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INVESTMENT STRATEGY QUARTERLY

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Investment Strategy Quarterly is intended to communicate current economic and capital market information along with the informed perspectives of our investment professionals. You may contact your wealth manager to discuss the content of this publication in the context of your own unique circumstances. Published July 2018. Material prepared by Raymond James as a resource for wealth managers and investors.

RAYMOND JAMES

INVESTMENT STRATEGY COMMITTEE MEETING RECAP – HELD ON 4 JUNE 2018

Major macro factors affecting the economy and financial markets over the next six to twelve months include trade policy, interest rates, earnings growth, Federal Reserve (Fed) policy, and geopolitical uncertainty.

U.S. ECONOMY

Approximately 95% of the committee is neutral (2.3%) to somewhat positive (2.4 – 3.0%) on real GDP growth over the next six to twelve months.

- "We began the year with two key themes: strong momentum at the start of the year, and greater uncertainty in the second half. Growth is still trending beyond a sustainable rate over the long term. We know that because the unemployment rate is falling."
- "The Fed is trying for a soft landing, a task that has been difficult to achieve in the past. The Fed believes if they don't act soon enough, there will be more work to do later on. They are likely to raise rates until the economy shows definitive signs of slowing to a more sustainable pace."
- "For market participants, trade policy concerns are expected to continue. Increased tariffs raise costs for U.S. consumers and businesses, disrupt supply chains, invite retaliatory tariffs, and undermine global fixed investment."

  – **Scott J. Brown, Ph.D.,** Chief Economist, Equity Research

- "We've had a pretty active month here in D.C., as Congress finally passed (and the president signed into law) the bank deregulatory bill. Following that, we've had trade noise. We continue to believe that this is more in the negotiating tactics, but it is absolutely going to add to volatility."
- "We are also watching the potential investment restrictions on China. Those are set to go into effect or be announced on June 30. They're holding this over China, saying, 'Hey, cut a deal, or we're really going to get pretty nasty.' The car tariffs and steel and aluminum tariffs on Canada and Mexico are all about jump starting NAFTA."

  – **Ed Mills,** Washington Policy Analyst, Equity Research

U.S. EQUITY

87% of the committee is neutral to bullish on U.S. equities over the next six to twelve months.

- "This is a market for active management. You can't just buy anything and expect it to do well. You have to do a little extra research."
- "There's a lot that could go wrong, but, all things considered, the U.S. stock market seems to be hanging in there about as well as we can hope for. There's still a lot going right."
- "Investors seem to be looking in very growth-oriented areas and less so in more interest-rate sensitive and defensive areas of the market, as you would expect with rising rates."
- "We're in a sideways pattern. I think it's the result of what's happening in Washington with protectionism as the administration flip-flops one day to the next as they negotiate."

  – **Andrew Adams, CFA, CMT,** Senior Research Associate, Equity Research

- "There is plenty of room to expand CAPEX with cash flow strong and companies liquid with repatriated cash. Projected CAPEX spending plans have increased markedly this year, but, in general, spending has been tepid during the current economic expansion. The lack of investment may not bode well for earnings further down the road given that spending today fuels the earnings of tomorrow."
- "The underpinnings of this bull market appear fine. The global economy is growing. Earnings are advancing at a healthy clip. Technically, small caps are at a new high, and semi-conductors and transports are trading well. Despite solid underpinnings, I feel the S&P 500 is likely stuck in a trading range until the trade battle plays out. Unfortunately, the battle may continue for several more months."

  – **Michael Gibbs,** Managing Director, Equity Portfolio & Technical Strategy

- "Earnings growth this quarter was stellar by all accounts: 9.5% sales growth and 25% earnings growth. Yet, all people want to talk about is peak earnings. Late cycle, it is highly unlikely we will get stronger earnings growth than this, but 'peak earnings growth' should not be confused with 'peak earnings.' Fundamental momentum is attractive, and earnings growth next year is expected to be ~10% (which would be better than the 2012-2016 period)."
- "Given the monetary policy environment, financial engineering has been common throughout this bull market instead of investing in CAPEX and growing organically. So, what you're seeing this year on the heels of tax reform is a pretty sharp increase in CAPEX."

  – **Joey Madere,** Senior Portfolio Strategist, Equity Portfolio & Technical Strategy

INTERNATIONAL EQUITY – Chris Bailey, European Strategist, Raymond James Euro Equities*

87% of the committee is neutral to bullish on non-U.S. developed market equities over the next six to twelve months.

- "Reform is the key in Europe and in the rest of the world, too. And last year it was all about positive reform surprise: Brexit wasn't as bad as people thought and the election of Macron in France seemed to be a good sign that progress would continue. We've seen a bit of a reversal in the last few months with the Italian elections resulting in a surprise coalition between a populist party and a slightly nationalistic party - traditionally on different sides of the political spectrum. It shows uncertainty and that people want change. Otherwise, the European Union as we know it will slowly fall apart."
- "While I still see huge European potential, I also see massive scepticism, both within Europe and in the international community. Meanwhile, thinking about global trade, the view from Europe is that ultimately a deal needs to be made. Both China and the U.S. have too much to lose from blowing up the world's trade group and it's the same for Europe."

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INVESTMENT STRATEGY COMMITTEE MEMBERS

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Kristin Byrnes – Committee Vice-Chair Senior Manager, Investment Strategy

U.S. FIXED INCOME

Approximately 70% of the committee expects the 10-year U.S. Treasury yield to be about the same (2.9%) six months from now.

