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INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

The Great American Road Trip

With autumn in the air, it's a great time for a road trip! There's something exciting about the open road irrespective of where you live, with friends and family in tow. "It's not the destination, it's the journey," Ralph Waldo Emerson once said, but he never had to manage portfolios—both are critically important. Why? Because like road trips, even as unexpected detours occur, investors cannot lose sight of their long-term goals. Case in point: as we look at today's economy and financial markets, in the US and elsewhere, we are at a crossroads: Will it be a long straight road to a soft landing, or will it be a bumpy track down to recession? Will November's US election results provide a fork in the road on taxes and tariffs in that country, and what might the outcome mean beyond US shores? And what road signs should we follow in positioning portfolios? So, fill up the tank, fire up your playlist, grab snacks, and let's go on a trip to find these answers!

We begin at Raymond James headquarters in sunny St. Petersburg, Florida. Florida is known as the 'sunshine state'—and the local (and national) economy has been shining brightly over the last four years as it recovered from COVID. Admittedly, a slowdown has been anticipated for a while. But each time consumer, business and government spending proved resilient, our economic GPS said: 'recalculating.' Even the most aggressive Federal Reserve (Fed) tightening in 40 years, a spike in inflation, and slowing consumer spending have yet to cloud the economy's vitality.

But as our journey heads north along the Blue Ridge Parkway through the great Appalachian Mountains, we encounter SLOW AHEAD and FALLING ROCKS signs that speak to our economic forecasts. We expect US GDP of 2.6% in 2024 and 2.0% in 2025. The important point is that while the economy is slowing and on a narrow path to a soft landing, it is not expected to crash into a recession. Remember, a slower, more consistent speed is better for gas mileage efficiency. Slowing, but not negative, job growth, healthy business spending, and a continuation in government spending—80% of the Inflation Reduction Act has yet to be spent— to re-industrialise the US should help the economy avert a recession. The 'falling rocks' that could jeopardise our outlook are a precipitous decline in consumer spending—either by buyers' choice or by crushingly high interest rates—dynamics the Federal Reserve understands well.

That is why our next stop is Washington, DC, the home of the Federal Reserve itself. Maybe the central bank's national headquarters isn't a top destination for most road trippers, but it's certainly the most-watched institution for global markets as the long-awaited rate cutting cycle has now begun. After cutting interest rates by 0.50% points at its September meeting, the central bank has more cuts in the tank—at least 50 basis points (bps) more in 2024, and at least 100 bps more in 2025. Chairman, Mr Jerome Powell can answer the question "Are we there yet?" with a resounding "yes!" regarding lower inflation and can now focus on sustaining the health of the domestic economy and employment conditions. In conjunction with central banks around the developed world, local economies should receive a helping hand too. Lower interest rates are a significant driver of our hoped-for global economic reacceleration in 2025.

Next up: a leisurely drive through Pennsylvania, Michigan and Wisconsin—the proverbial 'Blue Wall' that may prove decisive in the forthcoming Nov 5 elections In these States. The Great Lakes generate uncertain 'lake effect' weather—but it might be easier to forecast these surprise storms than the upcoming election results (let alone how each party would govern versus how they have campaigned). We expect the race between Vice President Harris and former President Trump to be a "nail-biter". In Congress, our base case is that the Senate flips Republican and that the House flips Democratic. The election outcome will likely impact tariffs, taxes, regulation and fiscal spending priorities. However, we advocate that the economy, the Federal Reserve, fundamentals and sentiment ultimately have more profound impacts on the financial markets than politics.

Now we head west—into the 'breadbasket' states of Iowa, Nebraska and Kansas, passing oceans of waving grains. Just as the agricultural production of these states helps sustain the US economy, fixed income is a staple part of a portfolio wherever you live. Like a steady supply of foodstuffs, bonds (particularly high-quality bonds) provide stability and consistent income. And, in times of uncertainty, bonds help dampen volatility. The good news is that the run-up in yields from pandemic lows has provided a frugal feast for fixed-income investors starved for higher yields. We forecast bond yields will likely stay relatively stable over the next 12 months with, in the US, the 10-year Treasury yield staying in a tight range around 4%. Good farmers know that patience and crop rotation are important. As the Federal Reserve and other systemic central banks continue to cut interest rates, investors should slowly transition their cash holdings to longer-duration bonds. Our favoured parts of the fixed-income market are investment-grade bonds, particularly short term, and in the US context, municipal bonds.

Turning southwest, the grandeur of the Texas oil rigs towers over our vehicle. Interestingly, while Texas is still the largest oil-producing state, we must drive further to find the largest oil-producing county. It's New Mexico's Lea County, which sits atop the Permian Basin. Currently, US oil production continues to notch record highs on the back of new technologies and better efficiency, while weak demand from China keeps oil prices low. This supply / demand imbalance causes us to adjust our 12-month target for US crude to $75 per barrel. Surprisingly, even recent geopolitical skirmishes in the Middle East have not lifted oil prices at all.

Reaching the West Coast, we cruise along the beautiful Pacific Coast Highway out of San Diego. San Diego's near-perfect weather conditions (not too hot, not too cold) remind us of the equity market. If everything goes 'just right,' we expect a soft landing, more interest rate cuts, positive earnings growth, and a record amount of cash on the sidelines to support the bull market that we believe has a long road ahead. Our 12-month target for the S&P 500 is 5,850. But our optimism isn't on autopilot. As drivers anywhere, not just Southern California, can testify, accidents and traffic jams can occur at any time: election uncertainty, the potential for an economic 'growth scare,' and investor over-optimism could prove temporary challenges. As we expect US smaller company earnings to trough this quarter, it may be time to take the top off the convertible as small-cap equities should enjoy the tailwinds of interest rate cuts and the reacceleration in economic momentum over the next 12 months.

Our favourite sectors in the US are still Health Care, Industrials, and Technology. As we pass through the epicenter of tech innovation, Silicon Valley, our technology preference remains steadfast because of its healthy earnings growth, robust buybacks, increased dividends, and still strong competitive advantages. Thematically, with the AI story likely in its early stages, US exposure to tech-related stocks (which account for ~42% of the S&P 500) is a key reason behind our preference for the US over other developed markets in the long term. Areas within emerging markets that have some technology exposure, like India, remain on our radar screen too.

In our final stretch, we cross over the most photographed bridge in the world—the Golden Gate in San Francisco. It reminds us that our asset allocation goal is to build a bridge from your investments today to a sustainable future. Creating pillars of strength and a suspension system to weather various market conditions maximises the probability of reaching your investment destination safely. Our trip ends at the iconic Space Needle in Seattle. Like a solid portfolio, it was built to last. From its observation deck, you can see 20 miles into the distance—from the mountains to the water to the city itself. That is the kind of broad perspective you need when managing a portfolio. With your wealth manager riding beside you, take the long view when it comes to investment decisions; don't be distracted by the day-to-day headline noise. No matter what the road ahead brings, we are revving our engines and ready to meet it.

