RAYMOND JAMES

VOLUME 13 | ISSUE 4 | OCTOBER 2021

INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

The U.S. View From The Mountaintop

As we sit atop our prosperous peak, admiring the views of the fastest economic growth since 1984, the best start to a bull market, and the record-breaking quarter of earnings growth, it's wise to remember that not too long ago we began our uphill journey from the depths of the COVID-19 ravine. Often, the best views come after the hardest climbs. So now it's time to catch our breath and peer over the horizon at what's to come as we begin our descent from this peak. However, just as the summit of one mountain can become the base of another, the investment landscape goes on indefinitely, which makes adhering to a disciplined investment strategy of the utmost importance.

Akin to a stout rope extended to a slipping climber, a record amount of fiscal stimulus restrained the unprecedented tumble in economic growth. Now, as seasoned hikers, we've headed back to stadiums, theatres, schools, and restaurants, moving the economy onward and upward—despite the new variants lurking along the trail. But the days of soaring fiscal aid are ending. Even as Congress debates over as much as $4.5 trillion of 'physical' and 'human' stimulus, a compromise will likely yield half that amount, with the distribution spread over a ten-year period. With excess disposable income already descending ~$1 trillion from its $2 trillion peak, an unavoidable fiscal cliff looms next year. Fortunately, four factors should cushion the economy from a hard fall: 1) gradually filling the record 10+ million job openings; 2) increasing wages; 3) rebuilding depleted inventories; and 4) boosting business capital expenditures. Indeed, the economy should keep climbing at an above-trend economic pace through at least 2022 (2022 GDP Forecast: 3.3%).

The eruption in economic growth over the last year has packed sizable returns in commodities' backpacks, particularly for oil. Higher crude oil prices have reached a scenic overhang, soaking in views of increased production (a positive for GDP) and further incentives for developing alternative energy sources (e.g., solar, wind, nuclear, etc.). With supply and demand approaching equilibrium, our forecast calls for tempered moves in oil prices—peaking slightly higher in the first quarter of 2022 before subsiding in the mid $70s by this time next year. However, be on the lookout for oil prices sustainably above our target. As miles driven in the US approach a record, rising gasoline prices could pose a risk to our economic outlook. In fact, soaring gas prices were one of the root causes of recessions in 1981, 1990, 2001, and 2008.

The economy trekking upward at a sustainable pace eases pressure on the Federal Reserve (Fed) to maintain an ultra-accommodative monetary policy. As a result, the Fed's first step this quarter will be dialling back the emergency-induced bond purchasing program. But until the Fed's balance sheet plateaus mid next year, we're in the camp that believes there are many miles to go before it tightens policy and raises interest rates (not until 2023). The expected decrease in Fed bond purchases has many analysts concluding interest rates will spike, but we don't follow that path. The reason: our government will issue significantly less debt next year. As a result of healthy economic growth, the 10-year Treasury yield will scale gradually higher to 1.75% over the next 12 months. However, the upward climb will be limited due to solid demand from foreign buyers, pension funds, and retirees acting as a rappelling force. While low yields can be discouraging, investors should view bonds as a safety harness for their portfolio. Bonds may not seem necessary during the less challenging legs of a journey, but they will be appreciated when the trip gets tough. With rates likely to move slightly higher, we favour short to intermediate bonds over longer-dated maturities. Historically tight credit spreads limit the upside potential for investment grade and high yield bonds, but both sectors should earn more than Treasurys. We also expect supply dynamics to remain supportive for municipal bonds.

The equity bull market keeps ascending to higher altitudes. With a secure macroeconomic backdrop, above-trend earnings growth, rising dividends, and low interest rates, this rally should have endurance. Impressive earnings have been the bedrock, and CEOs are signalling that supply chain shortages, pricing pressures, and labour misalignments will resolve soon. Therefore, our S&P 500 2022 earnings estimate of $230 translates into a 4,XXX price target by the end of next year. While our bias is to the upside, the proposed corporate tax hike could result in a 3-5% reduction to our earnings forecast. However, given the history of previous tax increases and the resiliency of corporate America, it should not cause a cre-

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 financial advisor to discuss the content of this publication in the context of your own unique circumstances. Published 05/10/2021. Material prepared by Raymond James as a resource for its wealth managers.

vasse-like decline at this early stage of the bull market. As any hiker knows, the higher the altitude, the thinner the air becomes. While the S&P 500 has avoided a 5%+ pullback for over ten months, the market may experience temporary periods of fatigue. But given the supportive long-term fundamentals, equities should regain their footing and offer up some attractive buying opportunities.

US equities remain our preferred region, as the strong economic recovery and magnitude of earnings growth make it the leader of the pack. Given the recovery's durability, we favour select cyclicals. Clipped to our carbineer are the Consumer Discretionary, Financials, Communication Services, Industrials, and Energy sectors. From a market capitalisation perspective, we're eyeing opportunities for small-cap stocks as the Delta variant falls off, as they are more highly leveraged to recovery prospects. For similar reasons, we remain constructive on the emerging markets when assessing international exposure, particularly select regions in Asia. A ramp up in the pace of vaccinations in the region could create near-term opportunities given the relative attractiveness of valuations. However, as the recent regulatory-induced equity declines in China have shown, active management is paramount to grapple with the complexities of these less-liquid markets.

Skilled mountain climbers undergo months of preparation: visualising their goals, conditioning their bodies, packing for inclement weather, and evaluating the best route (and alternatives) to reach the summit. Wise investors practice similar preparation when preparing for their financial future: identifying objectives, assessing risk tolerance, protecting against events that could be detrimental to the plan, and determining asset allocation parameters that act as a compass for the stated goals.

Our outlook serves as a panoramic view of the economy and various asset classes as we enter the final quarter of 2021. We understand that there can be an avalanche of financial headlines at times, but with confidence in your plan and a trusted advisor as your spotter on the belay rope, we hope you have the guidance and tools needed to move mountains when it comes to accomplishing your investment objectives and that you reach your investment summits safely.

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

All expressions of opinion reflect the judgment of the Chief Investment Office and are subject to change. Investing involves risk including the possible loss of principal. Past performance may not be indicative of future results.

Investment Strategy Committee Members

Lawrence V. Adam, III, CFA, CIMA®, CFP® – Committee President, Chief Investment Officer, Raymond James

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

Scott J. Brown, PhD Chief Economist, Raymond James

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

Doug Drabik Managing Director, Fixed Income Research

J. Michael Gibbs Managing Director, Equity Portfolio & Technical Strategy

Nick Goetze Managing Director, Fixed Income Solutions

Nicholas Lacy, CFA Chief Portfolio Strategist, Asset Management Services

Joey Madere, CFA Senior Portfolio Analyst, Equity Portfolio & Technical Strategy

Ed Mills Managing Director, Washington Policy Analyst, Equity Research

Pavel Molchanov Director, Energy Analyst, Equity Research

Tracey Manzi, CFA Senior Investment Strategist, Investment Strategy

Chief Investment Office

Anne B. Platt, AWMA®, AIF®, RICP® – Committee Chair, Vice President, Investment Strategy

Giampiero Fuentes, CFP® Investment Strategy Manager, Investment Strategy

Kailey Bodine Investment Strategy Analyst, Investment Strategy

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

The World Awakens

Chris Bailey, *European Strategist,* Raymond James

> “Following the light of the sun, we left the Old World”
>
> **- Christopher Columbus**

This year, the first half of November may help progress a range of important initiatives for much longer than just the rest of this decade. The international climate summit COP26 will take place in Glasgow between Monday 1 November and Friday 12 November and there is much to discuss. After all - as noted by the U.K. government recently - COP26 may be our last ‘best hope for the world to come together and tackle climate change’, beyond hopes already forged at the 2015 Paris Agreement.

