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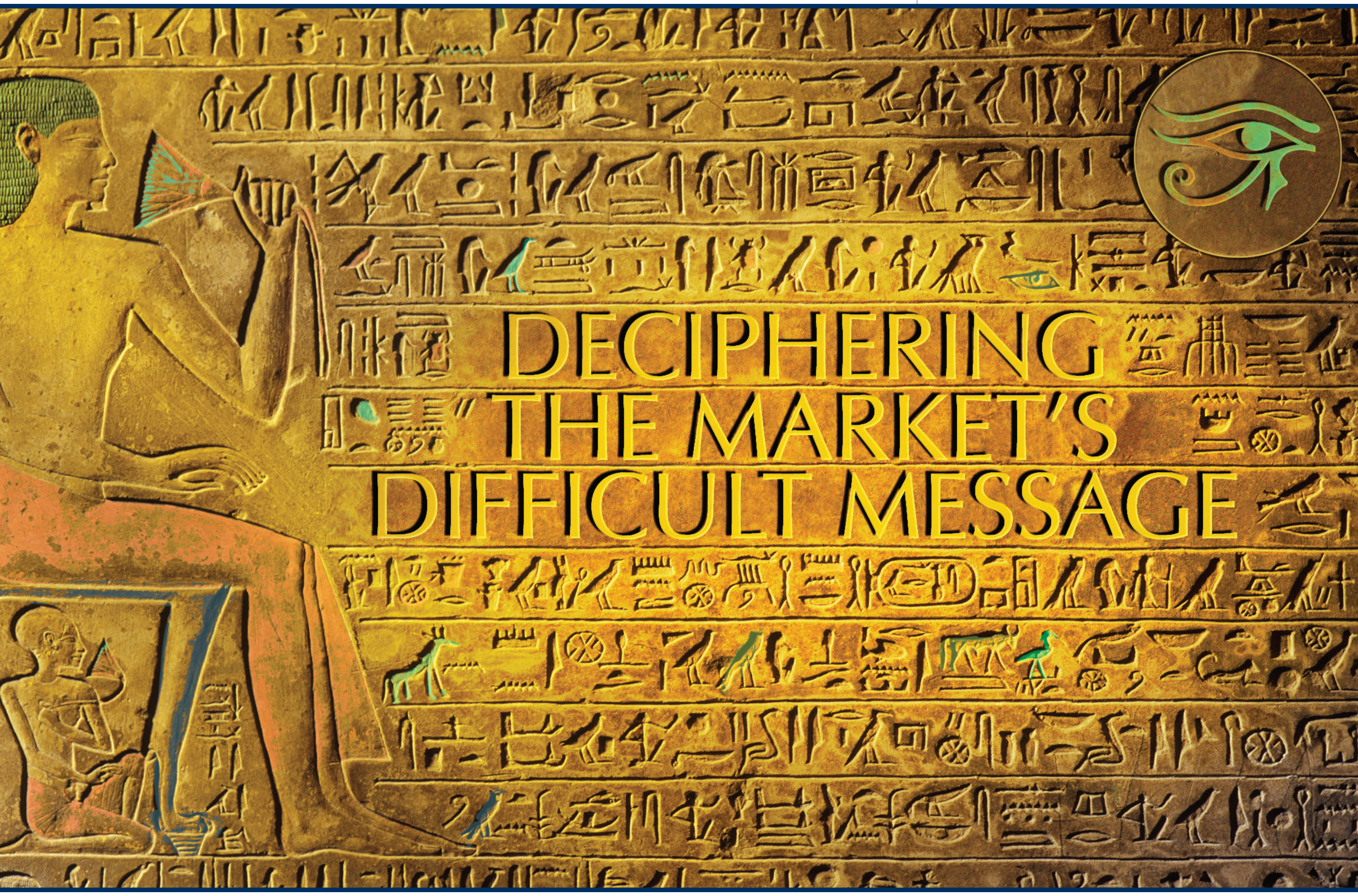

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Letter from the Chief Investment Officer

Deciphering the Market's Difficult Message

More than 200 years ago, a French military officer stumbled across the Rosetta Stone, a 2000-year-old carving with clues to deciphering the Egyptian hieroglyphs that had puzzled the world for centuries. We don't exactly have a Rosetta Stone for our perplexing market's future – no one does. But just as the Rosetta Stone opened a window into Egypt's mysterious past, we have some clues that might help investors crack the code in the coming months.

Back then, the discovery of the Rosetta Stone was unexpected – just like the duration of the Ukraine crisis, China's zero-tolerance COVID policy, and elevated inflation are today. As 2021 came to a close, few analysts (including us) would have predicted the worst start to a year in decades for both equity and fixed income investors. Then, the world's developed economies appeared *easy to read*. Whether you *read it from right to left or top to bottom,* the consumer was well positioned due to strong job growth, wage gains, and abundant savings. The only question was how quickly consumers would transition their spending from goods to services.

Now, *a picture is worth a thousand words* as data from airlines, restaurants, and holiday destinations sketch the speed and magnitude of that shift. Unfortunately, uncomfortably high inflation clouds the picture. Yet from our vantage point, that should clear up soon since retail inventory levels remain high, transportation prices are falling, and discounting is becoming more prevalent. If that anecdotal evidence isn't enough, the message being delivered by the most important of the world's central banks *cannot be lost in translation*: inflation will be their singular focus as they aggressively raise rates to slow demand. We believe the Federal Reserve, the world's pre-eminent central bank, will raise rates to as high as 3.5%, with most of the rate hikes by year end. Of course, there are risks to the interest-rate-sensitive US economy (particularly for the housing market) and the possibility of a recession next year is growing. But we hope the Fed can construct the *eighth wonder of the world*: a front-loaded tightening cycle that doesn't tip the economy into the *ruins* of a recession. Our base case sees 2022 GDP of approximately 2%.

The one *straw that could break the global economy's back* is towering oil prices. With gasoline prices near $5 per gallon, drivers dread the fuel pump hieroglyph on their dashboard; on average, per driver, it could represent $600-$850 in additional costs annually. A similar fate awaits motorists in the UK and Europe too. (Add to this the potential of higher heating costs this winter.) The price of gasoline has a strong inverse correlation with consumer confidence, so the more it costs, the lower confidence trends. If consumer and business confidence sink simultaneously, spending could retreat and create a self-fulfilling prophecy of recession. Controlling energy pricing pressures may seem like *a riddle from the Sphinx*. It remains to be seen how, in particular, the Biden administration will engineer an exodus from these price pressures to dodge a recession and float the US president's approval rating higher. While increased production by the US and OPEC might drive oil prices modestly lower by year end (Target: $105), peace in the Ukraine will likely be needed to sustainably sink oil below $100 per barrel.

With elevated inflation and expectations for Fed tightening *flooding* the bond market like the Nile River's annual rise, we have lifted our near-term outlook for the 10-year Treasury yield. But unlike the Nile, the world's longest river, the increase in yields will be short. The Egyptians still celebrate the river's high-water mark; we'll celebrate as soon as the eventual easing of inflationary pressures causes interest rates to recede. Our year-end and 12-month targets for the US 10-year yield are 2.85% and 2.65%, respectively. After a year-long drought of attractive options for fixed income investors, the 10-year yield recently approached 3.4%, making Treasury bonds appealing, and for globally diversified international portfolios, too, so long as the US dollar retains its year-long strength. So too is the approximately 5% yield for high-quality, investment-grade debt.

With strong state finances and favourable supply dynamics expected this summer, municipal bonds are also compelling.

