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SUMMARY

- In our view, stagflation scenarios tend to be worse for balanced portfolios than recessions.
- Portfolio strategy for each differs, especially in Fixed Income.
- We believe both outcomes to be unlikely.

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Stagflation vs. Recession

Defining Two Different Negative Market Outcomes

Earlier this month we saw volatility spike as markets repriced recession risk, giving investors unpleasant flashbacks to 2022. However, unlike in 2022, it seems the market believes the greater risk lies today in a typical garden-variety 'recession' and not in the much rarer but more pernicious 'stagflation'. While we continue to believe that the market is going to avoid both of these tough market outcomes in the near-term, a big part of our proactive risk process is summarizing possible broad economic scenarios, the conditions for their occurrence, and their impact on the economy and corporate earnings. From there, we continually update our likelihood of each scenario as new data becomes available. In this Strategic View, we will dig into two of the most market-negative (and unlikely in our view) outcomes – recession and stagflation - defining them and discussing their ramifications.

Recession vs. Stagflation

When looking at a typical disinflationary recession and a stagflation scenario, their commonality is that inflation-adjusted (aka "real" in economist parlance) economic activity declines in both scenarios. Looking at Figure 1, we can begin to see the differences between these two scenarios:

Figure 1: The Similarities and Differences between Recession and Stagflation

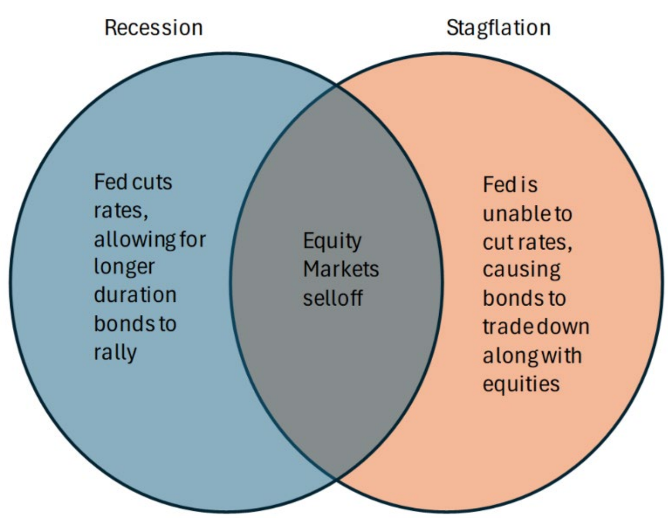

Chart shown for illustrative purposes only. Past performance is no indication of future results.

The major differentiator between the two scenarios is inflation levels, and the Federal Reserve's ability to respond to slowing growth with interest rate cuts and stimulus. For a standard recession, slowing economic growth reduces aggregate demand, which reduces inflation over time.

On the other hand, stagflation is the combination of economic STAGnation and inFLATION. While a much rarer occurrence – stagflation has only occurred once in the last century, during the 1970s and early 80s –, this particular combination of economic factors creates a very difficult investing landscape. The key to understanding why these two tough scenarios are different is understanding that the Fed has a dual mandate to both balance full employment and control inflation. During a typical recession, unemployment rising and inflation falling may give the Fed license to enact expansionary policies, such as rate cuts, to help stimulate both economic growth *and* inflation. However, given that inflation would be above its' target during stagflation, the Fed's decision becomes much less clear. They must either pursue policies to reinvigorate the economy *or* policies to reduce inflation…two actions that are often mutually exclusive. If they were to cut rates, economic growth may reaccelerate, but they would risk having inflation run rampant. On the other hand, continuing with restrictive policies would hopefully keep inflation in check, but the economy might remain sluggish for a prolonged period. We believe it is this difference in the Fed's potential response that truly differentiates these two investment scenarios.

Ramifications of Recession vs. Stagflation: Bonds Not a Ballast in Stagflation

While the major economic recessions in 2008/9 and 2020 had very different causes, both resulted in significant bear markets for stocks. Stock markets traded down indiscriminately, with more defensive sectors such as consumer staples tending to perform relatively better than broad indexes, though still negatively. With the Fed pivoting to expansionary policy, long maturity treasury securities helped provided ballast to balanced portfolios, whereas high yield corporate bonds traded down in concert with equities as credit spreads widened. In a typical recession, we believe that if the Fed is able to cut rates and provide a bit of a safety net, stocks can find a bottom relatively quickly (usually within 12 months).

