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INVESTMENT STRATEGY QUARTERLY

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Investment Strategy Quarterly is intended to communicate current economic and capital market information along with the informed perspectives of our investment professionals. You may contact your wealth manager to discuss the content of this publication in the context of your own unique circumstances. Published October 2017. Material prepared by Raymond James as a resource for wealth managers and investors.

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INVESTMENT STRATEGY COMMITTEE MEETING RECAP – HELD ON SEPTEMBER 5, 2017

Major macro factors affecting the economy and financial markets over the next six to twelve months include U.S. earnings growth, Federal Reserve policy, tax reform and interest rates.

U.S. ECONOMY – Scott J. Brown, Ph.D., Chief Economist, Equity Research

The majority of the committee is neutral (2.5 – 2.9%) to somewhat negative (2.0 – 2.4%) on real U.S. GDP growth over the next six to twelve months. Inflation is expected to remain about the same at 1.5% for the same time frame.

- "Hurricanes Harvey and Irma will distort much of the economic data and possibly shave a few tenths off of 3Q17 GDP growth, but we should see a rebound in the fourth quarter."
- "Much of the economic data were looking spotty ahead of the hurricanes, with overall growth trending at a lackluster to moderate pace."
- "The showdown over the FY18 federal budget and debt ceiling has been postponed to December 8. A budget agreement is necessary before tax reform efforts can get underway. Broad tax reform (lower rates and reduced deduction) is nearly impossible, as nobody wants to give up their deductions, but lower tax rates are still expected at some point (just on a smaller scale)."

U.S. EQUITY

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

- "We've transitioned from an interest-rate driven to an earnings-driven secular bull market that has years left to run."

  – Jeff Saut, Chief Investment Strategist, Equity Research

- "The S&P 500 continues to sustain its momentum due to improving economic activity and earnings growth, along with renewed optimism over tax cuts. While participation in the S&P 500's advance had been narrowing (causing technical concerns), relative performance for the small and mid caps has sharply improved over the past month. This came on the heels of President Trump and Congressional Democrats agreeing on a three-month extension to the debt limit, which spurred the return of the reflation trade and was supported by the Trump administration's tax proposal."
- "The path of tax changes (timing, size, and details) will likely increase volatility now that it has been brought to the forefront of the Congressional agenda and will continue to be a significant influence on the equity market in the coming months. If we do see choppiness, the downside should be limited. We would be buyers of those pullbacks until something changes with these pillars of support – a healthy global economy, earnings growth, low interest rates, and fairly loose monetary policy around the world. They remain supportive of equities longer term."

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

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

Almost 90% of the committee is bullish to some degree on non-U.S. developed equities, while 75% are bullish on emerging market equities over the next six to twelve months.

- "There are several events coming up in the next few months. The first, and probably the least important, is the German election. Angela Merkel is going to win it." [1]
- "Emmanuel Macron has the opportunity to actually push through some proper change in France. If France moves, then you'll see the tone and the shape of the whole European debate move as well. I'm the most optimistic I've been about European reform right now. I actually do think this time it is changing."
- "The third aspect is Brexit, which remains – to be honest – totally boring. Debates continue, which is good because it means the whole timetable gets kicked out. Rather than a very hard, fixed two-year period, in practical terms it will probably be somewhere between four and six years, having less impact on economies."
- "The opportunity set in Europe remains good. I do believe in the reform process, and I believe this is the source of gains from a global asset allocation basis for European markets. I think similarly about Asia and am still really impressed by Chinese economic reform efforts."

FIXED INCOME

We don't see anything trend-wise changing in the near term, and should continue to see rates trickle down.

- "We are certainly seeing intermediate and long-term interest rates trickling down. The support on the short end of the curve has been central bank interference. We have to acknowledge that the markets are also being driven by cash. Combined, central banks are currently over $19 trillion in size now – that's the size of U.S. GDP."
- "For a lot of reasons, interest rates aren't going up quickly any time soon. Along with central bank cash, there is interest rate disparity among most other economic powers with rates well below ours. This is seen through strong indirect participation in Treasury auctions, which is also placing downward pressure on rates."
- "We've seen a shift within some of the sectors, too. Munis have become more expensive and corporates are cheapening. But the belly of the curve is still staying whole. You've got to go out about 15 years on the muni curve to get 85% of the total value, while the corporate curve provides 85% of its value around 11 years out. At the very short end, even some short-term instruments like CDs are starting to play a role."