However, the world has already evolved in many ways over the last six years with the growing global influence of emerging market nations - even given the COVID-19 crisis. This alone can make discussions more challenging for a world where rising global emissions are already expected to breach the Paris Agreement temperature target, namely restricting a rise in temperature to 1.5^{C} by halving carbon dioxide emissions by 2030. Whilst the convergence of a ‘movement of movements’ is building, it is difficult to have truly global applications, given that developed market nations cannot easily criticise the very same economic growth engines that they applied themselves over recent decades. Fortunately, periods of change and new insights are applied all the more quickly. Acknowledgement of this alone would allow discussions in Glasgow to have some real impacts over the next two or three decades, something that financial markets might find comfort in.

But what about current energy price concerns, not just in the U.K. despite the rise of both wind and solar power solutions? ‘Green’ energy focus by the end of the next decade and hitting net zero emission by 2050 remain far more consistent with continued nuclear energy than gas and coal in particular. As always change occurs over time.

Source: The UK Green Building Council (UKGBC)

Global populations are due to change in other ways over the next couple of decades. The growing number of older people is a cause for real celebration, but it does also mean heightened healthcare challenges while also having implications for governments' taxation requirements. For most developed market countries over the next twenty years, it would suggest a 5-10% proportional GDP increase to meet the tax bill. Whilst countries such as Germany and Japan have been particularly forward-looking by focusing on long-term solutions to cope with the demands that come with an ageing population, avoiding higher taxation levels becomes more difficult. Meanwhile, even in the emerging markets, China's ageing population problem continues to cause economic concerns (providing a justification for the country's government to focus more on 'common prosperity' efforts for all business sectors). As shown by smaller family norms in the developed markets, China's extension of its two-child policy to three children is unlikely to have much of an effect.

> The real key for all countries around the world remains to embrace change.

The real key for all countries around the world remains embracing change. Whilst jobs in some sectors are changing due to an evolving world centred on more technology, the highest job creation numbers will come in areas impacted by home health and personal care. So whilst proportional taxation levels are likely to rise, it is not all about the consequence of heightened government borrowing levels over the last decade.

For investors, it is always a world of change, even beyond the steady rise, during the 2020s, of Generation X and Millennial investors compared to Baby Boomers. It will certainly make careful stock-picking more relevant as already highlighted so far in global markets in 2021. Challenges always bring opportunities too. It would be more of a worry if climate change, ageing populations and government debt levels were not major points of discussion. Life, business and financial markets are all always a trade-off. Whilst there may not always be solutions, there are always opportunities to improve (and invest).

KEY TAKEAWAYS:

- The international climate summit COP26 is held in early November.
- Discussions are focused on key issues over the next two or three decades.
- Ageing global populations are set to have impacts on tax rates.
- Challenges always bring opportunities too.

When Rubber Hits the Road

Jeremy Batstone-Carr, *European Strategy Team,* Raymond James

The United Kingdom is facing an energy crisis. This goes well beyond the terrible optics associated with petrol stations running out of fuel. The country has recently experienced a 400% spike in natural gas prices and a 250% increase in the price of electricity. The subject was touched upon, albeit obliquely, by Bank of England Governor, Mr Andrew Bailey, in the wake of the conclusion of the most recent Monetary Policy Committee meeting. "The shocks that we are seeing are restricting supply in the economy relative to the recovery in demand. This is important because monetary policy will not increase the supply of semiconductor chips, it will not increase the amount of wind, and nor will it produce more HGV drivers".

It is certainly true that the domestic energy generating industry has been hit by a confluence of unforeseen factors serving to throttle-back supply, including extremely low wind levels, a fire at an important France – U.K. electricity interconnector, nuclear power outages and a gas shortfall sweeping not just Britain but across Europe too. This has resulted in the collapse of some energy providers and forced activities from steelmaking to manufacturing to shutdown during peak hours to avoid having to pay excessive energy fees. The situation has been exacerbated, argue some critics, by the U.K.'s drive towards a "net-zero" carbon emissions policy. Over the past 50 years, the U.K. has reduced its dependency on coal power and become increasingly dependent on gas as its primary source of electricity generation, most of it imported from Europe. Furthermore, heavy investment in renewables over the past ten years has boosted wind output which now contributes around 24% of total power generation.

At this moment in time the global economy, not just that of the U.K., faces some very testing economic challenges. The squeeze on the availability of energy supply is contributing to an increase in inflationary pressure, exacerbated by the fracturing of supply lines across a wide range of goods and services. Yet the temptation to blame everything on the after-effects of the Covid-19 crisis really ranks alongside "the dog ate my homework" in terms of credibility. After all, global GDP fell by just 3.3% last year, poor but hardly catastrophic.

> In truth, the global economy has been deteriorating for a very long time.

In truth, the global economy has been deteriorating for a very long time. The term "secular stagnation" was coined in the 1990s, and with good reason. Whilst it might be tempting to take the view that ultra-easy monetary policy has boosted global activity over the past dozen years, in reality, the size and complexity of the modern economy is the direct derivation of the use of fossil fuels; oil, gas and coal. From the mid-1990s onwards, the cost associated with extracting traditional energy sources has been on a relentlessly rising trend. Meanwhile, the window of "environmental tolerance" towards their use has been closing.

This might not have been a problem had a fully "utilisable" replacement source of energy been available, coupled with a willingness on the part of the authorities to adapt and adjust the economy onto a new basis consistent with a radically altered energy source. But neither has been the case. Wind and solar power cannot completely replace fossil fuel energy, for three reasons.

Firstly, the creation, expansion and maintenance of the infrastructure associated with renewable energy sources is completely dependent upon materials whose supply is driven by legacy energy from fossil fuels. Secondly, overcoming the intermittence of wind and solar power requires batteries, a dependence which "ups the ante" against seamless transmission to an even greater extent. Thirdly, and perhaps most importantly, even accounting for the use of technological know-how, renewables are unlikely ever to deliver the energy density to which two centuries of reliance on coal, oil and gas have led us to become accustomed. Sometimes there really are no ways around the immutable laws of physics.

