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INVESTMENT STRATEGY QUARTERLY

TRADE LIKE A DRAGON, TWEET LIKE AN EAGLE

Letter from the Chief Investment Officer

The Wizard of Oz – Dreams versus Reality

The "Wizard of Oz" celebrated a magical milestone in August, returning to the town of its original screening to commemorate its eightieth anniversary. Decades after its release, many of the movie's characters and themes provide parallels to today's economy and financial markets.

The state of the economy is paramount in determining the return potential of the major asset classes. We forecast that US gross domestic product (GDP) will grow 2.2% in 2019 and 1.7% in 2020, averting a recession through at least the 2020 presidential election. Similar to Dorothy's companions on her journey, the symbolism of the **Scarecrow**, the **Tin Man,** and the **Cowardly Lion,** who were in search of a **brain,** a **heart,** and **courage,** respectively, frame our optimistic outlook. Our 'brain' relies on the facts, and although there has been a spike in recessionary fears, the mosaic of data we observe (such as Leading Economic Indicators, real-time activity metrics, employment conditions and history), all point to an extension of this already record-setting economic expansion. While many pessimists point to the yield curve inversion, inversions historically precede a recession by approximately 22 months. The US consumer is the 'heart' of both the US and global economy. Collectively, US consumers represent approximately 70% of the US economy and US consumption is greater than the economies of Japan, Germany, and the UK combined. With healthy job creation, rising wages, and high consumer confidence, this 'heart' should continue pumping. Business spending is the next largest component of the economy. For the economy to grow more rapidly, businesses will need to find the 'courage' to deploy investment capital and reverse the decline we have seen recently.

In this real-life rendition, investors seek guidance from not one, but **two 'wonderful wizard(s)'**—President Trump and Fed Chairman Powell. Trade frictions are beginning to weigh on the economy as a recent poll[1] suggested that for the first time since President Trump took office, more respondents believe the economy is getting worse rather than better. The full implementation of a third tranche of tariffs (on $300 billion of Chinese imports) will squarely affect the consumer. With a presidential election looming in 13 months, it would be detrimental to increase consumer costs and potentially send the economy into a tailspin. As a result, this last tranche will likely be postponed or not fully implemented if a deal is not secured. With the Federal Reserve (Fed), it is simple. It will cut interest rates enough to maintain the momentum of this economic expansion. The specific number of cuts is of less importance. As long as the economy does not fall into a recession, riskier assets like equities should move higher.

The **'wicked witches'** that need to be watched include oil prices and the dollar. We estimate that the consumer can absorb oil prices up to $70/barrel (our base case) as that keeps gasoline prices below the psychologically important $3/gallon level. However, festering geopolitical risks from the Middle **'East'** and new International Maritime Organization (IMO) sulfur regulations could place upward pressure on oil prices. In the **'west,'** the race to the bottom with interest rates has caused declines in many currencies like the euro. With the dollar at its highest level since May 2017, concerns are mounting that it is hampering the competiveness of US exports. However, our forecast is that the dollar will stabilize over the next year, alleviating some pressure on the US economy.

As for the bond market, we are **"not in Kansas anymore."** Fundamental factors (such as domestic economic growth and inflation) that traditionally dictate the level and direction of interest rates are overshadowed by massive global central bank bond purchases and global growth fears. With a record level of negative-yielding debt (which technically guarantees an investor a loss if the bond is held to maturity), many roads lead to the US bond market when it comes to the search for positive yield. In some countries, such as Germany, the entire yield curve is negative. With international investors seeking positive yields and baby boomers adjusting their portfolios to include more exposure to bonds, the extra demand for US Treasuries should keep US rates lower for longer. Our 12-month forecast for the 10-year Treasury yield is 1.40%. In the credit space, the best start to a year in more than 20 years has narrowed spreads

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[1] Pew Research Center

and made these bonds less attractive. We favor investment-grade bonds and emerging-market bonds over high-yield bonds, which at current yields do not adequately compensate investors for their level of risk.

Our belief that **"there is no place like home"** favors US equities over other developed countries. While international markets may temporarily outpace US equities on the expectation of more monetary and fiscal stimulus, we remain skeptical, as the effects from previous policy stimulus have not yielded sustainable momentum. Our 12-month forecast for the S&P 500 of 3,122 is predicated on a favorable economic backdrop, positive earnings growth, attractive valuations, and supportive seasonality factors. Within the US, we reiterate our preference of large cap over small cap. From a sector standpoint, we prefer Technology, Communication Services, and Health Care and find many of the defensive sectors, such as Utilities and Consumer Staples, expensive. For less risk averse investors, emerging-market equities are attractive but remain dependent upon the outcome of the trade dispute.

Dorothy's quest to return home began when her house was caught in a terrifying **tornado.** For investors, President Trump's tweets, a divided Fed, recessionary fears, Brexit, and Iran are swirling around financial markets causing elevated uncertainty and turbulence. History suggests that trying to time markets around these types of events is a 'fantasy' and the outcome is usually investors making poor, emotionally-driven decisions. Thus, regardless of the daily 'noise,' successful investors follow a well-thought out financial plan, just as Dorothy followed the **yellow brick road.** The 'bricks' along the road include assessing your asset allocation, investment objectives and risk tolerance, selecting appropriate investment vehicles, and periodically reviewing your portfolio with your advisor. So before making a hasty portfolio change, click your **red ruby slippers** three times and remind yourself that having a disciplined investment strategy is the most likely path to realizing your financial dreams **somewhere over the rainbow**.

Lawrence V. Adam, III, CFA, CIMA®, CFP®
Chief Investment Officer, Private Client Group

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Trade Like a Dragon, Tweet Like an Eagle

Ed Mills, *Managing Director, Washington Policy Analyst,* Equity Research

This summer saw a new chapter develop in the trade fight between the US and China, with rapid escalation in a period of just a few months. This opens the door to tariffs on virtually all Chinese goods and increasingly threatens a significant commercial decoupling between the world's largest economies.

The driving forces of the latest period of elevated hostility are threefold:

1. President Trump's frustration with China's lack of follow through on what he sees as key commitments.
2. The trade conflict taking on additional elements of a battle for primacy in global affairs.
3. Trade issues taking on greater political significance as the 2020 presidential election season intensifies.