- “Credit is definitely extended in my opinion. Corporate bond spreads are at all-time lows if you take into account that roughly 70% of the investment-grade universe is now triple B rated. So, when we look at the income and yield space, I still favour agnostic capital structure approaches for income investment from a product design standpoint.”
- “Short to intermediate bonds, including Treasuries, now yield more than the broad equity market. These are the best options in pure fixed income investment.”
- “On the pure bond side, you can dial up duration, or dial down credit, neither one of which I care to do right now.”

  – James Camp, CFA, Managing Director of Fixed Income, Eagle Asset Management*

- “We still have this interesting phenomenon where the Fed is moving in the opposite direction of most central banks around the world. It’s also moving in the opposite direction of the administration, which is doing everything it can to promote growth, while you have the Fed calming growth with steady rate hikes.”

  – Doug Drabik, Senior Strategist, Fixed Income

- “As long as we have strong demand for our Treasury bonds and global rate disparity continues, we expect long-term rates to stay range bound - maybe creep up - but at a very slow pace.”
- “Demographics also place pressure on rates. The baby boom generation is massive. If we can get to 4% or 5% tax free, those buyers have a lot of money to pour into those markets to meet their retirement income goals. Right now, a lot of that money’s being put in other places.”

  – Nick Goetze, Managing Director, Fixed Income

- “The muni market is going through a significant transition this year as a result of tax reform, and supply being down in the early part of the year. For the summer, it’s likely that we’ll see municipals strengthen relative to Treasuries.”

  – Ted Ruddock, Head of High Net Worth, Fixed Income

ENERGY AND OIL – Pavel Molchanov, Energy Analyst, Equity Research

“There are two inflationary factors in the energy complex: the price of oil and the price of electricity.”

- “There has been pushback recently, both social and political, to rising fuel prices. More seriously, the major strike in Brazil essentially brought the country to a halt because truckers were protesting high diesel prices. Similar social protests are occurring in India, the Philippines, even Russia.”
- “With Brent Crude close to $80 a barrel (levels not seen since late 2014), we have to increasingly pay attention to the demand side since this will create headwinds to other sectors of the economy - aviation, trucking, plastics, and other types of relatively energy-intensive manufacturing.”
- “This administration is on the cusp of creating an unprecedented rule that will require uneconomic, high-cost electric generation plants (coal and nuclear) to effectively be bailed out through higher prices paid by the consumer. It’s very unpopular, as you can imagine, for the natural gas, wind, and solar industries. If this type of regulation is executed, it will raise electricity prices across the United States.”

UK Investment Outlook: H2 2018 and Beyond

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"It is easy to hate and it is difficult to love. This is how the whole scheme of things works" Confucius

Typically the way it works in financial markets is that after generating the best quarterly performance for over five years, faith in an individual stock market will be rampant. Extrapolation, after all, is one of the most dangerous words in the investment world. Whilst it is true that perceptions towards UK assets have improved - for the first time in over a year, UK assets are not the most disliked versus historic norms in the most comprehensive monthly survey of global fund manager opinion - it is hard to say that faith has materially recovered. The last quarter also saw a generally lacklustre performance by the Pound and a decision by the Bank of England to pass on an interest rate increase.

So what is going on? As an open economy where international trade relationships have been a critical influence on the country's political and economic power for many centuries, it is not difficult to see how the combination of tariff fears and Brexit uncertainty could be perceived as an uncomfortable pincer movement. And with muted real wage growth and a housing market that continues to stutter, individual household finances and wealth perception is under pressure too.

Outside the worsening of global trade related chat, have we not heard all of this before? At the turn of the year the twin peaks of Brexit and potential domestic political instability would have been cited as major risk points, supplementing the patchy economic backdrop. Frankly, none of these issues are going away soon and equity market investors, in particular, need a glass half full view of both ongoing trade and Brexit discussions. However, even in a world of complex political calculations and game theory related threats and credibility tests, I still expect the spirit of compromise to show through, as otherwise, all participants end up at a lose-lose point. In short, an aggressive trade war does not develop and Brexit ends up occurring but - in the terminology that has developed around the issue - 'soft' with a lengthy transitional period.

With these big issues unresolved but known knowns, strategy for UK investors for the balance of this year should again be concentrated on finding attractive, specific opportunities. In the equity markets, two clear trends in recent months have been an expansion in sourced-from-overseas takeover activity and the start of a rotation back into more domestic revenue and profit centred shares. Angst and low sentiment towards the UK equity market, aided by the lower Pound, have made UK equities more of an affordable target for foreign buyers, and a number of contested bids indicate a real demand. Similarly, a domestic economy that is far from perfect - but also not precipitously wilting into recession - can offer opportunity for stock selection in names with strong market shares, sensible balance sheets and - often - attractive dividend yields.

Whilst sticking with old-fashioned active investment management techniques appears the best tactic for equity market investors, spotting relative value opportunities for fixed income investors may prove more challenging. Whilst the immediate outlook for a sharp increase in UK interest rates is unlikely, current compressed yields across much of the fixed interest spectrum continues to make the likelihood of even positive income included returns from this asset allocation class difficult in 2018. UK investors would be wise to continue to look

> Angst and low sentiment towards the UK equity market, aided by the lower Pound, have made UK equities more of an affordable target for foreign buyers