Where to next? We'll see you there. Bring road snacks. Safe travels.

Lawrence V. Adam, III, CFA, CIMA®, CFP®
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UK Outlook – Big Challenges, Big Rewards

The UK Budget Presents An Opportunity, Will The Chancellor Grasp It?

Prof Jeremy Batstone-Carr, *European Strategist*

The summer is over and politics is back in the air. One can hardly open a newspaper or turn on the television or radio without being told that the 30 October Budget will be painful and that tough decisions must be taken if Britain is to be rebuilt. Everybody must do their bit but the reward, we are told, is a robust, resilient and more prosperous economy shovel-ready to face the demands of the future. The newly installed Labour administration, galvanised by a substantial majority in the House of Commons, is ready to lay the foundations for big changes. Instituting change is a tough challenge, but the rewards are there if the right choices are made.

The size of the challenge that lies ahead was described by the Office for Budgetary Responsibility (OBR) in its recently released "Fiscal Risks and Sustainability Report". Gazing into the distant future the Report concludes that, if unaddressed, the UK's public debt to GDP ratio would soar from an already high 98% to a whopping 274% in 50 years' time. Not only that, adding in the impact of recession roughly once a decade, which typically adds to the debt pile, the projected number rises to an even more eye-watering 324%, the highest level ever by a comfortable margin and easily dwarfing the previous peak 250% at the end of WW2. In the context of the OBR's findings, complaining about the existence of a £22bn "black hole" feels like a drop in the ocean.

Beyond simply identifying the quantum of the long-term challenge, the OBR goes further. The Report argues that just to keep the debt / GDP ratio at around 100% would require a fiscal policy tightening of 1.25% of GDP, equivalent to £35bn, each decade over the next fifty years totalling 6.25% of GDP or £176bn. In practical terms that either means shrinking the size of the state (lower spending) or a huge increase in taxation the consequence of which would surely disincentivise work, investment and saving. But before becoming too gloomy, the OBR offers a third way, growth, which in the context of the above feels like an olive branch too good to be true.

Specifically, the third option focuses on the necessity to improve the UK's extremely low potential growth rate and the way to achieving that prize is through delivering a sustainable boost to the country's woeful productivity track record. Quantifying the target, the OBR concludes that an increase in productivity from today's dismal 0.3% back to pre-Great Financial Crisis levels of c.2.5% would be sufficient to drive down the debt to GDP ratio to just 65% by the mid-2070s. At issue is not the hand-wringing and gnashing of teeth articulated in the, frankly, questionable assertion that the new administration has inherited "the worst set of economic circumstances since the Second World War", but whether Chancellor Ms Rachel Reeves and her team at the Treasury are up to the task of delivering transformation in the years ahead?

So, while the media's emphasis lies inevitably on the role of the state and / or the size and extent of the tax burden in the very short term, the far more important point is the creation of a framework that paves the way for a sustainable increase in targeted investment involving both the public and private sectors. Here again the OBR analysis provides guidance, concluding that a 1% increase in public investment would be sufficient to boost the UK economy's supply potential by 0.4% after five years and by 2.5% after fifty years, driving the country's debt to GDP ratio down to a far more manageable 65% in so doing. That, then is the overarching long-term goal to be addressed at the end of October and the financial markets will be watching.

Although achieving the aspirational target is clearly a long-haul journey, the Chancellor has to make a start somewhere. With that in mind the more immediate task will be the prudent day-to-day management of the public finances, something that is likely to find favour with the gilt-edged market against widespread concern regarding the poor health of public finances and overall indebtedness globally. In that context the government's spending plans and the extent of likely proposed tax increases are highly relevant.

With regard to the former we have already been told that day-to-day spending will increase by £22bn in the current fiscal year, mainly associated with pay awards for public sector workers. We also know that around £5.5bn will be saved by cutting spending elsewhere, amounting to a net fiscal loosening of around £16bn. Although certain specific taxes have been ringfenced (income tax, national insurance and corporation tax), tax hikes elsewhere are surely "on the table". But despite being told the forthcoming Budget will be "painful", just how boxed-in might the Chancellor be in reality? By delaying the Budget date for some considerable time following the election, the Treasury will have been able to reap substantial benefits from an economy growing strongly having rebounded from last year's shallow recession. Not only that, but the Organisation for Economic Co-operation and Development (OECD) has recently upgraded its GDP growth forecasts, awarding the UK economy an "A" on its report card in so doing. The fiscal headroom against the pre-existing rule that underlying debt must be falling as a share of GDP in five years' time increases from £9bn at the last Budget in March to £22bn now. Maintaining or adjusting the fiscal rules could provide even more "wiggle room" for both spending and, crucially, investment in improvements to long-term supply capacity.

The most likely course of action, though, is that the Chancellor goes ahead with £16bn of spending and pays for it with £16bn of tax increases leaving the broad fiscal policy stance unchanged. However, from the perspective of the financial markets the most important issue will be the likely impact on growth, inflation and by extension, interest rates. A neutral Budget, as described, could add c.0.2% to pre-existing GDP growth forecasts (c.1.5% in both 2025 and 2026) on the basis that higher spending adds more to near-term growth than higher taxes subtract from it. However, depending on how the money is spent the flip side to higher growth might be slightly higher inflation (little wonder the Bank of England is so cautious). However, as the labour market loosens and persistent underlying price pressures continue to fade, inflation should remain subdued and close to, if not below, the Bank's 2% target over the medium term. This implies that while the Bank's current caution is warranted, its commitment to lower interest rates will build as time passes and at a rate over and above that already anticipated by financial markets, an enticing prospect for investors in the gilt-edged market.

KEY TAKEAWAYS:

- A recent OBR Report identifies the challenge faced by the Chancellor in the 30 October Budget but also offers a solution and a pathway to long-term fiscal health and prosperity.
- Potential growth can be boosted by targeted investment to improve productivity.
- The Chancellor will wish to assert her commitment to fiscal policy orthodoxy through careful management of the country's day-to-day finances.
- The UK economy has rebounded strongly following last year's shallow recession, providing more latitude for Budget initiatives including on both spending and taxation.
- A "neutral" Budget in which both spending and taxation are matched would boost growth but may add to near-term inflation.
- The Bank of England is cautious ahead of the Budget but interest rate cuts will resume as inflation subsides over the medium term.