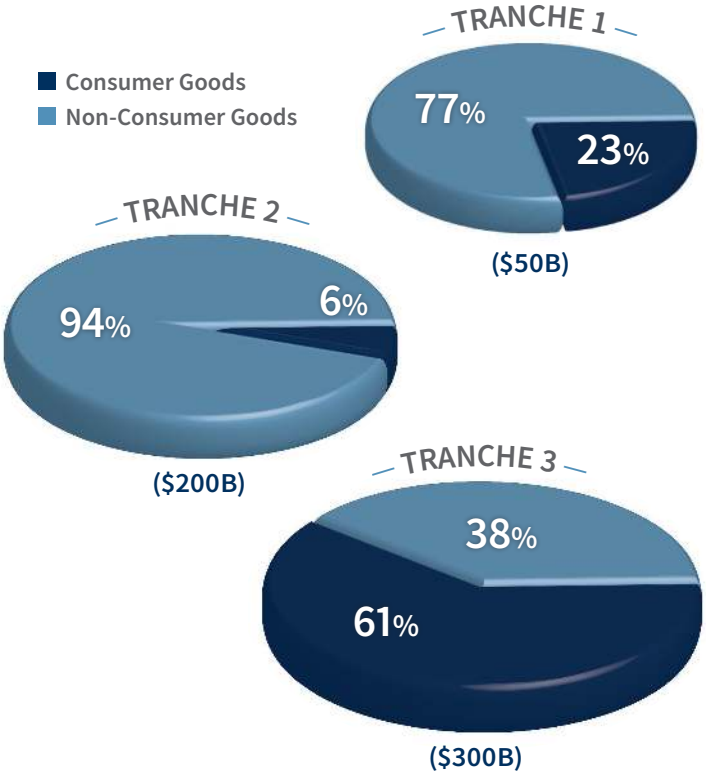
Fears over a protracted trade war have been mitigated by the belief that Trump's style as a 'winner' will resurface closer to Election Day and make a comprehensive trade deal likely. However, we view the role of the 'fighter' as more consistent with Trump's personal brand, raising the likelihood that any resolution to the trade dispute will not materialize until after the 2020 election.

TASTE OF THE SAME MEDICINE

The post-June G20 stalemate illustrates the difficulty in de-escalating the current conflict. Large-scale agricultural purchases and an easing of the US export restrictions targeting Huawei were the key short-term bargaining chips. Ultimately, neither materialized and President Trump's frustration at the slow pace of progress led to a new round of tariffs on an additional $300 billion of Chinese imports. Further, President Trump has called on China to make progress to stem the flow of fentanyl into the US for well over a year, and the lack of follow-through has seemingly contributed to the eroded trust between the two sides. Trump clearly views China as responsible for the continued endangerment of the US population via a modern day 'Opium War,' not unlike the Opium Wars of the 19th century (when western powers illegally smuggled opium into China). This reinforces the belief among the more hawkish White House advisors that the US and China are fighting a much broader battle. This view can be seen in the rhetoric the administration associates with China, which is slowly undergoing a shift from a 'strategic competitor' label to 'foreign adversary.' If this trend continues, the case for a national emergency declaration under the International Emergency Economic Powers Act

Tariff Tranches: Consumer in the Crosshairs

Unlike previous tranches of tariffs that primarily targeted manufacturing inputs and industrial goods, this third tranche of tariffs primarily targets consumer goods.



Source: US Trade Representative

(IEEPA) to exert greater control over commercial ties with China may see increased political support.

THE GREAT WALL TO NEGOTIATION

The erosion of goodwill between the two sides can also be seen in unfolding geopolitical events. An ever-present barrier for China's leaders in trade talks has been what they see as an encroachment on China's sovereignty by the US given the specific changes to China's economic and legal system sought by the Trump administration. The sovereignty sensitivity has flared up with the latest protest movement in Hong Kong, which China's leaders have vocally blamed the US for inciting. The question of Taiwan's independence is also a source of friction, and may become a more significant issue in late 2019/early 2020. The US has recently approved significant arms sales to Taiwan, and a looming January 2020 election, which is likely to pit pro- and anti-China parties against each other, appears ready to further inflame US-China political tensions in the global arena.

THE BOXER'S REBELLION

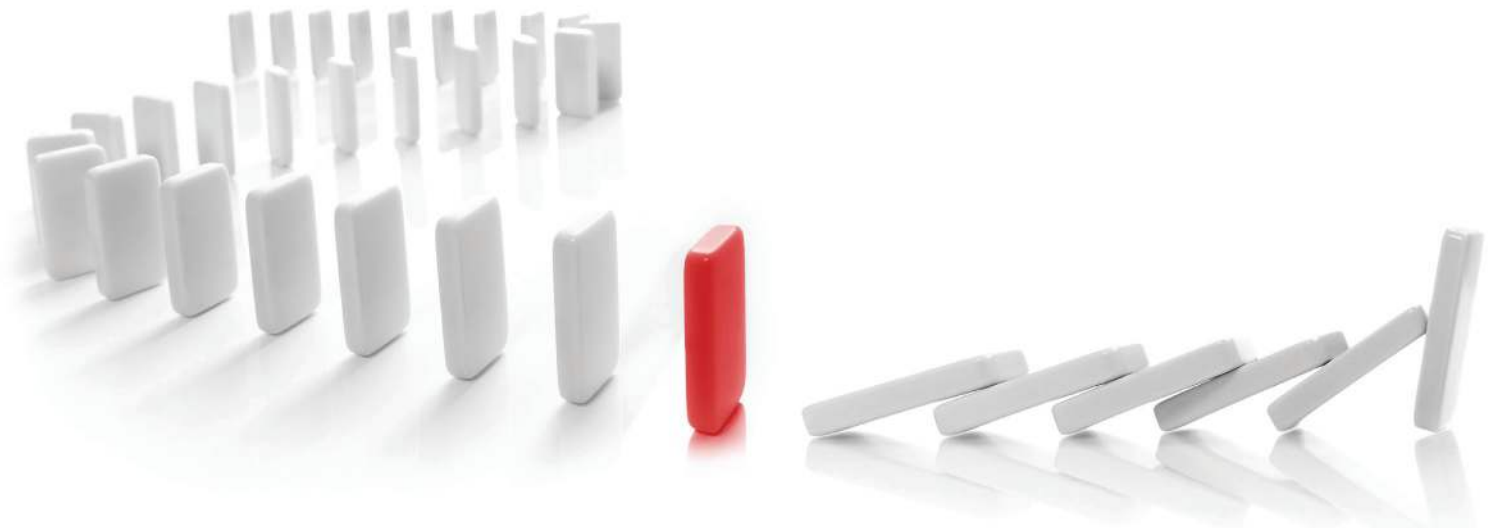
These issues will be difficult to fully resolve to the liking of President Trump or China's leaders in the next year, especially in the heat of a presidential campaign during which Trump's policies will see intense scrutiny from political opponents. China trade issues have emerged as a central topic at the Democratic debates, and are due to see greater prominence on the campaign trail going forward in agricultural/manufacturing states specifically impacted by the trade fight.

> President Trump has used the trade battle to attack potential Democratic opponents, arguing that a changeover in administration would ease the current pressure applied by the Trump administration and benefit China.

Some progress remains possible over the next year – particularly on more clear-cut issues of fentanyl flows or agricultural purchases. However, we believe a broad-scale deal will continue to be elusive until after the election given the complicating factors. If Trump is given the choice between a weak deal or showing voters in key swing states that he is a fighter, we expect him to decide to play the role of the fighter through the 2020 election.