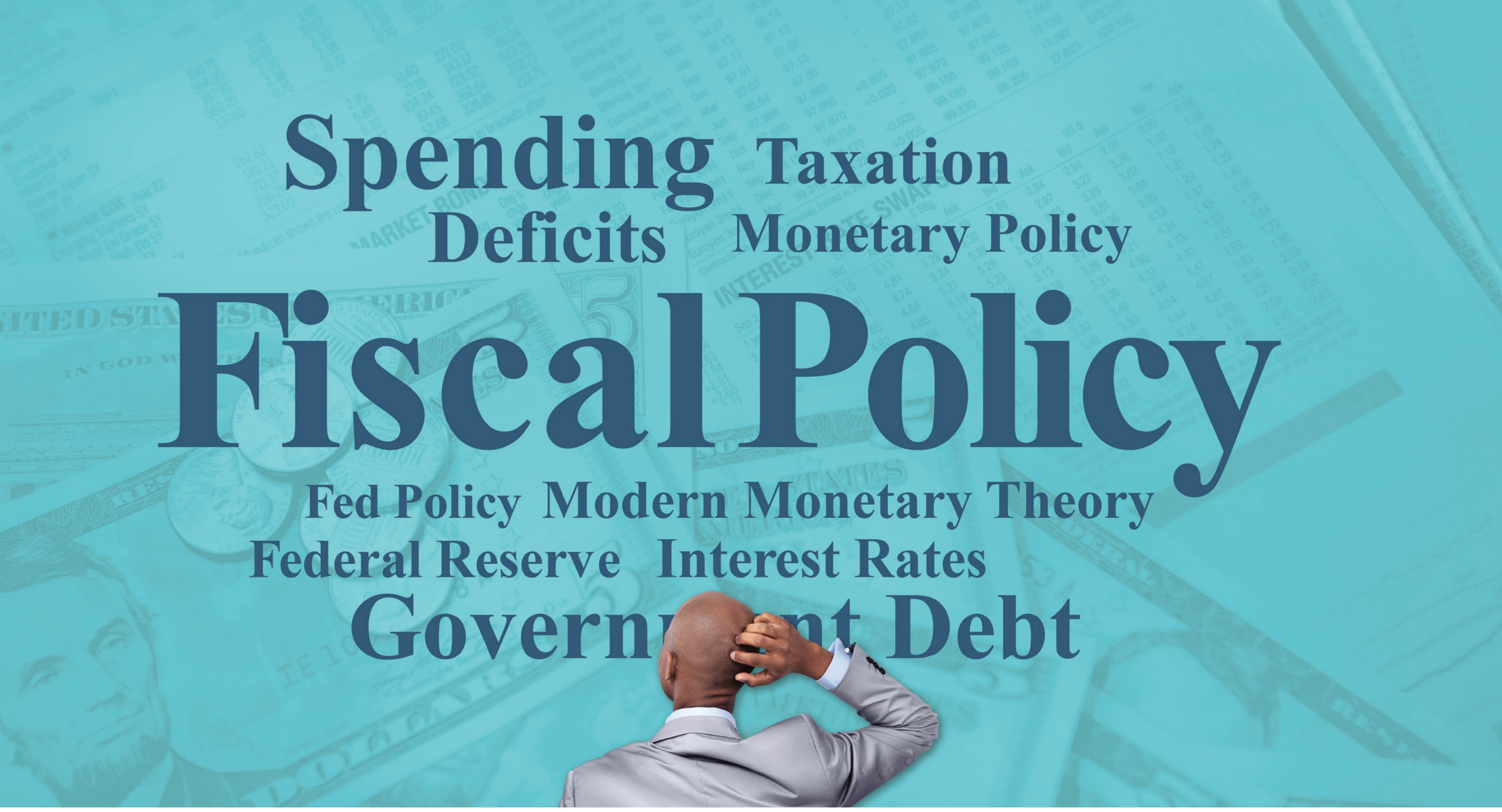
In the early days of the industrial revolution, the financial cost associated with the extraction of fossil fuel was incredibly low. However, as resource has diminished, so the cost of extraction has steadily increased, slowly at first but much more rapidly over the past three decades. It is this rapid recent acceleration, coupled with the recognition that the "energy cost" associated with renewables will never get down to the ultra-low levels of the late eighteenth and early nineteenth centuries, that lies behind secular stagnation. In short, the heretical assertion is that the world is not, and has never been, a financial system but rather an energy system. The current crisis makes this observation all the more telling, and the air is thick with the sound of chickens coming home to roost.

The inexorable rise in energy costs, thrown into sharp relief by the current crisis must, inevitably, result in the steady increase in the cost of items perceived by households as essential. So, as the proportionate cost of these items increases, so overall prosperity is trending downwards. This is important for a stock market the vast majority of constituent businesses for which have models based upon the supply of discretionary and non-discretionary goods and services. As the pressure on prosperity increases so, in addition, will come pressure on businesses models dependent on household income streams. Rising costs associated with fractured supply chains are adding to building inflationary pressure beneath the surface and this is putting governments and central banks in a bind.

Smug as one might feel, when charging one's electric vehicle up at the power point (until the point when the cost of materials used in the manufacture of batteries becomes exorbitant too), the broader point is that the world is reaching the point where perpetual fiscal and monetary stimulus reduces in its effectiveness and actually becomes dangerous as credit-based lifestyles, even for necessities, become unsustainable. Central bankers may initiate the conversation about tightening monetary policy, but in truth, they are trapped. The cost of achieving short-term price stability is likely to result in more volatility therefore, a well-diversified portfolio is vital.

KEY TAKEAWAYS:

- Inflation is likely to remain above target for longer.
- The global economy faces testing economic challenges, not all due to COVID-19.
- Energy prices will likely remain high.
- Volatility will continue.



U.S. Economic Outlook: Fiscal Policy Beyond the Pandemic

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

To counter the economic effects of the COVID-19 pandemic, U.S. lawmakers approved $5.2 trillion in fiscal stimulus in 2020 and 2021 – over 25% of annual gross domestic product (GDP) and more than most other countries. At the end of August, the national debt stood at $28.4 trillion. Should investors be worried? What do we mean by 'fiscal stimulus' and have attitudes toward federal deficits and debt changed?

WHAT IS FISCAL POLICY?

Fiscal policy refers to the use of tax and spending policy to influence economic behaviour. Cutting taxes or increasing government spending is expansionary (or 'stimulative'), meaning that it adds to growth. Raising taxes and cutting spending is contractionary, meaning it subtracts from growth.

Fiscal policy stands in contrast to monetary policy, which is the setting of short-term interest rates (or also, in recent years, large-scale buying of Treasury and mortgage-backed securities) to influence economic activity. In the U.S., Monetary policy is quick to implement as the Federal Reserve can lower short-term interest rates whenever it decides to do so; however, it has a long and variable lag and it could take a year or more before the full impact is felt. In contrast, the effects of fiscal policy are more immediate, though it often takes time to implement. The conventional view among economists is that neither policy can be used to fine tune the economy. Monetary policy is the primary tool to guide the U.S. economy, and has been likened to steering a supertanker, while fiscal policy is reserved for fighting recessions. However, we're seeing some debate about whether the conventional view will continue.

> The government is not like a household. Our children and grandchildren do not have to pay off the national debt.

In a recession, the loss of jobs and income leads to reduced spending, which leads to further job losses, and further reductions in spending, and so on. Fiscal stimulus is intended to halt this snowballing and can be thought of as a bridge supporting aggregate demand while the private sector recovers. That bridge should be long enough to get to the other side. Stimulus was massive following the 2008 financial crisis—the U.S. federal budget deficit rose to 10% of GDP. In hindsight, while it prevented a much more substantial downturn, it wasn't large enough to propel the economy to a full recovery right away. From the start, the Biden administration did not want to make the same mistake.

In every recession, U.S. lawmakers announce some sort of tax rebate. Economists caution that sending one-time checks to individuals isn't effective as these checks are more likely to be used to pay down debt or add to savings, and are less likely to be spent. However, as we saw during the pandemic, income support can provide a critical lifeline for people who have lost jobs and income, and can prevent more substantial economic weakening.