  – Doug Drabik, Senior Strategist, Fixed Income

[1] As expected, Angela Merkel and her party won a plurality of the vote in the national election held on September 24, 2017.

INVESTMENT STRATEGY COMMITTEE MEMBERS

Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

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

Chris Bailey European Strategist, Raymond James Euro Equities*

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

Robert Burns, CFA, AIF® Vice President, Asset Management Services

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

Doug Drabik Senior Strategist, Fixed Income

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

Nick Goetze Managing Director, Fixed Income Services

Peter Greenberger, CFA, CFP® Director, Mutual Fund & 529 Plan Product Management

Nicholas Lacy, CFA Chief Portfolio Strategist, Asset Management Services

Pavel Molchanov Senior Vice President, Energy Analyst, Equity Research

Kevin Pate, CAIA Vice President, Asset Management Services

Paul Puryear Director, Real Estate Research

Jeffrey Saut Chief Investment Strategist, Equity Research

Scott Stolz, CFP® Senior Vice President, PCG Investment Products

Jennifer Suden, CFA, CAIA Director of Alternative Investments Research

Tom Thornton, CFA, CIPM Vice President, Asset Management Services

Anne B. Platt, AWMA®, AIF® – Committee Chair
Vice President, Investment Strategy & Product Positioning, Wealth, Retirement & Portfolio Solutions

Kristin Byrnes – Committee Vice-Chair
Product Strategy Analyst, Wealth, Retirement & Portfolio Solutions

- "To me, the Fed's balance sheet unwind is a non-event. The numbers that I've looked at suggest a two-year unwinding of $600 billion, maybe 25 or 30 basis points assuming the Fed sticks with their plan, which they really haven't done for the last four or five years. We were supposed to get a number of rate hikes this year. We may be done, so I think dovishness still rules the globe. Central bank balance sheets are still expanding."
- "The amount of liquidity, risk-taking, and the lack of discipline in the debt markets, at least on the taxable side, is extraordinarily loose."

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

ENERGY AND OIL – Pavel Molchanov, Senior Vice President, Energy Analyst, Equity Research

As of September 30, energy was 6.1% of the S&P 500 market cap, just about the lowest level in 14 years. Our view is that this is absolutely a place that ought to be overweighted, because it's hard to see how much lower it can get.

- "In regard to Hurricane Harvey, one-fifth of U.S. refining capacity, which is 4% of the world's refining capacity, was offline. That's an extremely impactful statistic, much more impactful compared to Hurricane Katrina. However, structural damage looks very, very small. Yet, shutting down and restarting a refinery takes time. It will take a period of weeks, maybe months at the most, until these are up and running again."
- "The amount of crude production that was offline was never particularly needle-moving, which is why we didn't see a run on crude prices. At the peak, Gulf of Mexico outages were 400,000 barrels a day compared to refining, which was ten times the scale."

HOUSING – Paul Puryear, Director of Real Estate Research, Equity Research

As far as housing is concerned, nothing has changed in the past few months. We're tracking along very modestly with housing starts.

- "We need houses – the same message as last quarter. We just can't build moderate- to low-priced housing. The economics just don't work and we don't see that changing any time soon."
- "It's a healthy environment. We've got residential fixed investment going up. That's a data point that we track very closely. Typically when it's increasing, the economy is doing well. If it turns and starts to head the other way, we're going to get very nervous. In a lot of ways, it's an indicator of what the consumer is doing. Right now, that all looks good to us."
- "We have 6 - 7% inflation in residential real estate. I'm talking 6 - 7% inflation replacement cost relative to income growth. That's not a good equation, and we don't see that changing."

ALTERNATIVE INVESTMENTS – Jennifer Suden, CFA, CAIA, Director of Alternative Investments Research, PCG Investment Products

In terms of fee transparency, managers are responding to investors' demands and concerns. They are coming up with somewhat more creative ways of addressing fee structure concerns.

- "We are seeing allocations to global macro funds creep up. We haven't seen very much in terms of volatility and dislocations across the globe over the last few years. For those investors that are expecting an uptick in volatility levels, global macro funds tend to play well in more volatile environments and when there are those global dislocations."
- "We're also seeing allocations picking up in long-short equity, as people are looking to continue to participate in equity markets but with some sort of downside protection. The long-short equity funds have actually been doing quite well as we are starting to see an increase in alpha creation on the short side."

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Is the Bank of England on the Cusp of Tightening Policy?