KEY TAKEAWAYS:

- This summer saw rapid escalation in the trade fight between the US and China.
- Three driving forces of elevated hostility: President Trump's frustration with China's lack of follow through, the trade conflict taking on elements of a battle for primacy in global affairs, and trade issues taking on greater political significance.
- Some progress remains possible over the next year – particularly on more clear-cut issues of fentanyl flows or agricultural purchases.
- We believe a broad-scale deal between the US and China will continue to be elusive until after the 2020 election, given the complicating factors.



Regarding Recessions

Scott J. Brown, PhD, *Chief Economist* , Raymond James

We are never 'due' for a recession. The likelihood of entering a downturn does not depend on the length of the expansion. However, we do know that recessions are inevitable.

The National Bureau of Economic Research (NBER) defines a recession as:

A significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real gross domestic product (GDP), real income, employment, industrial production, and wholesale-retail sales.

It is not two consecutive quarterly declines in real GDP (there were not consecutive quarterly declines in real GDP in the 2001 recession).

LONG IN THE TOOTH?

The normal state of an economy is expansion (that is, growing). A recession begins when the economy stops growing (and begins contracting) and ends when the economy starts growing again. The NBER's Business Cycle Dating Committee (BCDC), a group of senior academic macroeconomists, is the official arbiter of recessions. The BCDC determines the beginning and ending dates of recessions and its job is to be definitive, not timely. It may be a year or more before it declares that a recession has begun and it may be a year or more before it declares that a recession has ended.

Recessions are marked by their breadth, magnitude, and duration. Each has its own characteristics, but there are some common similarities. Typically, a recession is preceded by a period of over-investment or malinvestment, which leads to a correction. Think of the savings and loan crisis or the dot-com bubble. Individuals postpone big-ticket purchases, such as a car or new home, and as the economy rebounds, this pent-up demand fuels a robust recovery.

The 2007-09 recession was a different sort of animal. We know that recessions that are caused by financial crises tend to be more severe. They last longer and the recoveries take a long time. The collapse of the housing bubble meant the housing sector and areas fueled by the extraction of home equity would recover only slowly at best. It would not be a V-shaped recovery.

Can a recession be forecasted? We have only had 11 recessions since World War II (and just three in the past 37 years). That's a very small sample size. The economy has evolved in significant ways over time. So, past experience may not tell us much.

Snowballing to a Slowdown

As businesses fear a weakening economy, they curtail spending and hiring. This, in turn, crimps consumer spending, which leads to further declines in business confidence. This self-reinforcing cycle ultimately perpetuates a snowball-style effect that exacerbates an economic slowdown.

CURVEBALL

The yield curve has historically been the single best predictor of recessions. As the yield curve inverts, long-term interest rates fall below short-term interest rates. That's because short-term interest rates are expected to decline (think of long-term rates as a series of short-term rates). Why? Because the Federal Reserve (Fed) would cut rates in the face of a weakening economy. In this sense, expectations of recession may become self-fulfilling. If consumers expect the economy to weaken, they would be less likely to buy a new home or a new car. If businesses expect a recession, they would be less likely to invest in new plant and equipment or hire new workers. The economy would weaken. A positively-sloped yield curve creates incentive for banks to lend. Conversely, an inverted curve dampens loan growth, and in turn, economic growth. Note that it may be a year or more between yield curve inversion and the start of a recession.

There are few signs that the overall economy is currently in a recession. The household sector fundamentals (job gains and wage growth) have remained strong, and consumer spending (68% of GDP) should provide support for overall economic growth in the near term. However, the odds of a recession developing over the next 12 months have been rising. A simple yield curve model of recession now puts the odds of entering a recession within the next 12 months at about 40%, too high for comfort.

"There are few signs that the overall economy is currently in a recession. The household sector fundamentals (job gains and wage growth) have remained strong, and consumer spending (68% of GDP) should provide support for overall economic growth in the near term."

Moreover, interest rates are lower than in the past, which means that the odds could be even higher. The model only signaled a 50% chance of a downturn ahead of the Great Recession.

Factory output has been weakening since the start of this year, down 1.6% from December to July. However, we have often had recessions in the manufacturing sector without a recession in the overall economy. In contrast, a recession in the overall economy essentially guarantees a recession in manufacturing.

Central Bank Toolbox

Most central banks are tasked with price stability, but the US Federal Reserve is also required to foster maximum sustainable employment. The Fed's primary tool is the federal funds rate, the overnight lending rate that banks charge each other for borrowing excess reserves – and will lower the target rate to boost growth if needed. As we saw during the financial crisis, the Fed has a number of non-standard tools to support the economy. These include forward guidance, the conditional commitment to keep short-term interest rates low for an extended period, and large scale asset purchases (or quantitative easing). This year, the Fed is revisiting its monetary policy strategies, tools, and communications policies, but the focus has already turned to maintaining an ample level of bank reserves in the system.

TRADING CERTAINTY FOR TARIFFS

Trade policy has been a factor this year. Tariffs raise costs for US consumers and businesses, invite retaliation, disrupt supply chains, and undermine business investment. Should the US reach a trade agreement with China, uncertainty would decrease and that may help avoid a recession in 2020. However, if the trade war continues to escalate, the downside risks to the economy will increase. Disruptions to supply chains have been costly, and the May 10 increase in tariffs (from 10% to 25%, now 30%) has pressured margins in manufacturing. The final round of tariffs on Chinese goods (15% on $300 billion of goods), 60% of which were delayed to December 15, falls on consumer goods, most of which come only from China. The trade conflict threatens a permanent separation of the world's two biggest economies.

FEDERAL (RE)ACTION

Stimulative fiscal policy means cutting taxes or increasing government spending. In 2009, Congress enacted an $831 billion package of tax cuts and spending, spread mostly over two years. That helped to reduce the damage, but as large as it was, it wasn't big enough to offset the magnitude of the economic downturn.

> "Should the US reach a trade agreement with China, uncertainly would decrease and that may help avoid a recession in 2020."

While we typically focus on the federal budget, state and local governments also matter. Most have balanced budget requirements. In the Great Recession, tax revenues dried up, eventually leading to sharp cuts in state and local government jobs. This was a significant difference from previous recessions, where government spending provided a base level of support for the economy. Cuts in spending restrained the recovery.

> "Stimulative monetary policy means that the Fed lowers short-term interest rates to support growth. In a normal recession the Fed cuts rates by 5%, or 500 basis points. The central bank currently has a lot less room to work with."

ADDING AUSTERITY TO ADVERSITY

With the annual federal budget deficit nearing $1 trillion, fiscal stimulus may be constrained in the current environment. We can expect the deficit to rise further in a recession. This may lead to calls for austerity (tax increases or spending cuts), which would make the downturn worse and dampen the recovery. After providing fiscal support during the recession, many European countries turned to austerity, dampening their recoveries. The US also embarked on austerity, but on a limited scale.