The Egyptians are credited with the first written language, but it took time for the hieroglyphs to evolve from simple pictograms to the complex forms that for so long mystified archaeologists. While the equity market has also evolved, dry times such as these inspire us to get back to basics; valuations, earnings growth, and corporate shareholder actions. Like a camel in the desert, the S&P 500 is wandering in a bear market, but hope for the future is not a mirage. Even if the economic expansion ceases, the recent decline in equities has already discounted about 98% of the pullback historically seen during a mild recession. Therefore, the potential rewards from a significant rebound outweigh the risks of further declines. The *building of the pyramids* may seem an easier feat than timing this market's bottom, but investing in equities following a selloff has paid off, time and again. Since 1950, the S&P 500 has rallied about 15% on average and is positive 70% of the time after a 20% index drop. Attractive valuations, mid-single-digit earnings growth, increased dividends, and robust buybacks support our year-end and 12-month S&P 500 forecasts, not just in the US, but in the UK and Europe too. The three least expensive sectors are our favourites: Energy, Financials, and Health Care. From an international perspective, a more dynamic, resilient US economy, with less direct ties to the Ukraine conflict, is *extending the reign of* US equities over other, more geographically diversified, global investments.

Until inflation abates and central bank policy clarifies, market volatility may continue. In the meantime, view your portfolio through the *Eye of Horus* – a symbol of both prosperity and protection. Don't be misled by the incessant headlines that cause many investors to misconstrue the market's messages and make ill-timed portfolio decisions. Diversification, asset allocation, and a long-term investment horizon remain timeless investing principles. An ancient Egyptian proverb says: "To have peace there must be strife; both are part of the structure of the world," and this is true of the financial markets too. The first half of this year brought significant strife, but when those more peaceful times inevitably come, we'll appreciate them all the more.

Have a wonderful, enjoyable and restful summer!

All the best.

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

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Fed Air: Prepare for Landing

Eugenio J. Alemán, PhD, *Chief Economist,* Raymond James

Giampiero Fuentes, CFP®, *Economist,* Raymond James

Online searches for the word 'recession' are near what they were during the Great Recession, and economists, big banks, and news outlets are all fuelling global fears by ringing the recession bell. Surging global inflation, hawkish central banks, supply chain struggles, a war between Ukraine and Russia, and China's zero-COVID policy are just some of the many factors negatively affecting the global economic outlook, leading economists and institutions worldwide to lower their respective growth forecasts for 2022.

The combination of these issues has significantly impacted investors, who were left with no place to hide this year except within the commodities space, as both equity and fixed income markets have experienced negative performance year-to-date. The biggest question mark among investors remains whether Western systemic central banks will be able to achieve the famous 'soft landing,' ergo, slow economic growth enough to reduce inflation, but without tilting their economies into recession. However, this is by no stretch of the imagination an easy task to achieve, as there are a multitude of factors that are not within any central bank's control that could hinder efforts.

> The S&P 500 has been positive 71% of the time 12 months following the first Fed rate hike.

ENGINEERING A SOFT LANDING

Since 1965, the Federal Reserve has only been able to achieve a soft landing on three occasions (1965, 1984, and 1994) out of eleven occurrences. However, it would be unfair to just blame the Fed for the subsequent recessions, as in most instances there were other factors that led to economic contractions. For example, the last two recessions followed hiking cycles. However, in the former, the Fed helped to burst the housing bubble, while the pandemic was the real culprit of the latter.

Since they started to hike rates, the Fed has been successful in having an impact, with long-term interest rates rising significantly and mortgage rates skyrocketing. With a 75 basis point hike in June, the Fed changed its tone, taking a more assertive policy stance regarding its commitment to bring inflation down to the 2% target. Whilst not to the same order of magnitude, the ECB and Bank of England are also tightening policy to address

Average GDP Before and After the Fed Starts Hiking

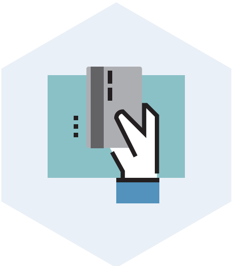
Source: FactSet, as of 21/06/2022

inflationary pressure significantly above target. Over the summer months, inflation is likely to roll over in Europe as in the US, but monetary policy should remain on a tightening path for the rest of the year and into next year, if the current assessment of rates is not modified in coming policy meetings.

While we don't expect that the US will enter a recession this year, it is important to consider what a potential recession could look like, if one were to occur (particularly given the increased likelihood of recession in Europe). Tightening cycles have historically dampened economic growth, and consequently investment returns. However, it is important to remember that the economy and the stock market, while connected, are not the same thing. In fact, equity markets measured by the S&P 500 Index have had, on average, negative performance in the three months following the first Fed rate hike, but tend to have positive but relatively muted performance after that. Most importantly, the S&P 500 has been positive 71% of the time 12 months following the first Fed rate hike. The same is broadly true of UK and European equity benchmarks too. On the other hand, taking the US as an example, average real gross domestic product (GDP) growth leading into the first Fed rate hike has been positive and growing up until the first rate hike (with some uncertainty leading up to it), and then steadily slowing down on average over the next 36 months. While a negative GDP reading is not ideal, it is important to note that historically it remains positive more than 85% of the time in the three years following the first rate hike. While all four components are important, consumption

> “Recessions do not start with the consumer, but rather with a slowdown or a decline in private investments.”

GDP = C + I + G + (X – M)



Personal Consumption Expenditures (C)
- Durable Goods
- Non-durable Goods
- Services

Gross Private Domestic Investment (I)
- Residential Investments
- Non-residential Investments
- Change in Inventories

Government Consumption and Gross Investment (G)
- Gross Investments
- Federal
- State & Local

Net Exports (X – M)
- Exports
- Imports

is by far the largest one of the four, accounting for approximately ~70% of GDP. So what drives consumer spending? Employment is arguably the biggest factor behind personal consumption. In fact, as people earn a steady stream of income, they tend to keep consuming. At the time of this writing, the unemployment rate stands at 3.6%, and there are over 11 million jobs available (almost one for every two unemployed people). Therefore, the labour market continues to be strong, and unless this changes significantly, it should not negatively impact spending.

Another factor is consumer confidence, which indicates future expectations of the consumer; and, while it's been on a downward trend, it's still above its 30-year average. Lastly, interest rates and prices have a big impact on consumers. The first makes consumers choose between present and future consumption. That is, as interest rates increase, consumers tend to postpone current consumption for higher consumption in the future. However, since interest rate increases have not translated into much higher rates paid on savings, it is unlikely that consumers are going to postpone current consumption for future consumption.

Meanwhile, higher prices reduce the purchasing power of incomes and thus puts downward pressure on consumption. However, the accumulation of savings during the pandemic seems to be keeping consumers in the consumption lane for the time being.