Increased government spending is also used to fight recessions. Such stimulus should be targeted, timely, and temporary. Large-scale spending is difficult to plan quickly and, as we saw in the aftermath of the 2008 crisis, there may not be shovel-ready projects. Getting the money out rapidly is important. You don't want to add stimulus after the economy has already recovered. Ideally, added spending should be pulled back as private-sector demand recovers.

The 2008 financial crisis and the pandemic both led to significant economic downturns, but they were different than typical recessions and very different from each other. Following the financial crisis, it would take a long time to repair the damage to household and business balance sheets. We tend to focus on federal fiscal policy, but state policy played a key role in dampening the recovery. Most states have balanced budget requirements and state budgets turning red in the aftermath of the financial crisis led to spending cuts. About a third of the $831 billion American Recovery and Reinvestment Act of 2009 was aid to states, which limited job cuts initially, though state and local government employment still fell sharply and did not fully recovery until 2019.

State tax revenues appeared to be at risk in the early stages of the pandemic, but federal support helped the national economy to recover, and most states saw a quick rebound in revenues. The pandemic recession was the sharpest and briefest on record, but brought massive job losses. The recovery has been swift, but par-

Fiscal and Monetary Policy

Fiscal Policy

The use of tax and spending policy to influence economic behaviour

- Implemented by the government to fight recessions
- Can take time to implement but effects are felt quickly

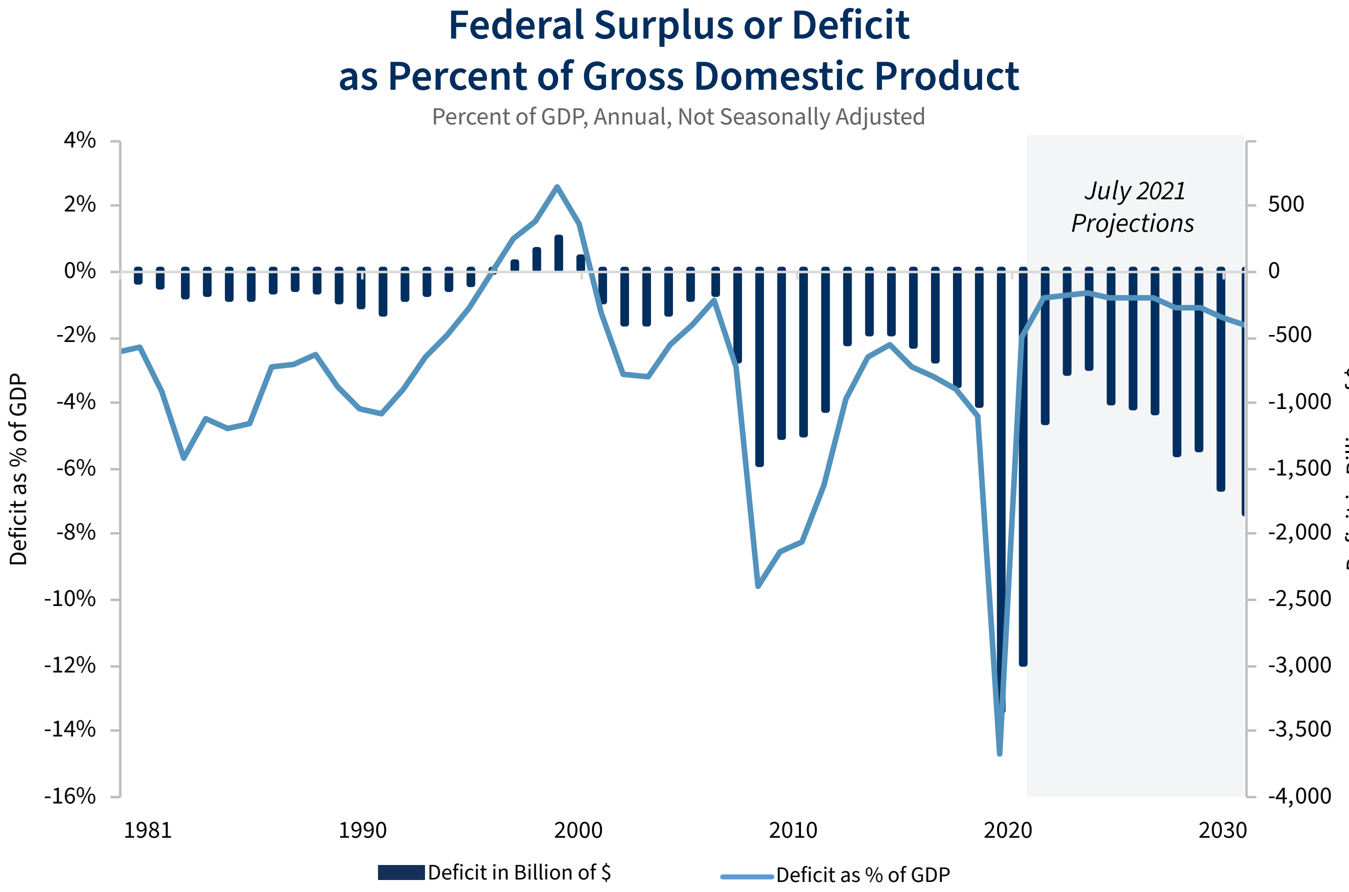
GOVERNMENT

Monetary Policy

The setting of short-term interest rates or buying of assets to influence economic activity

- Implemented by the Federal Reserve to guide the economy
- Is quick to implement but may take time for the impact to be felt

CENTRAL BANK



Source: Congressional Budget Office, as of 7/31/2021 (based on current legislation – does not include infrastructure plan)

tial. A full recovery is not going to happen until the pandemic is fully behind us, and it won't be over until it's over everywhere.

DEFICITS AND DEBT: SHOULD WE BE WORRIED?

The government is not like a household. Our children and grandchildren do not have to pay off the national debt. Does that mean we shouldn't be concerned about the debt? The key issue is whether we can meet interest payments on the debt and whether we can roll over existing debt as it matures. So far, the U.S. government can easily borrow and making payments on the debt shouldn't be a problem if interest rates rise moderately. Of course, there may come a point when government borrowing begins to crowd out private borrowing, reducing business investment and constraining consumer spending, but there's no sign that we're anywhere close to that.

What about inflation? Federal debt and deficits do not cause inflation. We ran deficits of around 5% of GDP in the 1980s and inflation trended lower. Japan has a debt-to-GDP ratio of 265% and has been battling deflation for years. That said, fiscal stimulus, especially direct payments to individuals, has boosted demand, while the pandemic has disrupted supply chains. Supply chain issues usually resolve themselves over time, but pandemic-related pressures have been more severe and have lasted longer than initially expected. The danger is that long-lasting supply chain disruptions could boost long-term inflation expectations, which could become self-fulfilling. While that is unlikely to be the case, we won't know for sure until much later.

MODERN MONETARY THEORY – A NEW ERA?

Over the last few decades, Democrats, when in power, adopted pay-go rules. Tax cuts or increased spending had to be matched by additional revenue sources or spending cuts in other areas. Exceptions were made for recessions and war, but otherwise spending and tax changes had to be deficit neutral. For example, this is how the Affordable Care Act (Obamacare), which passed in 2010, was paid for.

When the Democrats gained control of the House in 2019, they did not reinstate pay-go rules. Many on the far left have embraced Modern Monetary Theory (MMT), which essentially says that deficits don't matter and the government can spend whatever it wants (up to a point). Proponents of MMT argue that the pandemic experience of large deficits and low interest rates proves

> “Fiscal stimulus is intended to halt this snowballing and can be thought of as a bridge that must be long enough to get to the other side.”

the theory, while opponents say it has been set against a naïve ‘straw man’ interpretation of conventional macroeconomics.