DESENSITIZED TO STIMULUS

Stimulative monetary policy means that the Fed lowers short-term interest rates to support growth. In a normal recession the Fed cuts rates by 5%, or 500 basis points. The central bank currently has a lot less room to work with. In response to a downturn, once rates are taken down near zero, the Fed would employ forward guidance, a conditional commitment to keep short-term interest rates low for an extended period. We may also see another round of large-scale asset purchases, commonly called quantitative easing. Comments from the Fed indicate that officials are unlikely to pursue negative interest rates, as has been adopted by other central banks.

There's some concern that more accommodative monetary policy may not do much to turn the economy around. Business fixed investment does not appear to be sensitive to interest rates and consumers may not want to take on additional debt. The idea that the Fed would be 'pushing on a string' is a worry we have during every recession. However, Fed rate cuts improve financial conditions, setting the stage for economic recovery.

THE BUST OF THE BABY BOOM

Demographic changes brought on by an aging population and slower trend growth in the workforce mean that the recession/recovery scenario will differ from past cycles. A few decades ago, baby boomers were still entering the workforce and female labor force participation was on the rise. The labor force was growing at 2.5% per year in the late 1970s. Those trends are now well behind us. Labor force growth is now rising about 0.5% per year, further dampened by restrictions on legal immigration. Barring an unprecedented surge in productivity growth, the underlying trend in real GDP growth is now seen as 1.5-2.0%, compared to 3.0-3.5% in the 1980s. Slower trend growth in GDP means that recessions may become more likely and recoveries more muted than in the past.

In summary, there are few signs that the US economy is currently in a recession, but the odds of entering a recession next year have been rising. We don't see the kind of excesses that would lead to a more pronounced economic downturn, but the tools for fighting a recession are likely to be constrained. Investors should consider that while recessions are transitory phenomena and the prospects for longer-term expansion remain good, demographic changes will have a dominant impact on the economy in the decades ahead.

KEY TAKEAWAYS:

- We are never 'due' for a recession. However, recessions are inevitable.
- The yield curve has historically been the single best predictor of recessions. It may be a year or more between yield curve inversion and the start of a recession.
- There are few signs the overall economy is currently in a recession. Job gains and wage growth have remained strong, and consumer spending (68% of GDP) should provide support for overall economic growth in the near term.
- Should the US reach a trade agreement with China, uncertainty would decrease and that may help avoid a recession in 2020. However, if the trade war continues to escalate, the downside risks to the economy will increase.
- While recessions are transitory phenomena and the prospects for longer-term expansion remain good, demographic changes will have a dominant impact on the economy in the decades ahead.

International: Brexit, Tariffs, and Protests, Oh My!

Chris Bailey, *European Strategist,* Raymond James Investment Services Ltd.*

***'Happiness is when what you think, what you say, and what you do are in harmony.'* - Mahatma Gandhi**

National stereotypes tend to always have a hint of truth about them. The British can always be relied upon to run a good administration, the Germans are efficient and forward moving, Hongkongers are obsessed about money and property prices to the apparent detriment of everything else, and in Italy it is best to focus on the food and local culture rather than try to get something done. But the times they are a-changing – at least from the perspective of events so far in 2019.

DOING DONUTS

Winston Churchill once described Russia as "a riddle, wrapped in a mystery, inside an enigma," and this form of words also almost perfectly describes how I perceive, as a British citizen, the Brexit debate in the United Kingdom must be viewed around the world. Well over three years into the debate – with two prime ministers already sacrificed on its political altar and the country still horribly split down the middle – an end is still not clear. Attempts to forge an agreement (or leave with no deal) on October 31 have been unsettled by a British constitutional crisis involving the British Supreme Court, Parliament, the Prime Minister, and even Queen Elizabeth the Second. Brexit sits like a handbrake on the country, a suppressor to economic forecasts, business investment or employment decisions and, of course, consumer confidence.

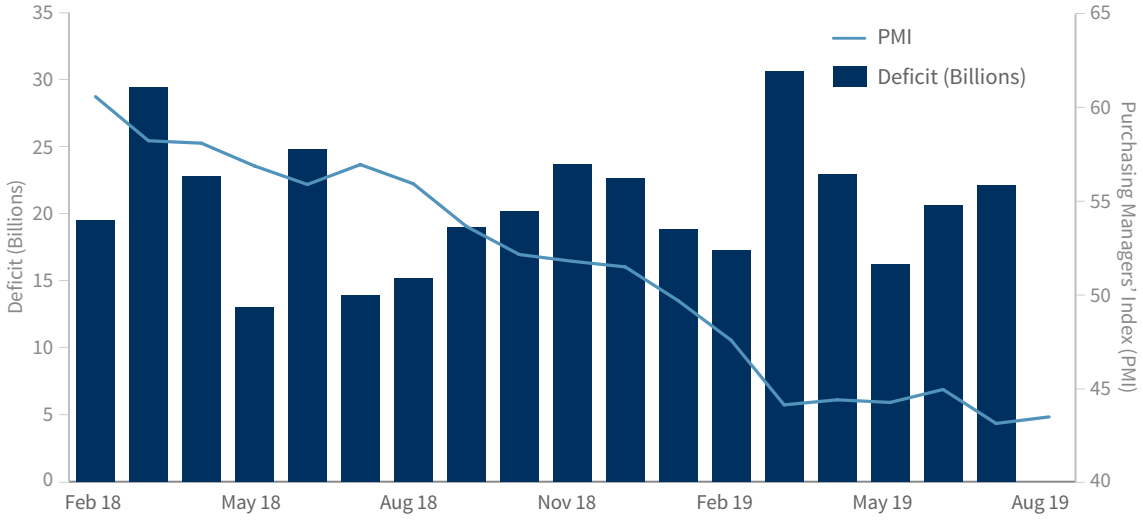
LOOK! IT'S BIG BEN AND PARLIAMENT

It is amazing, this long into the debate over Brexit, that multiple finale scenarios still exist. This is due to complexities around issues that have now become central to British political life, such as the backstop underpinning the land border in Ireland. Predictability around a further election occurring, let alone its precise result, remains very low, as well as whether any of this may persuade the European Union to exhibit more flexibility to induce some form of a deal. Most strikingly, however, the average allocation to UK assets by global investors versus recent history is at very low levels. So much is factored in, but the cost in national credibility and cohesion has been material, as well as leading to a fall in value of the British pound. As one British commentator put it, 'We want control of our borders... but still an opportunity to buy all our favourite imports.' Both having cake and eating it tends only to happen after striking a deal. However, the real irony of Brexit is that whilst a compromise (a 'soft Brexit') that maintains a good amount of the trade and general coordination infrastructure that has been built up between the UK and the continuing European Union is the least disliked option for a majority of voters, it is far from a favourite option for a majority of voters. It is, however, the sensible option to pursue.

