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- A healthy measure of optimism is currently priced into the valuations of US equities.
- Further market gains will be dependent on the resilience of corporate profit margins, the continued health of the US consumer, and resolution to trade disputes, in our view.
- While we remain positive, we recognize recent challenges and will be monitoring each with our usual healthy skepticism.

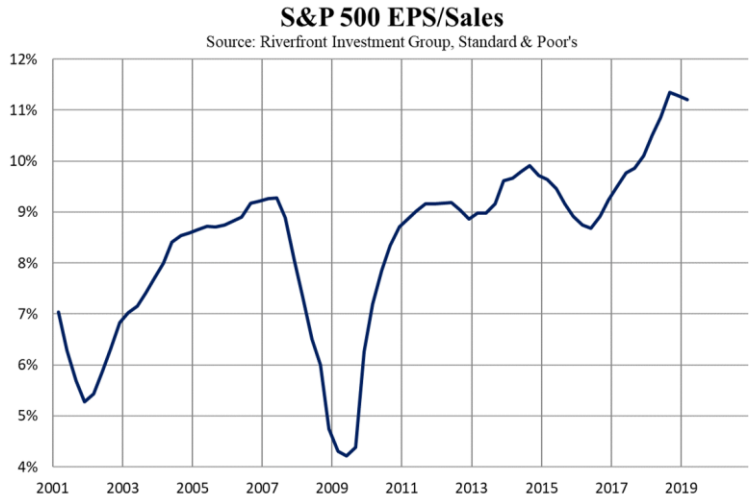
What Could Go Wrong?

A View from RiverFront's Risk Managers

At Riverfront we place a strong emphasis on risk management – monitoring what's working and what's not. We know mistakes are inevitable; while its ok to 'be wrong,' there are few excuses for 'staying wrong.' At RiverFront, we designed our risk management process to recognize those times when we are wrong and to act if appropriate. A good risk manager needs to be independent and skeptical, and this week we highlight three popular US investment themes which are currently on our radar. In each case we have concluded that risk management is not currently required but we want to acknowledge the risks to stock prices that they pose.

CORPORATE PROFIT MARGINS NEAR AT ALL-TIME HIGHS

Throughout the bull market, expanding profit margins have been the magic elixir to combat slower economic growth. However, over time profit margins tend to mean-revert and falling profit margins can sap the positive benefits from an anticipated resurgence in economic growth. Year-to-date, profit margins have remained robust (chart below) and are a big reason that earnings announcements have been above expectations throughout the first quarter. However, buried within a growing number of earnings reports we have noted that companies across a variety of industries have begun to cite escalating margin pressures in their discussion of current conditions and forward guidance. This has led to a steady drumbeat of concerns as Wall Street strategists and media pundits question whether corporate profit margins have peaked.



Past performance is no guarantee of future results. Shown for illustrative purposes and not indicative of RiverFront performance. You cannot invest directly in an index.

S&P 500 profit margins, represented by the left chart, are near multi-decade highs.

In our view, future US stock market performance is dependent on profit margins remaining at their current elevated level.

For this reason, it's a metric we are currently monitoring.

Going forward, the pressure on profit margins could increase if companies are unable to raise prices to offset their rising input costs. There are three areas that we could expect to see future challenges to profit margins. First, the rate of change in margins, a statistic