Critics of MMT point out that it isn’t particularly ‘modern’ (such ideas have been around for a while), it isn’t ‘monetary’ (we’re talking government taxation and spending, which is fiscal policy), and it isn’t much of a theory. It starts with its conclusion, unlike conventional economics which is built up from basic principles.

Conventional wisdom on deficits has evolved, but not due to MMT. In the late 1980s, a decade of government borrowing had begun to put upward pressure on long-term interest rates. Fed Chair Alan Greenspan had an agreement with Congressional leaders to lower interest rates if they moved to reduce the budget deficit. The first President Bush and President Clinton each signed legislation to reduce the deficit.

In recent years, the conventional view has come to see more leeway in government debt. The key is that real interest rates (the rate at which the government borrows adjusted for inflation) should not exceed the growth rate of GDP on an ongoing basis.

WHERE DO WE GO FROM HERE?

In July, the Congressional Budget Office (CBO) projected that the federal budget deficit would fall from 14.9% of GDP in fiscal year 2020 to 13.4% in fiscal year 2021 (ending in September), and then drop to 4.7% of GDP in fiscal year 2022 and 3.1% of GDP in fiscal year 2023. The CBO’s projections are based on current law and do not include the infrastructure bill, which would add a few tenths of a percent of GDP to the deficit in each of the next few years. The important point is the deficit will be coming down significantly, much as it did after the response to the 2008 financial crisis.

The federal budget deficit was on an unsustainable trajectory before the pandemic, around $1 trillion and rising as a percentage of GDP. We don’t have to balance the budget, but we should eventually try to get our fiscal house in order. That means having a deficit that grows no more than GDP, which would stabilise and begin to reduce the debt-to-GDP ratio. Achieving this could involve increased tax enforcement and debate about spending reductions, including entitlement reform. Increasing taxes will be difficult, but lawmakers could work to reduce ‘tax expenditures’, the $1 trillion-plus in tax breaks that are embedded in the tax code. The important point is that there’s no need to rush.

KEY TAKEAWAYS:

- Both fiscal and monetary policy are used to support the economy. Fiscal policy refers to the use of tax and spending policy to influence economic behaviour. Monetary policy is the setting of short-term interest rates (and also, in recent years, large-scale buying of Treasury and mortgage-backed securities) to influence economic activity.
- In a recession, the loss of jobs and income leads to reduced spending, which leads to further job losses, and further reductions in spending, and so on. Fiscal stimulus is intended to halt this snowballing and can be thought of as a bridge supporting aggregate demand while the private sector recovers.
- Should we be worried about the debt? The key issue is whether we can meet interest payments on the debt and whether we can roll over existing debt as it matures.

Emerging Markets: An Uneven Recovery, but Strong Long-Term Potential

Tracey Manzi, CFA, *Senior Investment Strategist,* Investment Strategy

The global economy has recovered strongly from the pandemic, however, growth has been uneven. Advanced economies have been in the driver's seat throughout the recovery, as access to vaccines and acceptance rates have accelerated the reopening process in their respective economies. Emerging markets have faced considerable challenges as the lingering virus and slower than anticipated vaccine rollouts have created headwinds for their recoveries.

These diverging paths have led to a narrowing in the growth premium between developed and emerging markets and caused the performance of emerging market equities to fall further behind their developed peers. While the recent setback is disappointing, we still believe that emerging markets offer strong long-term potential and diversification benefits in a balanced portfolio. Below, we outline the factors that are shaping our view and some issues to watch in the current macro environment.

> We still believe that emerging markets offer strong long-term potential and diversification benefits in a balanced portfolio.

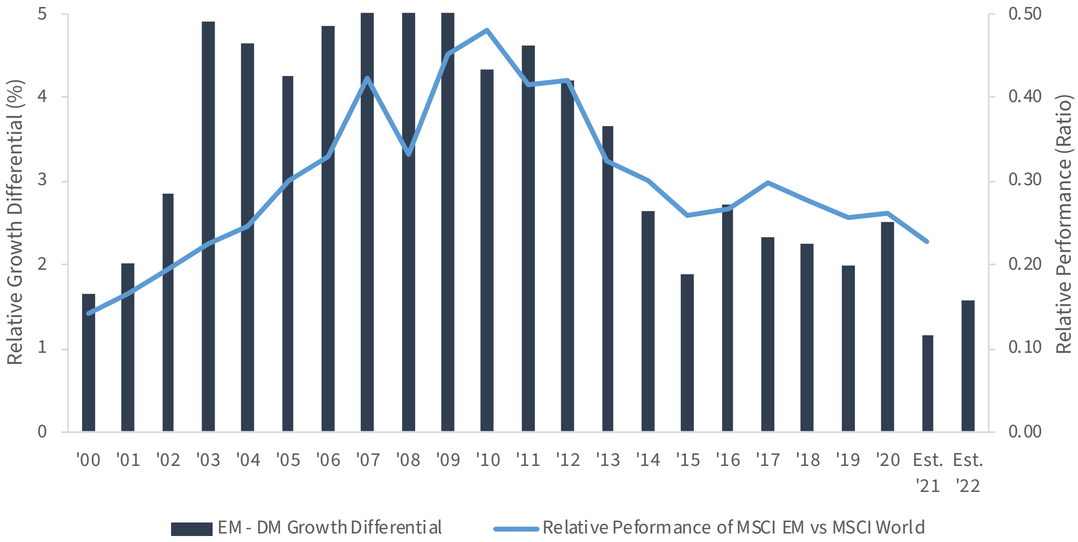
FACTORS SHAPING OUR OUTLOOK

GROWTH SETBACK IS TEMPORARY

Emerging markets have been a dominate force in the global economy over the last twenty years. In 2001, emerging markets accounted for over 40% of global growth. Today, they represent nearly 58% of the global economy. The International Monetary Fund expects their share to rise to over 60% by 2025 as the urbanisation of their economies and growth of the middle class continues. While pandemic-related challenges are temporarily restraining growth relative to developed markets, we do not expect this trend to continue. With vaccination rates improving and tentative signs that COVID cases are stabilising, the near-term weakness in emerging market growth may not be as soft as the market fears. This should tilt the growth differential back in favour of emerging markets, with another meaningful boost when the impact of the sizeable fiscal and monetary stimulus in developed markets starts to fade.

