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The Odds of a Positive Resolution to Trade Disputes Have Increased, In Our View

In RiverFront's 2018 Outlook, we contended that President Trump's approach to trade disputes was a key variable that could catalyze our optimistic upside scenario for financial markets or derail the accelerating global recovery by inadvertently igniting a trade war. We believe that recent developments in the Trump Administration's ongoing trade dispute with China have increased the odds of a positive outcome, and that the probability of our Pessimistic, Baseline and Optimistic Scenarios are all now approximately equal at 33%.

| | PESSIMISTIC Rise of Populism and Fall of QE | BASELINE Spreading the Wealth | OPTIMISTIC "Party Like it's 1999" |
|-------------------|--|--|--|
| PROBABILITY | 33% | 34% | 33% |
| POLICY OUTCOME US | Trade war with China, NAFTA breaks up, consequences magnified by unwind of QE. | Growth accelerates thanks to deregulation and tax reform. Tight labor markets accelerate pay increases. Trade disputes contained but not fully resolved. | Economy gets additional boost from opening China market to more imports. |

The table above depicts RiverFront's predictions for 2018 using 3 scenarios (Baseline, Optimistic, Pessimistic). Our assessment of each scenario's probability is also shown. Please note that these predictions reflect RiverFront's views as of the date of publication. These views are subject to change and are not intended as investment recommendations. There is no representation that an investor will or is likely to achieve positive returns, avoid losses or experience returns as discussed for various market classes.

OPTIMISTIC SCENARIO

In an April 11th speech, Chinese President Xi Jinping offered several concrete and meaningful concessions on trade. These concessions included lowering China's tariffs on imported cars and eliminating the requirement that foreign companies operate in China through Chinese controlled joint ventures. President Xi also offered platitudes about protecting intellectual property that may or may not amount to much, but his rhetoric creates an opportunity for President Trump to save face with his base and claim a win. Yi Gang, governor of the People's Bank of China, followed the next day with a proposed package of reforms that would substantially liberalize foreign access to China's financial sector.

We think the combination of Xi's and Yi's proposals form the basis for a potential deal. President Trump is unlikely to want a trade war to dominate headlines and financial markets in the run up to the midterm elections, especially since China has made clear that their retaliation will specifically target farm exports from parts of the country that strongly support him. Treasury Secretary Mnuchin will undoubtedly remind the president that financing our \$1 trillion deficits will be much easier with China's cooperation, and our new Secretary of State could make a similar point about the upcoming summit with North Korea. Agreeing to the existing package of Chinese proposals allows President Trump to show his base that he kept his campaign promises regarding trade without the dire consequences predicted by his opponents. If China fails to implement the proposed reforms or if these reforms prove inadequate to shrink the trade deficit, then the Trump Administration can renew their confrontational strategy after the midterm elections.

A positive resolution to the current trade disputes may become even more important if additional concerns arise for the Trump administration and financial markets. Special Counsel Robert

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Mueller's investigation appears to be increasingly aggressive in targeting figures close to the President. Should President Trump fire Assistant Attorney General Rod Rosenstein (Mueller's boss) or even Mueller himself (which his administration recently asserted he has the authority to do), it could prompt a severe political backlash in Congress and in the midterm elections. The Syrian poison gas strike raises the prospect of deeper involvement in the conflict and potentially a direct confrontation with Russia. We believe that even a confrontational personality like President Trump might want to eliminate the prospect of a trade war before engaging in additional controversial policy initiatives.

BASELINE SCENARIO

President Trump has an offer from China's leadership that, if accepted, has the potential to substantially change the trading relationship between the US and China. However, a frequent complaint we hear from US companies operating in China is that negotiations truly begin after an agreement is signed. Significant disagreements frequently arise over the meaning of contractual obligations and the extent to which those obligations have been met. US trade negotiators may find that China agrees to sweeping changes, but the actual implementation of those changes consistently falls short of expectations.

In this scenario, the short-term resolution of the trade dispute should allow continued strong global growth for the rest of 2018 and a renewed upswing in global equity markets, in our view. However, the global economy would not receive an additional boost from Chinese reforms and the trade dispute would likely be resumed sometime in 2019.