Final Stretch Before US Election Day: Everything & Nothing Has Changed

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

A series of unprecedented and historic events have completely shifted the candidates and dynamics of the race for the presidency and Congress—yet the key issues and likely market impacts of the race remain largely the same, following the entry of Vice President Kamala Harris as the Democratic challenger to former President Donald Trump. Despite a notable shift in sentiment and momentum behind Harris (compared to when Biden was the nominee) the race is likely to be close through Election Day. Given this unpredictability, we caution against viewing individual incremental shifts in either direction (especially in polling) as clear evidence that either candidate is headed to victory. On the policy/financial markets front, while both Trump and Harris have offered some previews of their respective agendas, policy specifics will still need to be filled in, including monitoring who is selected for key roles in either Administration. Control of Congress will also play a key role in the ability of either candidate to enact his or her agenda. Republicans have a clear advantage in the Senate and Democrats have a slight advantage in the House, but a sweep by either Party remains a very real possibility—adding additional uncertainty to the 2025 agenda and market reaction. From now until November, we will be watching for a series of known factors (including longer-term momentum in polling trends and favourability statistics) and unknown factors—for example, whether the wave of momentum shifts behind either candidate heading into November, or whether the race definitively becomes framed as a referendum on one or the other leading protagonists.

> The biggest change in the race (aside from the nominees) has been the resurgence of momentum and enthusiasm within the Democratic base.

HOW HAS THE STATE OF THE RACE BEEN UPENDED?

The biggest change in the race (aside from the nominees) has been the resurgence of momentum and enthusiasm within the Democratic base, compared to when President Biden was the nominee. While expectations of a 2020 rematch dominated much of the election conversation in Washington DC in the past year, we have consistently highlighted the possibility of unexpected events upending the race.

Those unexpected events have since occurred in spades, with the poor performance by President Joe Biden at the June presidential debate kicking off the series of events that led to his historic withdrawal from the Democratic nomination and Harris' rapid ascent to the top of the ticket. Harris' clinching of the nomination was met by a material uptick in Democratic voter enthusiasm—with likely down-ballot impacts—as well as fundraising dollars and polling numbers. This will be especially impactful in House races in New York and California, where there are eight Republican House members in races that are rated as 'toss-up.' While New York and California are unlikely to be competitive at the presidential level, higher turnout among Democrats could be decisive in these House races and potentially determine the outcome of the House majority.

HOW HAS THE STATE OF THE RACE REMAINED THE SAME?

To win the presidency, a candidate needs to secure 270 Electoral College votes and the structure of the Electoral College favours Republicans. As in recent presidential elections, a small set of voters in a handful of swing states are likely to determine the outcome of the 2024 presidential election. Pennsylvania is emerging as a potential tipping state, with the candidate who wins Pennsylvania having the likeliest path towards the 270 Electoral College votes necessary to win the presidency.

A key metric we follow in presidential elections is favourability ratings – something we frequently highlighted as a significant warning sign of the re-election bid of President Biden. The favourability rating can be a proxy for an individual's willingness to vote for a candidate. In 2016 and 2020 each presidential candidate had a net-negative favourability rating, which led to a discussion as to who can win votes, despite a negative perception. We will be monitoring the favourable/unfavourable ratings of each candidate to see if it provides insight into who can win over a majority of undecided voters.

> It does not change the reality as to what the race is likely to come down to: a small set of voters in key swing states (especially Pennsylvania).

The market impacts of the range of electoral outcomes have also not changed on a fundamental level. We largely view Harris' policy platform as an extension of Biden's on key issues including trade (where we would expect a continuation of the current targeted tariff approach) and tax, where we would likely see a push to raise the corporate rate and potentially allow the individual provisions of the 2017 individual tax changes to expire. While we have got some additional clarity as to Harris' specific policy priorities with regard to the cost of living and taxation, the lack of a traditional nominating process reduces the amount of specific policy details.

Recent calls from Trump for a 60% tariff on all Chinese goods and a 10-20% global tariff are examples of a key dynamic to consider when assessing the market impact of a potential second Trump term:

	TAXES	TARIFFS & TRADE	HOUSING
HARRIS	Higher taxes on corporations and wealthy, renewal of child tax credit	Supports domestic production, tax credits for small businesses	Tax credits for builders, down payment assistance for first-time homebuyers
TRUMP	Reduce taxes/ extend tax cuts	Impose 10% tariff on all imported foreign goods, 60% on items from China	Open federal land for development, eliminate regulations

these policy proposals should be taken seriously, but not literally. Our conversations with Washington contacts reaffirm our expectation that while a Trump victory would likely bring changes to impactful policy areas including tax, immigration, tariffs and geopolitics, the specifics are not set in stone—and influenced by who is appointed to key roles. The changes in regulation would also be a notable change in a second Trump term compared to the Biden Administration. Equities in heavily regulated industries could see a positive sentiment shift following the election, but we always advise that the regulatory environment is only one of many factors to consider when making investment decisions.

ARGUMENTS FOR AND AGAINST EACH CANDIDATE

As we enter the final stretch of the 2024 election, the race between Harris and Trump remains highly competitive, and there are compelling arguments that either candidate could win. Arguments in favour of Trump include his strong base of support, the Republican advantage in the Electoral College, and historical polling misses that have underestimated his support. Conversely, there are concerns about stalled momentum, poor favourability ratings and a 'low ceiling' (46% in 2016 and 47% in 2020) with voters in the previous elections.

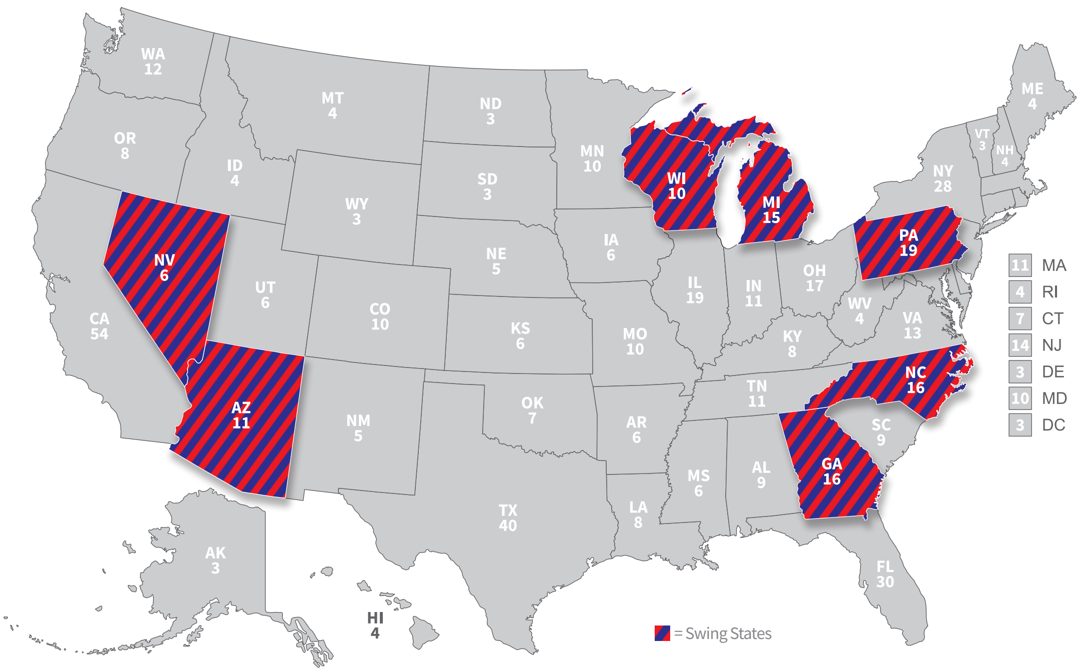
> There are compelling arguments that either candidate could win.