Growth Differential and Relative Performance Are Highly Correlated

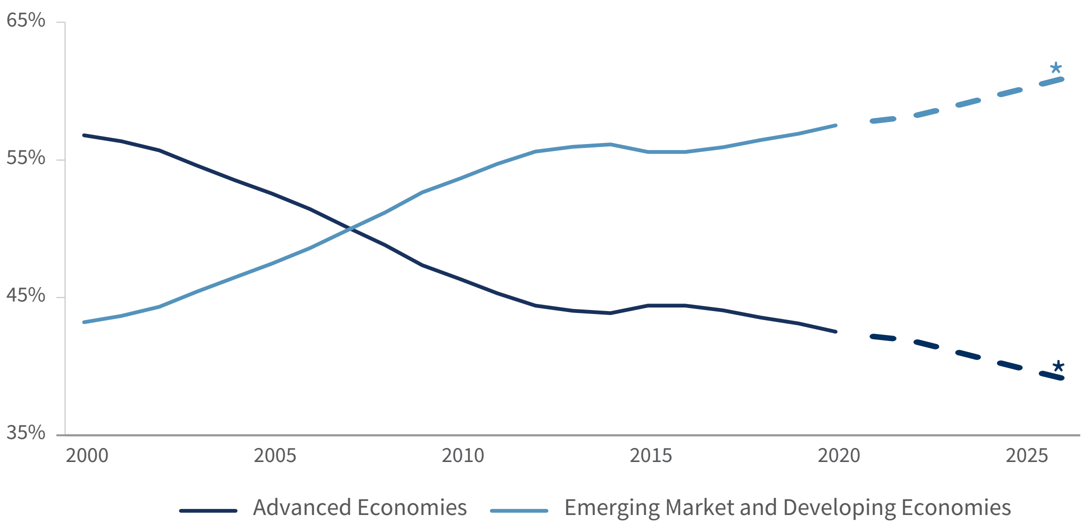
Emerging markets tend to grow faster than advanced economies, with the relative performance of equity markets closely tied to the directional trends. While emerging markets have lagged, we expect rising vaccination rates and a strong global recovery to turn the growth differential back in their favour.



Share of Global Growth

The International Monetary Fund expects emerging markets to capture an increasingly larger share of global growth on a purchasing-power parity basis in the coming years, making their economic importance hard to ignore.

* Dotted lines represent forecasted numbers



Source: IMF, as of 9/15/2021

ATTRACTIVE VALUATIONS

The recent weakness in emerging market equities has widened the valuation gap with developed markets even further from already discounted levels. The underperformance of the asset class has caused the MSCI Emerging Markets Index to trade at a 30-35% discount relative to the MSCI World Index and a 40% discount to the S&P 500 Index. This is significantly below historical averages. While much of the discount is attributable to the valuation premium associated with US stocks, emerging market equities are nearing their cheapest levels in over 20 years. These attractive valuation levels will surely appeal to valuation conscious investors.

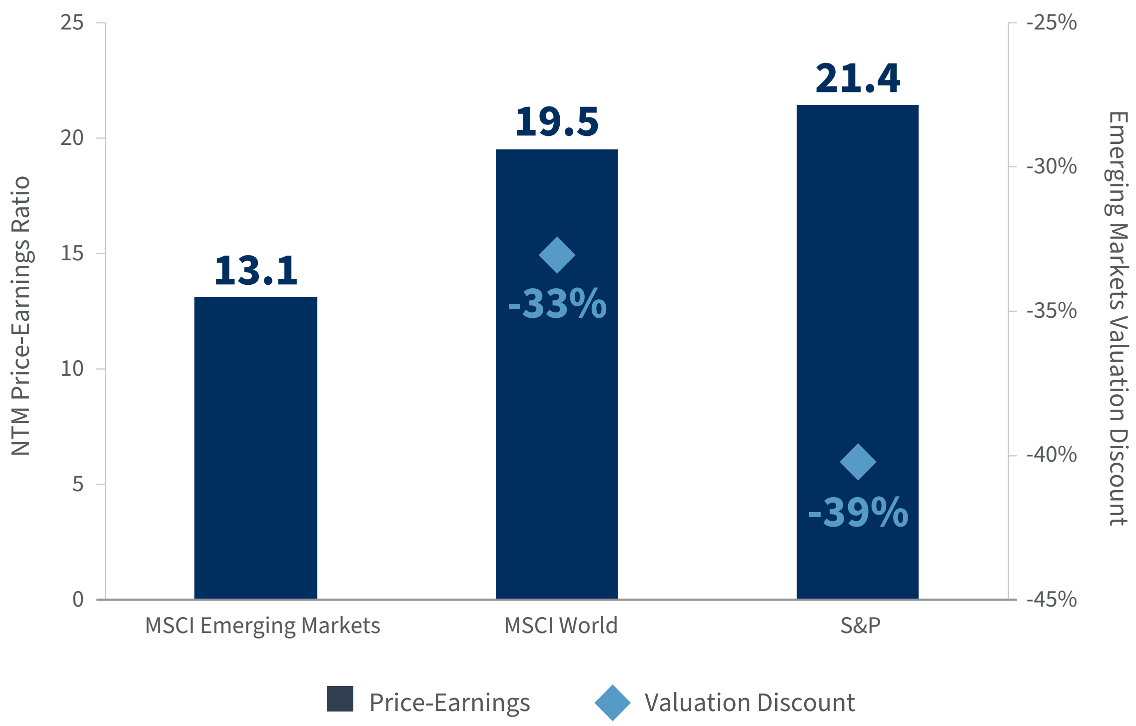
EXPANDING MIDDLE CLASS

The rapid ascent of the middle class has been one of the key drivers behind the explosive growth in emerging markets over the last two decades. While the pandemic may have stalled consumption growth across the globe, we do not believe that the slowdown will turn into a permanent impairment in emerging markets. With the size of the global middle class expected to rise considerably over the next decade, and the bulk of the gains coming from the Asia Pacific region, we believe the slowdown will be short-lived. Once the pandemic-related challenges start to level off, the rising middle class should support increasing consumption and underpin growth trends for years to come.

TECHNOLOGY LEADERS

Over the last decade, emerging markets have transformed from cyclically-oriented, commodity-based markets to high-powered technology leaders. While cyclical factors continue to play a role, the Technology sector has emerged as one of the most important drivers within emerging market growth. While China was at the forefront of this revolution, a growing list of tech-related companies within the emerging market universe are trying to capitalise on the growing markets for e-commerce, mobile banking, artificial intelligence, health care, electric-vehicle batteries and more. We expect these trends to continue as more companies look to meet the needs of their tech-savvy consumers.

Emerging Markets are Attractively Priced



Source: FactSet, as of 9/7/2021

WHAT TO KEEP AN EYE ON

CHINA

While China emerged quickly from the pandemic, lingering virus outbreaks and ongoing supply chain issues have taken a toll on its domestic economy. The slowdown is coming at a time when Beijing's broadening regulatory crackdowns have also undermined investor confidence in the market, leading to underperformance of Chinese equities over the last six months. It has also weighed on the performance of emerging market equities given China's heavy weight in the index. While it is impossible to know how long China's regulatory reforms will continue to weigh on Chinese stock prices, the weakness does not seem to be spilling over into the wider emerging market universe. One of our favoured indicators for flagging risk aversion in emerging markets is the JP Morgan Emerging Market Bond Index spread, which has been remarkably stable through China's recent rout.

FED TAPERING

Emerging markets are extremely vulnerable to changes in Federal Reserve (Fed) policy. History has shown that Fed tightening, or even the expectation of future rate increases, can often trigger instability and capital flight away from emerging markets. With the Fed inching toward tapering its asset purchases, emerging markets have been bracing for what could come next. The last time the Fed signalled tapering was on the horizon in 2013, 10-year Treasury yields climbed nearly 1.25% over a four-month period, which caused a 10% decline in emerging market equities. We do not expect a repeat of the 2013 episode, as the Fed has been carefully preparing the markets so there will not be any surprises that would lead to an unwanted tightening in financial conditions.