*An affiliate of Raymond James & Associates, Inc., and Raymond James Financial Services, Inc.

PMIs & Surpluses: Surpluses to Spend

As Germany's manufacturing sector slips further into contraction, the German government will be under renewed pressure to loosen the fiscal purse strings and inject more of its budgetary surplus back into the economy.



Source: FactSet

Talking about the continuing European Union, unsurprisingly the region has been extremely worried about both the political and economic fallout from Brexit. However, as Brexit is still yet to formally occur or unduly influence performance, the 2019 economic travails seen in Germany have been cut from broader issues.

NO FEST IN OKTOBER?

Germany's superior average productivity and ongoing commitment to innovation within its core manufacturing competencies helped make the country the dominant economic actor within Europe. This position was only strengthened over the past decade by the seemingly insatiable desire of neophyte Chinese manufacturers to buy German capital goods know-how and equipment, a situation replicated in many other emerging nations. Fast forward to today, however, and an almost perfect storm has developed for Germany. Economic growth has been sluggish across Europe for over a decade and bilateral trade discussions between the United States and China have contributed to a deterioration in the global trade backdrop, impacting key industrial, chemical, and automotive exports from Germany. The net result is an economy on the brink of a formal recession.

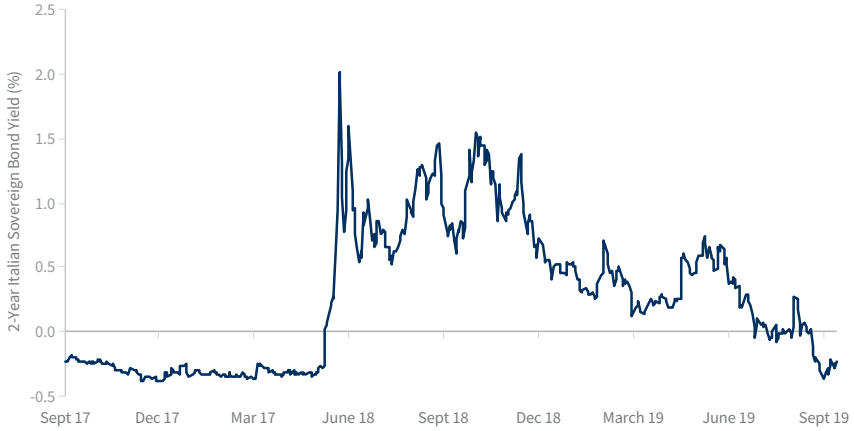
Politically, these are sensitive times in Germany. The lengthy chancellorship of Angela Merkel is within a couple of years or so of ending, and a newer generation of political leaders has yet to really establish itself. Coalition governments that span the mainstream political spectrum that once gave a stable leadership backdrop are now struggling to find new ideas. Meanwhile, a rigid orthodoxy to a balanced fiscal budget may appear laudable to many other countries struggling with fiscal (or trade) deficits, but it has led to a growing feeling of inertia. In short, Merkel is yet to pass the point domestically where she feels able to give the green light to more stimulus, but can live with the European Central Bank - in policy moves announced in December - moving deeper down the rabbit hole of quantitative easing and negative interest rates. This half-hearted approach to tackling contemporary challenges is apparent in the country's global trade policies too. Germany is a quiet player on the global political stage given its economic and export prowess, but would be wise to find its (fiscal) voice fast.

AN ITALIAN RENAISSANCE?

If true dynamic regional leadership is missing from Germany, in Italy there has been something of a renaissance in political dynamism. The summer that just passed may have seen yet another Italian government break up, but the strange union between two populist parties lasted longer than many expected and shook up the Italian political establishment. The current forging of a new government, composed of one of the populist parties in combination with a centrist mainstream political group, appears to offer more potential for longer-term stability. The question now is whether the country can move away from the situation of economic intensive care it has been in.

Italian Bond Yields: A Return to Negative Territory

As Matteo Salvini's bid to take over the Italian government disintegrated, a newfangled coalition between the 5 Star and Democratic Party factions witnessed rates return to negative levels.



Source: FactSet

> "The challenge for leading politicians and other policymakers is to devise ways to embrace change more as an opportunity than a threat."

Italy also has been struggling with low growth. However, unlike Germany, Italy has material debts to worry about as well, a situation that naturally causes a lot of concerns. Yet, the tone of the debate within the country has started to change and there is a realisation that this is a time for action. Additionally, the financial markets are giving an opportunity for change with compressed global bond yields reducing any shorter-term burdens from the weak Italian fiscal position. It really is now or never for Italy. A period of technocratic government focused on building both growth and confidence levels in the local economy can go a long way.

FOR KONG AND COUNTRY

Finally, we have to look east to Hong Kong, where an unprecedented level of public protest against progressively tighter oversight from China has led to violence, disruption, and a new uncertainty that is already impacting local property prices and economic performance. So, are the times a-changing in Hong Kong too? Certainly, high income inequality, the challenges of getting into the local housing market, and a feeling that the best days for economic growth have passed are very apparent. But the real fear is centred on what a developing China really means for the city state that for so long has been the natural gateway into the broader East Asia region. This longer-term focus is why Chinese authorities have not gone beyond the threat of mainland military and policing forces on the streets of Hong Kong. Go to mainland Chinese cities today proximate to Hong Kong and it is increasingly difficult to tell the difference on the ground. Hong Kong retains the advantage of capital flow freedom and a convertible currency, but this will not last forever. What today is centred around freedoms may still be ultimately influenced by longer-term economic realities.

Change is a constant but also can induce uncertainty. Across the UK, Germany, Italy, Hong Kong, and many other countries, we are seeing the political, economic, and social impacts of an evolving world. These challenges are going to keep on coming in new and varying ways in the 2020s. The challenge for leading politicians and other policymakers is to devise ways to embrace change more as an opportunity than a threat. Where this is achieved, or at least perceived more positively, investment returns will follow. In a changing world, this most commercial of observations, at least, does not change.

KEY TAKEAWAYS:

- Brexit suppresses economic forecasts, business investment or employment decisions and, of course, consumer confidence.
- Germany is on the brink of recession. Sluggish European growth and the US-China trade discussions have impacted key industrial, chemical, and automotive exports from Germany.
- Italy has seen a renaissance in political dynamism. The new government appears to offer more potential for longer-term stability.
- The challenge for politicians and other policymakers is to devise ways to embrace change more as an opportunity than a threat.