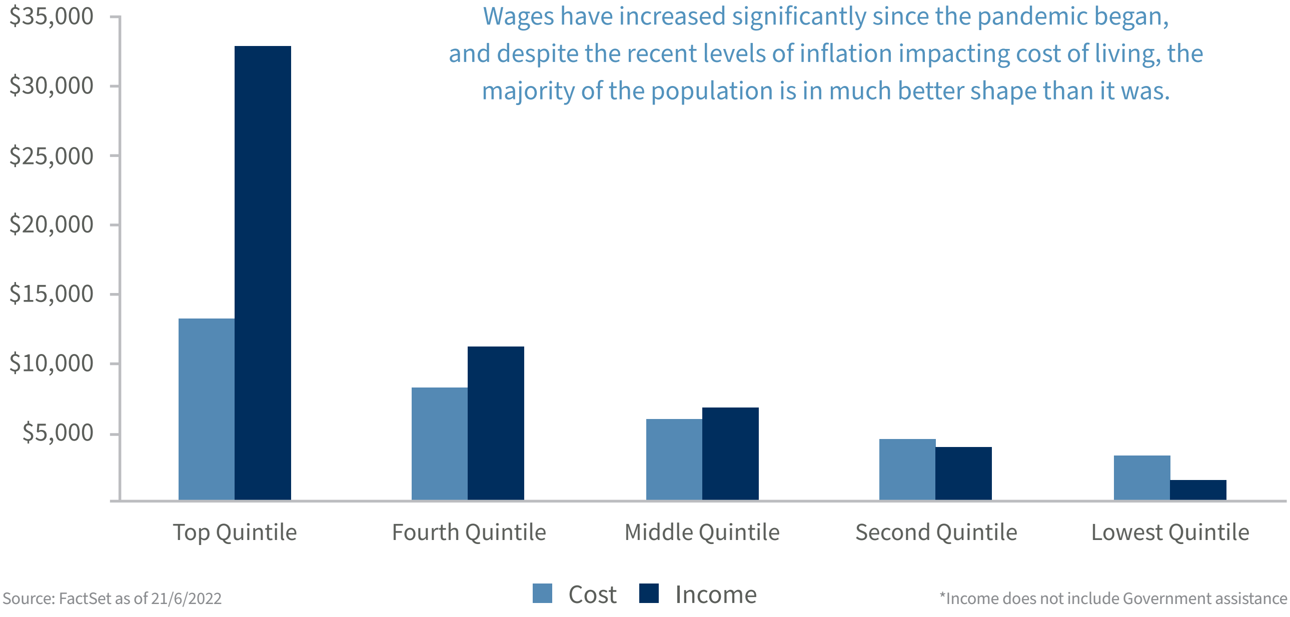
While consumption is the largest contributor to GDP, gross private domestic investments is the component that tends to be a harbinger of future economic growth. Recessions do not start with the consumer, but rather with a slowdown or a decline in private investments. When the economic outlook deteriorates, companies tend to decrease their investments to weather a potential storm. One of the first indications of a change of heart by firms comes as an increase in the accumulation of inventories. As inventories accumulate over a typical level, they first start to adjust their purchase/production. Thereafter, they start to lay off workers, slow down or temporarily halt hiring, and stop or postpone the purchase of machinery and equipment, and so on to reduce spending.

THE WEALTH EFFECT MISCONCEPTION

Western populations, particularly the most wealthy, have seen their net worth surge significantly since the pandemic began, but the truth is, most people don't live off their net worth. While experiencing an increase in net worth puts a consumer's mind more at ease when purchasing big-ticket items, for most people, income from their jobs remains the most important factor. The good news is that across the various income quintiles, most incomes are higher than they were prior to the pandemic, and even more important, they increased more than what we

Income Growth Outpaced Cost Growth Since 2020

Wages have increased significantly since the pandemic began, and despite the recent levels of inflation impacting cost of living, the majority of the population is in much better shape than it was.



Source: FactSet as of 21/6/2022

*Income does not include Government assistance

> The Western developed economies are still fairly resilient, the jobs market is strong, especially in the UK and US and many of the wealthiest are flush with cash ready to be deployed.

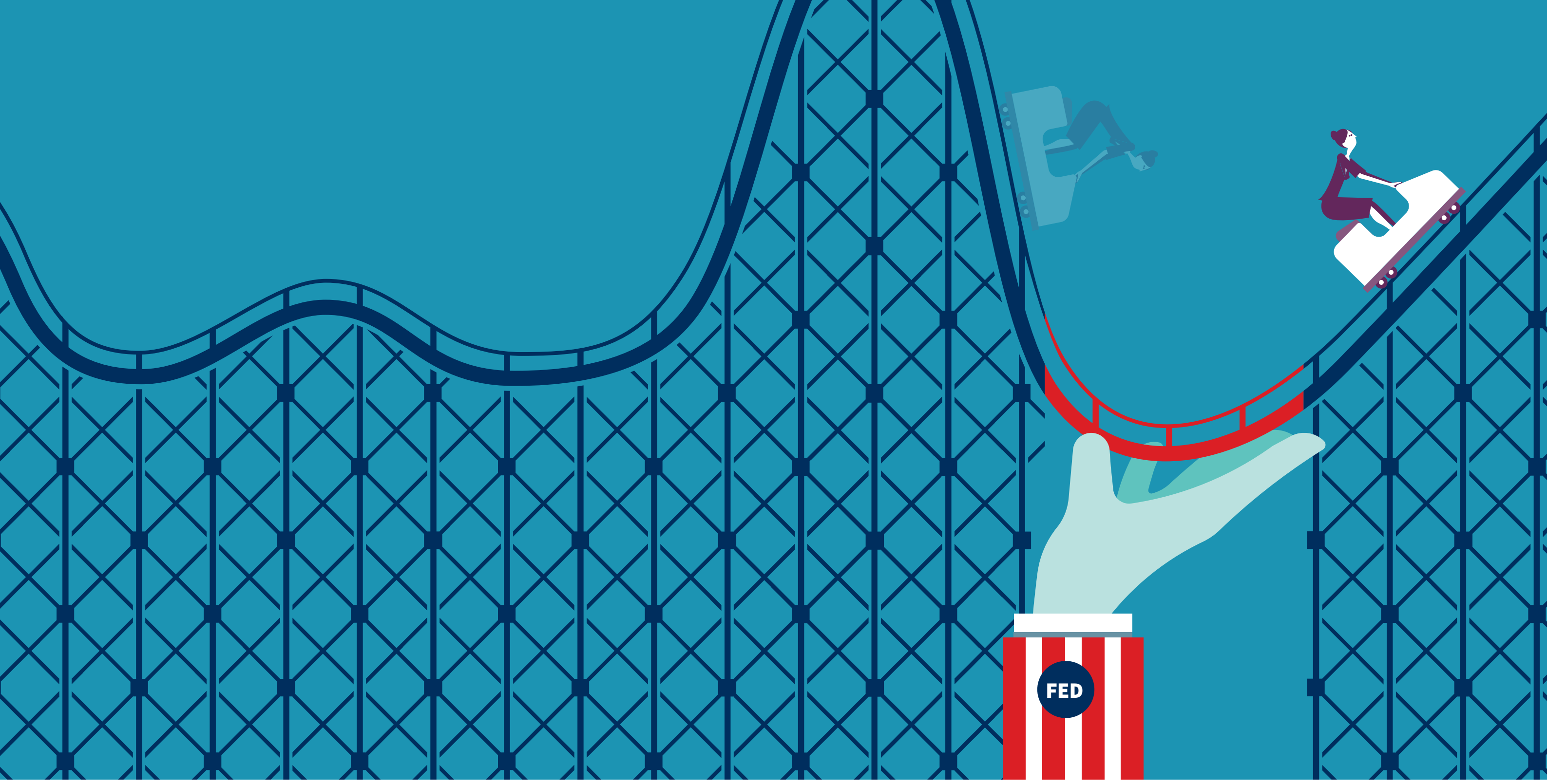
estimate their expenses have increased. Additionally, more people have the ability to work remotely nowadays than they did back then, reducing or eliminating their commute to work and consequently reducing their gasoline expenditures.

BOTTOM LINE:

Will there be a recession in the US or in Europe and when will it be? We don't know, but recessions have occurred many times in the past and will occur again in the future. However, if one were to come along in the near future, it is likely that it won't be as strong as the Great Recession, but rather a mild economic slowdown due to the effects of tighter monetary policies. The Western developed economies are still fairly resilient, the jobs market is strong, especially in the UK and US and many of the wealthiest are flush with cash ready to be deployed. However, business investments should be paid close attention to, as repeated changes in some of its components could signal troubles ahead.