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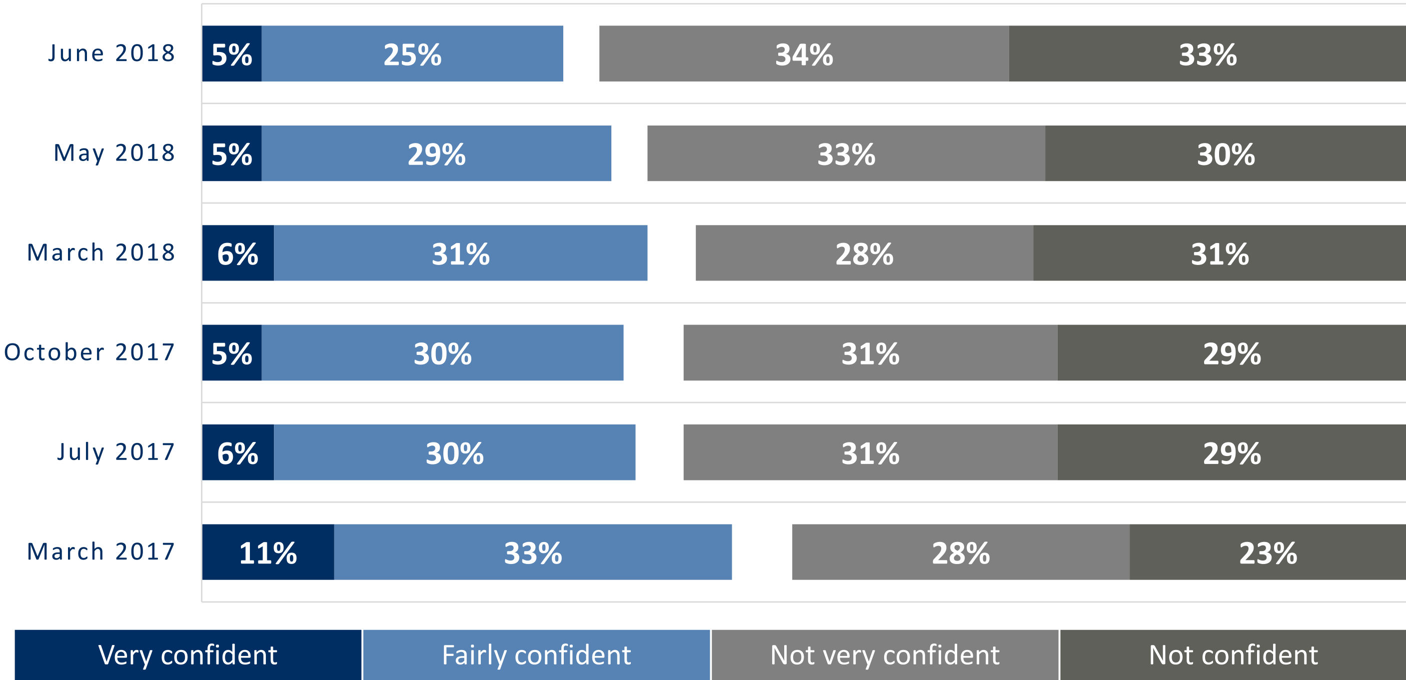
through the mist of uncertainty and keep the faith in their local equity market. Very low but improving sentiment levels usually take much more than a single quarter to play out... even with a backdrop of both ongoing trade and Brexit discussions, and much, much more. The darkest sentiment hour is usually just before the dawn.

> The darkest sentiment hour is usually just before the dawn

KEY TAKEAWAYS:

- It is hard to say that faith has materially recovered towards UK assets
- Expect the spirit of compromise to show through over time on major issues
- Strategy for equity investors should be concentrated on finding attractive specific opportunities
- Spotting relative value opportunities for fixed income investors may prove more challenging



Source: Ipsos Mori

Squaring Off: A High-Stakes Global Game

Chris Bailey, *European Strategist, Raymond James Euro Equities*,* provides an update on the state of geopolitical affairs around the globe, including developments in China and challenges facing the European economy.

If I cast my mind back to the start of the year, one of the words commonly used to describe the global outlook was 'Goldilocks' – an homage to the age old children's story reflecting a world where economies were anticipated to grow neither too fast nor too slow. Whilst headline economic growth rates have not particularly surprised, the same cannot be said about the broader global diplomatic and trade backdrop. Are such shifts a burgeoning threat to both the global economy and the world's major financial markets over the next year or two?

'G2' RELATIONS

The most powerful bilateral country-to-country relationship in the world today is between the United States and China, or 'G2' as many commentators have started to refer to it. China's singular focus on economic development over the past generation has achieved huge success. In more recent years, the Chinese have made efforts to broaden their global influence as well as their diplomatic and political roles. The recently launched Belt and Road Initiative, with the aim of creating a trade zone stretching from Western Europe back to Beijing (along with maritime trading routes to Africa and South America), is a clever move to curry favour and build economic and diplomatic friendships.

Normally, the new kid on the block would not be a concern or challenge to America's hegemony, but the heads of old allies are being turned by China's overtures. For emerging markets, often it is simply a question of basic economics: can more goods and services be exported to China or America over the next few years? For Europe, however, deeper more existential issues are at work.

STRUGGLES IN EUROPE

Europe has generally struggled over the last decade with far lower average economic growth and financial market performance relative to the United States. The optimism felt 20 years ago about the potential of a single European currency has since been replaced by distrust and a lack of coordination. This has manifested itself in the UK's populace choosing to exit the European Union and, over the last year or so, ever-rising dissatisfaction with incumbent politicians. France elected a political high office novice, the long-standing German chancellor struggled to put a coalition government together, and Italy's recent inconclusive election raised the spectre of a more populist/nationalistic political leadership cadre.