US DOLLAR

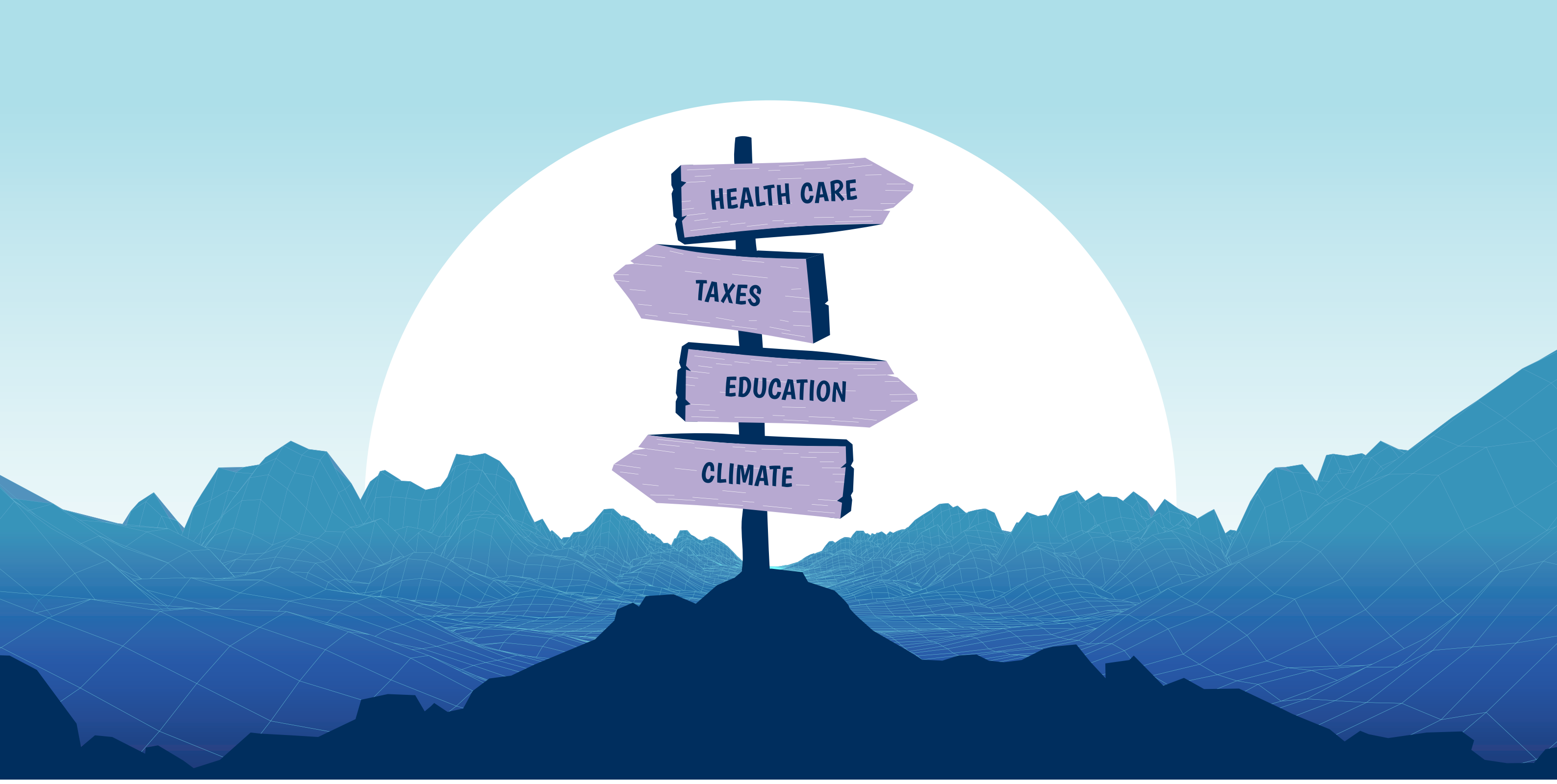
There is a strong inverse relationship between the performance of emerging market equities and the US dollar. This means that when the dollar is appreciating relative to foreign currencies, emerging market equities tend to underperform the S&P 500 Index, and vice versa. Emerging markets have remained weak as the Fed's Broad Trade Weighted Index has been in a structural uptrend since late 2011. While our longer-term view suggests the dollar is overvalued and should weaken relative to its foreign trading partners, pandemic-related uncertainties and the dollar's role as a safe-haven currency have kept its value elevated on a relative basis.

IN CONCLUSION

We continue to believe that emerging markets will remain a powerful driver of global growth and the recent narrowing in its growth premium should be short-lived. The longer-term benefits of investing in economies with superior growth prospects and supportive demographic and consumer trends should lift valuations relative to its developed market peers. While the coming months may bring some additional turbulence, emerging market equities remain cheap. As always, it pays to be selective when investing in emerging markets as the asset class is not a homogeneous group.

KEY TAKEAWAYS:

- Global growth continues to shift away from advanced nations toward emerging markets.
- Emerging market equities are nearing their cheapest levels in over 20 years.
- The rising middle class should support increasing consumption and underpin growth trends for years to come.



Biden's Agenda: Defining Fall Policy Sprint—Infrastructure, Fiscal Cliffs, and America's Global Role

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

Passing the bipartisan infrastructure deal, negotiating a budget reconciliation package, funding the government for the next fiscal year, raising the U.S. statutory borrowing limit ('debt ceiling'), and settling key defence and foreign policy decisions top a long list of priorities in DC. Add in a variety of must-pass deadlines creating a series of fiscal cliffs, and we could see a fairly volatile several months in DC.

The market impact will depend upon the overall success or failure of these efforts, with a debt limit being a top near-term concern. Longer term, the market will be closely watching the tax and spending decisions of the reconciliation bill. Overall, we expect 2021 to end with the finalisation and passage of Biden's 'Build Back Better' infrastructure and domestic agenda before DC transitions to a midterm election year that will determine control of the House and Senate for the remainder of Biden's term.

LEADING THE CHARGE: FINALISING AND PASSING BIDEN'S 'BUILD BACK BETTER' ECONOMIC PACKAGE

President Biden's 'Build Back Better' plan, aimed at funding infrastructure and domestic priorities, faces a series of critical tests in the coming weeks. The process is likely to be complicated by political negotiations and various fiscal cliff deadlines. However, we believe the most likely final outcome remains passage of an overall economic package between \$2 trillion and \$3 trillion, with tax increases and other revenue changes to offset a significant portion of the new funding.

We believe the most likely final outcome remains passage of an overall economic package between \$2 trillion and \$3 trillion, with tax increases and other revenue changes to offset a significant portion of the new funding.

The portion with the greatest clarity and highest probability of passage is the bipartisan infrastructure package that has already cleared the U.S. Senate and includes approximately \$550 billion in new infrastructure spending. The bipartisan portion broadly targets new funding for roads and bridges, rail, transit, ports, airports, water systems, power and grid, electric vehicles, and broadband.

Passing the bipartisan infrastructure deal, negotiating a budget reconciliation package, funding the government for the next fiscal year, raising the U.S. statutory borrowing limit ('debt ceiling'), and settling key defense and foreign policy decisions top a long list of priorities in DC.