KEY TAKEAWAYS:

- Surging global inflation, hawkish central banks, supply chain struggles, a war between Ukraine and Russia, and China's zero-COVID policy are just some of the many factors negatively affecting the world's economic outlook.
- Monetary policy will remain on a tightening path until the end of this year, when we believe the Fed will revise its views on further policy tightening in light of incoming information on inflation.
- Western populations have seen their net worth surge significantly since the pandemic began, but the truth is, most people don't live off their net worth.
- If a recession were to come along in the near future, it is likely that it won't be as strong as the Great Recession, but rather a mild economic slowdown.



Q&A: The Path Forward for Fixed Income

James Camp, CFA, *Managing Director,* Strategic Income at Eagle Asset Management*
Nicholas Lacy, CFA, *Chief Portfolio Strategist,* Asset Management Services

After the first half during which fixed income investors saw the worst bond market in 40 years, what is the direction of fixed income going forward? Can the US Federal Reserve lead? And what opportunities may present themselves along the way?

James Camp recently delved into past, present, and likely future factors shaping the bond market with Nicholas Lacy.

Lacy: What caused the large decline in bond prices before the Federal Reserve (Fed) took action?

Camp: The intermediate and longer-term bond market was anticipating the Western central banks' need to raise interest rates to combat inflation, which it had finally concluded was non-transitory. So, the intermediate and longer-term tenor of fixed income had already priced in a series of rate moves.

The large declines were partially a function of where we started. When we closed 2021, the 10-year Treasury yields, on both sides of the Atlantic Ocean were significantly lower. A large part of the mark-to-market decline in fixed income instruments occurred in the up-move since the start of the year. Also, prior to the Western central banks finally committing to "lift off" short-term interest rates, spreads in municipal bonds and non-Treasury bonds such as corporates began to widen. As mark-to-market losses in bonds showed up in the first half, that created a spread widening and liquidity issue with a lot more bonds for sale than buyers ready to step in at those levels.

Lacy: If the bond market is trading ahead of what central banks seem likely to do, do you think the worst is over?

Camp: Our thinking is that the worst, in terms of performance for the Treasury market, is behind us and that Treasury yields are in a peaking process and are consolidating around a narrower range. That would be supportive of bond prices going forward and ultimately will prove to be a good entry point for new funds or for dollar-cost averaging into the bond market.

Lacy: How do you think the Fed, in particular, is doing in what it's doing, and how are you going to know if the Fed has succeeded in taming some of those inflation numbers?

Camp: The Fed has a couple of tools. Interest rate moves on the short end are one of those, but it also has stated that it wants to slow aggregate demand. I think the Fed knows that the supply chain issue does not resolve itself overnight, and the best way to marry up supply and demand

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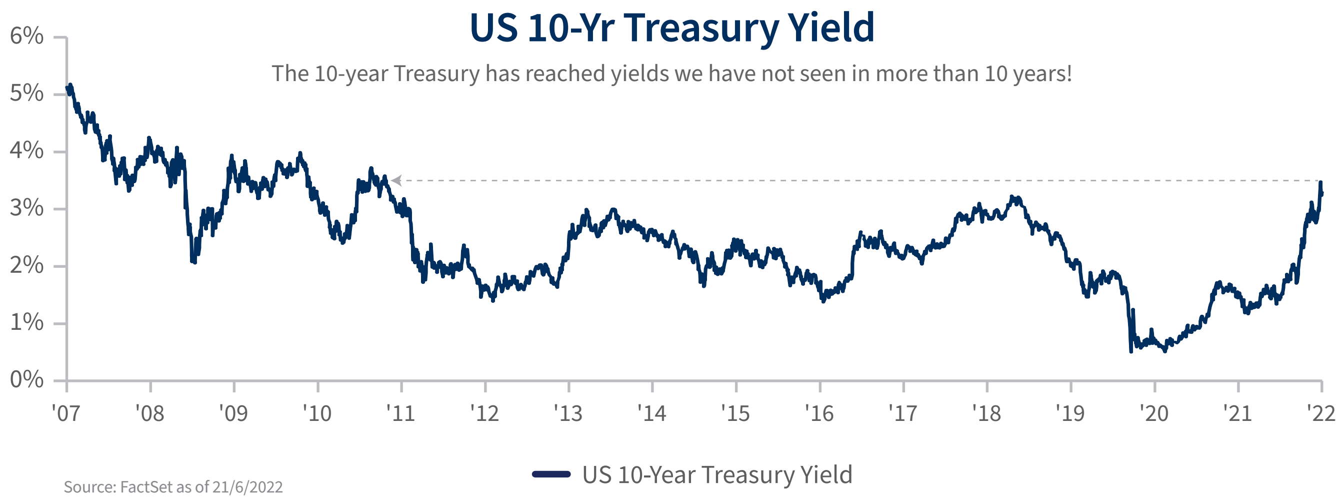


Source: FactSet as of 21/6/2022

imbalances, unfortunately, is going to be a period of demand destruction, with the Fed, through its monetary policy, raising short-term interest rates. We will know, I think, if the Fed is successful if we begin to see an acceleration downward in the rate of change of inflation.

Lacy: With spreads widening, where do you see opportunities and risks today?

Camp: One of the things to remember about the difficult bond market in 2022 is that this is not a credit event. We are not seeing widespread defaults or the creditworthiness of any of the large investment-grade obligors in trouble in either municipal or corporate bonds. What we have seen in corporate bond spreads after the first half is a pretty significant widening, with investment-grade bond spreads wider than they were at year end. To us, that represents a good yield opportunity.

Lacy: Where do you see the municipal bond market today, and what does that opportunity look like?

Camp: In the first half, the most difficult bond market in the last 40 years, clients, particularly in the municipal or retail arena, started to see mark-to-market declines and en masse began to sell. That gave us twenty consecutive weeks of outflows, totalling nearly $60 billion. Consequently, muni yield ratios became very generous relative to their taxable counterparts. Now we're heading into a seasonal period of strength for municipals with redemptions and coupon payments, particularly in the summer. Because yield ratios got so generous, yields and particularly tax-adjusted yields are beginning to attract buyers. May closed with a positive total return in the municipal index and credit quality by and large in the public finance municipal space has or is improving. There will be buyers, and we believe we're on the precipice of seeing them come back into the market.

Lacy: What is your impression of the bond market for the next two or three years, and what should investors expect from their bond holdings?

Camp: In our programs and products, we have increased the bond allocation, in many cases at the expense of dividend stocks, at least temporarily, because we now have the 10-year Treasury yielding significantly higher than the S&P 500. We believe that a 3.25% level on the 10-year is key. That was the level that we hit back in 2018. If we were to violate and hold above that, we would reconsider our outlook. As of now, we are still confident that the peaking process in the 10-year Treasury is occurring. The things we'll watch most closely are rate-of-change data on inflation, Fed policy, credit conditions that by and large are still tight and getting tighter, and what effect that has on growth and consumption, which we think will be moderating.

At the end of the day, we are not in a 1970s-style unravelling of the bond market or a gigantic spike in interest rates. Our impression is that COVID essentially collapsed time to create the biggest drawdown and most rapid recession ever. The policy responses were nearly immediate and broad-reaching. Their effects are now showing up in inflation data that we believe will be moderated because of a reversal and tightening of Fed policy. But to be sure, growth will slow. As we move into the 12- to 18-month time frame, we will possibly see more pro-growth, more pro-economic stimulus policies. In that case, these yield levels, these entry points, and these opportunities in fixed income should prove to be very generous.