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

"Lower interest rates are usually considered good for stocks because they lower the cost of borrowing and make bonds a less attractive alternative investment" Alex Berenson

What were you doing on the 5 July 2007? I cannot remember either, but the history books tell us that this was the last date when the Bank of England raised interest rates (by a quarter of a percentage to 5.75%). Since this point, interest rates have only fallen, including the most recent August 2016 decrease to the current rate of just 0.25%.

But is this about to change? Traditionally, independent Central Banks with relatively narrow inflation control mandates, like the Bank of England, typically raise interest rates when the level of price increases threatens to pierce their target inflation level. For the Bank of England this moment was, a number of months ago, influenced by the impact on imported prices, like energy, by the sharp fall of the Pound in the second half of last year.

Given the uncertainties around Brexit and recent economic growth data, which has been typically weaker than other developed market peers, this has caused a conundrum for the Bank of England. Reflecting this, the Bank's own Monetary Policy Committee (MPC) observed a few weeks ago, after a meeting which concluded that interest rates should be currently held, that:

"The MPC's remit specifies that, in such exceptional circumstances, the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity."

'Exceptional circumstances' covers a variety of sins but maybe something has changed in the water at Threadneedle Street because Mark Carney, the Governor of the Bank of England, in an even more recent national radio interview said that 'we can see that in the coming months if the economy continues on this track it may be appropriate to raise interest rates'.

Well that is a surprise - and certainly induced an immediate response from both the bond markets as well as mortgage lenders. So what is the reality and can we expect, for the first time in over a decade, an increase in interest rates?

> Given the uncertainties around Brexit and recent economic growth data this has caused a conundrum for the Bank of England

The economic case for an interest rate increase is currently not wholly proven. Brexit negotiations are an uncertainty and the average consumer remains under pressure with limited wage increases and high personal debts. However, monetary policy remains exceptionally loose with a negligible 0.25% base interest rate, the Pound on a trade weighted basis near multi-decade lows and a quantitative easing stimulus programme, which was further augmented at the time of the last interest rate reduction in August 2016 when the big fear was an imminent shift of the UK economy into recession.

In short, a very mild tightening of policy - maybe reversing some of the extraordinary additional stimuli measures implemented fourteen months ago - is quite plausible and would reflect an acknowledgement that, whilst the backdrop is still uncertain on an absolute basis, relatively speaking there is slightly more clarity. However, the bigger insight is that anyone expecting a return to the interest rate or broader monetary policy norms of the generation before the global financial crisis a decade ago is going to be incorrect.

The Bank of England is not the only central bank coming to these conclusions. The Federal Reserve in the United States was the first

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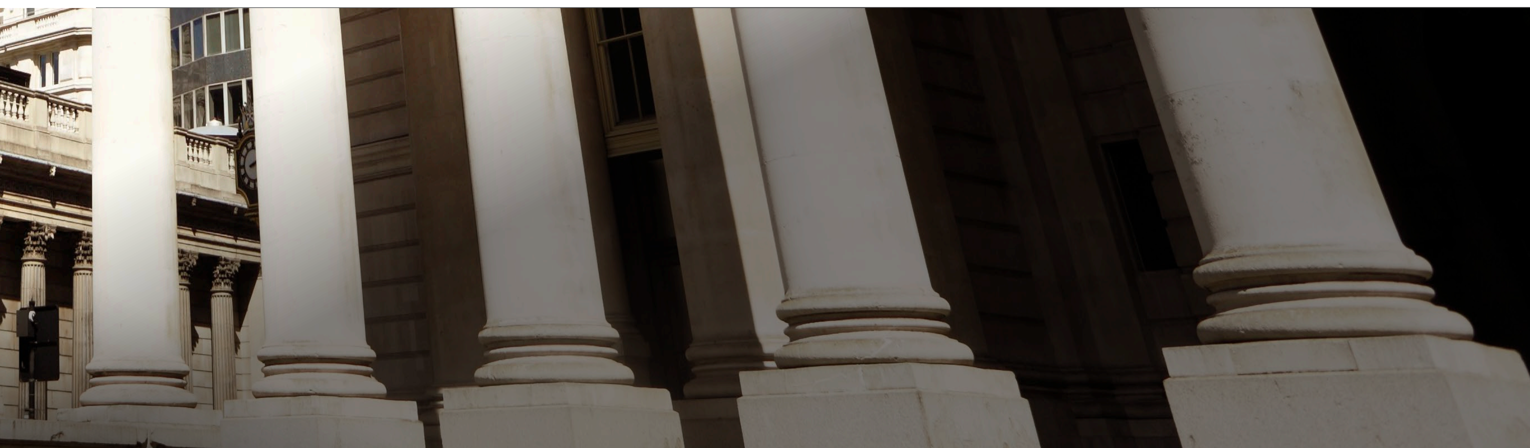


