Before the Bell

Morning Market Brief

June 24, 2019

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MONDAY MORNING MARKET STRATEGY: David M. Joy, Chief Market Strategist

U.S. stocks established a new closing high last Thursday on optimism that the Fed is preparing to lower interest rates and hopes that this week’s meeting in Japan between presidents Trump and Xi will prove to be constructive on the trade front. The S&P 500 ended the day at 2954.18, eclipsing the previous record of 2945.83 established on April 30th, just prior to the latest escalation of the ongoing trade war with China. The weekly close of 2950 was also a new all-time high, as the index rose 2.2 percent. Energy stocks led the way higher on rising tensions in the Persian Gulf. Otherwise, technology and communication services were the leading sectors, while consumer staples, materials, and financials all lost ground.

Last week the Fed left the overnight rate unchanged but, as expected, downgraded its assessment of the economy while dropping language referring to its intention to be “patient” regarding interest rate policy. Expectations are high that a rate cut could happen as early as July when the Fed meets on the 30th and 31st. The CME FedWatch Tool now ascribes a 100 percent chance that rates will be lowered in July, the only question being whether the cut will be one-quarter percent or one-half, to which the tool ascribes a 28 percent chance. St. Louis Fed president Bullard abstained from voting to leave policy unchanged, preferring an immediate quarter-point cut.

Global markets also received a boost earlier in the week when European Central Bank president Draghi reiterated his view that the bank is prepared to use all available tools at its disposal to support growth and reach its inflation target.

To what extent central banks ultimately ease policy, and how effective it might be, remains to be seen. Much depends on the path forward in the U.S.-China trade war. No major breakthrough is expected this week, but there is a chance that the meeting might still be viewed as constructive if negotiations are reengaged and new tariffs are put on hold. Such an outcome could lend additional support to the current rebound in stock prices, and likely push bond yields somewhat higher. Of course, the opposite is also true, leaving much riding on the outcome.

Bond yields fell in the wake of the Fed’s decision. After trading as high as 2.08 percent before the Fed’s decision, the yield on the ten-year note dipped as low as 1.97 percent on Thursday, its lowest since November 2016 before rebounding to end the week at 2.05 percent. And after trading at 1.90 percent prior to the Fed’s announcement, the two-year note fell to 1.70 percent on Thursday, its lowest level since November 2017, before climbing back to end the week at 1.77 percent. Below-investment grade bond yields extended their descent which began on June 4th when Fed Chair first said that the Fed will “act as appropriate to sustain the expansion”, the same language contained in the post-meeting statement. On June 3rd the yield on the B of A Merrill Lynch High Yield index was 6.96 and its spread over treasuries was 470 basis points. By Friday, the yield had dropped to 6.41 and the spread had contracted to 395 basis points.

The dollar also fell in response to the Fed. After closing at 97.64 on Tuesday, the DXY dollar index fell for three straight days to end the week at 96.22, erasing all but a fraction of its gain from the start of the year. Emerging market equities

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- Unless specifically stated otherwise, comments contained in this document should not be construed as an investment opinion or recommendation of any securities mentioned. Charts depicted are from FactSet unless otherwise noted.
responded favorably as the MSCI EM index climbed 3.8 percent for the week. Over the same final three days of the week gold climbed $53 to $1400 an ounce, its highest price in almost six years. And the price of oil spiked in response to rising tensions between the U.S. and Iran.

The global economy is slowing, and central banks are preparing to respond. Most of the slowdown is contained in the manufacturing sector, where such activity in the U.S. slowed again in May to just above the expansion/contraction divide. But in the U.S., consumers and small businesses remain healthy and optimistic. This leaves the Fed in a delicate position. Just as investors are watching closely the G-20 meeting this week, so too is the Fed. With an economy likely growing somewhere near 2 percent, and unemployment at a five-decade low, how much additional monetary accommodation is needed is unclear. If the outlook improves following the G-20 meeting, the answer may be less than the market is currently assuming. On the other hand, if little progress is made in Osaka, and manufacturing and trade remain under pressure, along with business sentiment, the burden will only increase on the Fed and its international counterparts to do the heavy lifting.