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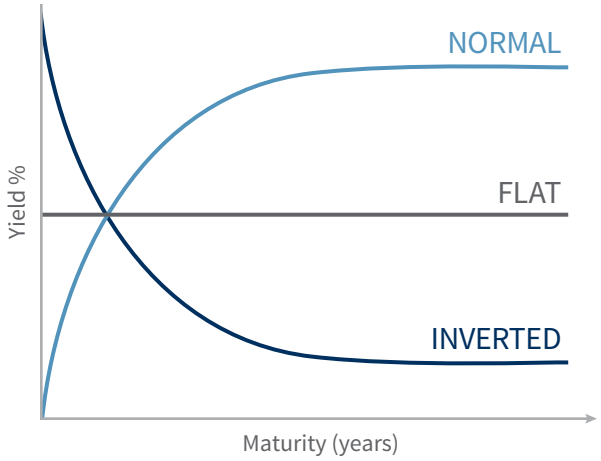
In Limbo: How Low Can Interest Rates Go?

Doug Drabik, *Managing Director,* Fixed Income Research

Yields around the globe have fallen precipitously in the last year largely as a consequence to struggling global economies and central bank responses. This has had a significant impact on the US Treasury yield curve, a line that plots the yields of US Treasury securities.

Generally, this curve is positively sloped as it rewards investment in longer-term maturities (with greater market risk) with relatively higher rates of return versus those with shorter-term maturities (less market risk). However, under certain economic circumstances, this curve can become negatively sloped and thus 'inverted' (i.e., when bonds with shorter-term maturities have higher yields than those with longer-term maturities). When this paradigm is 'inverted,' it often signals that something is amiss. This is why inverted yield curves are so often considered an indicator of a looming economic recession or an end to an economic cycle.

In the US, yields on Treasuries with long-term maturities have recently fallen more than those with short-term maturities, causing several key points along the Treasury yield curve to invert. The spread between the 2-year/10-year Treasuries inverted briefly for 12 days at the end of August, while the 3-month/10-year spread has remained inverted for a little over four months. While such inversions are often alarming to investors (as evidenced by the volatility immediately following the 2-year/10-year inversion), several key factors would suggest that the US yield



curve has been influenced to a greater degree by certain global circumstances that bear mentioning.

The lack of inflation and slowing economic growth around the world (especially outside of the US) has prompted central banks to assume increasingly accommodative monetary policies. This has included cutting interest rates and implementing asset purchase programs in an attempt to stimulate slumping economic growth and inflation. The asset purchase programs directly influence lower global interest rates. Through quantitative easing, the world's four major central banks (the Federal Reserve, the European Central Bank, the Bank of Japan, and the People's Bank of

World Bond Markets

	2-YEAR	5-YEAR	10-YEAR	30-YEAR
UNITED STATES	1.622	1.526	1.646	2.103
CANADA	1.517	1.338	1.304	1.478
FRANCE	-0.670	-0.621	-0.295	0.509
GERMANY	-0.734	-0.760	-0.600	-0.119
GREECE	-	0.703	1.331	-
IRELAND	-	-0.447	-0.045	0.779
ITALY	-0.219	0.283	0.833	1.883
JAPAN	-0.317	-0.353	-0.234	0.350
NETHERLANDS	-0.720	-0.680	-0.446	-0.130
SPAIN	-0.526	-0.304	0.118	0.999
SWEDEN	-0.580	-0.577	-0.276	-
UNITED KINGDOM	0.457	0.377	0.528	0.953

Source: Bloomberg LP, Raymond James; As of 9/24/2019

China) have swelled their combined balance sheets to ~$19.4 trillion (up over 200% since the start of the Great Recession). In many markets (most notably, Europe and Japan), negative interest rates have become commonplace and total worldwide debt with negative yields has recently crested at over $17 trillion.

The current global interest rate environment and growing worldwide uncertainty has, in turn, swayed investors into both a flight to quality and search for yield. The US bond market, albeit historically low in yield, boasts comparatively high interest rates and a strong credit standing. Thus, the subsequent demand for US debt has been a significant headwind to higher interest rates. Volatility along the yield curve has been rewarding for investors that took on duration. For example, the 30-year Treasury (3.375% coupon, maturing 11/15/48) that closed 2018 at around $107 was valued at $132 in early September. That equates to a total return of approximately 32.3%. Metaphorically, longer-duration bonds have been on fire and although many bond investors don't employ bonds as total return investments, the total returns have outperformed most other asset classes this year.

Market uncertainty culminates with the often-asked question "how low can interest rates go?" Many pundits suggest that rates have a barrier or minimum level at which investors will engage. Clearly, we have not reached such a point nor does anyone know whether one actually exists. Overseas, the European Central Bank declared its willingness to use any and all means at its disposal to stimulate the economy, as evidenced by its recent announcement of a new round of monthly asset purchases.

Domestically, the US may be swayed toward choices that prevent the dollar from getting too strong and/or interest rates too varied from global rates. Even with our still-growing economy and robust employment, the Federal Reserve has lowered rates twice this year. The bottom line is that global influences will impact interest rates more than the economy here in the US. As long as the world's central banks continue to intercede, it is very plausible to conclude that interest rates can go much lower.

Despite lower interest rates, it is imperative that investors maintain asset allocation discipline. Individual bonds provide consistent income, predictable cash flow, and greater protection of principal. These features hold true at any interest rate level. As shown during recent bouts of volatility this year, longer-duration assets fared extremely well. Being cognizant of reinvestment risk is just as important (if not more important) than duration risk in the current environment. In order to weather the volatility, investors must stay true to their long-term financial plans.

KEY TAKEAWAYS:

- Yields around the globe have fallen precipitously in the last year largely as a consequence to struggling global economies and central bank responses.
- While inverted yield curves are often considered an indicator of a looming economic recession or an end to an economic cycle, several key factors suggest that the US yield curve has been influenced to a greater degree by certain global circumstances that bear mentioning.
- The current global interest rate environment and growing worldwide uncertainty has, in turn, swayed investors into both a flight to quality and search for yield.
- Despite lower interest rates, it is imperative that investors maintain asset allocation discipline. Individual bonds provide consistent income, predictable cash flow, and greater protection of principal. These features hold true at any interest rate level.

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Sending the Right Signals?

James Camp, CFA, *Managing Director,* Strategic Income, Eagle Asset Management*

'Inverted yield curves have preceded every recession over the past 50 years' is a statistically accurate and ever more frequent refrain of the financial press. The US Treasury market is one of the most liquid and efficient debt markets in the world, and investor activity and preferences therein provide important insights into the outlook for economic and inflation expectations. To wit, a collapse in global yields, together with a massive rally in the benchmark 10-year US Treasury note, is indicative of a significant global economic slowdown and muted inflation.

Moves in rates occur because the economy is dynamic, always going through periods of acceleration, deceleration, or no change, essentially mini-cycles within the expansion (see chart on next page). The most recent of these moves was a 175 basis point collapse in the 10-year note from last year's peak. Ranges for yields within an expansion are normal. However, a +100 basis point swing close to the zero bound is a relatively large move that needs to be closely managed. The yield on the 10-year note has hit 1.5% twice before during this expansion – each time central bank policy responses were at the ready and economic growth and rates moved higher.