Date UK interest rates changed	Base rate level
4 August 2016	0.25%
5 March 2009	0.50%
5 February 2009	1%
8 January 2009	1.50%
4 December 2008	2%
6 November 2008	3%
8 October 2008	4.50%
10 April 2008	5%
7 February 2008	5.25%
6 December 2007	5.50%
5 July 2007	5.75%
10 May 2007	5.50%

Source: Bank of England

major western central bank to slash interest rates and introduce a quantitative easing stimulus programme in the aftermath of the events in 2007 and 2008. As is often the case with economic policy, the 'first in, first out' rule is very apparent. Famously, the Federal Reserve raised interest rates after seven years of pause in December 2015, and since then there has been a further three small tweaks up. Perhaps more insightfully is that the pause on the creation of new central bank stimulus pre-dated any of these interest rate movements and occurred in October 2014 (and actual balance sheet size reduction is only starting this month).

The essential conclusion from all of this is that the speed of policy tightening is, by historical standards, desperately slow reflecting the ongoing challenges for most global economies. This broad profile is highly likely to be replicated by the Bank of England: potentially a minor tweak up in interest rates and a progressive end to new expansion of the quantitative easing balance sheet. If the Bank of England does decide to move in upcoming months, the magnitude of the shift will be extremely minor: there are too many fears out there to do anything else.

And this is why knowing what you are investing in and why is absolutely critical for the next few years, whether you are a bond or equity investor.

KEY TAKEAWAYS:

- The Bank of England last raised interest rates in 2007 but rumours are swirling of an imminent increase
- Current policy is extremely loose and fears from this year that the UK will enter a recession have abated
- The Federal Reserve indicate that any policy tightening is extremely slow and will focus first on reversing the new stimulus added after the Brexit vote

If the Bank of England does decide to move in upcoming months, the magnitude of the shift will be extremely minor: there are too many fears out there to do anything else

Federal Reserve Policy: What's Next?

Scott J. Brown, Ph.D., *Chief Economist, Equity Research,* provides perspective on the pace of balance sheet unwinding amid the moving parts of monetary policy.

> "The near-term outlook remains constructive for the stock market."

Federal Reserve (Fed) officials continue to emphasise that monetary policy will remain data dependent. While the pace is uncertain, short-term interest rates are expected to rise gradually over the next couple of years. The unwinding of the balance sheet has begun slowly, but the pace will pick up over the course of next year.

INFLATION

Much of the recent monetary policy debate has focused on the low inflation trend. Fed officials note transitory effects on inflation, such as the sharp drop in wireless telecom services in March, and most believe that tighter labour market conditions will lead to higher wage inflation. Yet, they are also aware that longer-term structural changes may make the inflationary response to low unemployment more muted than in the past. Time will tell. Officials have signalled a willingness to wait for more information.

INTEREST RATES

While the Fed has raised short-term interest rates in the first half of the year (still very gradual by past standards), credit has generally become easier, suggesting that there is more work to do in order to get the economy on a more even keel. Fed Chair Janet Yellen has said that the federal funds target rate is not far below what would be considered a 'neutral rate', a level neither contractionary nor expansionary. However, the neutral rate is expected to rise over time as the economy improves – hence, an outlook of gradual policy rate increases.

During the financial crisis, the Fed effectively hit the lower bound on short-term interest rates. Large-scale asset purchases, commonly called 'quantitative easing' or QE, were further accommodation. The balance sheet surged as securities were added to the Fed's portfolio. The Fed has now begun to unwind that. The Fed telegraphed its intentions and the pace of the reduction, so market reaction to the announcement has been limited. It's estimated that QE lowered the 10-year Treasury yield by about 100 basis points. Therefore, the balance sheet unwinding is expected to raise long-term interest rates in the quarters ahead (and this will be a multi-year process). Importantly, the Fed does not view the balance sheet unwinding as 'active' policy. Rather, it's been described as 'background.' Officials have emphasized that the federal funds target rate will remain the main policy lever.

OVERALL

The near-term outlook remains constructive for the stock market. The economy continues to expand, but not so fast that the Fed rushes to 'take the punch bowl away.' However, demographic constraints (slower growth in the labour force) will restrain GDP growth and perhaps present some challenges for the markets in the months ahead.