There is also the issue of inflation, which remains stubbornly below the targets of the major central banks, including the Fed. The PCE deflator for May is scheduled for release on Friday, and the core rate is expected to hold steady at 1.6 percent year-over-year, below the target of 2 percent, another reason for the Fed to want to lower rates. Given these uncertainties, the Fed was wise to wait and see what transpires this week, allowing for a more informed decision in July.

**MORNING MARKET COMMENTARY:** Anthony M. Saglimbene, Global Market Strategist

- **Quick Take:** U.S. futures are pointing to a slightly higher open; European markets are trading lower; Asia ended mixed overnight; West Texas Intermediate (WTI) oil trading at $57.87; 10-year U.S. Treasury yield at 2.03%.

- **Earnings Expectations On The Decline:** As we noted on Friday, the last time the S&P 500 Index was at an all-time high the party ended quickly, and stocks took a turn lower in May. Fortunately, stock prices have recovered all their May losses this month, but it’s the defensive sectors that continue to be the areas that are making new highs.

  - Utilities, Real Estate, Consumer Staples, as well as the S&P 500 Index each made new all-time highs last week, while Technology, Communication Services, and Consumer Discretionary sectors still need to push through their April/May highs.
• The short end of the yield curve remains inverted, global growth is moderating, we believe expectations for Fed accommodation is too high, and earnings growth is slowing. These are hardly small issues and critical reasons why retail and some professional money managers are skeptical of the recent rally. Until there is more clarity on these subjects, it may be hard for less defensively positioned sectors to break out to new highs and outside of just euphoric momentum.

• As the embedded FactSet chart above helps highlight, we’ve been above the 2900 level in the S&P 500 Index three times inside of twelve months, including this most recent trip. In the previous two trips, stock prices quickly reversed course after buyers’ exhaustion, which was sparked by increasing growth fears. In our view, it remains to be seen if a Fed-induced rally can keep stock prices on an upward trajectory in the coming months or if possibly easing trade tensions next week put a bid under stock prices. For the rally to continue at this pace, we believe the Fed will need to stick its landing, and trade tensions will need to move to the back burner. As of right now, both seem like tall orders.

• When focusing in on earnings trends, which we believe are now an understated driver in stock prices at the moment, expectations keep turning lower. As the two embedded FactSet charts below show, companies that have provided Q2’19 earnings per share (EPS) guidance have decidedly guided estimates down, at the same time, Q2 EPS estimates are weaker for several large S&P 500 sectors compared to the end of Q1.

![Number (#) of S&P 500 Cos. with Q2 Positive & Negative Guidance](source: FactSet)

• Importantly, Q3’19 EPS estimates have fallen considerably since the end of March, as the last embedded FactSet chart at the top of the next page shows. Earnings growth for S&P 500 companies was always back-end loaded for this year, and we believe it is a worrisome development that estimates keep falling for the back half of the year. Further, much of the EPS growth built into this year’s full-year estimate comes from a rather robust expectation for earnings growth in Q4’19. At the end of December, analysts expected Q4’19 S&P 500 EPS to grow by +11.6% y/y. At the end of March, analysts expected +8.6% y/y growth. Currently, those final quarter EPS growth expectations now sit at +6.7% y/y. From an earnings perspective, the final quarter of the year is primarily holding full-year estimates in positive territory. If this expectation changes for the worse, stock prices may face more headwinds in the coming months.
Stock prices can climb higher, while earnings growth is declining or outright negative. The first quarter of this year, as well as periods during 2015 and 2016, are recent examples of weak earnings growth trends accompanied by higher stock prices. Nevertheless, we believe slowing economic growth, increased trade tensions, rising geopolitical concerns, ‘and’ weakening earnings growth could leave stock prices vulnerable at all-time highs. A lot must go right for stocks to keep pushing higher from here, and from an investors’ standpoint, possibly with limited upside. But if developments go sideways or deteriorate, there seems more downside risk near-term for stock prices, especially at all-time highs.
Asia-Pacific: Asian equities finished mixed on Monday. Last week, it was all about the Federal Reserve and how it would set market expectations for interest rates. This week, it’s all about the Trump/Xi G20 meeting in Osaka Japan, where both leaders are expected to discuss trade tensions. The G20 event begins on Friday, and both presidents are expected to meet in a sideline dinner event following high-level trade discussions before the leader dinner. While hopes are running high that a breakthrough deal could put trade tensions to rest following the Trump/Xi meeting, we suspect the market would be ok if both sides agree to continue talks without escalating tariffs.