Navigating Choppy Markets

J. Michael Gibbs, *Managing Director,* Equity Portfolio & Technical Strategy
Joey Madere, CFA, *Senior Portfolio Analyst*, Equity Portfolio & Technical Strategy

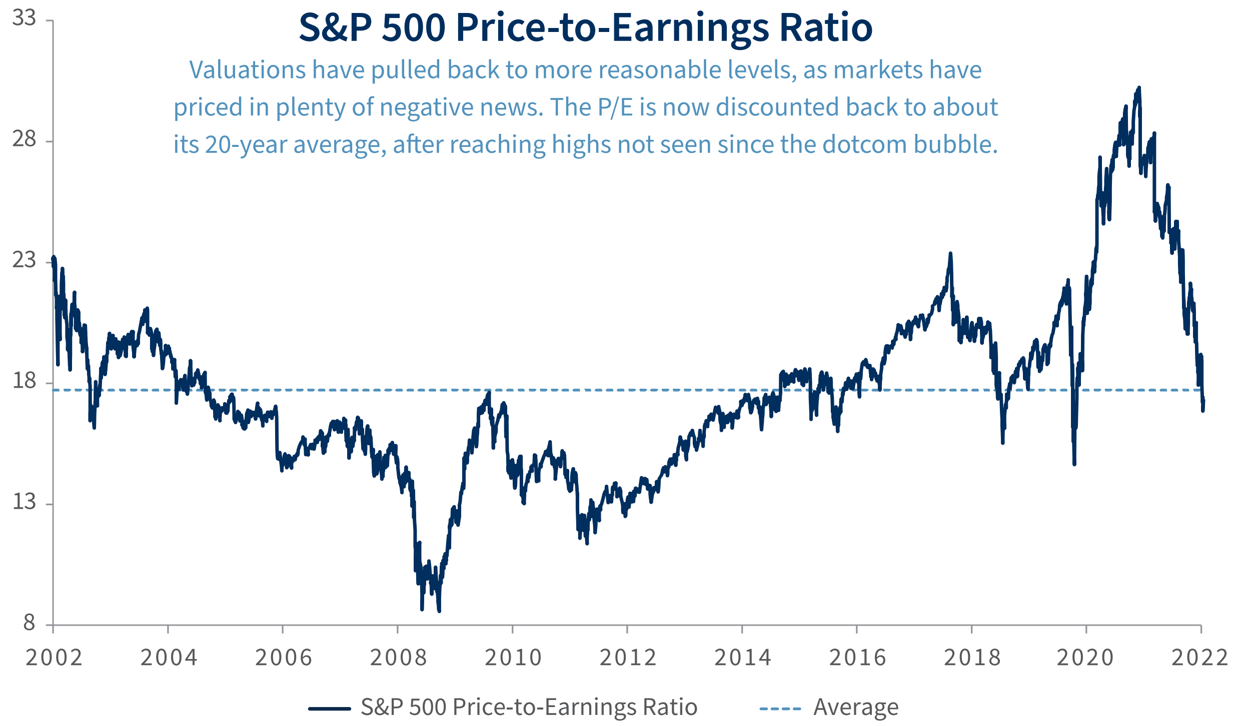
Inflation is currently the number one driver of equity markets. Its stickiness at high levels is weighing on consumer disposable income and corporate margins, along with complicating the job of Western central banks as they attempt to bring inflation under control within a slowing economic backdrop.

We believe that inflation has likely peaked (on a year-over-year basis) and can moderate over the back half of 2022 and into 2023, as the supply/demand imbalance for goods and labour normalizes. But the stakes are high, and investors have grown impatient with consecutive hiccups in inflation's trajectory – i.e., the Delta variant last fall, the Omicron variant, the Russia/Ukraine war, and China COVID lockdowns. The longer it takes inflation to come to a level that central banks can be more comfortable with, the higher the odds that they may need to overtighten monetary policy (potentially to the point of economic contraction) in order to bring inflation down. Thus, the degree to which inflation may moderate over the coming months should have a significant influence on the path ahead for the Fed, the Bank of England and the ECB, resulting in a wide range of potential equity market outcomes over the next six to twelve months.

FINDING THE BOTTOM

This elevated uncertainty is reflected in market volatility. At its recent lows (3,667) the S&P 500, a critical global equity benchmark, had pulled back -23.6% from its early January highs. It was not alone, as global developed market equity benchmarks also struggled. Whereas enormous fiscal stimulus through the pandemic fuelled lofty valuation multiples, the US and UK central banks have at last started shrinking their balance sheets and swiftly hiking interest rates this year has resulting in valuations pulling back to more reasonable levels. Plenty of negative news is priced in at prevailing valuations in our view, and the P/E reduction is in line with that seen in bear markets historically. Investor sentiment has also become overly bearish, which often takes place near lows (contrarian indicator). However, numerous timing indicators we monitor, along with market internals in the relief rally, have not reached levels often consistent with durable lows. Unless the narrative changes in regard to Russia backing off or China ending lockdowns, it will be difficult for equities to sustainably move to the upside without better inflation data in our view.

While we believe that the market may remain challenged with additional weakness possible in the coming weeks and months, we also believe equities will be higher over the next 12 months given our belief that inflation moderates as the year progresses.



Source: FactSet as of 21/06/2022

Thus, we recommend long-term investors use the market downdrafts as opportunities to accumulate high quality, favoured stocks. Looking at the S&P 500 Index for guidance (as UK and European often, but not always, take their cue from US leadership) our favoured area of potential downside support remains 3,400-3,600 as we see plenty of fundamental and technical justification for this range. The S&P 500 found a bottom at ~14-16x P/E during the last several severe market downturns (i.e., 2015/16 US manufacturing recession, 2018 trade war, 2020 COVID shutdown). At 16x trailing 12-month earnings ($216), the S&P 500 would trade at 3,456 (coincidentally, just above pre-COVID prices), and that would be a 43% multiple compression (in line with that seen in the dotcom bubble and credit crisis). Additionally, 3,648 represents the average -24% non-recessionary bear market decline historically. Technically, the S&P 500 200-week moving average has been a good level of support over the past decade in major market weakness – and is currently 3,500. In a worst-case scenario where inflation is unable to improve over the coming months (and the economy moves into recession), we believe the S&P 500 could ultimately trade to 3,000-3,200.

Regardless of when or where equities ultimately find a bottom during the current volatility, we do not want to lose sight of the inevitable elongated rally that we believe stocks will see on the other side of the current weak trend. Timing is difficult in bear markets with equities oftentimes bottoming before the negative headlines conclude. Indeed, when sentiment and positioning become 'washed out,' the rallies can be very sharp. On average, to use the US example again, the S&P 500 has gained ~15% in the first 30 days out of bear markets historically. Diversification is paramount in weak trends, as is finding the right balance of 'defence' for the current trend and opportunity for the eventual recovery.

> "We do not want to lose sight of the inevitable elongated rally that stocks will see on the other side of the current weak trend."

POSITIONING AMID VOLATILITY

Market weakness has been most acute in the higher-valuation growth style, whereas value has held up relatively well. This is a good example of managing the present, while keeping an eye on opportunity for the future within portfolios. Value is likely to outperform in the current weak trend (as long as it persists), but growth could also see the sharpest rally in the eventual recovery. This bear market is likely to end with convincing improvement in inflation, which is likely to correspond with a moderation in bond yields – in turn removing the headwind on growth valuation multiples. So, while we would continue to tilt portfolios in favour of value for now, we recommend using the downdrafts as an opportunity to accumulate growth – increasing our conviction once momentum builds and/or the economic picture improves.