Next on the agenda is the negotiation of a reconciliation bill, with a maximum total of $3.5 trillion – a number that is extremely likely to be negotiated downward. According to the framework developed by Congressional Democrats in August, this bill is seeking to addresses priorities on climate, housing, technology, education, and health care. The reconciliation bill is expected to extend the current Child Tax Credit, which is set to expire in December. The spending in this package is anticipated to be offset by tax changes and policy changes that increase revenue. As this is being done through 'budget reconciliation,' passage requires a simple majority in the House and Senate (no filibuster/60-vote threshold applies). Leaders are aiming to finish this bill in the October-November timeframe, but as we have seen in past policy debates, this could easily slip until December. Disagreement among Democrats could also prevent final passage, so depending on what is included or excluded among the spending and tax priorities, we could see policy-driven market volatility.

Changes to individual, corporate, international, and investment taxes are being discussed as ways to pay for the reconciliation bill. There has been a pledge by Congressional Democrats to limit tax increases to households above $400,000. President Biden has proposed a corporate tax rate increase from 21% to 28%, while House Democrats have proposed a 26.5% top rate, coupled with a tax cut to 18% for small businesses with taxable income below $400,000. Tax relief around the restrictions on State and Local Taxes (SALT) have also been promised, but details are limited. Dividends, capital gains, and other non-wage income taxes are also likely to be increased in a final bill. House Democrats have proposed raising the top income tax rate from 37% to 39.6% and increasing from 20% to 25% (28.8% with the 3.8% Affordable Care Act surtax) the long-term capital gains and qualified dividends for households with annual income above $400,000. Households with annual income above $5 million would be subject to a 3% surtax. Limits to Roth IRA conversions are also proposed. Increased IRS enforcement on unpaid tax liabilities is also a key revenue raiser expected in the final bill. These tax details provide an outline of the trajectory of a potential final bill. However, as negotiations remain fluid, these tax provisions could change significantly before a final deal is struck.

One final thing to watch that will have a dramatic impact on the final bill: The Senate's 'Byrd Rule' named after former Senator Robert Byrd (D-WV). Generally speaking, the Byrd Rule requires items in a budget reconciliation to be tied to spending and revenue. This could cause some policy priorities to be ruled out of order by the Senate parliamentarian. Candidates for Byrd Rule exclusions include a clean energy standard and immigration citizenship changes. The biggest question remains what level of spending and revenue can attract the support of both the moderate and progressive wings of the Democratic Party to get a final bill across the finish line. The fate of the bipartisan infrastructure bill has been tied to these dynamics for both sides to retain leverage and has contributed to the friction seen within the Democratic Party on the path forward.

BREWING BEHIND THE SCENES: FISCAL CLIFF THREATENS MARKET VOLATILITY

As lawmakers work to settle the expansive economic agenda outlined above, key fiscal deadlines around government funding and the debt limit add complicating factors to this fall's political dynamics. The initial strategy for Democrats has been to tie a debt limit increase to a short-term government funding bill at the end of September. This initial strategy elevated government shutdown/ debt limit concerns in the market. Although the initial budget resolution unlocking the reconciliation process for a follow-on supplemental bill did not include an immediate pathway for Democrats to raise the debt limit with a simple majority vote, the option is not off the table. Ultimately, the reconciliation instructions can be amended, or a separate budget resolution can be passed purely to address the debt limit, although this is a procedurally drawn-out process. From a big picture perspective, although concerns over fiscal showdowns have been elevated, we see a pathway to the resolution of the debt ceiling debate without threatening a breaching of the fiscal cliff.

PREPARING FOR WHATS NEXT: U.S./CHINA TENSIONS ON ESCALATORY TRAJECTORY

Earlier this year, we highlighted that the Biden administration views U.S. domestic and foreign policy as interconnected and aims to enact economic policy to ensure the U.S. remains globally competitive with China. This philosophy has arguably led to a 'no bark, all bite' dynamic as capital markets, national security, and human rights pressures drive the downward trend in U.S./China relations. Looking ahead, we see greater chances of increasing confrontation tied to the year-end target for commitments made under the 2019 "Phase One" trade deal, hawkish legislation being developed in Congress, China enacting foreign capital market barriers for domestic firms, and 2022 focusing attention on China's human rights issues ahead of the February Winter Olympics. The Biden administration's actions may turn more hawkish on China in the aftermath of the Afghanistan withdrawal and ahead of the 2022 midterms, which may be reflected in comprehensive China policy legislation Congress aims to finalise this fall.

A top geopolitical risk for the market is China's approach on Taiwan reunification efforts and the impact on global supply chains. There are major market concerns over a potential invasion or other military moves on Taiwan by China, which may rise as a concern for investors as tensions continue. Rhetoric may add to this concern by both the U.S. and China over Taiwan's fate, especially in and around the renewal of General Secretary Xi Jinping's leadership position in 2022. Taiwan will continue to be seen as one of the top geopolitical risks, and current U.S. military posturing toward building up U.S. forces in the pacific region is a dynamic to watch for increased conflict potential. In the near term, these dynamics accelerate U.S. planning and policies investing in the diversification of semiconductor and other sensitive supply chains to areas deemed less vulnerable to potential economic disruption.

IN ALL, A CONSEQUENTIAL FALL

As discussed, the scope of the political agenda through the end of the year sets up a key timeframe for the market as a catalyst for the finalisation of Biden's domestic economic agenda. We expect decisions made by lawmakers in the coming weeks and months to carry significant impact into 2022 and beyond as key policy changes are implemented and digested by markets. The finalisation of these policy priorities also opens the door to new focus areas by the administration and Congress in 2022, which at this stage we see focusing on reigning in the market power of dominant technology platforms and increasing broader antitrust/market concentration scrutiny. Expect the rest of this year to define the political conversation into the 2022 midterm elections that will determine the impact of policy decisions from DC through 2024.

KEY TAKEAWAYS:

- We believe the most likely final outcome remains passage of an overall economic package between $2 trillion and $3 trillion, with tax increases and other revenue changes to offset a significant portion of the new funding..
- Although concerns over fiscal showdowns have been elevated, we see a pathway to the resolution of the debt ceiling debate without threatening a breaching of the fiscal cliff.
- The Biden administration's actions may turn more hawkish on China in the aftermath of the Afghanistan withdrawal and ahead of the 2022 midterms, which may be reflected in comprehensive China policy legislation Congress aims to finalise this fall.
- Expect the rest of this year to define the political conversation into the 2022 midterm elections that will determine the impact of policy decisions from DC through 2024.

DISCLOSURE

Issued by Raymond James Investment Services Limited (Raymond James). The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance is not a reliable indicator of future results. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. The taxation associated with a security depends on the individual's personal circumstances and may be subject to change.

The information contained in this document is for general consideration only and any opinion or forecast reflects the judgment of the Research Department of Raymond James & Associates, Inc. as at the date of issue and is subject to change without notice. You should not take, or refrain from taking, action based on its content and no part of this document should be relied upon or construed as any form of advice or personal recommendation. The research and analysis in this document have been procured, and may have been acted upon, by Raymond James and connected companies for their own purposes, and the results are being made available to you on this understanding. Neither Raymond James nor any connected company accepts responsibility for any direct or indirect or consequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon such research and analysis.

If you are unsure or need clarity upon any of the information covered in this document please contact your wealth manager.

APPROVED FOR CLIENT USE

RAYMOND JAMES

Head Office Ropemaker Place 25 Ropemaker Street London EC2Y 9LY

www.RaymondJames.uk.com

Raymond James Investment Services Limited is a member of the London Stock Exchange and is authorised and regulated by the Financial Conduct Authority Registered in England and Wales number 3779657 Registered Office Ropemaker Place 25 Ropemaker Street London EC2Y 9LY