Europe: Markets across the region are trading lower at mid-day. According to a recent Reuters poll, over 80% of survey respondents believe the European Central Bank (ECB) will either cut interest rates by September or soften its forward guidance. Although 70% of respondents believe the ECB will turn more dovish, some believe the central bank could still lift interest rates in 2020.

According to the Financial Times, Italy will receive more time to reach a budget agreement with the European Union (EU). The EU is expected to hold off launching a disciplinary process this week and has until early July to decide whether it wants to proceed with such a course of action against Rome. Italy is expected to send a spending bill to parliament for review on Wednesday, which should provide more color on its plan of action for deficit spending.

U.S.: Equity futures are pointing to a slightly positive open this morning. As we discussed above, earnings expectations for this year continue to come down for U.S. companies. If S&P 500 companies in aggregate cannot surpass the negative growth expectations for the second quarter, it would mark the first back-to-back profit decline in three years.

Following last week’s downing of a U.S. surveillance drone by Iran, the White House is expected to impose new biting sanctions against Tehran as early as today. In a tweet from President Trump, he said he wanted to make a deal to bolster Iran’s flagging economy to help ease tensions. However, Tehran insisted it shot down the unmanned drone over its airspace, and it would respond firmly to any U.S. threat, according to FactSet. Over the weekend, White House officials, including the president, continued to stress that it is not seeking war with Iran.

According to the National Retail Federation (NFR), if the U.S. imposes tariffs on the final $300+ billion tranche of Chinese imports, it could cost U.S. consumers $12.2 billion a year in total. Apparel ($4.4 billion more per year), footwear ($2.5 billion more per year), toys ($3.7 billion more per year), and household appliances ($1.6 billion more per year) are all expected to take an additional bite out of consumers pocketbook if the U.S. presses ahead with further tariffs. Importantly, the NFR said it would be impossible for all market participants in its industry to simultaneously move sourcing to other countries, noting capacity does not currently exist.

Not surprisingly, all the largest U.S. banks passed the Federal Reserve’s stress test, with results released on Friday. All the big banks have enough capital to continue lending in the Fed’s most severe downturn scenario.

Speaking of the Fed, Bloomberg noted that expectations for easier monetary policy this year has fueled a rally across multiple asset classes. Stocks have surged to new all-time highs, bond prices have risen, oil is up, and even gold has caught a bid. The article highlighted that in a back-of-the-envelope calculation, the recent ‘rally in everything’ is the strongest since 2011.
### WORLD CAPITAL MARKETS
(all data as of approximately 8:00 AM ET)

<table>
<thead>
<tr>
<th>Region</th>
<th>World Index</th>
<th>GAAC Tactical</th>
<th>Recommended</th>
<th>Region</th>
<th>World Index</th>
<th>GAAC Tactical</th>
<th>Recommended</th>
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<tr>
<td>Americas</td>
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<tr>
<td>S&amp;P 500</td>
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<td>Nikkei 225 (Japan)</td>
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<tr>
<td>Dow Jones</td>
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<td>0.14%</td>
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<td>Singapore STI</td>
<td>0.30%</td>
<td>10.18%</td>
<td>3,311.5</td>
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<td>Brazil Bovespa</td>
<td>1.70%</td>
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<td>#######</td>
<td>Shanghai Comp. (China)</td>
<td>0.21%</td>
<td>21.53%</td>
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<td>Bombay Sensex (India)</td>
<td>-0.18%</td>
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<td>-0.27%</td>
<td>6.50%</td>
<td>43,526.7</td>
<td>S&amp;P/ASX 200 (Australia)</td>
<td>0.22%</td>
<td>21.13%</td>
<td>6,665.4</td>
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*Note: International market returns shown on a local currency basis. Equity index data is total return, inclusive of dividends.*