The efficacy of central bank policy responses are diminishing, but with virtually 99% of the yield curve now inverted, they are front and center once again.

Short-term rate inversions are consequential for risk assets as funding costs increase for levered financial positions. The economic slowdown last fall in combination with the Federal Reserve's (Fed) signaling of additional tightening led to market expectations of this dynamic, which became the proximate cause for the fourth quarter selloff.

CORRECTION OF THE DIRECTION

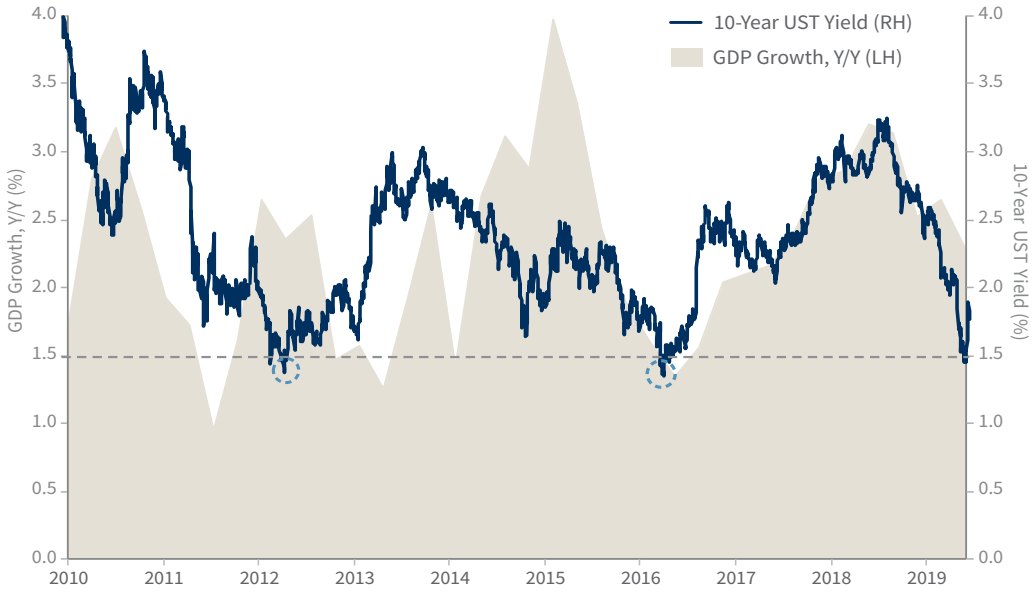
A more consistent march higher in short-term rates would have caused a more prolonged correction in risk assets. Fortunately, the market forced the Fed away from this expansion killing policy error. But some damage had been done, and it was in March, after the rally in longer-term interest rates, when the 3-month bill inverted to the 10-year note. The message from the market was clear, financial conditions were still tight and if the Fed didn't act, such conditions could hurt the economy further.

In mid-August, the 2-year/10-year Treasury curve inverted as Fed officials failed to be dovish enough in their expectations for the future path of interest rates at the July Federal Open Market Committee meeting, and after they had dragged their feet for several months into the first rate cut of the cycle.

Yet the slope of the curve is only one indicator. In prior periods, the inversion of the curve was later coupled with a variety of other signaling economic conditions such as labor market weakness and, most notably from our perspective, deterioration in credit performance. Such is not the case currently.

*An affiliate of Raymond James & Associates, Inc., and Raymond James Financial Services, Inc.

Gross Domestic Product (GDP) Growth and 10-Year US Treasury Yield



Source: Bloomberg; market data for US Treasury yield as of September 19, 2019; quarterly data for GDP growth as of June 30, 2019.

> "Yet the slope of the curve is only one indicator. In prior periods, the inversion of the curve was later coupled with a variety of other signaling economic conditions, such as labor market weakness and, most notably from our perspective, deterioration in credit performance. Such is not the case currently."

The traditional banking system would tighten credit as the short-borrowing-long-lending model was disrupted in prior cycles. Now, much of the credit creation in the US economy occurs in the 'shadow banking' securities markets. For these markets to continue to issue bonds, the slope of the corporate-credit curve is most relevant. Since this slope is still positive (short- to long-term credit spreads), financial conditions are still accommodative for deal flow.

Here, credit is readily doled out to ever increasing demand from pension funds and retail investors. In fact, the number of new credit funds has accelerated and pushed the size of credit markets to record levels. The issue for the real economy lies not just with the inverted yield curve, but the continuation of the credit-boom cycle enabled by central banks and yield starved investors, and the misallocation of capital that follows.

KEY TAKEAWAYS:

- The US Treasury market is one of the most liquid and efficient debt markets in the world and investor activity and preferences therein provide important insights into the outlook for economic and inflation expectations.
- The efficacy of central bank policy responses is diminishing, but with virtually 99% of the yield curve now inverted, they are front and center once again.
- The slope of the curve is only one indicator. In prior periods, the inversion of the curve was later coupled with a variety of other signaling economic conditions such as labor market weakness and, most notably from our perspective, deterioration in credit performance. Such is not the case currently.

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Economic Snapshot

DR. SCOTT BROWN
Chief Economist

Consumer spending is expected to propel overall economy growth, supported by solid fundamentals, over the next few quarters. Weak global growth and trade policy uncertainty have hampered business investment and much of the outlook hinges on whether trade tensions escalate or de-escalate. Housing activity should continue to pick up in the near term. The inverted yield curve implies that the odds of entering a recession within the next 12-18 months have risen. The Federal Reserve (Fed) has cut interest rates twice in what is expected to be an insurance move or mid-cycle adjustment (not the start of a long easing cycle), and would move further to support the economy if there are more significant signs of weakness.

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	EMPLOYMENT	The job market remains tight and firms continue to note difficulties in hiring skilled labor. The underlying trend in job growth has slowed this year, partly reflecting job market constraints. Wage growth has picked up.
FAVORABLE	CONSUMER SPENDING	Job gains, wage growth, and consumer confidence remain supportive. Spending is likely to moderate from a strong 2Q19 pace (which had followed two soft quarters).
FAVORABLE	HOUSING AND CONSTRUCTION	Continued strength in the labor market and low mortgage rates should support housing activity in the near term. Higher building costs and affordability remain key issues.
FAVORABLE	THE DOLLAR	In the short term, exchange rates are driven by differences in monetary policy across countries. Other central banks are expected to be more aggressive in cutting rates.
NEUTRAL	GROWTH	Economic activity has been mixed, but generally moderate, with an increased drag from tariffs. Risks to the growth outlook are weighted to the downside, but a lot hinges on the direction of trade tensions.
NEUTRAL	BUSINESS INVESTMENT	Expected to remain weak in the near term. A slowdown in energy exploration, problems at Boeing, slower global growth, and trade policy uncertainty have been negative factors.
NEUTRAL	MANUFACTURING	Slower global growth has dampened export growth, while trade policy has disrupted supply chains and raised production costs. Factory output contracted in the first half of the year.
NEUTRAL	INFLATION	The sub-2% trend in the Personal Consumption Expenditures (PCE) Price Index is a significant concern for the Fed. Despite tariffs, pipeline pressures have moderated. Firms have had mixed success in passing higher costs along.
NEUTRAL	MONETARY POLICY	The Fed has lowered short-term interest rates twice, but officials differ in their expectations of whether further cuts will be needed. The Fed may start mini QE to maintain an adequate level of bank reserves.
NEUTRAL	LONG-TERM INTEREST RATES	Long-term interest rates remain low outside of the US, putting downward pressure on US bond yields. Inflation is expected to remain low and the risks to growth are weighted to the downside.
NEUTRAL	FISCAL POLICY	The impact of the 2018 tax cuts has faded in 2019. The federal budget deficit has increased, but has not put much upward pressure on bond yields. State and local government fiscal policy is expected to be pro-cyclical.
NEUTRAL	REST OF THE WORLD	The global economic outlook has deteriorated further, with increased concerns regarding China, Europe, and Brexit. Trade tensions between the US and China aren't helping.