We believe small-cap equities are another area likely to provide opportunity in a recovery. Small caps are now trading at 12.2x P/E – the lowest of the past 20 years outside of the credit crisis and COVID shutdown which hit ~10x. The current 35% P/E discount to the S&P 500 was only lower at the COVID shutdown bottom (~40% discount). While this is intriguing, our view that the current bear market may have more to go (in price or time) creates a pause for the higher beta, more volatile small caps. For example, if the economy moves into recession, and the market moves to new lows, small caps are likely to underperform. However, small caps are likely to outperform on the other side of this bear market as well. For now, we lean toward large-cap equities but look to accumulate small caps when opportunity presents itself.

Within sectors, there are clear winners and laggards in the current environment. Energy is the clear leader right now – buoyed by high oil prices and capital discipline, resulting in strong fundamentals. The more defensive areas such as Utilities have also held up relatively well through the market's volatility. While these groups may continue to outperform the longer market weakness persists, they are unlikely to outperform when the economic backdrop improves. On the flip side, the Consumer Discretionary sector has come under intense pressure with high energy prices and input costs weighing on margins. Additionally, sharply higher interest rates have weighed on Technology's high valuations, though fundamental trends remain solid. Finding the right portfolio balance is important for managing the current environment. We would continue to err on the defensive side for now, but use the downdrafts as opportunity to accumulate those stocks more levered to an improvement in inflation.

At the stock level, valuation has become more compelling across sectors. We see plenty of companies trading near or below pre-COVID prices, while earnings are significantly above early 2020 levels – resulting in attractive valuations, particularly for companies with stable or improving fundamental outlooks. Valuation can be a poor timing indicator, but it matters for potential returns over the long term, presenting a more favourable setup once the dust settles on this bear market. And while these stocks can get cheaper before the downside pressure abates, earnings often win out over the long term.

THE TIDE WILL TURN

In sum, we believe it will be difficult for the market to move sustainably higher without an improvement in inflation. We do believe that inflation will moderate over the next six to twelve months, and that equities will be higher than current levels over the next year. But this progress is unlikely to occur quickly, and stocks may ultimately need to move lower before all is said and done. The trajectory of inflation will remain a large influence on Fed policy and the economy, in turn being a key impact on equity market trends moving forward. With that said (and given the S&P 500 is already down 24% from its highs), we believe investors should manage the current environment with an eye on opportunity for the other side of this bear market. Large caps, value, Energy, and more defensive areas are likely to outperform as long as the market downtrend persists. But small caps, growth, and areas more levered to inflation improvement and lower bond yields (i.e., the Consumer Discretionary and Technology sectors) are likely to see the sharpest rallies once the dust settles. We recommend long-term investors use the market downdrafts as opportunities to accumulate favoured areas – increasing conviction as inflation and/or technical momentum improves.

"We see plenty of companies trading near or below pre-COVID prices, while earnings are significantly above early 2020 levels – resulting in attractive valuations."

KEY TAKEAWAYS:

- Unless the narrative changes in regard to Russia backing off or China ending COVID lockdowns, it will be difficult for equities to sustainably move to the upside without better inflation data.
- While overall we believe that the market may remain challenged with additional weakness in the coming weeks and months, we also believe equities will be higher over the next 12 months given our belief that inflation moderates as the year progresses.
- Diversification is paramount in weak trends, as is finding the right balance of 'defence' for the current trend and opportunity for the eventual recovery.
- We recommend long-term investors use the market downdrafts as opportunities to accumulate favoured areas – increasing our conviction as inflation and/or technical momentum improves.

No Simple Recipe For Energy Security

Pavel Molchanov, *Managing Director, Equity Analyst,* Equity Research

Among the many geopolitical consequences of Russia's war in Ukraine, front-and-centre is the recognition by European policymakers, businesses, and individuals that the continent's long-standing dependence on Russian energy is no longer a viable option. Disentangling the European economy from Russian oil and natural gas is vital for a combination of moral, strategic, and economic reasons. Continuing to pay Russia $20 to $30 billion every month would be tantamount to supporting the Kremlin's war machine.

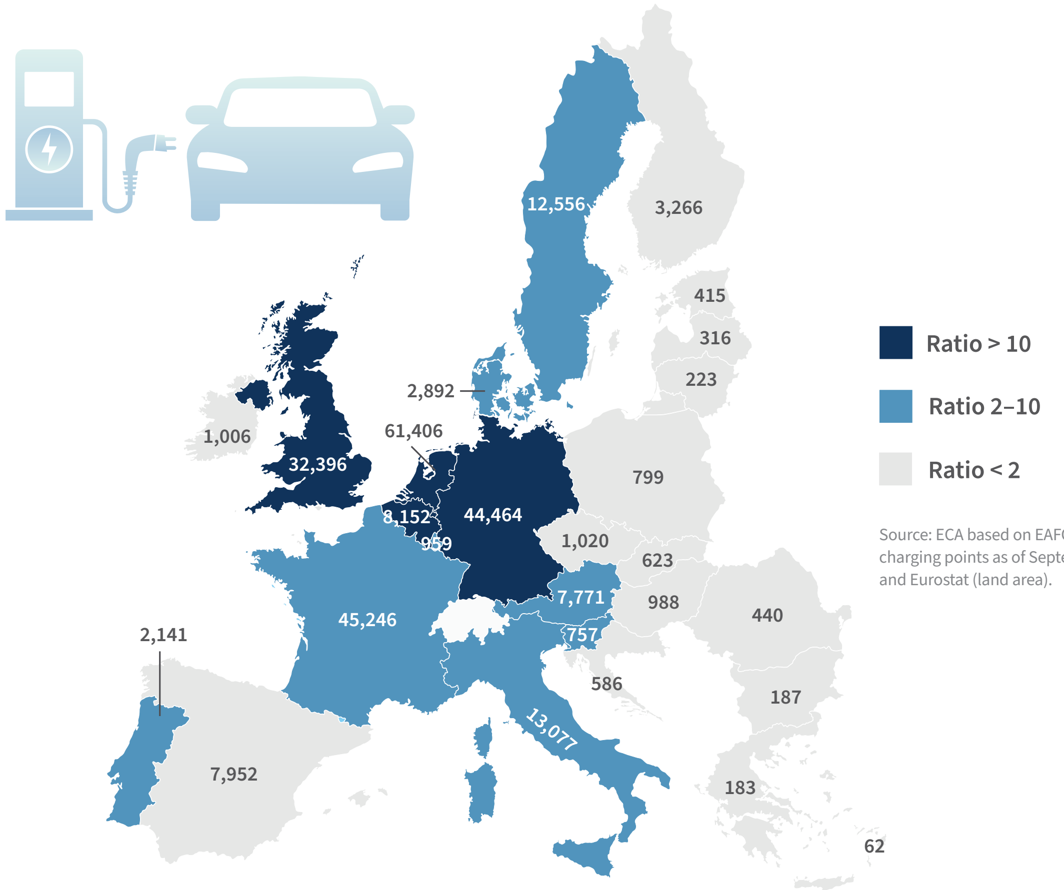
Beyond the moral argument, Russia has demonstrated that it is an unreliable energy supplier, given its willingness to use energy as a 'weapon' against countries it considers hostile. Finally, the war has raised the price of fossil fuels – around the world, but especially in Europe – to such levels that reducing their consumption is important for Europe's economic health. All that being said, the path toward European energy security will be a marathon rather than a sprint.