### Global Equity Region - Tactical View

<table>
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<tr>
<th>Region</th>
<th>Weight</th>
<th>Tactical View</th>
<th>Recommended</th>
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</thead>
<tbody>
<tr>
<td>1) United States</td>
<td>54.7%</td>
<td>Overweight</td>
<td>+3.1%</td>
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<tr>
<td>2) Canada</td>
<td>3.0%</td>
<td>Equalweight</td>
<td>-</td>
</tr>
<tr>
<td>3) United Kingdom</td>
<td>5.2%</td>
<td>Underweight</td>
<td>-1.0%</td>
</tr>
<tr>
<td>4) Europe ex U.K.</td>
<td>14.6%</td>
<td>Underweight</td>
<td>-1.0%</td>
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</table>

Index weighting represents relative weightings based on the regional market capitalization balance of the MSCI All-Country World Index; may not add due to rounding. The GAAC Tactical Overlay, as well as Recommended Tactical Weights, is derived from the Ameriprise Global Asset Allocation Committee (GAAC). Views are expressed relative to the Index and are provided to represent investment conviction in each region. Tactical Allocations are designed to augment Index returns over a 6-12 month time horizon. Index weights as of 3/22/19. Numbers may not add due to rounding.

### Emerging International - Tactical View

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<th>Region</th>
<th>Weight</th>
<th>Tactical View</th>
<th>Recommended</th>
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### Americas

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<th>Region</th>
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### U.S. Equity Sector - Tactical View

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<th>Sector</th>
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THE WEEK AHEAD: Russell T. Price, CFA, Chief Economist

- The economic calendar offers a diverse slate of reports this week. We start on Monday with what is normally a “third tier” economic release, the Dallas Federal Reserve’s Texas Manufacturing Index. The report takes on added significance this month given the weakness portrayed in the New York and Philadelphia releases last week. There’s little doubt that the manufacturing sector has hit a soft-patch due to a confluence of factors, including: trade turmoil, an inventory overhang, and cautious business investment. The Texas measure of demand for manufactured goods is also likely to see some added downside pressure as a consequence of sharply lower crude oil prices. Tuesday’s manufacturing index from the Richmond Fed, and that of the Kansas City Fed on Thursday, will take on more significance than usual as well.

- On Tuesday, New Home Sales for the month of May are expected to show a fairly solid monthly gain of about 2%. The expected gain follows a sales dip in April of nearly 7% due to bad weather conditions. May sales are still expected to be about 5% above year-ago levels versus the 6% gain reported in April. Like most housing related measures, new home sales have been erratic in recent months due to a number of factors, particularly a lengthy stretch of very difficult weather across the eastern U.S. Overall, however, new home sales have been running about 4% to 5% above year-ago levels on average this year and builders are slowly improving the available supply.

- On Wednesday, New Orders for Durable Goods are expected to be weak for a second straight month with a near-absence of orders at civilian aircraft maker Boeing being a primary culprit. Overall, new orders are expected to be flat to slightly lower, with a modest gain expected when the transports sector is excluded. As noted above, however, we could see more pronounced weakness in new orders from the energy sector given the recent slump in energy prices.