> "It has been said that arguing against globalisation is like arguing against the laws of gravity."
>
> - Kofi Annan

With Europe seemingly stuck in political and economic sclerosis, a range of emerging markets are progressively viewing an increasingly confident China as their natural economic partner. The more hard-nosed U.S. trade and diplomatic policies of recent months can either be viewed as a strategic masterclass to lengthen its global leadership epoch or a desperate attempt to stop an inevitable decline by any means possible. The on-off nature of talks with North Korea[1], the pulling away from global agreements with Iran, newly announced trade sanctions against Europe and China, and the extended NAFTA discussions have all made headlines in recent months. This is far from a classic 'Goldilocks' scenario.

WHAT'S NEXT?

So what happens next in this high-stakes game? Analysts of such scenarios often talk about 'credibility,' and both members of the exclusive 'G2' club have their strong positive points, as well as their Achilles' heels. America has to finance its fiscal deficit in order to keep the economic show on the road, and China needs relative global economic stability in order to continue its fairly seamless rapid development. A deal opening up China's domestic trade markets in exchange for a continued flood of U.S. Treasury purchases from the Middle Kingdom still remains the central and most likely outcome.

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[1] North Korea - United States Summit was held on June 12, 2018

However, there will be bumps in the road. In addition, in terms of long-game players, few have the foresight and focus of the Chinese.

This latter point is manifest in recent Chinese opportunism, which has paved the way to closer relationships with Russia and Iran over recent months. This is more complex than 'my enemy's enemy is my friend.' Instead, it reflects a growing pragmatism in Chinese diplomatic and trade decision making, as Russia and Iran both offer significant commodity supply potential. President Xi's January 2017 Davos speech extolling free trade is still receiving plaudits, most notably in Western Europe. Looking at a map of the world, the reasons for this start to become more obvious. The potential for Europe's economies to gain dynamic trade benefits from China remain clear and, given the region's continued troubled backdrop, getting closer to the Chinese rather than the U.S. orbit has grown more attractive. The coordinated negative reaction by Europe, Russia, and China to the U.S. pulling out of the Iranian deal highlights an ever-closer working relationship.

HIGH STAKES

However, greater coordination is no panacea. A slow slide into a period of disruptions to global trade and diplomatic disagreements with the U.S. is highly likely to be a lose-lose for all involved. It is far better to keep full interaction with the world's number one economy today whilst pushing domestic change and reform initiatives. In Europe, planning for a lengthy Brexit transition period and measures to make the entire European economy more dynamic should continue to be top priorities. Despite all the negative headlines, this is still within the grasp of Europe's policymakers. Recent weeks have seen progress in forming the basis of a more extensive regional redistribution budgetary strategy. This is likely to be one carrot offered to the lagging Southern European countries to implement structural reforms that make labour markets more flexible and encourage risk-taking and entrepreneurship. The scope for further progress in developing China's economy continues apace, as the domestic change initiatives to encourage greater individual consumption are unveiled.

Of course, such arguments in favour of change, reform, and pragmatism apply to the United States as well. Globally, it is a time for a firm debate with calm heads. The stakes could not be higher.

KEY TAKEAWAYS:

- China's singular focus on economic development over the past generation has achieved huge success. In more recent years, the Chinese have made efforts to broaden their global influence as well as their diplomatic and political roles.
- America has to finance its fiscal deficit in order to keep the economic show on the road, and China needs relative global economic stability in order to continue its fairly seamless rapid development.
- In Europe, planning for a lengthy Brexit transition period and measures to make the entire European economy more dynamic should continue to be top priorities. Despite all the negative headlines, this is still within the grasp of Europe's policymakers.
- It is far better to keep full interaction with the world's number one economy today whilst pushing domestic change and reform initiatives.

US Corporate Earnings: The Fuel that Powers the Stock Market

Andrew Adams, CFA, CMT, *Senior Research Associate, Equity Research,* examines the current headwinds and tailwinds facing U.S. equities in the wake of high earnings growth.

Typically, when a company's earnings rise above the market's expectations over time, the price of its shares follows a similar path higher. And when this kind of better-than-expected earnings growth occurs across the majority of publicly traded companies, a bull market is often the result. A similar environment has been in place since the end of the 2008 financial crisis, with notable improvements in both the pace and quality of earnings growth occurring over the past two years.

AN EARNINGS-DRIVEN BULL MARKET

This positive backdrop for businesses has been consistent with one of our major themes since 2016: An improving economy should transition the interest-rate and stimulus-dependent market to an earnings-driven secular bull market. Data confirm that both the U.S. economy and corporate earnings improved over this time period, which produced one of the best years on record for the stock market in 2017. The positive trend in profits does not appear to be slowing down. Twelve-month S&P 500 operating earnings growth hit its highest level since 2011 in the first quarter of this year and is projected to be even better over the next two quarters, according to consensus analyst estimates from Standard & Poor's (as of 1 June). On the surface, this rosy outlook bodes well for the future, but sky high expectations have led many pundits to wonder just how much better things can get.

> "Data confirm that both the U.S. economy and corporate earnings improved over this time period, which produced one of the best years on record for the stock market in 2017."

A PAUSE IN THE ASCENT

Indeed, investors mostly scoffed at the high percentage of top and bottom line beats and impressive growth during the first quarter earnings season, a possible sign that optimistic sentiment had already priced in better profits. However, to be fair, after such a remarkable price ascent over the previous two years, including a 7.5% gain for the S&P 500 in the first few weeks of January, some sort of meaningful pause in the market was likely in order.

There has also been no shortage of headlines regarding global trade,

CRUISE CONTROL

Measuring the pace of earnings growth

2017 → 11% GROWTH

ESTIMATED 2018 → 20% GROWTH

ESTIMATED 2019 → 10% GROWTH

Source: FactSet as of 06/18/2018

rising input costs, tension with North Korea, and potential political landmines both in the U.S. and Europe to further discourage investors from committing capital to stocks, despite the healthy earnings landscape. However, the clear pickup in uncertainty as a result of these potential headwinds could go a long way toward lowering investor expectations for the market in the months to come, setting the stage for upside surprise potential if things do not deteriorate the way many fear they will.