THE PESSIMISTIC CASE

The primary risk to these optimistic scenarios, in our view, is the potential that President Trump may be seeking the far more sweeping concessions that President Reagan extracted from Japan in the 1980s. Robert Lighthizer, President Trump's trade representative, was one of President Reagan's lead negotiators with Japan. We believe such sweeping concessions are unlikely because, unlike Japan, China is not an ally of the US and is not dependent on the US for its defense. Furthermore, China believes that the concessions Japan granted to the US in the 1980s were a primary cause of Japanese stagnation that began in the 1990s (we disagree but our opinion does not count).

China's leadership has already signaled how they will respond if they feel China is being pushed too hard to make trade concessions. Several Chinese officials (with the notable exception of President Xi) have indicated that China will not negotiate with the threat of tariffs hanging over its head. In fact, China's state-run media asserted that Xi's proposals were not concessions made in response to threats, but rather were initiatives that China already intended to implement. If President Trump pushes too hard for additional concessions, Chinese leadership could dig in on a principle of not negotiating while being threatened with tariffs. That could leave President Trump facing a choice between a humiliating retreat from his tariff threats or an outright trade war.

Should a trade war erupt, the Trump administration's current tariff proposals apply to \$150 billion in Chinese imports. That exceeds total US exports to China, so any Chinese retaliation may have to venture into the dangerous ground of threatening to sell their vast Treasury bond holdings or explicit retaliation against the Chinese operations of US companies. Both equity and fixed income markets could suffer significant price declines as a result, in our view, which could cost Republicans and President Trump dearly in the midterm elections. It is important to note that if China sells its Treasury holdings, their currency is likely to appreciate as they sell dollar assets and repatriate the money into yuan. A rising yuan could put further downward pressure on Chinese exports.

RISK MANAGEMENT

We believe markets are poised for significant upside if Trump's aggressive strategy results in potentially meaningful reform of China's trade policies. However, the consequences for corporate earnings and global growth could be dire should the current dispute spiral into a trade war, in our view. Financial markets have been bounced around by every angry tweet and every signal of potential compromise. An environment with a high probability of a binary outcome (either very good or very bad) significantly complicates our risk management strategy.

We are implementing a multi-faceted approach to deal with the complexity of the possible outcomes. In our shorter time horizon portfolios, those portfolios with horizons less than 7 years, we will likely reduce equity exposure in the portfolios if our stop loss level is breached. This approach should help mitigate drawdowns in these portfolios. We believe that our longer time horizon portfolios can endure greater volatility and therefore we intend to maintain our current equity exposure in these portfolios if our initial stop loss is breached. However, we have set a lower stop loss for these portfolios in case our pessimistic scenario becomes increasingly likely. *Views and opinions are as of the date published and subject to change.*

CONCLUSION

In his book ***The Art of the Deal***, President Trump describes his negotiating style as an initial series of unreasonable demands and heated rhetoric followed by unexpected compromises. He appeared to follow this pattern in his dealings with North Korea, in his proposed steel and aluminum tariffs, and in his sudden decision to reconsider US participation in the Trans Pacific Partnership. China has offered significant concessions that, if accepted, can be marketed as a big triumph for the Trump administration's aggressive approach to trade disputes. President Trump's track record thus far in office suggests that he will compromise quickly once he thinks he has achieved all he can achieve. Given the concessions China has put on the table, we believe the odds have significantly increased for a compromise solution offering at least the potential that China opens its markets to more foreign goods and services.

Market volatility will not end if we see a positive resolution to the China trade dispute, in our view. Our 2018 Outlook contended that markets will experience higher levels of volatility for the foreseeable future. Fed interest rate hikes along with continued political drama should provide plenty of opportunity for markets to become unsettled. However, we believe that a positive resolution to the current trade dispute could eliminate the primary risk to the global economy and allow continued strong earnings growth to push global equity market higher despite continued volatility.

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Diversification does not ensure a profit or protect against a loss.

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.

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.

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