- On Thursday, the Commerce Department will issue its third and final (short-term) estimate of Q1 Real GDP. Initially, Commerce estimated growth in the period at +3.2%. That was shaved to 3.1% last month, and this week the final reading is expected to be revised back-up to +3.2% due to upward revisions to retail sales and housing construction. Growth in the first quarter is still expected to have been heavily reflective of temporary factors, including a further gain in business inventories which added 0.6 percentage points to the total. Business inventories were already high and working them back-down to more efficient levels is going to weigh on GDP numbers in Q2 and beyond, in our view.

- Finally, on Friday the Commerce Department will report on Personal Income and Spending for the month of May. Both numbers are expected to show fairly solid gains with income expected to be up about 0.3% and spending up approximately 0.5%. Income is coming off of a strong 0.5% gain in April while spending was weak in April with a flat reading for the month due to weak auto sales and very poor weather conditions.
Where Market Fundamentals Stand Heading into The Week:

S&P 500 Trailing and Forward P/E valuations:  Source: FactSet

Please note: Although we try to maintain consistency as much as possible, Price to Earnings (P/E) ratios may differ modestly from one source to another. Most notably, P/E numbers can often show their most notable differences during an earnings release season as some sources may still use the last full 'actual' earnings number (for instance, currently Q4 trailing 12-month earnings per share) while others use earnings per share that are updated for Q1 using a combination of actual and estimated earnings per share. The calculation of earnings (operating earnings versus 'as reported' or GAAP) also often differs modestly from one data source to another due to the proprietary use of calculation methodologies. The “average” shown in the charts below represent averages for the period shown.

Consensus Earnings Estimates:  Source: FactSet

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<td>Q3</td>
<td>Q4</td>
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<td>Q2</td>
<td>Q3</td>
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<td>Quarterly $$ amount change over last week</td>
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<td>$36.29</td>
<td>$38.71</td>
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<td>yr/yr</td>
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<td>10.7%</td>
<td>6.7%</td>
<td>15.9%</td>
<td>25.4%</td>
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<td>27.8%</td>
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<td>qtr/qtr</td>
<td>-1%</td>
<td>6%</td>
<td>2%</td>
<td>8%</td>
<td>7%</td>
<td>6%</td>
<td>4%</td>
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<tr>
<td>Trailing 4 quarters $$</td>
<td>$119.02</td>
<td>$118.67</td>
<td>$119.64</td>
<td>$123.25</td>
<td>$126.42</td>
<td>$128.53</td>
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<td>yr/yr</td>
<td>6.9%</td>
<td>-0.3%</td>
<td>0.8%</td>
<td>11.6%</td>
<td>22.9%</td>
<td>18.0%</td>
<td>18.1%</td>
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<td>Implied P/E based on a S&amp;P 500 level c</td>
<td>2950</td>
<td>18.3</td>
<td>18.0</td>
<td>17.1</td>
<td>15.9</td>
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ECONOMIC NEWS OUT TODAY:


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<th>Time</th>
<th>Period</th>
<th>Release</th>
<th>Consensus</th>
<th>Actual</th>
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<tr>
<td>10:30 AM</td>
<td>JUN</td>
<td>Dallas Fed Manufacturing Index</td>
<td>-2</td>
<td>-5</td>
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Economic Perspective: **Russell T. Price, CFA – Chief Economist**

- **High levels of corporate debt challenge China's position in trade negotiations.** Markets will place considerable focus this week on the pending meeting between Presidents Trump and Xi at the G20 Summit in Japan. The meetings begin on Thursday but most world leaders are not scheduled to arrive until Friday for meetings that last through Saturday. President Trump has said that he will have an “extended” meeting with China’s President Xi while in Japan. Hopes for a “breakthrough” in the trade negotiations are slim but markets appear to be hoping for at least a “pause” or truce in the escalating tensions and a commitment to go back to the negotiating table.

- We are often asked: “Who has the upper hand in this dispute?” This is a multi-faceted question with no clear answer in our view, however, China’s economy appears as though it could face greater consequences from a material slowdown in economic activity – at least partially due to very high levels of corporate debt.

