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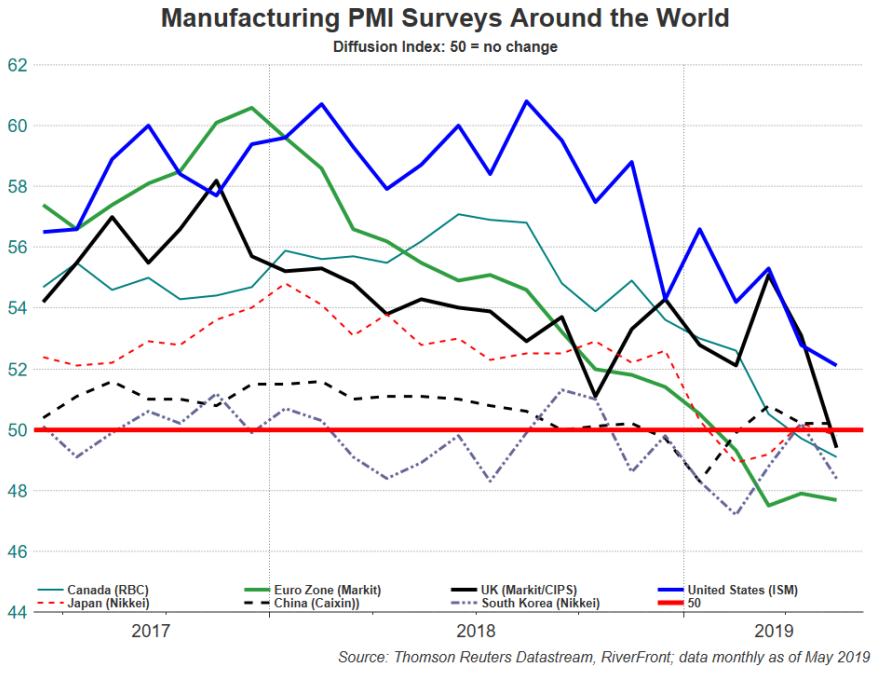
Even though global markets are higher today than before our last '3 Rs'' update in February, the fundamental framework has generally deteriorated, in our opinion.

'3 Rs' Update: Fed Policy Accommodative, but Economic and Trade Risks Have Risen

In our *2019 Outlook*, our base case scenario pointed to a positive outcome for stock markets in 2019… but that outlook was highly dependent on the path of three key market drivers that we call the '3 Rs' - **Recession Risk, Rates and Resolution of Trade Disputes**.

After a strong initial start to the year (see *Weekly View, 2/4/19: Checking in on Our '3 Rs': So Far, So Good*), this quarter's update paints a darker fundamental picture, particularly with regard to international economies. Surprisingly, global markets are higher despite these deteriorating fundamentals prompting RiverFront's portfolio managers to make portfolio adjustments in late May. In our short-horizon portfolios, we shifted some money out of international stocks and into cash, bringing overall risk levels to 'neutral' versus our benchmarks. In our longer-horizon portfolios, we chose to reallocate the proceeds from international sales back into US equities, where economic fundamentals appear stronger.

RECESSION RISK: STILL REMOTE IN THE US, BUT RISING INTERNATIONALLY



In the US, forward-looking business sentiment indicators such as the ISM Purchasing Manager's Index (PMI) survey have deteriorated but are still high enough to suggest the economic recovery remains on steady footing. Ed Hyman, Chairman of Evercore ISI, suggests that the May's ISM reading of 52.1 correlates to US GDP growth of around 2.5%. If Evercore ISI is right, it is premature to assume a US recession is just around the corner.

However, outside of the US trade concerns have contributed to less positive manufacturing sentiment readings. For example, the PMIs in Japan, UK, Canada, South Korea, and the Eurozone are now all under 50 (see chart above), with Germany

clearly in recessionary levels at 44.3. Export data in trade-oriented countries like Germany, Korea, and Japan is continuing to deteriorate as well.

RATES: THE FED STILL ON INVESTORS' SIDE

As markets were reminded last week, our tactical rule of "Don't Fight the Fed' is still very much in effect, as dovish comments from the Federal Reserve on June 4 helped spark a rally that ended a six-week slide in markets. One thing that keeps us from being more cautious on the US market is the 'Powell Put' – the idea that the Federal Reserve remains proactive in protecting the US economic recovery from increasing global economic and political risks. Fed Chair Jerome Powell's comments on Wednesday suggested the Fed is poised to cut interest rates, and a surprisingly weak May payrolls number on June 7th boosted the already high probability of preemptive Fed action in the summer. Outside the US, markets are less sanguine. While the European Central Bank (ECB), Bank of Japan (BoJ) and People's Bank of China (PBoC) all continue to employ accommodative policies, markets are concerned that they may be 'falling behind the curve' on stimulus.

RESOLUTION OF TRADE DISPUTES: FAR FROM BEING RESOLVED AT THIS POINT

Progress on trade is perhaps the most disappointing of our 3 Rs since May, when a relatively abrupt turn in US/China relations heralded a complicated new phase of trade negotiations. Rhetoric on both sides has turned much more aggressive, suggesting a long, drawn-out negotiation versus a quick resolution by June, as many had hoped for. A topic we discussed in detail last week (*Weekly View, 6/3/19: US/China 'digging in' on Trade*).

In addition, the trade 'war' has suddenly become a multi-front affair. While news over the weekend suggests that the Trump administration has dropped tariff threats on Mexico 'indefinitely', investors remain unsettled that the US can threaten unexpected tariffs to achieve non-economic objectives, like border security, despite previously agreed upon trade agreements. In addition, the US's exercise of leverage over the global tech supply chain with their war on Chinese telecommunication equipment maker Huawei has both Asian and US technology companies bracing for further retaliatory measures. These new approaches to trade make it more likely that tariffs will be threatened more regularly and that counterparties to US trade agreements, including some of our closest allies, may be more reticent to come to an agreement quickly. Ultimately, we believe that market valuations must discount these uncertainties for the foreseeable future. While we believe it is in both the US and China's best interests to reach a cease-fire, we are concerned it may be delayed until the start of 2020, which would disappoint investors, in our view. If positive progress can't be made by the end of the summer, both direct effects of the tariff increases as well as the indirect hits to business and consumer confidence could start to create a negative feedback loop into our 2nd 'R' – Recession Risk - forcing us to reevaluate our neutral stance on market positioning.

S&P 500 TECHNICALS: S&P 500 SETTLING INTO A NEW TRADING RANGE?

The technical picture has grown more mixed in the US. After a definitive break above its trading range in early April, the S&P 500 pulled back sharply on trade concerns. The pullback caused the primary trend, as defined by the 200-day moving average (red dotted line), to turn

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slightly negative. Thus, we have lowered the bottom end of our trading range to 2775. Beyond that 2700 may serve as support and we continue to view meaningful resistance near the old highs at 2950.