For Harris, she has seen enthusiasm within the Democratic base, has achieved record-breaking fundraising numbers, has polling momentum compared to Biden's performance, and dramatically increased her favourability rating. However, we would also highlight the structural disadvantage for Democrats in the Electoral College, in addition to previous polling misses overcounting Democratic support. Importantly, only one sitting vice president (George H.W. Bush in 1988) has been elected president in the last 188 years.

With weeks left until Election Day, both candidates are intensifying their efforts to sway undecided voters and energise their bases. In the remaining weeks and with the above arguments in mind, we are watching several key factors that could shape the final result of a very tight race, including how the race is framed in the media, performance in battleground states, polling, voter turnout and campaign spending.

Battleground States

The race is likely to come down to a small number of voters in key swing states.



BATTLEGROUND STATE ELECTORAL STRATEGY

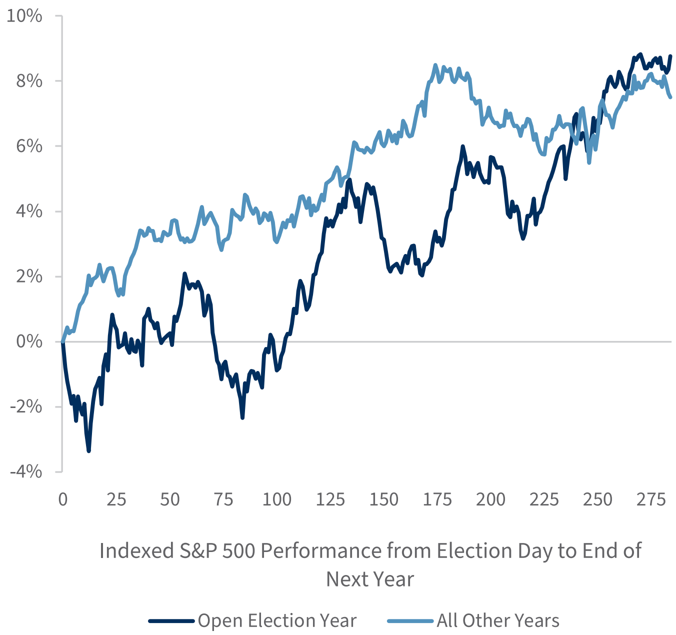
The election will likely be decided in seven key swing states: Arizona, Georgia, Michigan, Nevada, North Carolina, Pennsylvania, and Wisconsin. In addition to these seven states, swing districts in Nebraska and Maine, which award single Electoral College votes, will also receive significant attention. Increasingly Pennsylvania is looking like the key state where a win for either side would make it very difficult for the other candidate to capture the necessary 270 electoral college votes necessary to win the presidency. One important note about Pennsylvania is a law that forbids opening mail-in ballots until 7 p.m. on election day. Like 2020, a close election in PA could take days to clearly identify a winner.

POLLING DATA

We receive many questions about polls. While they can be a useful tool to get a general sense of the direction of a political contest, we recognise their limitations. In 2016 and again in 2020 public polls undercounted the final strength of Donald Trump at the national and swing state level. In 2016 polls under-reported the final vote total for Donald Trump by 3.43% and 2.28% in the swing states. Polling errors can occur in either direction, with the 2012 election undercounting the strength of Barack Obama by 1.43%. The closer the final polling data, the greater the probability of another surprise on Election Day.

Equities Rally Following Election Day

The S&P 500 tends to make up losses and move higher in the year after the election, regardless of who wins.



Source: Bloomberg Finance LP, Data as of 8/30/2024

MARKET VOLATILITY AROUND ELECTIONS

As the election approaches, investors should be prepared for increased market volatility—typical in the lead-up to elections. We have seen periods of notable weakness when there is the greatest amount of uncertainty, especially when a sweep by either political party becomes increasingly likely. We view our job as trying to bookend the risks and opportunities of various Washington-related decisions. It is easier to provide narrower bands of outcomes when the election outcomes are known, especially when there is split government. When the House, Senate and White House are all controlled by the same party—more policies become possible, and outcomes become harder to predict.

That said, despite the current close race and potential for numerous factors to sway the outcome, it is crucial for investors to maintain a long-term perspective. Historically, while pre-election periods often experience heightened volatility, the first year of a new presidential term typically sees positive market returns, regardless of which party wins the White House.

KEY TAKEAWAYS:

- A series of unprecedented and historic events this summer has completely shifted the dynamics of the race for the presidency and Congress—yet the key issues and likely market impacts of the race remain largely the same.
- Harris' clinching of the nomination has injected enthusiasm into the Democratic base and will likely have down-ballot impacts.
- The reality is the race is likely to come down to a small number of voters in key swing states.
- Historically, while pre-election periods often experience heightened volatility, the first year of a new presidential term typically sees positive market returns, regardless of which party wins the White House.

Trade and Tariffs: The Impact on Consumers

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

A tariff is a tax levied on imports. Historically, tariffs have been imposed to generate tax revenue or to protect domestic producers from competition in the form of cheaper foreign goods. In essence, tariffs artificially make domestically produced goods more competitive in the local market by making imports more expensive. At the same time, tariffs allow domestic producers to increase the price they otherwise would have charged for their product had they faced foreign competition. In many ways, trade without tariffs keeps domestic producers' attempts to increase prices at bay. While tariffs have been utilised heavily in the past, both their usage and rates have fallen considerably over the past half century as countries have engaged in different stages of trade negotiations. Both the volume and value of global trade have grown exponentially as tariffs and barriers to trade have fallen over the decades. This has coincided with the growth of the global economy over the same period, which is, on average and in aggregate, more prosperous than at any time in human history.

In essence, tariffs artificially make domestically produced goods more competitive in the local market by making imports more expensive.