> "Since the end of the financial crisis, economic growth in the U.S. has largely been attributed to additions in the labour market, as the unemployment rate has steadily decreased since 2008."

To be sure, the pace of earnings growth should slow down in future quarters. However, we believe the market understands this and does not expect 20% earnings growth to continue indefinitely. There is also a big difference between the pace of growth slowing and negative earnings growth. Even if S&P 500 operating earnings 'only' grow at 10% (the rate currently estimated for the end of 2019) instead of the more impressive pace seen in the first quarter of this year, it is still a very healthy growth rate that we believe can sustain the secular bull market. In fact, S&P 500 12-month operating earnings have grown at an average of 7.7% since 1990, so growth at a 10% clip would still be better than the recent historical average.

FUTURE DRIVERS OF GROWTH

So, what can help keep the economic and earnings expansion going? Economic growth is generally defined as an increase in the real value of products and services produced over time. In simplest terms, this growth occurs because more workers become employed and/or existing workers become more productive. Since the end of the financial crisis, economic growth in the U.S. has largely been attributed to additions in the labor market, as the unemployment rate has steadily decreased since 2008. However, productivity growth has not been nearly as impressive and will become more of an issue now that the labor pool has shrunk. It is unlikely that the U.S. will continue to add workers at the same pace of the past few years, which means companies will instead have to focus on productivity growth to keep the wheels turning.

TAX REFORM: A WILD CARD

Last year, Washington bet heavily that lowering taxes, particularly on corporations, would lead to more business investment, higher wages, and, in turn, better productivity and higher consumer spending. Perhaps, more than anything else, what companies decide to do with their tax bill-boosted cash balances will determine how the U.S. economy performs in the years ahead. If companies invest wisely in projects and M&A activities that will grow their businesses, and if wage increases translate into more consumer spending, the economy has the potential not only to keep growing, but maybe even grow at a faster pace.

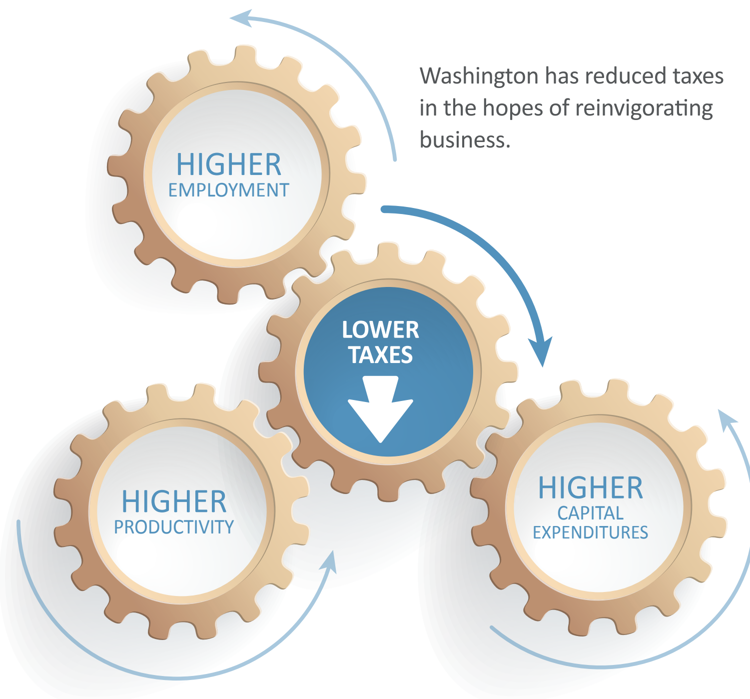
Many critics of the tax bill, however, have voiced concern that any tax savings may be merely passed on to shareholders in the form of share buybacks and increased dividends, and we do expect these options to remain popular among companies. Buybacks, in particular, draw the wrath of many individuals. It is true that a disproportionate amount of tax savings going toward share buybacks will not generate the long-term economic growth that investments in capital can. Still, keep in mind that buying back shares does help increase earnings per share and can be an attractive alternative for companies that do not feel they can generate high returns on internal or external investments.

WILL THE TREND CONTINUE?

Investors are still gathering evidence of what companies are doing with their excess cash, but preliminary signs show some pickup in both business investment and wages. According to Strategas Research Partners, capital expenditures in the first quarter of this year among S&P 500 companies increased 21% over the first quarter of 2017, after falling in the first quarter the previous two years. Moreover, the second estimate of first quarter real gross domestic product (GDP) and the May employment report show that fixed business investment and average hourly earnings grew slightly above consensus estimates. However, it is too early to tell if these trends are likely to continue, especially with respect to capital expenditures since many companies may have simply put off making investments until the new year in order to take advantage of the tax incentives that were included in the bill.

US Corporate Earnings: The Fuel that Powers the Stock Market (cont.)

GREASING THE GEARS: EFFECTS OF LOWER TAXES



Early evidence is promising, but we will need to watch these metrics closely in the coming months to see if companies are investing in the future and making productivity improvements a priority. If so, it will increase the chances of continued economic expansion while helping the stock market combat rising input costs and the higher expectations of today's investors.

"Early evidence is promising, but we will need to watch these metrics closely in the coming months to see if companies are investing in the future and making productivity improvements a priority."

