



by CHRIS
KONSTANTINOS, CFA

THE RIVERFRONT WRITING TEAM

ADAM GROSSMAN, CFA
Global Equity CIO |
Co-Head of Investment Committee

CHRIS KONSTANTINOS, CFA
Director of Investments |
Chief Investment Strategist

KEVIN NICHOLSON, CFA
Global Fixed Income CIO |
Co-Head of Investment Committee

DOUG SANDLER, CFA
Head of Global Strategy

ROD SMYTH
Chairman of the Board of Directors

DAN ZOLET, CFA
Associate Portfolio Manager

SUMMARY

- Leading indicators and government bonds are still forecasting recession...
- ...but unemployment levels, construction spending, stock and credit markets are not.
- We think a mild recession in the next 6-9 months remains the most likely outcome.

DATE 05.15.2023

The US Economy: A 'Riddle Wrapped in an Enigma'

Contradictory signals coming from our Recession Dashboard

A 'recession' is defined by the National Bureau of Economic Research (NBER) as a "significant decline in economic activity that is spread across the economy and lasts more than a few months". Other economists define 'recession' more specifically, as representing two straight quarters of negative real (adjusted for inflation) GDP growth. Just as there is no one single definition of 'recession', there is similarly no one perfect way to predict it.

We once again revisit our 'Recession Dashboard', a list of indicators that we have found, in our experience, to be useful recession predictors. This is not an exhaustive list of what we track, and of course, no one indicator is infallible. However, taken in aggregate, we believe this provides a robust estimation of recession risks over the next 6-12 months. Shaded gray regions on the charts in this piece denote historical recessions as defined by NBER; each indicator we show has data back to at least the 1970s.

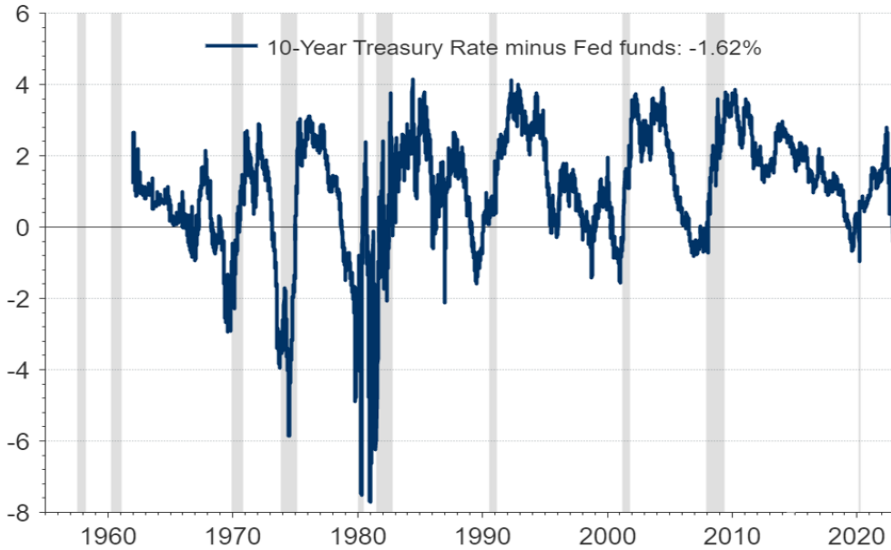
Our conclusion today – as it was back in January (see [Weekly View 1/31/23](#)) – is that the highest probability outcome is a mild recession sometime towards the back half of 2023 or early 2024. The conviction in our statement is higher today, as government bond signals and other leading economic indicators have weakened since January. We have also started seeing the early signs of a tightening of credit availability to smaller businesses. The looming US debt ceiling is yet another economic risk factor.

However, to paraphrase Winston Churchill, for us the 'riddle wrapped in a mystery inside an enigma' is that employment data remains so solid, and stock and credit markets – arguably the most reliable recession predictors – remain sanguine. Perhaps both messages are 'right' in that we are indeed heading for a recession, but just a mild one that allows for US corporate earnings to hold up ... a theme we explored in more depth in our [2023 Outlook](#).

Treasury-to-Fed Funds Rate Differential: *Negative - Inversion is Flashing a Warning Signal*

The difference in yield between 10-year Treasury Note and Fed Funds (FF) yields has remained officially 'inverted' as 10-year yields are lower than short-term interest rates (see Chart 1, next page). An inverted yield curve has historically been a reliable signal of impending recession, because falling long-term interest rates often mean bond investors expect some combination of lower future inflation and growth. When they fall below the levels set by the Federal Reserve, the bond market is suggesting the Fed has raised rates too much. After the curve inverts, a recession typically starts a year later, in our view. The yield curve has been inverted since November '22, implying a formal 'recession' could start this upcoming winter or early next year. This signal has been a reliable but not perfect indicator for a half-century and as such must be taken seriously.