While it is readily apparent that emerging economies have reaped outsized rewards because of freer trade, developed economies as a whole have benefited as well. The availability of cheaper imported goods has enabled consumers in developed economies to retain a larger share of their income for consumption, saving or investment. The same holds true for companies, which benefit from lower input costs and higher profit margins when there are fewer barriers to trade. The strength and dominance of the US dollar as the world's dominant currency, helped by the sizable and consistent demand for US financial assets, the growth of the US economy, as well as the large fiscal deficits over the years, have all contributed to the increase in US consumption and thus to a sizable increase in imports from the rest of the world. This has created a large current account deficit (this includes the trade deficit in goods as well as the surplus in the trade of services), which must be financed with foreign savings. That is, the rest of the world has essentially financed the expansion of US consumption by purchasing US financial assets and investing in its economy. In exchange, the rest of the world has been buying US physical assets as well as receiving interest and dividend payments from these transactions. Thus far, this arrangement has, on the whole, greatly benefited the US economy and will remain a non-issue as long as the US dollar remains the world's reserve currency and the US economy the preeminent place to invest.

Trade is almost always better than no trade.

When tariffs are imposed or increased the price of those goods affected rises too, potentially increasing inflation. Goods become more expensive to consumers and inputs become more expensive to companies, reducing both purchasing power and profitability, respectively. That is to say, the aggregate impact to the entire economy at large is negative. Furthermore, if nations engage in a 'trade war' wherein each nation retaliates with their own tariffs, which is what happened when the US enacted tariffs the last time, the negative economic effects could be amplified.

Trade is almost always better than no trade. And, as we mentioned above, the process toward freer trade over the last several decades has benefited the world economy as a whole, not only in terms of economic growth but also in terms of allowing countries to benefit from comparative advantage and produce, and export, products they are most efficient at producing. We are not saying that there may be some arguments for the imposition of tariffs, more that those instances have to be considered on a case-by-case basis. The imposition of blanket tariffs as an argument to solve trade imbalances is not a good way to tackle the root cause of these deficits. Sometimes, governments impose tariffs when they think that countries/companies are 'dumping' or selling products in the international market at prices that are lower than in their domestic market.

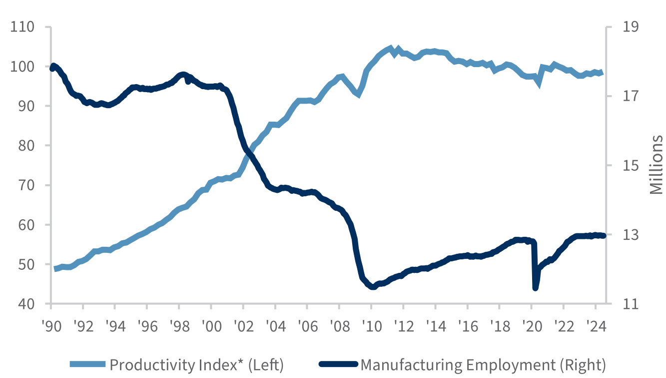
On other occasions, governments impose tariffs to temporarily protect a company that is experiencing short-term issues at home, and politicians deem that the company's existence is at risk if the government doesn't intervene. Sometimes a country imposes tariffs if it believes that companies in the foreign country are being subsidised and are improving the competitiveness of their products vis-à-vis domestic companies, etc.

An alternative that can help to reduce the trade deficit, if this was the true reason for the imposition of tariffs, might be to reduce the fiscal deficit. However, this would slow economic activity as well as economic growth and politicians are probably not going to be willing to consider this avenue for improving the trade balance.

THE 2018 TRADE WAR

The US manufacturing sector has been transformed over the last several decades as cheaper imports have put pressure on the sector's competitiveness. Higher manufacturing wages in the US compared to the rest of the world are probably the root cause of such a shift. According to the National Association of Manufacturers (NAM), the average salary of a manufacturing worker in the US in 2022 was $98,846, including benefits, compared to about $13,638 in China and $15,804 in Mexico.[1] However, the sector's transformation has meant that it is using more machines and more skilled labour to produce goods and this requires fewer workers to produce than in the past. This means that the sector has continued to specialise in the production of those goods that it is most efficient in producing. That is, although employment in manufacturing has declined by nearly 30% since the 1990s, manufacturing productivity has doubled during the same period. This increase in manufacturing productivity has meant that manufacturing workers are highly paid compared to workers elsewhere in the developed world.

Manufacturing Productivity Has Doubled Since the 1990s



Source: FactSet, data as of 9/30/2024
*Productivity Index is measured as total output per hour worked

[1] https://nam.org/manufacturing-in-the-united-states/facts-about-manufacturing-expanded/#:~:text=Manufacturing%20employees%20earned%20%2498%2C846%2 on,2022%2C%20 including%20pay%20and%20benefits.

During the Trump presidency the US raised tariffs on many US trading partners, tariffs that the Biden administration has kept almost unchanged. China was affected the most, with over $380 billion worth of steel, aluminium, washing machines and solar panels impacted by tariffs, for a total increase in tariff revenues of ~$80 billion. It has been estimated that the average household has paid an additional ~$300 annually due to the 2018 trade war.[2]

A POTENTIAL 2025 TRADE WAR?

The COVID-19 pandemic, the government's massive fiscal package, the inflation spike of 2022, and the Federal Reserve's (Fed) monetary policy journey have certainly overshadowed any impact that the 2018 trade war might have had. However, that's behind us, pandemic-era excess savings are depleted, inflation is close to the Fed's target, the central bank has started to ease rates, and we are now staring at the possibility of a new trade war. While trying to estimate the effects of additional tariffs and potential retaliation from foreign countries is an extremely complex task with lots of variables at play, we've tried to estimate the potential impact on the US economy from the imposition of 10% import tariffs on all trading partners and 60% tariffs on all Chinese imports.

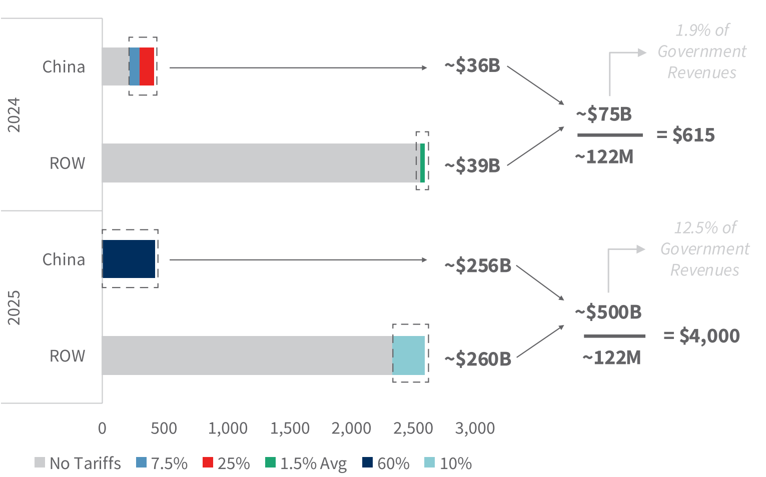
Under this scenario, the tariffs will generate ~$500B in revenues, which could, on one hand, have a negative impact on GDP if the revenues from tariffs are not returned to the economy. Typically, higher tariffs are paid by consumers through higher prices for the goods they consume. Furthermore, the impact on consumers, especially those in the lower income quintiles, could be severe as not only are they likely to have fewer options, but may be forced to spend much more as businesses will likely pass the bulk of the price increase to consumers. On the other hand, domestic producers will likely attempt to use the impact of tariffs on imported goods to boost their profit margins by increasing prices of competing domestically produced goods. Overall, if tariff revenues increase more than sixfold (from $80 billion to $500 billion) then the extra amount that the average household will have to pay increases from ~$300 annually to ~$1,900 annually, then that could adversely impact the US economy by as much as 1.9% of total GDP.