Moving to stagflation, we believe that equity markets would broadly sell off similarly to recession, though we believe sector relative performance may differ. While we believe defensive sectors would perform best in a normal recession, in a stagflation scenario energy and other commodity-and real asset-related equities would likely be relative winners. However, the bigger difference is the Fed is no longer firmly on the bond investors' side in stagflation. This means that long maturity bonds would no longer provide protection to balanced portfolios during stagflation. We can look to 2022 to see this in action. When markets began to fear runaway inflation and started to price in a higher probability of stagflation, we saw the worst year for the traditional '60/40' balanced portfolio in decades. This negative outcome was partly due to the exceptionally low interest rates at the beginning of 2022. While rates are higher today than 2022, in a stagflation scenario, investors would still need to look at alternative options for portfolio protection. These alternatives, in our view, include short maturity treasury inflation-protected securities (TIPS) and commodities, both direct and via equity exposure.

CONCLUSION: We Believe Neither Negative Scenario is Likely

To start, **we do not believe either recession or stagflation is a likely outcome.** As discussed in last week's Weekly View, we place less than a 30% probability combined for both scenarios over the next 6-12 months. With recent lower inflation data and a more dovish tone from the Fed, we view a recession as more likely than stagflation if markets begin to trend downward, and our portfolio positioning broadly reflects this belief. Our fixed income positioning reflects our lower concern around the probability of stagflation relative to a garden-variety recession; we view long maturity bonds as a good tail risk hedge and have Treasuries and Investment Grade Credit in the 10+ year part of the curve as a hedge for this outcome. Specifically, we view ten-year rates within a range of 3.75% and 4.75% as attractive prices for this protection.

However, if inflation begins to reaccelerate meaningfully, or if we see a large spike in commodity prices, our perceived chance of stagflation would rise as well, leading us to consider TIPS and/or commodity exposure for the portfolio. Since we view a recession as the more likely negative outcome, typically defensive equities would be positioned as potential partial 'tail risk' hedges. However, we currently view most of these sectors as overvalued or overly reliant on interest rates to drive their returns. Instead, we prefer to focus our defensive positioning on alternative equity strategies. These strategies sacrifice some of the upside of equity markets for more current income. This income can provide ballast to portfolios should markets make a downturn.

Given we do not foresee these negative outcomes, we remain overweight equities in our portfolios. We remain overweight large cap technology, relative to our global benchmarks. In a reflationary scenario, we would expect market breadth to increase, specifically in typically value-oriented sectors.

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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.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios. For more information on our other portfolios, please visit www.riverfrontig.com or contact your Financial Advisor.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Treasury inflation-protected securities (TIPS) are a type of Treasury security issued by the US government. TIPS are indexed to inflation in order to protect investors from a decline in the purchasing power of their money. As inflation rises, TIPS adjust in price to maintain its real value.

US large cap equities include equities of companies with a market capitalization of over $10 billion. Although large cap equities are generally considered to be safer securities, large cap equities are still subject to the risks associated with stocks.

Definitions:

Real gross domestic product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. Real GDP is expressed in base-year prices. It is often referred to as constant-price GDP, inflation-corrected GDP, or constant-dollar GDP. Put simply, real GDP measures the total economic output of a country and is adjusted for changes in price.

Commodities include securities that tract bulk goods and raw materials, such as grains, metals, livestock, oil, cotton, coffee, sugar, and cocoa, that are used to produce consumer products. Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

High yield bonds are debt securities often referred to as "high-yield" or "junk" bonds issued by corporations. High-yield bonds tend to pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

Stagflation is the persistent high inflation combined with high unemployment and stagnant demand in a country's economy.

Disinflation is a temporary slowing of the pace of price inflation and is used to describe instances when the inflation rate has reduced marginally over the short term.

A recession is a significant, widespread, and prolonged downturn in economic activity. A common rule of thumb is that two consecutive quarters of negative gross domestic product (GDP) growth indicate a recession. However, more complex formulas are also used to determine recessions.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

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