- According to data from the Bank for International Settlements (as reviewed by Moody’s Analytics), of the world’s $70.7 trillion in nonfinancial corporate debt outstanding (which equates to about 83% of global GDP at the end of 2018 on a nominal basis), China accounted for a hefty $20.6 trillion, representing 154% of its nominal GDP. By contrast, nonfinancial corporate debt in the U.S. was $15.2 trillion at the end of 2018, or about 74% of U.S. nominal GDP.

- The structure of China’s economy leaves it in better position to manage such problems, but the solutions implemented can also often leave more significant consequences down the road. As such, a further slowing of the Chinese economy could have notable consequences, a factor Chinese leaders are no doubt considering amid this ongoing problem.

**FIXED INCOME NEWS & VIEWS: Brian M. Erickson, CFA, Fixed Income Research & Strategy**

- **Trading today:** Ten-year Treasury yields slid to 2.02% this morning after closing Friday at 2.05%. We see 2.00% as a critical technical level for bond markets. Ten-year yields at down 60 basis points year to date and 38 basis points so far this quarter as investors who initially added to Treasury as a safe-haven, extend bidding after the Fed, European Central Bank and the Bank of Japan suggested more accommodation to come at their latest policy meetings last week.

- **The week ahead:** We are focused on the G20 summit on Friday and Saturday in Osaka, for further developments in the U.S./China trade war. This week also holds a line-up of economic data that could add to the context for how the Fed should follow-through with potential rate cuts if necessary later this year, including June Confidence Board readings Tuesday; May preliminary Durable Goods Orders on Wednesday; and Personal Income and Spending on Friday. Finally, this week is the last full week of trading ahead of the holiday shortened 4th of July week coming up next.
Bond Markets Priced to Perfection

- We believe investors waiting for a good time to reposition around risk within fixed income portfolios have that chance today. The rally in Treasury prices and compression in credit spreads offers an ideal opportunity for investors who have been looking for an opportunity to de-risk, whether that is a short-term tactical change, or the on-going repositioning of long-term portfolios. While upside theoretically exists for equities, in fixed income risk compensation is capitated to a different extent, suggesting now is another opportunity to take risk off the table where portfolios remain over extended.
- De-risking is a theme we have touched on all year, beginning with the rebuilding of core fixed income allocations to 85% of fixed income investments for portfolios with a moderate risk tolerance. Exiting excess high yield, foreign bond, multi-asset or nontraditional bond allocations to re-focus on core fixed income offers the stabilizer we are looking for in diversified portfolios. We see the risk of a sharp jump in inflation data as highly unlikely given the slowing pace of growth here in the U.S. as well as around the globe.
- **What reduce:** Exit excess high yield, foreign bond, multi-asset or nontraditional bond allocations above 85% of fixed income allocations (as a percent of fixed income only). Avoid levered credit strategies such as buying credit on margin, excessive exposure to levered closed end funds, or allocations to highly complex bond funds that contain futures or swaps strategies that may be levered to credit. This late in the cycle, we believe de-risking is an appropriate approach for long-term investors and short-term investors alike.
- **What to buy:** Core bond funds and laddered bond portfolios using strategies short-term, intermediate-term, and long-term to target fixed income portfolio duration of six years. For example, if a core bond allocation is too short, add a small allocation to long-term Treasuries. If the duration for the core fixed income allocation alone is too short, consider layering in an allocation to multi-asset to shorten the duration and to pick-up non-core exposure.

**Source:** Bloomberg L.P. and Bloomberg Barclays Indices.
Before The Bell
June 24, 2019

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Energy/Utilities
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Financial Services/REITs
Lori Wilking-Przekop – Sr Director

Health Care
Daniel Garofalo – Director

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Beta: A measure of the risk arising from exposure to general market movements as opposed to company-specific factors. Betas in this report, unless otherwise noted, use the S&P 500 as the market benchmark and result from calculations over historic periods. A beta below 1.0, for example, can suggest the equity has tended to move with lower volatility than the broader market or, due to company-specific factors, has had higher volatility but generally low correlations with the overall market.

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