If these tariffs are enacted, a trade war is likely to ensue as trading partners retaliate by imposing similar tariffs on US exports. In this escalation, the trade deficit will likely widen further, and US exporters may experience as much as a ~$400B hit on revenues depending on how much the quantity demanded by trade partners might decline. Additionally, if the US dollar were to appreciate in response to the imposition of tariffs, US exporters would have a harder time selling their products overseas, which would likely have a negative impact not only on exports, but also on US production and the labour market.

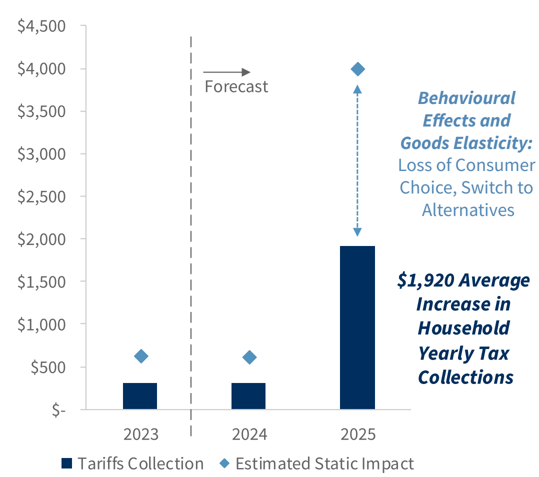
Inflation is likely to increase as tariffs are implemented and prices increase, but unless the trade war continues over the years, the inflation spike may be short-lived. However, if inflation increases then the Fed may be pushed to either increase interest rates or keep interest rates higher for longer compared to a no-tariff-war scenario or until the effects from the tariffs are pushed through the US economy. It is difficult to know the actual impact on overall inflation, but an across-the-board increase in tariffs has the potential to push inflation higher.

Tariffs on US Imports ***(In Billions)***

Tariffs Impact on 122 Million US Households



Potential Impact of New Tariffs



Source: FactSet, TaxFoundation.org, US Census Bureau, US Customs and Border Protection, US Trade Representative

[2]US Customs Border Patrol, US Trade Representative, Tax Foundation sources

An across-the-board increase in tariffs has the potential to push inflation higher.

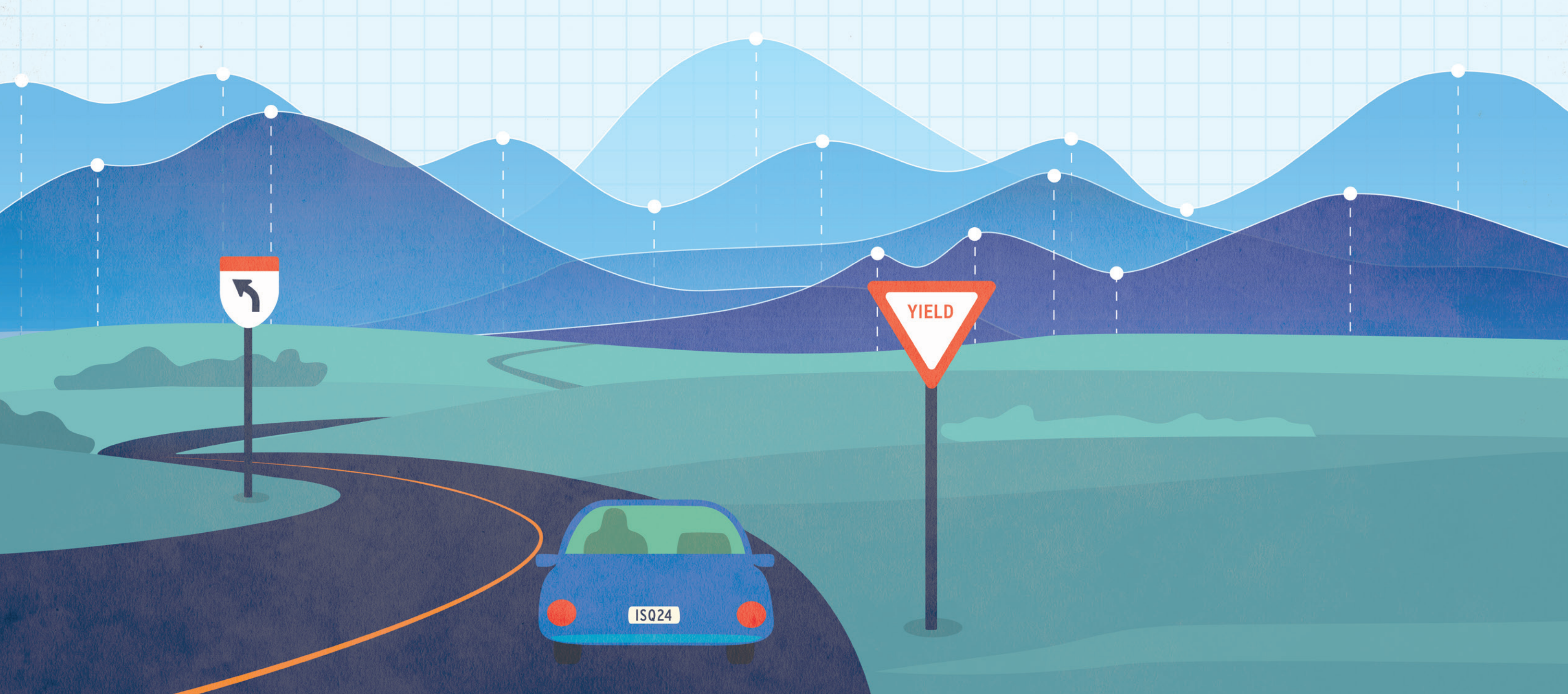
CONCLUSION:

Those who believe that freer trade is not good for a country typically believe that international trade is a 'zero-sum game,' which means that if one country loses, that is, has a trade deficit, then the country with the corresponding, and opposite, trade surplus, is the winner. However, trade is, typically, not a zero-sum game but a 'positive-sum game' in which everybody wins by engaging in mutually beneficial commercial endeavour. The idea that a trade surplus is better than a trade deficit comes from the old and discarded theory of 'mercantilism,' a view of the world that lasted from the 16th to the 18th centuries and considered the wealth of a nation depended on the size of its trade surplus while limiting imports through the imposition of tariffs.