CHART 1: Treasuries-to-Fed Funds Signalling Recession



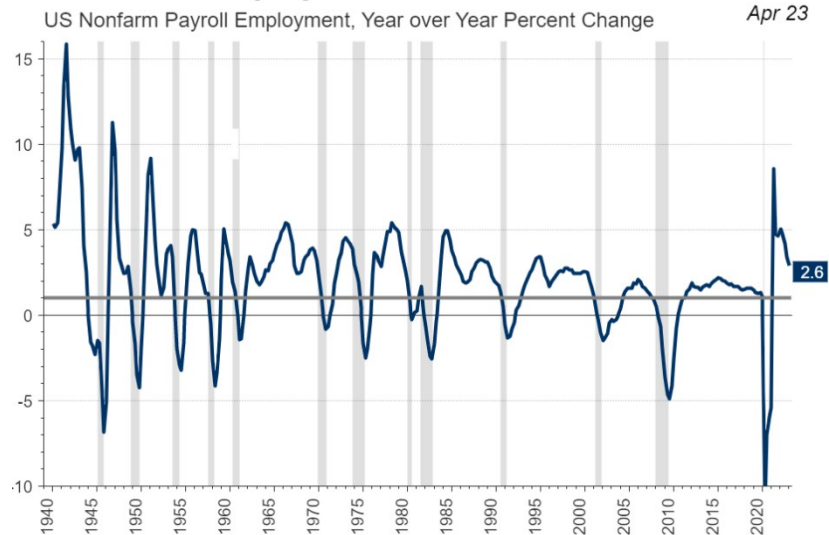
Source: Refinitiv Datastream, RiverFront. Data daily as of 5.15.23. Chart left shown for illustrative purposes. Not indicative of RiverFront portfolio performance.

Labor Market: Positive - Employment Picture Remains Stable

Employment: Slowing employment trends can give important warning signals concerning the health of the economy. When employment growth falls below 1% (it's long-term trend), a recession often follows, in our view. Despite a surge in layoff headlines, payrolls are still growing above +2.5% year-over-year (Chart 2, right), down a little from January's reading of 2.9%. **There seems to be a structural shortage of workers and so any downturn in the labor market will be less than usual, in our view.** Other employment-related signals we like to follow also remain in a constructive zone, in our opinion.

Source: Refinitiv Datastream, RiverFront. Data monthly as of 4.14.23. Chart right shown for illustrative purposes.

CHART 2: Employment Picture Remains Stable



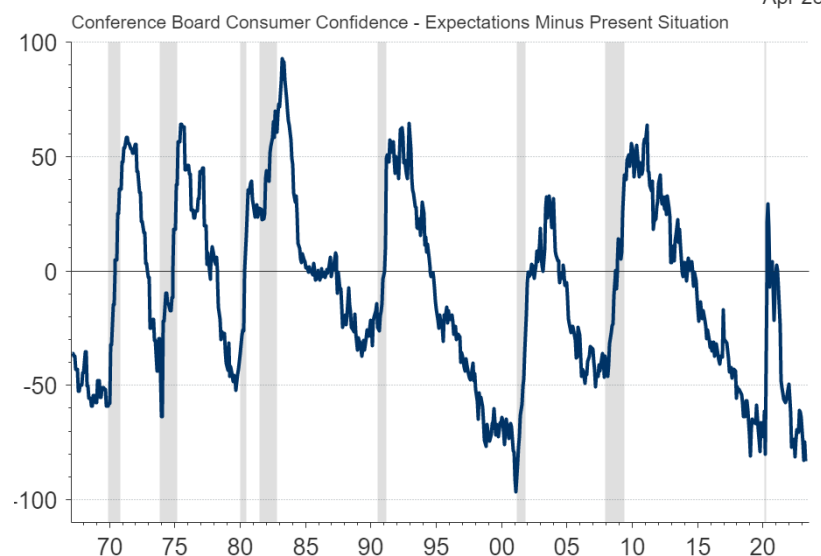
Consumer Confidence: Negative - Confidence Again Near Multi-Year Lows

The psyche of the US consumer is important, given that consumer spending represents nearly 70% of the US economy. A large drop in the difference between the Conference Board's Consumer Expectations Index and the Present Situation Index usually precedes recession, but the lag times vary greatly. We believe it is most predictive at extremes, where it is today.