LOOKING AT THE NUMBERS

Let's first quantify how much of Europe's energy comes from Russia. Looking at pre-war numbers, approximately one-third of Europe's oil consumption (4.5 out of 13 million barrels per day) and also natural gas (15 out of 45 billion cubic feet per day) came from Russia. This is a long-established trading pattern, dating back to the Cold War era, enabled by pipelines that predominantly go in an east to west direction. Within Europe, countries which are geographically closer to Russia tend to have higher levels of dependence on Russian energy. Among the major economies, Germany is the most tied to Russian energy; among smaller ones, Hungary and Slovakia are highly dependent. When we look at this same issue from the perspective of Russia's energy sector, we see even higher levels of dependence; slightly more than half of Russia's oil exports and three quarters of natural gas exports traditionally went into the European market. In other words, both sides need each other – but, all else being equal, Russia needs Europe as a customer more than Europe needs Russia as a supplier. On a side note: in case you are wondering, Russia accounted for only 7% of US oil imports in 2021, and the US has been a net exporter of natural gas since 2017.

Number of Public Charging Ports and Ratio of Charging Ports to 100 km^3 Land Area (EU-27 and the UK)

It is essential for Europe to support its transition to electric vehicles with a massive build-out of public charging stations.



Source: ECA based on EAFO (number of charging points as of September 2020) and Eurostat (land area).

OIL OR GAS?

Between oil and gas, which is easier for Europe to displace? The answer is oil, because it is inherently more fungible. That is to say: oil can be transported by tanker from anywhere to anywhere (well, other than landlocked countries). The UK and EU have already imposed embargoes on Russian oil, set to take effect by year-end 2022. What will happen, in practical terms, is a reshuffling of oil tanker routes. When Europe stops accepting oil tanker shipments from Russia, most of those barrels will end up going to countries that haven't imposed sanctions, such as China, India, and Turkey. Because these countries will buy more from Russia, they will buy commensurately less from OPEC suppliers such as Saudi Arabia and Iran. The OPEC suppliers will ship more of their production to Europe. Simply put, Europe is swapping one source of imports for another. Russia's oil industry will take an economic hit, because the shrinking pool of prospective buyers means that Russian oil is being sold at widening discounts versus the global Brent benchmark. This

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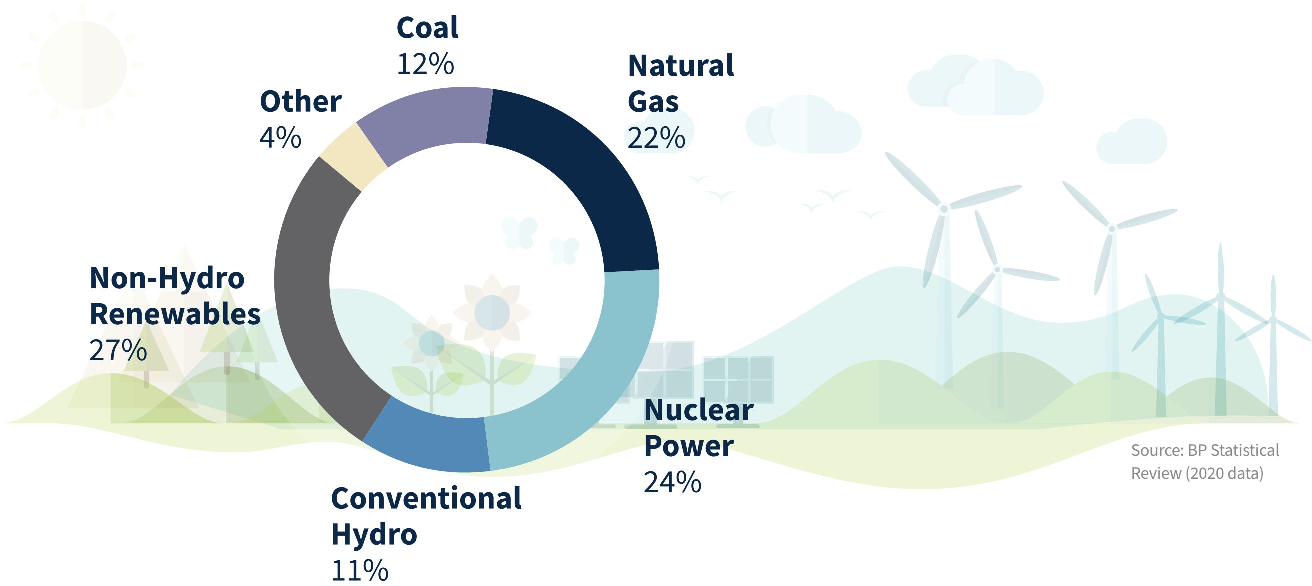
Europe's Electricity Mix

% of total, 2020

As Europe transitions away from coal and natural gas, hydro-generated electricity appears to be gaining the most market share – along with other renewable sources.



Source: BP Statistical Review (2020 data)

also reflects the fact that some top-tier marine shipping and energy companies are reluctant, for reputational reasons, to do business with Russia, even if there are no legal barriers to doing so. The current discount is around $35 per barrel, whereas it had been only $2 per barrel before the war. Russia can still export as much oil as it is physically able, but it is less profitable, and thus there is less cash flow for the Kremlin.

Is it 'better' for Europe to be dependent on oil imports from the Middle East than Russia? In the sense that Middle Eastern countries are not currently embroiled in a major war and seem less inclined to use energy in the future as a means of geopolitical leverage, the short answer is yes, but it is a debatable point. In the long run, the only solution for Europe to reduce its oil imports is to use less oil, period. Europe cannot drill its way to energy independence, because it lacks the hydrocarbon resources. Consuming less oil requires moving to electric mobility. Europe already has the world's highest level of electric vehicle (EV) market share: 19% of 2021 light-duty auto sales, four times the US figure. However, the replacement cycle means that EVs still comprise less than 5% of Europe's cars on the road. If we suppose that one-third of cars will be electric by 2030, that would have the effect of displacing around 2 million barrels per day of oil demand, or half of what is currently being sourced from Russia. With electric buses and trucks added in, the displacement could be 2.5 million barrels per day. To support this massive acceleration in EV sales, the EU targets an equally ambitious buildout of EV charging infrastructure: a ten-times increase by 2030 from the year-end 2021 level of 370,000 publicly accessible chargers. In this context, let's keep in mind that only one-third of Europe's population lives in detached single-family homes (versus two-thirds in the US), and for everyone else, public charging is essential.

NATURAL GAS COMPLEXITIES

Turning to natural gas, the transition from Russian supply will be even more time consuming and logistically complex. Natural gas in its normal (gaseous) state cannot be transported via tanker. To do that, it must be cooled to an ultra-low temperature and thus turned into a liquid called liquefied natural gas (LNG). After transoceanic delivery, the LNG must be regasified before being used for ordinary purposes: electric power generation, home heating, and various industrial processes. The LNG supply chain requires capital-intensive infrastructure and does not come cheap. As a result of the war, European natural gas prices are the highest in history – ranging in recent months between $20 and $30 per Mcf[1], three to four times the level of the US – and that is

[1]MCf is a conventional natural gas measurement that is used primarily in the United States, where the imperial measuring system is standard.

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incentivising more LNG shipments from all of the major producers (US, Qatar, and Australia). That said, building new LNG projects with European demand in mind requires signing multi-decade contracts, and there is less certainty about how demand will evolve over such lengthy timeframes. For example, there is a proposed EU regulation that aims to ban the signing of LNG contracts beyond 2049, this being the year before the EU's legally mandated target of net zero CO2 emissions.