However, the reality is more complex. As discussed above, trade deficits and surpluses do not necessarily denote whether a nation is at an inherent economic advantage or disadvantage. In this sense, trade is more like a 'positive-sum game' with a variety of possible payoffs. Generally speaking, all nations stand to benefit by 'cooperating' in an environment of freer trade. However, tariffs and protectionist measures disrupt global supply chains, increasing costs and reducing profitability. In other words, nations stand to be harmed by 'defecting' from free trade and engaging in trade wars.

KEY TAKEAWAYS:

- A tariff is a tax on imports.
- Historically, tariffs have been enacted to generate tax revenue or to protect domestic producers from competition in the form of cheaper foreign goods. Imports are made more expensive so domestically produced goods can be more competitive in the local market.
- When tariffs are imposed or increased the price of the goods rise, potentially increasing inflation. Goods become more expensive to consumers and inputs become more expensive to companies.
- China has been most affected by US tariffs imposed by former President Trump and continued by President Biden.
- In our view, the imposition of further tariffs should be considered on a case-by-case basis, rather than applied as a blanket strategy to decrease a trade deficit.



The Inverted Yield Curve: Still a Reliable Signal?

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

For decades, sovereign bond yield curve inversions have been a closely watched indicator by financial professionals and the media. And there is good reason for that, as inverted yield curves (i.e. when shorter-maturity yields are above longer-maturity yields) have historically served as an early warning sign of an impending recession. In fact, the three-month to 10-year US Treasury yield curve has correctly predicted the last nine recessions, dating back to the early 1960s, only giving one false signal in 1966—with a recession typically following twelve months, on average, after the curve first inverts. However, this economic cycle has seen many formerly reliable indicators provide false signals, with the inverted yield curve among them. Below we explore whether the yield curve is providing a false signal this time around and what, if any, implications this may have for investors going forward.

> Inverted yield curves have historically served as an early warning sign of an impending recession.

WHAT DOES THE SHAPE OF THE YIELD CURVE SIGNAL?

Let's take a step back and look at what signal the yield curve is sending to the market. While there are countless yield curve segments to monitor, the most widely quoted yield curve in the financial media is the two-year to 10-year US Treasury difference (or "spread" to use financial market parlance). Under normal circumstances, the shape of the yield curve is positively sloped, meaning that short-term interest rates are lower than long-term interest rates. Positively sloped yield curves signal that the market expects economic growth to expand in the future, with yields on longer-term maturities higher than yields on short-term maturities as investors demand extra compensation for inflation and the potential for future rate increases. Conversely, inverted yield curves signal that economic growth is expected to slow and that interest rates will be lower in the future. Hence, the yield curve captures the market's expectations for growth, inflation and the direction of monetary policy going forward and can be applied to any geographic location.

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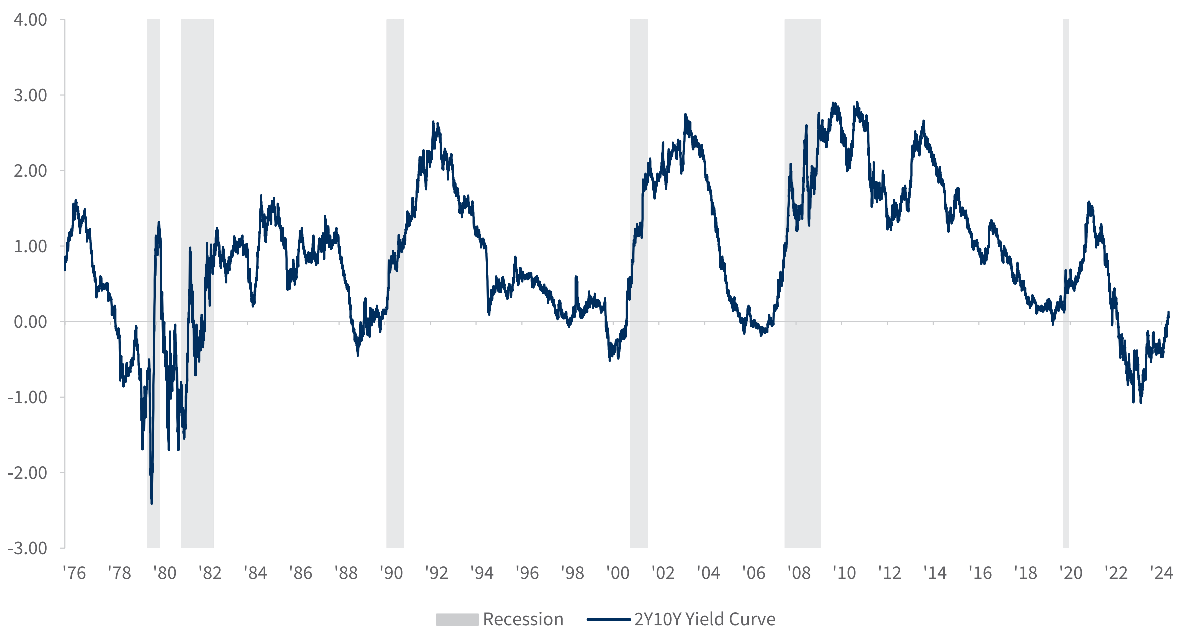
Inverted yield curves also tell you that the federal reserve's (Fed's) monetary policy stance is restrictive whether a central bank's policy stance is restrictive as policymakers (who control the shorter-dated end of the yield curve) are actively seeking to restrain growth and dampen inflation pressures. More important, history has also shown that when the two-year to 10-year yield curve shifts from its peak inversion point to a positively sloped curve, that has traditionally been one of the strongest signals that a recession is imminent. In fact, a recession has typically followed within two to six months of the curve slope turning positive again. That is why investors are so interested in what comes next, and how best to position their portfolios. In Europe, the German Bund yield curve has dis-inverted too, another portent signalling that a "double dip" recession could be around the corner for the region's largest economy.