The improvement we witnessed from last summer to early this year has now dissipated, and this indicator remains well into recessionary territory, judging from history.

Source: Refinitiv Datastream, RiverFront. Data monthly as of 4.14.23. Chart right shown for illustrative purposes.

CHART 3: Consumer Confidence Still Poor



Construction Spending and Heavy Truck Sales: *Positive - Still Growing, but Slowing*

Construction plays an important role as a job creator across many industries and as a driver of demand for both natural resources and finished goods. Construction spending is growing at around 3.8+% as of March, down from 6.3% in January but still positive for future GDP growth if it can stabilize, in our view.

Heavy Truck Sales*: Another related data point is yearly heavy truck sales, which are running above 40k units/month – at the high end of its historical range – suggesting continued strong demand for goods and construction.

*Heavy trucks weigh over 26,000 pounds and include 18-wheeler tractors, cement mixers and city buses.

Lending: *Mixed - Bank Loan Creation Still High, but Heading the Wrong Direction*

Capital represents the 'lifblood' for most businesses. Without access to capital, companies are unable to grow and may even need to restrict existing operations.

Bank loan creation grew at a historically strong year-over-year rate of almost 10% in April, slightly down from the levels we reported on in January. However, given the recent 'mini crisis' for regional lenders (see [Weekly View](#) 5/1/23), we expect the recent negative inflection in US bank loans to continue, at least for end markets such as commercial real estate and small business loans. The recent Senior Loan Officer Survey corroborated this inflection, as demand for Commercial & Industrial loans were down -53.3%, the second lowest level on record.

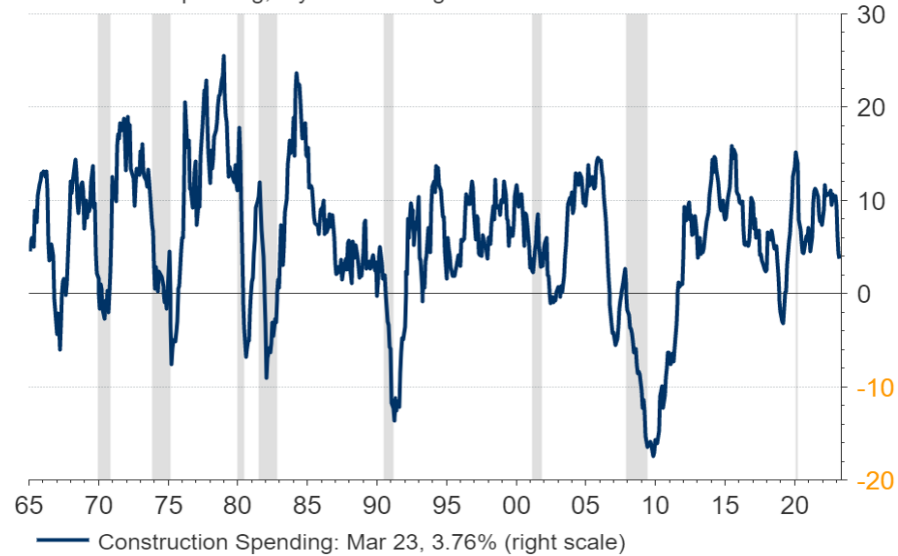
Leading Economic Indicators (LEI): *Negative - Indicator Below Zero Since September 2022*

The Conference Board's 'Leading Economic Indicators' (LEI) is a predictive variable that is designed to anticipate turning points in the business cycle by roughly 7 months. The LEI is comprised of 10 indicators related to employment, business orders, residential housing demand, stock market prices and bond market credit conditions. The LEI has now fallen consistently for over a year, and is well below zero, which we typically associate with pre-recessionary conditions.

CHART 4: Construction Positive but Slowing

Construction Spending, 1-year % Change

Mar 23



Source: Refinitiv Datastream/Fathom Consulting. Data monthly as of 3.31.23.

Chart shown for illustrative purposes.