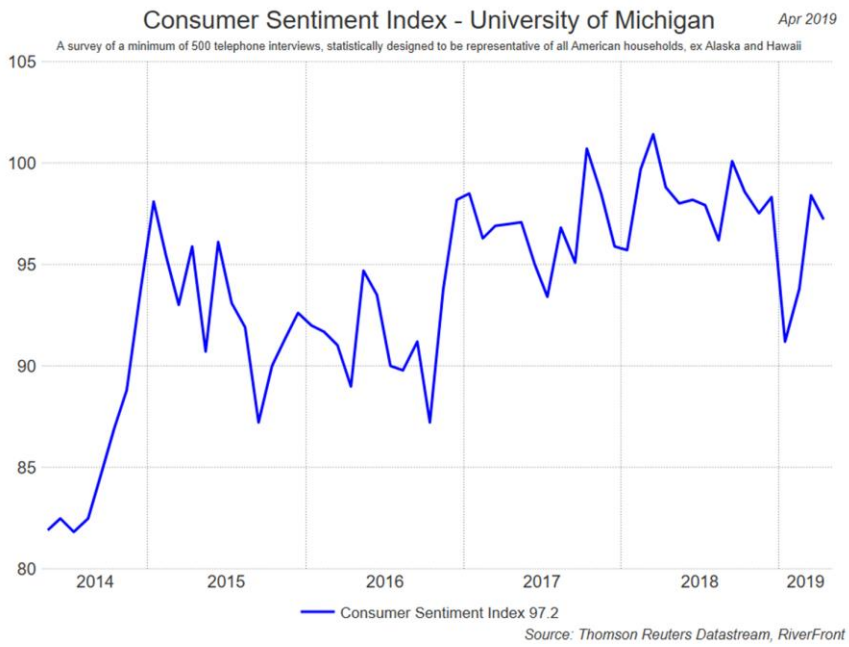
that has historically been important to investors, can be expected to slow as the impact from the 2018 corporate tax cuts starts to fade. Second, employers are beginning to face increasing payroll pressures as unemployment remains below 4% and workers can more forcibly demand higher wages. Finally, raw material prices specifically the prices of some base metals and oil have begun to climb. If we use plastics as an example, over 17 million barrels of oil are required to produce the plastic bottles that are used in the bottled water industry, annually (Pacific Institute). With oil prices having risen nearly 40% year to date, input costs can be expected to spike for petroleum-based products including cosmetics, synthetic rubber, medicines, cleaning products, or anything packaged in a plastic container.

The willingness on the part of investors to look through the current earnings period has left the S&P 500 at valuation multiple levels that leave little room for error. Currently, the S&P 500 is being valued at around 17x forward 12-month earnings estimates, 2 full multiple points above its 10-year average of roughly 15x. Reported earnings that are in-line with or above analysts' expectations can keep investors optimistic in the moment but a more detailed assessment of profit margins and their direction as well as listening to management guidance can be equally important. While we remain optimistic as to an earnings recovery later this year, we will continue to look for additional signs of increasing margin pressures.

US CONSUMER SENTIMENT REMAINS VERY OPTIMISTIC

While the concerns about corporate profit margins have made their way into mainstream media, the market remains relatively complacent regarding the American consumer. The importance of the American consumer cannot be overstated. Since the Financial Crisis they have been one of the most stable and reliable sources of global demand and they are estimated to be responsible for over two-thirds of US economic activity.

However, the American consumer is not infallible, and we have started to closely monitor their health due to some recent red flags that could impact future spending. As noted above, wages are generally higher for many Americans but so are the costs of many non-discretionary items such as gasoline, education, and health care. A study released last year by the Federal Reserve Board noted that 40% of Americans would be unable to cover a $400 unexpected expense. Other factors that could impact discretionary spending include this year's lower tax refunds, higher interest rates on car loans and credit cards, and deteriorating confidence toward the economy in general. While potentially less obvious than corporate profit margins, attention to consumer spending and confidence (right chart) and the potential impact on the economy from any downturn bears watching.



Shown for illustrative purposes only.

INVESTORS MAY BE TOO COMPLACENT REGARDING TRADE

Throughout 2019 investors, RiverFront included, have been optimistic that the trade tensions that plagued equity markets in 2018 were likely to be resolved favorably. However, over the weekend President Trump put the world

on ‘alert’ that a US/China trade deal was far from complete. The President’s weekend tweets are a stark reminder of the fragility of trade negotiations and why a healthy amount of skepticism is necessary when handicapping things that can be as high-stake, complex and political as trade. Currently it is unclear whether the President’s threatened tariff hikes are simply a negotiating tactic or a sign of an irreconcilable breakdown in the trade talks and we hope to have additional clarity in coming days.

BOTTOM LINE

At RiverFront, we are generally optimistic and believe the long-term trend of markets remains higher. However, we also understand the need to incorporate processes within our discipline that will insure our decision-making is balanced and unemotional. Perhaps in Lake Wobegon, all stocks and bonds outperform just like the residents’ ‘above average’ kids but in the real-world it is not that simple. The job of RiverFront’s risk management team is to be skeptical and to consider and plan for ‘what could go wrong’ with the same energy and thoughtfulness that we use when we consider and plan for ‘what could go right.’