In early september, the two-year US Treasury yield fell below the 10-year yield for the first time since July 2022—ending its longest inversion period in history (547 trading days) since records began. This is a big move as the two-year treasury yield was nearly 1.0%-Point, a wide margin, above the 10-year treasury yield in July 2023 when the Federal Reserve delivered its final rate hike after policymakers aggressively raised rates to stamp out inflationary pressures following the reopening of the economy after the pandemic. The return to a positively sloped yield curve is a noteworthy development—as the signal has traditionally put the market on notice that a recession may be approaching. However, it is important to remember that not all segments of the US yield curve have normalised at the time of this writing. For example, the three-month to 10-year yield curve remains deeply inverted (currently 1.0% point or -100 basis points) as the central bank's policy remains restrictive. But now that the Fed has kicked off its easing rate cutting cycle, both curves should steepen, with the two-year to 10-year yield curve spread becoming more positively sloped and the three-month to 10-year continuing to unwind its inversion. How quickly this occurs will be dictated by how quickly the Fed lowers rates during this easing cycle.

Inverted Yield Curve Historically Predicted Recession

The two-year/10-year curve was inverted for a record number of days & no recession yet.



Source: FactSet as of 9/23/2024

WHY THIS TIME MAY BE DIFFERENT

These words may come back to haunt me, but it does appear that the Treasury yield curve is giving a false signal. While the government bond market has been on recession watch for well over two years now, starting just after the US economy recorded two consecutive quarters of negative GDP growth in 2022 and again following the first inversion of the yield curve later that year, there is little on the horizon that suggests that the economy is at risk of tipping into a recession any time soon. Yes, the economy is slowing, and our economist still expects a modest slowdown in the coming quarters; but barring an exogenous shock, a soft landing remains the most probable outcome. There are several reasons:

1. The US economy has been remarkably resilient in the wake of the Federal Reserve's most aggressive tightening cycle in forty years. Up until now, weakness in some sectors of the economy (i.e. interest-rate-sensitive sectors, such as housing and manufacturing) has largely been offset by strength in other areas. The initial boost of spending on things like travel following the reopening of the economy after the pandemic turbo-charged the recovery. Several rounds of fiscal stimulus in the form of the CHIPS, IRA and Infrastructure Act passed by Congress over the last few years have also boosted growth. Sure, these areas of support could fade, but the point is: the central bank has plenty of fire power at its disposal to lengthen the expansion's runway and fend off any recession risks that arise.

2. While the labour market is cooling, the unemployment rate (at 4.2%) remains low by historical standards even though it has climbed 0.8% since 2023. Thus far, much of the adjustment has come from a slowdown in the pace of hiring, with job growth averaging 114k over the last three months, down from a 196k pace over the last 12 months. The key point: the slowdown in the labour market from its overheated pace has occurred with minimal job losses. And if our economist is right, we should not see any job losses this cycle—that's a big difference versus other cycles.

3. Finally, the Federal Reserve did not overtighten. While there is some truth to the old adage that "The Fed will keep raising rates until something breaks"—it has done an exceptional job navigating one of the most challenging economic cycles in modern history. For sure, there have been some growth scares along the way, and we are not fully out of the woods yet—but so far, the Fed's campaign to slow the economy and rein in inflation has done so without plunging the US into a recession.

While the predictive power of the inverted yield curve has waned in this cycle, it does not mean that investors should dismiss the warning signs entirely. That is why we continue to monitor it; but augment our analysis with other fundamental macro signals. And for now, these signals suggest the US economy is on track to achieve its much-desired "Goldilocks" (neither too hot nor too cold) soft landing.

IMPLICATIONS FOR FIXED INCOME INVESTORS

One of the biggest questions on investors' minds, particularly with more than $6 trillion sitting in cash in money market accounts, is whether they should stay invested in this cash—which right now, offers a higher yield—or lock in rates further along the duration curve at attractive, albeit lower yields. As we have noted in the past, Treasury yields have moved significantly lower in anticipation of the Federal Reserve's forthcoming easing cycle and the scope for further declines from current levels is limited outside of a recession, which is not our base case.

History tells us that cash rarely outperforms bonds once the monetary policy easing cycle has begun. However, in cycles in the periods where the three-month to 10-year Treasury curve was deeply inverted (as it is today) it took about a year or less for Treasurys to outperform cash. This suggests there may still be a small window of opportunity to earn some incremental yield while waiting for further clarity on the pace and magnitude of the Fed's easing cycle rate cuts. While yields on money market funds remain attractive, it is important to remember that cash rates are only guaranteed overnight. Once the Federal Reserve begins its easing cycle, money market yields will immediately adjust lower. In fact, the current rate on a one-year Treasury bill is just 4.25%—nearly 100 basis points lower than today's cash yield, but well above the current two- and 10-year notes!

For investors who are reluctant to give up the yield advantage of cash, but who are willing to take on additional risk, we recommend they consider US investment grade corporates. While spreads are historically tight, all-in yields near 4.7% still remain attractive.

KEY TAKEAWAYS:

- In early September, the 2-year Treasury yield fell below the 10-year yield for the first time since July 2022--ending the longest inversion in history!
- While yield curve inversions have correctly predicted recessions, we think it may be sending a false signal right now.
- History tells us the cash rarely outperforms bonds once an easing cycle has begun, but the deep inversion suggests there may be a small window of opportunity.

Investment Strategy Framework

The investment landscape is complex and changing, with multiple factors to consider. Our Investment Strategy Framework ranks the following factors in order of importance to developing our views.

1	ECONOMIC GROWTH	• Business cycle (recession/growth) • Employment • Consumer spending
2	FUNDAMENTALS	• Earnings trends • Corporate guidance • Balance sheet strength
3	MONETARY POLICY	• Central bank policy • Impact on US dollar
4	INTEREST RATES & INFLATION	• Borrowing and lending rates • Price pressures • Commodity price trends
5	VALUATIONS	• Price multiples/earnings • Relative value • Spreads/yield curve
6	SENTIMENT	• Consumer, employment, business surveys • Investor attitude/risk appetite • Market expectations
7	CORPORATE ACTIVITY	• Capital expenditures • Dividends/buybacks • Mergers and acquisitions
8	POLITICS	• Regulatory environment • Tax policy and fiscal spending • Trade policy
9	GEOPOLITICAL EVENTS	• Wars, coups, ongoing tensions • Economic and commodity impact
10	NATURAL DISASTERS	• Damage to infrastructure • Disruption of commerce/supply chains

Disclosure

All expressions of opinion reflect the judgment of the authors and are subject to change. Past performance may not be indicative of future results. There is no assurance any of the trends mentioned will continue or forecasts will occur. The performance mentioned does not include fees and charges which would reduce an investor's return. Dividends are not guaranteed and will fluctuate. Investing involves risk including the possible loss of capital. Asset allocation and diversification do not guarantee a profit nor protect against loss. Investing in certain sectors may involve additional risks and may not be appropriate for all investors.

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

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

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

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

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

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

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

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

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

The process of rebalancing may result in tax consequences.

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

The companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

The indexes are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities.

The Russell 2000 Index is a small-cap US stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

This is not a recommendation to purchase or sell the stocks of the companies pictured/mentioned.

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