CHART 5: Loan Growth Positive For Now

US Bank Loans, 12-month % change

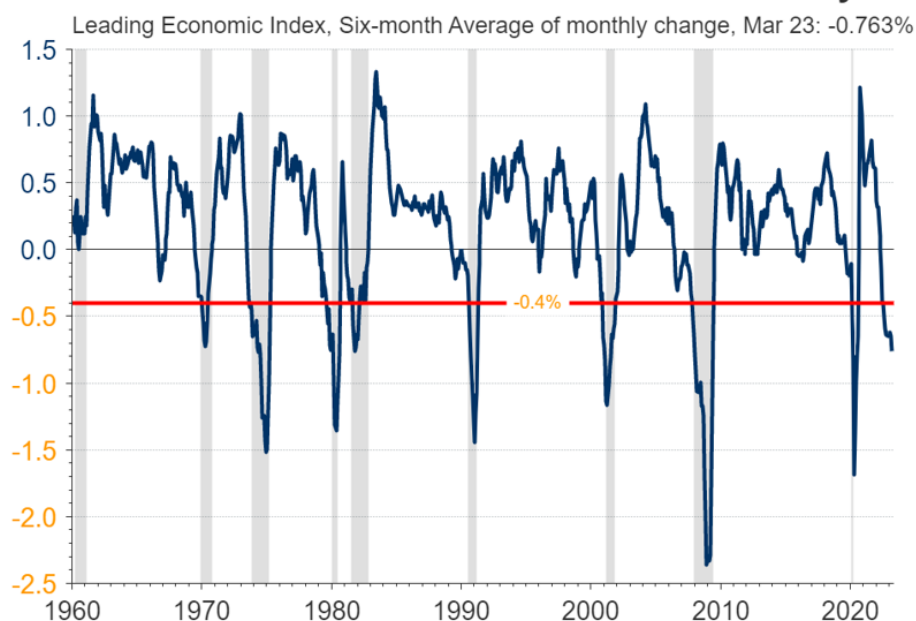
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Source: Refinitiv Datastream, RiverFront. Data monthly as of 5.03.23. Chart shown for illustrative purposes.

However, we would note that the recent Purchasing Manager Index (PMI) surveys tell a slightly different story. In those surveys, the S&P Global/Markit US manufacturing PMI is now slightly above 50 at 50.2. In addition, this indicator has now improved for the fourth straight month.

CHART 6: LEI Further Into Recession Territory



Source: Refinitiv Datastream, RiverFront. Data monthly as of 5.15.23. Chart left shown for illustrative purposes.

Conclusion:

As you can see from our selection of indicators, the more coincident indicators -- employment, construction and lending - suggest to us that the economy is quite healthy at the moment, but the more predictive indicators are negative. The enigma for us is that two major leading indicators for recessions -- the stock and corporate bond markets - are not flashing a warning.

We think the best explanation for this enigma is that a backdrop of reasonable nominal growth, which includes the effect of rising prices, and a tight labor market can keep corporate earnings from deteriorating further, supporting stocks and corporate bonds. The highest probability outcome in our opinion is a mild recession sometime towards the back half of 2023 or early 2024. Given the mixed signals from our Recession Dashboard, RiverFront's investment team remains roughly neutral in our stock-to-bond mix relative to our long-term strategic targets. Rather than large overweights or underweights to asset classes, we are focusing on security selection with an eye towards generating stable cash flow and income growth.

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Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Index Definitions:

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

Definitions:

The National Bureau of Economic Research (NBER) is a private, non-profit, non-partisan research organization with an aim is to promote a greater understanding of how the economy works. It disseminates economic research among public policymakers, business professionals, and the academic community.

The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity. The U.S. government partially funds itself by issuing 10-year Treasury notes.

The nonfarm payroll measures the number of workers in the U.S. except those in farming, private households, proprietors, non-profit employees, and active military. The Bureau of Labor Statistics (BLS) surveys private and government entities throughout the U.S. to obtain information about their payrolls. The nonfarm payroll numbers are reported monthly to the public through the closely followed Employment Situation summary.

The Conference Board (CB) is a not-for-profit research organization that distributes vital economic information to its peer-to-peer business members. Founded in 1916, this member-driven economic think tank is a widely quoted private source of business intelligence.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. The CCI is based on the premise that if consumers are optimistic, they will spend more and stimulate the economy but if they are pessimistic then their spending patterns could lead to an economic slowdown or recession.

A leading indicator is a measurable set of data that may help to forecast future economic activity. Leading economic indicators can be used to predict changes in the economy before the economy begins to shift in a particular direction. They have the potential to be useful for businesses, investors, and policy makers.

The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It consists of a diffusion index that summarizes whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting. The purpose of the PMI is to provide information about current and future business conditions to company decision makers, analysts, and investors.

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