KEY TAKEAWAYS:

- The pace of earnings growth should slow down in future quarters, but we believe the market understands this and does not expect 20% earnings growth to continue indefinitely.
- It is unlikely that the U.S. will continue to add workers at the same pace of the past few years, which means companies will have to focus instead on productivity growth to keep the wheels turning.
- Investors are still gathering evidence of what companies are doing with their excess cash, but preliminary signs show some pickup in both business investment and wages.
- Investing in the future and improving productivity will increase the chances of continued economic expansion while helping the stock market combat rising input costs and higher expectations of today's investors.

Is the Eurozone in Crisis?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"There cannot be a crisis next week. My schedule is already full" Henry Kissinger

The Eurozone has been in a troubled mode during 2018. The sight of German Chancellor Angela Merkel - Europe's longest serving and most important elected politician - struggling to not only put together but also to keep together a workable coalition has encouraged more commentators to write the political and economic obituary of the Eurozone.

Certainly international investors have voted with their feet in the past six months, with outflows at levels not seen since the days following the UK's European Union referendum in June 2016. Merkel's political scrambling has been accompanied by the surprise formation of a populist tinged government in Italy, a change of leadership in Spain after a long-running corruption scandal and underwhelming economic data.

> International investors have voted with their feet in the past six months, with outflows at levels not seen since the days following the UK's European Union referendum

So, has the hope of 2017 - following the election of an energetic new French President committed to reform and change - gone forever? Despite all the above, there has been some positive change and most of this has been centred upon the efforts of Emmanuel Macron. The French President has broadly lived up to his promise to introduce much needed economic, labour market, taxation and entrepreneurial reforms plus rebuild national confidence. And Macron's energy has not been the only encouraging regional positive: Greece is finally on the cusp of exiting its economic support programme, meanwhile the European Central Bank has set a date at which it intends to stop adding to its quantitative easing stimulus - although interest rates are set to remain in negative territory for at least another year.

In short, the hopes that a revitalised Franco-German leadership could push an attractive Europe 2.0 vision that could excite the pan-European electorate, has been unsettled by shorter-term political, economic and social considerations led - especially in Italy and Germany - by issues such as immigration and inequality. However, the history of the Eurozone has been that the most difficult and sometimes contentious decisions have generally been taken when political backs are against the wall. And there is the scope for 2018 to still be one of those years.

June's much-anticipated Summit of European leaders was ultimately hijacked by some of the shorter-term considerations noted above but, it is to the Eurozone's credit, that some progress was made and agreements reached. The new EU budget, stretching deep into the 2020s, deepens the Eurozone's regional redistribution capabilities - absolutely essential for the effective working of a single currency zone (as the United States would attest). More regional distributions towards southern Europe offers the scope of 'cash for reforms' style deals, but at the moment it is still just a hope, with further details to be worked out by the end of the year.

Economic realities at two levels will be critical influences over the balance of the year. The first is whether the Eurozone economy can start to surprise again after a first quarter badly hit by unhelpfully poor weather and tough comparisons. Regional economic growth rates remain below medium-term aspirations but an economic recovery is still taking place, which includes the best rate of bank lending growth

*An affiliate of Raymond James & Associates and Raymond James Financial Services

Is the Eurozone in Crisis? (cont.)

ECONOMIC GROWTH LEVELS		
	June 2018 est.	March 2018 est.
2018	2.10%	2.40%
2019	1.90%	1.90%
2020	1.70%	1.70%

Source: European Central Bank

since before the global financial crisis. Given, as aforementioned, interest rates for the Eurozone are still currently at negative levels, this should be no huge surprise, but more jobs and some wage growth can only be a positive at-the-margin for the whole region.

The second economic reality rests with the region's third largest economy: Italy. As the coalition government is fast learning, it is easier to talk than govern, and further signs that the country is embracing change and reform as a committed member of the Eurozone, can only help confidence towards the whole region. High debts and a still strained banking system - as the Greeks would agree - is best managed with the help of the Eurozone authorities. A pragmatic Germany and an energetic France could still yet find a workable formula for a future Eurozone that remains troubled but not, by any means, on its deathbed. For investors today there remains more opportunity than threat.

A pragmatic Germany and an energetic France could still yet find a workable formula for a future Eurozone that remains troubled but not, by any means, on its deathbed

KEY TAKEAWAYS:

- International investors have sharply reduced their holdings in the Eurozone during 2018
- The Eurozone takes the most difficult decisions when political backs are against the wall
- The new EU budget, stretching deep into the 2020s, deepens the Eurozone's regional redistribution capabilities
- An economic recovery is still taking place

Emerging Markets: Opportunity or Threat?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"Emerging markets are hugely important" James Dyson

In the world of emerging market investments it tends to either be feast or famine. Whilst the second half of 2016 and especially 2017 proved to be the latter, the first half of 2018 has proved to be somewhat more challenging. And it has not mattered one iota if you are an equity, fixed income or local currency investor - all have struggled at an aggregate emerging markets index level.

As with anything in the world of investments, there is the general and there is the specific. The biggest general (negative) influence on emerging markets during 2018 has been the appreciation of the US dollar. There are many reasons why emerging markets do not like a rising dollar, from higher interest rate burdens on dollar-denominated debt, to (typically) lower commodity sale prices plus the general tightening of global liquidity a higher dollar tends to stand for. During 2018 the higher dollar has also reflected a defensive shift by some international investors worried about rising trade tensions. Key emerging markets such as China and Mexico have been in the direct firing line of the 'fair trade' rhetoric and wishes of the US administration, a reality which has intensified concerns.