Sector Snapshot

This report is intended to highlight the dynamics underlying the 11 S&P 500 sectors, with a goal of providing a timely assessment to be used in developing your personal portfolio strategy. Our time horizon for the sector weightings is not meant to be short-term oriented. Our goal is to look for trends that can be sustainable for several quarters; yet given the dynamic nature of financial markets, our opinion could change as market conditions dictate.

Most investors should seek diversity to balance risk versus reward. For this reason, even the least-favored sectors may be appropriate for portfolios seeking a more balanced equity allocation. Those investors seeking a more aggressive investment style may choose to overweight the preferred sectors and entirely avoid the least favored sectors. Investors should consult their financial advisors to formulate a strategy customized to their preferences, needs, and goals.

J. MICHAEL GIBBS
Managing Director of Equity Portfolio & Technical Strategy

These recommendations will be displayed as such:

Overweight: favored areas to look for ideas, as we expect relative outperformance

Equal Weight: expect in-line relative performance

Underweight: unattractive expectations relative to the other sectors; exposure might be needed for diversification

For a complete discussion of the sectors, please ask your financial advisor for a copy of *Portfolio Strategy: Sector Analysis.*

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	INFORMATION TECHNOLOGY	21.8%	We are Overweight Information Technology. Despite our favorable position, we recognize reasons for potential caution such as elevated valuation and a downward trend for earnings revisions. The recent give back in relative price performance as the market rotated from growth to value raises caution as well. However, the leaders in the sector (software, payments, and IT services) have been resilient with fundamental momentum.
OVERWEIGHT	HEALTH CARE	13.8%	Our Overweight opinion requires selectivity across subsectors of health care as political attacks during the 2020 election season will result in winners and losers. Overall, fundamental trends are healthy (it is the only sector to see earnings revised higher this year), and valuation is attractive. Defensive characteristics are appealing with numerous potential headwinds for the overall stock market.
OVERWEIGHT	COMMUNICATION SERVICES	10.5%	The sector is attractive technically, is expected to produce decent earnings growth in 2020, and is attractively valued. Add in a barbell makeup of defensive holdings on one end, and hyper-growth holdings on the other and the sector is appealing in the current environment.
EQUAL WEIGHT	FINANCIALS	13.1%	Since the end of 2017, prices for the sector have been held back due to a tight correlation to the 2-year/10-year Treasury yield spread as it declined. Recently, the spread increased, but the correlation to the banks plummeted. The result? Relative performance weakened. With the Fed likely to cut rates (more than once), the banks may struggle (relative to the overall market). However, with the Fed cutting in an environment of decent economic conditions, the odds increase that longer-dated yields rise and steepen the curve. In such a scenario, banks may respond favorably. For now, we suggest patience.
EQUAL WEIGHT	CONSUMER DISCRETIONARY	10.0%	Earnings revision trends are lower. Valuation measures deliver a mixed message with the cap-weighted index at a premium, and the equal-weight index at a discount. Technical price trends are still negative for the equal-weight index despite recent improvement. The technical weakness suggests the average stock is struggling, making investment across the sector difficult.
EQUAL WEIGHT	INDUSTRIALS	9.3%	Despite some improvement in technical price action for the sector due to better news flow regarding the US/China trade war, weakening global manufacturing influences our market weight opinion.
EQUAL WEIGHT	ENERGY	4.6%	The attack on Saudi production sent a message to the world that the Saudis are not as protected as most believed. The sector offers opportunity if Saudi production fails to recover quickly as stock prices will likely breakout. Until such breakouts occur, we feel an Equal Weight is a proper position.
EQUAL WEIGHT	REAL ESTATE	3.2%	The defensive sector regained relative performance with the recent back-up in bond yields. With valuation attractive and an improving FFO (funds from operations) revision trend, we maintain an Equal Weight position.
UNDERWEIGHT	CONSUMER STAPLES	7.4%	Elevated valuation (relative to earnings growth) and recent lagging relative strength influence our Underweight opinion on this defensive sector.
UNDERWEIGHT	UTILITIES	3.5%	The sector made a healthy recovery as interest rates backed up in recent days. Despite a constructive technical picture for the sector, we remain Underweight given elevated valuation.
UNDERWEIGHT	MATERIALS	2.7%	The improving trade narrative boosted this cyclical sector in recent weeks. With global macro reports pointing to little improvement and with trade talks coming in a few weeks, we are comfortable being Underweight.

DISCLOSURE

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International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic volatility. Investing in emerging and frontier markets can be riskier than investing in well-established foreign markets.

Investing in small- and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor.

There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

U.S. government bonds and Treasury bills are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. U.S. government bonds are issued and guaranteed as to the timely payment of principal and interest by the federal government. Treasury bills are certificates reflecting short-term obligations of the U.S. government.

While interest on municipal bonds is generally exempt from federal income tax, they may be subject to the federal alternative minimum tax, or state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Municipal bonds may be subject to capital gains taxes if sold or redeemed at a profit.

If bonds are sold prior to maturity, the proceeds may be more or less than original cost. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revisions, suspension, reduction or withdrawal at any time by the assigning rating agency.

Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only form a small part of a diversified portfolio. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Investing in REITs can be subject to declines in the value of real estate. Economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of your portfolio.

Beta compares volatility of a security with an index. Alpha is a measure of performance on a risk-adjusted basis.

The process of rebalancing may result in tax consequences.

Alternative investments involve specific risks that may be greater than those associated with traditional investments and may be offered only to clients who meet specific suitability requirements, including minimum net worth tests. Investors should consider the special risks with alternative investments including limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements. Investors should only invest in hedge funds, managed futures, distressed credit or other similar strategies if they do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

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The performance mentioned does not include fees and charges which would reduce an investor's returns. The indexes are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities. The Shanghai Composite Index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

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