As with oil, Europe cannot produce enough natural gas to meet all its current needs, but reducing consumption is very realistic. Indeed, it is already happening; Europe stands out as the world's only major economy that is currently consuming less natural gas than it did in 2010. In case you think that Europe has shifted from natural gas to (much dirtier) coal, that is emphatically not the case. In 2020 (the last full year of available data), natural gas comprised 22% of Europe's electricity mix, with coal at 12%. By comparison, the 2010 figures had been 23% and 25%, respectively. If natural gas and coal are both shrinking, what is gaining share? The answer is renewables: wind, solar, and smaller amounts of biopower and geothermal. Combined with hydropower (which is plateauing), all renewables combined are at 38%, which is almost double the 2010 figure of 20%, and higher than in all other major economies except Canada and Brazil. We forecast that Europe's renewable penetration will increase to around 60% by 2030, which matches the pace of growth from the 2010-2020 period. In other words, this forecast does not require any game-changing innovations. Starting in the second half of this decade, Europe will probably never need to buy natural gas from Russia again, even if diplomatic relations with Moscow end up normalizing. LNG imports will continue beyond 2030, partly for the sake of flexibility (for example, in cases of extreme weather), and to support the continued phase-out of coal-fired power plants for environmental reasons.

KEY TAKEAWAYS:

- There is recognition that the European continent's long-standing dependence on Russian energy is no longer a viable option.
- Approximately one-third of Europe's oil consumption (4.5 out of 13 million barrels per day) and also natural gas (15 out of 45 billion cubic feet per day) came from Russia; however, Russia needs Europe as a customer more than Europe needs Russia as a supplier.
- With natural gas, the transition from Russian supply will be both time consuming and logistically complex.
- Europe reducing its consumption of natural gas is very realistic. Europe stands out as the world's only major economy that is currently consuming less natural gas than it did in 2010.

China’s Economy Reopens, But Outlook Unclear

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According to the IMF’s World Economic Outlook publication, released back in April, China’s economy has slowed sharply following strong growth in 2021. The Fund’s data indicates that China’s GDP grew by 8.1% last year, but is forecast to drop to just 4.4% this year before staging a partial revival, to 5.1% in 2023. These forecasts are, however, little more than estimates or informed guesses as Chinese data collection has historically, and remains, shrouded in mystery. This mystery has only deepened following the release of the most recent updates.

What is known is that multiple lockdowns across a broad spectrum of cities and provinces, in an effort to contain persistent Covid outbreaks, must have had a severely adverse impact on the country’s economic activity. Shanghai, China’s critical commercial and financial hub, was locked down entirely for two months, while the capital, Beijing, also suffered periodic quarantine measures. Add to that local reports that as many as 100 other major cities, home to as much as one-third of the nation’s vast population, were affected too, including critical port locations and a picture of unprecedented restriction on commercial activity emerges.

Initial evidence of economic damage was largely anecdotal, stories of sales and supply chain disruption hampering the revenue generation and earnings of Western businesses with local operations. Starbucks reported a 23% drop in revenues in what amounts to the company’s second-largest international market. Tesla’s Shanghai plant only achieved a 70% pre-lockdown production level by housing key workers on site. These reports marry with auto industry data reporting April production was 48% lower than March and 46% lower than year-ago levels. With the majority of quarantine restrictions only easing in early June, May data seemed sure to confirm further weakness.

And yet, when trade data for May was released in mid-June, where was the lockdown impact? China’s National Bureau for Statistics (NBS) reported an unadjusted merchandise trade surplus of RMB 543.9bn in May, orders of magnitude higher than the RMB 281.3bn reported one year ago. Further, the NBS reported a 15% increase in annualised exports in the May data, extraordinary when most port infrastructure was shuttered. Imports increased by just 2.8% year on year. Really? Isn’t Chinese import activity supposed to be surging? Industrial materials, crude oil, gas? Marrying the big increase in exports with what amounts to a sharp drop in import volumes year-on-year involves some serious arithmetical gymnastics.

Now that China’s economy is reopening again, activity is thought likely to rebound swiftly back to pre-lockdown levels. However, largely anecdotal reports regarding the recovery in truck and port traffic must be treated with caution. The movement of goods does not necessarily signal a resumption in the production of goods. Are items filling containers’ recently manufactured’ or, more likely, products produced back in early 2022 and subsequently lying idle in factory yards? The transportation of such products to ports certainly serves to boost the export component of GDP, but very likely at the cost of falling inventories.

The natural caution regarding the accuracy of Chinese data on the part of outside observers has been lent added credence following reports of a very high-profile difference of opinion between two of China’s most powerful politicians. In late May, Premier Mr Li Keqiang demanded that thousands of provincial and local leaders prioritise infrastructure spending and income support to bolster economic activity. This was not just an unprecedented step; it flew in direct contravention of the edicts of President Xi Jinping. The latter had earlier declared “Zero Covid” the country’s most urgent priority, eclipsing both growth and inflation concerns.

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This difference of opinion is the more extraordinary as President Xi aims for a further term as Supreme Leader, to be confirmed in October. Contradicting Mr Xi at this crucial time feels like a high-risk strategy for the 66-year-old Premier with one more Politburo term likely before mandatory retirement. Mr Li's difficulty lies in his limitation to just two terms in his current position; thus, any governmental post other than the big step up to the presidency (last achieved by Mao Zedong himself) would be a step-down. If there is support for Mr Li's apparently audacious bid for the summit, outsiders will likely be the last to know and only then following the result of October's vote. What is known is that President Xi has the ultimate authority to dismiss anyone at the top of China's political tree, making it unlikely that any support for Mr Li, if it exists, will be made public.

Meanwhile, President Xi maintains his global statesman persona, most recently evidenced by his hosting and chairing of the fourteenth annual BRICS Summit. This event was hugely significant for a number of reasons. Firstly, and most importantly, the virtual meeting was Russian President, Mr Vladimir Putin's first public engagement since the Ukraine invasion on 24th February. Secondly, none amongst Brazil, China, India and South Africa have either endorsed or supported US / NATO-led economic sanctions against Russia (all five choosing to abstain from US resolutions tabled at the United Nations). Thirdly, the optics associated with chairing such a meeting are hugely significant for Mr Xi himself at this critical time in his candidature for a third term in office.

For the West, arguably the biggest economic threat from such a confab is the possibility that a clearing system for trade transactions might be established in local currencies, supplanting the US dollar. Whilst no such agreement took place on this occasion, it remains a possibility. Sanction-laden Russia would likely be an enthusiastic supporter, while China harbours designs on the yuan, becoming the key currency for all BRICS trade at the very least. Brazil, India and South Africa are rightly much more wary regarding formalising ties with Russia at this time, thus risking becoming the object of US/NATO economic sanctions themselves. Indeed, the potency of the BRICS Summit is diminished by India's deep-seated wariness towards China, to say nothing of its much-vaunted involvement in an economic and security partnership with the US, Japan and Australia.

Whilst China's economic and commercial status is beyond doubt, for investors, exposure to the country seems likely to remain limited. A recent regulatory clamp-down on the information technology sector illustrates the extent to which Chinese authorities periodically intervene in commercial activities. Persistent sabre-rattling regarding the offshore island of Taiwan hardly helps. Yet investment opportunity does exist, as reflected in the 35% spike in the Chinese tech sector since the latest recent intervention was lifted. More generally, with (official) annualised headline CPI running at a mere 2% combined with obvious economic headwinds, scope exists for looser monetary policy, potentially serving to impart further downward pressure on bond yields. The Chinese currency has been under pressure on the foreign exchanges for much of 2022 to date; however, this has been tolerated by the central bank as it is perceived to support the economy's recovery.

KEY TAKEAWAYS:

- China's economy is reopening but supply chain bottle necks remain and activity data should be treated with caution.
- China's domestic political agenda is dominated by President Xi's third term candidature, to be confirmed in the autumn.
- Economic and geopolitical status is without question, but China and other BRIC partners fail to endorse Western sanctions on Russia.
- Investment in China to remain a marginal decision, supported by limited central bank policy easing.

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