Beyond investors booking some profits and dollar/trade issues, specific issues across a number of intermediate sized emerging markets have had an influence. Argentina requested formal assistance from the International Monetary Fund (IMF), whilst Turkey's combination of deficits and inflation led to high volatility. Both Russia and Iran have been impacted by economic sanction decisions led by the US administration whilst Brazil, Hungary and the Philippines have seen their local stock markets move into bear territory (a fall of 20%+).

> The biggest positive for emerging markets today remains the journey from a 'frontier', to 'emerging' and finally a 'developed' economy

The local Chinese stock market has also been flirting with bear market territory as the last thing the world's biggest emerging market needs is a slowdown in the rate of its economic growth. As noted above, trade concerns have started to impact the country and this has the capability to put pressure on China's ability to keep changing at a breakneck speed and hence, in turn, being the world's largest consumer at-the-margin of many commodities.

However it is not all about demand... sometimes it can be about change too. Despite trade concerns, lowered expectations and specific country level disappointments, the biggest positive for emerging markets today remains the journey from a 'frontier', to 'emerging' and finally a 'developed' economy. Themes centred on urbanisation, the growth of a middle class, heightened consumerism, more effective and less corrupt government, among many others still provides a heady strategic attraction which any international investor with a medium-term outook still really needs to be exposed to. Additionally, current valuation levels for both emerging market equity and debt markets look attractive against more developed market equivalents. Meanwhile, sentiment surveys show waning investor attraction towards emerging markets boosting the attraction for more contrarian minded investors.

By definition it can be hard to generalise about an area as diversified as emerging market investment. However, thinking at an index level, tactically, trade rhetoric and realities and the level of the US dollar will prove highly influential over the balance of this year for the area. With many emerging markets - especially the influential China - showing a

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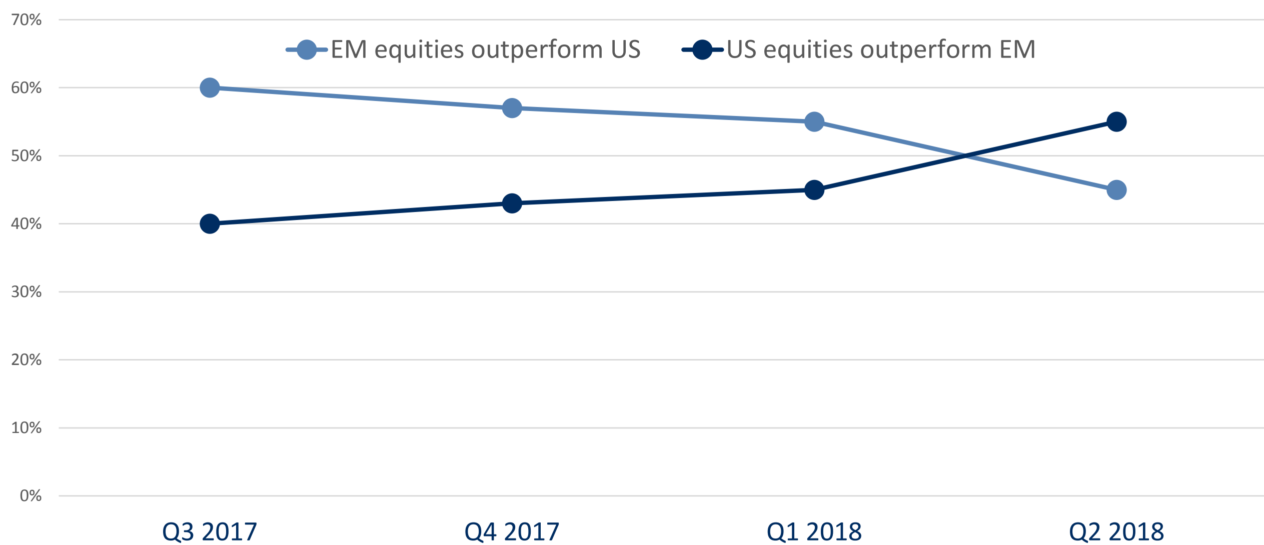
Emerging Markets: Opportunity or Threat? (cont.)

WHICH ONE OF EM AND US OUTPERFORMS NEXT 12 MONTHS?



stronger commitment to economic reform and change than their developed market cousins, investor caution should only really extend so far. Today I would rate broader emerging market indices as offering more opportunity than threat.

> With many emerging markets showing a stronger commitment to economic reform and change than their developed market cousins, investor caution should only really extend so far

KEY TAKEAWAYS:

- The first half of 2018 has proved to be somewhat more challenging for emerging market investors
- Trade rhetoric and realities and the level of the US dollar will prove highly influential
- Longer-term themes still provide a heady strategic attraction
- Current valuation levels for both emerging market equity and debt markets look attractive against more developed market equivalents

Q&A: Oil Prices at Four-Year Highs: What It Means for Energy Investors

Pavel Molchanov, *Energy Analyst, Equity Research,* examines rising oil prices and the effect this trend has on various stakeholders within the energy industry.

Q. OIL PRICES RALLIED THROUGHOUT THE SPRING, REACHING THE HIGHEST LEVELS SINCE 2014. WHAT'S DRIVING PRICES?

A. Basic economics holds that when demand exceeds supply, prices should rise. Well, that is precisely what has been happening in the global oil market – and for much longer than the past few months. The trough of the down cycle for oil prices occurred back in February 2016. The key fundamental metric we focus on is global petroleum inventories (not solely U.S.), which declined by an average of one million barrels per day in 2017. We are forecasting a similar decrease in 2018, with inventory levels falling below historical norms.

