation at 1.2% year over year and forward inflation expectations remaining well anchored. For large cap US stocks, our Price Matters® framework indicates fair value, which suggests a slower pace of appreciation than last year. In contrast, small and mid-caps are both more than 25% above their 88-year trends, hence our preference for micro caps, which have returned to trend.

Moving to Japan, as we wrote extensively last year, Japan's Prime Minister Shinzo Abe's economic policies, in addition to the world's most aggressive central bank easing by the Bank of Japan, have kick-started growth after decades of stagnation and deflation. This year's challenge is to incorporate 'third arrow' structural reforms to sustain growth with monetary and fiscal initiatives. We are focused on: (1) wage hikes that should more than offset consumer tax hikes, driven by 2013 earnings growth of 40% following significant yen weakness; (2) approval of the Trans-Pacific Partnership (Japan is a major partner) — a bipartisan bill to support the President Obama's 'trade promotion authority' is wending its way through congress, and (3) nuclear restarts following regulatory approval that will help reduce Japan's fuel import bill, lower energy prices, and rebalance trade.

THE WEEKLY CHART: SIGNIFICANT EXPORT ADVANTAGE



RiverFront has been overweight Japan across all portfolios since February 2013 (after raising our exposure from underweight to neutral in December 2012). The 20% decline in the Japanese stock market — about 14% on a US dollar basis — in the second quarter of 2013 tested our confidence. Fortunately, since last summer, Japanese stocks have performed roughly in line with US stocks and have recovered nearly all of last year's correction. One of the main factors that gives us the confidence to maintain our overweight is the ongoing weakness in the yen. As the yen weakens, Japanese goods become cheaper relative to its trading partners; with exports at 16% of GDP, increasing exports make a meaningful difference to the Japanese economy. The yen's weakness versus Japan's major export destinations is illustrated in the chart above — it has depreciated by 34% versus the euro since July 2012, and is down 30% versus the Chinese yuan and 26% versus the US dollar since September 2012. Japanese exports rose for the ninth consecutive month in November and were up 16% year over year, the best growth in three years, suggesting the weakening currency is helping exports gain traction. Even if the yen stabilizes around current levels, the benefits of its depreciation versus Japan's major trading partners will remain.