By definition, these inventory drawdowns mean that demand is running ahead of supply. For the fourth consecutive year, global demand is set to grow faster than its long-term average of 1.4% per year, with emerging markets continuing to drive (quite literally) the bulk of the increase. Supply is also up, but is limited by several factors. Larger U.S. oil producers are exhibiting restraint in capital allocation, meaning they are spending less on business investment, marking a shift from their historical tendency to overinvest. Additionally, OPEC's production discipline, led by Saudi Arabia, remains intact, and there are still supply declines in several non-OPEC geographies such as Mexico. Finally, supply disruptions/challenges, especially in Venezuela, continue to weigh on inventory levels.

That being said, it is worth underscoring that the oil futures curve is currently downward sloping (also referred to as 'backwardation'), suggesting that the commodity market is signaling a sharp drop in oil prices from current levels over the next three years. On the contrary, our view is that prices still have room to move higher over the next several years.

Q. WHO WINS AND WHO LOSES FROM THE HIGHER OIL PRICES?

A. As one would expect, energy investors are among the clear winners. After having underperformed the S&P 500 in six of the previous seven years (all except 2016), the energy sector is outperforming year-to-date. There have been outsized gains in higher-beta stocks with above-average leverage to oil prices, while defensive/conservative energy stocks and those with a focus on natural gas have generally lagged. More broadly, the current oil price landscape is helping to revive investment and job creation in geographies that felt the pain of the down cycle – Russia, Texas, and Alberta – not to mention many of the OPEC countries.

In general, higher oil prices are not ideal for the world's major economies since most of them are net oil importers. This is especially true for Japan, India, and most of Europe. The U.S. and China present more of a mixed picture, since they produce a sizable portion of their oil consumption. In oil importing countries, the average consumer will have to pay more for their fuel this summer than at any point since 2014. Average U.S. retail gasoline prices are already approaching $3.00/gallon, as compared to less than $2.50/gallon one year ago. This could result in a revival in sales of smaller cars, which have generally been sidelined in recent years as consumers gravitated to trucks and SUVs.

Q. WHAT ROLE IS IRAN PLAYING IN THE OIL PRICE RALLY?

A. The short answer is not much. The White House's decision in May to reinstate a range of economic sanctions against Iran is contributing to the geopolitical risk premium in the oil market, but this is mostly a matter of 'headline risk' and sentiment. The decision to impose sanctions, in and of itself, does not curtail Iranian oil supply. For such curtailment to materialise, one of two things would need to happen. First, a significant number of

Q&A: Oil Prices at Four-Year Highs: What It Means for Energy Investors (cont.)

European and Asian countries would have to revive their own import restrictions, returning to the 2012-2015 policies in place prior to the signing of the nuclear deal. Given how much Europe wants to salvage the nuclear deal, that's not likely, provided Iran does not escalate the situation.

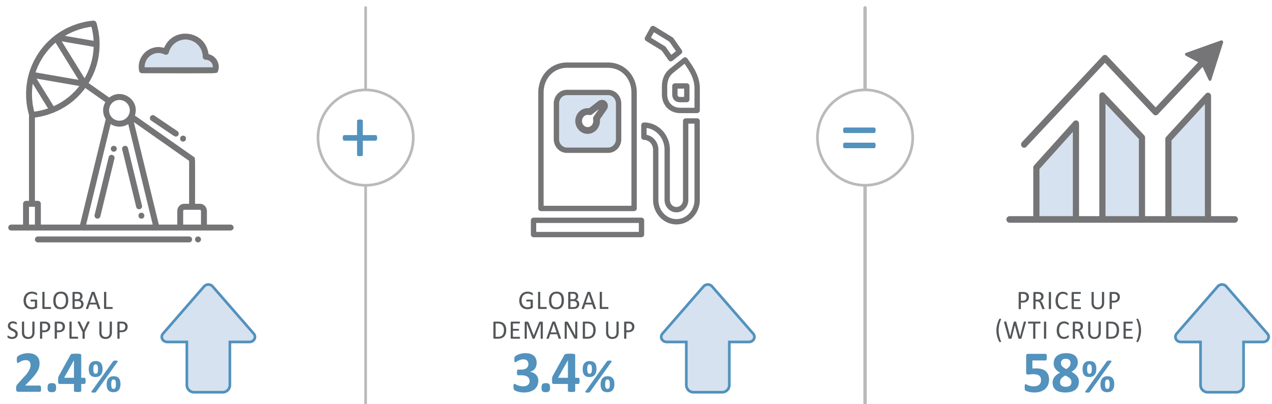
The second scenario would be a full-scale war with tankers physically blockaded – also not likely without major escalation. From a long-term perspective, the wild card will be the willingness of international energy companies to invest in Iran (bearing in mind that U.S.-based players have no operations there). The threat of U.S. secondary sanctions will create an additional barrier, but the fact of the matter is that such investments have been minimal anyway.

KEY TAKEAWAYS:

- For the fourth consecutive year, global demand is set to grow faster than its long-term average of 1.4% per year, with emerging markets continuing to drive the bulk of the increase. Supply is also up, but is limited by several factors.
- It is worth underscoring that the oil futures curve is suggesting that the commodity market is signaling a sharp drop in oil prices from current levels over the next three years. To the contrary, our view is that prices still have room to move higher over the next several years.
- Higher oil prices are not ideal for the world's major economies since most of them are net oil importers (especially Japan, India, and most of Europe). The U.S. and China present more of a mixed picture, since they produce a sizable portion of their oil consumption.

SUPPLY AND DEMAND PUSHING PRICES UP

(2016-2018)



Source: International Energy Agency and Raymond James research as of 06/18/2018

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