While future monetary policy moves are always uncertain, the future appears more clouded as we look beyond the early part of 2018. Trump will have a number of Fed governor positions to fill and will be able to shape the Fed's leadership. The choice of Fed chair remains key. Ben Bernanke and Janet Yellen were the right people at the right time.

Setting a Legacy: Mrs Merkel and the Future of Europe

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

"Worry about going out there and making your own legacy" Floyd Mayweather, Jr.

In the hard knocks world of politics, Angela Merkel looks likely to go down in history, as undefeated in Chancellorship elections as Floyd Mayweather was in the ring. However, her triumph in the late September elections was tempered by the need to form a new ruling coalition to allow her to effectively rule in her eleventh year as Chancellor and beyond. As a student of history, Mrs Merkel will be fully aware of the troubles her political mentor Helmut Kohl ran into near the end of his reign as Chancellor, and will be determined not to repeat these errors.

Fortunately for Mrs Merkel, the current political and economic backdrop for the Eurozone provides plenty of opportunities for the de facto leader of Europe to build this legacy. Whilst the German economy has performed respectfully over recent years aided by an export focus, the rest of the region has struggled, political unity has been poor and the criticism of German leadership has been high - and not just in Southern Europe. There is much work for Mrs Merkel to do and the next five years is likely to be the crucial epoch to achieve this.

Of course she has found a willing high level political partner in the form of Emmanuel Macron, the President of France. In a move reminiscent of the famous Mitterand-Kohl combination of the 1980s and 1990s, the leaders of the two most important Eurozone countries have the opportunity to drive forward the debate on the future of the region at multiple levels. Early signs about this combination are good, with President Macron borrowing much of the tone of the 1990s German labour market reforms in his own efforts to improve the dynamism of the French economy, changes which unsurprisingly Chancellor Merkel has publicly supported.

Fortunately for Mrs Merkel, the current political and economic backdrop for the Eurozone provides plenty of opportunities for the de facto leader of Europe to build this legacy

The next stage is unlikely to be as naturally cordial however. Particularly in a post-Brexit world, the Eurozone will look to simultaneously reform and pull together - in short try to get closer to the classic Anglo-American ideals on entrepreneurship and building economic dynamism, whilst also acknowledging a greater role for regional payment stabilisers and economic and taxation centralisation. The first half of these policies are likely to be well-received both by Mrs Merkel and the German populace, who have long been exasperated by the actions of many of their fellow Eurozone politicians and citizens. The latter is largely privately supported by the German political leadership but, as shown recently by the slightly lukewarm reaction to an idealistic speech by Emmanuel Macron about the future of the Europe, Angela Merkel will tread a little carefully whilst bedding down her likely new political coalition.

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

Setting a Legacy(cont.): Mrs Merkel and the Future of Europe

Name of Federal Republic of Germany Chancellor	Date served
Helmut Kohl	1982 - 1998
Konrad Adenauer	1949 - 1963
Angela Merkel	2005 - present
Helmut Schmidt	1974 - 1982
Gerhard Schroder	1998 - 2005

Source: Wikipedia

Of course we have seen all of this before. Compared to America, or even the UK or Switzerland, the German critique of ultra-low interest rates, quantitative easing, banking sector bailouts or even decisive economic support for the 'Club Med' nations over the last seven or eight years, has hurt the overall performance and political stability of the Eurozone. What is noteworthy however - in a policy I call 'German pragmatism' - is that all of the above measures and policies eventually got enacted with the tacit support of the German leadership. At heart a Merkel-led Germany remains inherently pro-Europe and additionally in favour of a stronger, more cohesive and ideally more dynamic Eurozone. The price though, has always been to largely undertake economic policy measures the German way. Whilst the concept of 'aid for reforms' has a lot of logic and fiscal prudence attached to it, unfortunately it has failed to fire up the Eurozone electorate whose multi-generational belief in a closer European ideal has been severely tested over recent years.

Fortunately, some of the more apocalyptic political choice thoughts for 2017 have failed to occur, with populists failing to take control after elections in countries like France and Holland, whilst internal strife in other materially sized Eurozone countries such as Italy has also not bubbled fully to life. Incumbent mainstream politicians have one more electoral cycle to re-inspire the Eurozone electorate. Angela Merkel will need to continue to exercise not just pragmatism but also a greater feeling of momentum to achieve the more dynamic and more integrated Eurozone she would like. And the best route is by encouraging other countries to look a little bit more like Germany, whilst agreeing with that most un-German policy of loosening the spending purse strings to help ease the transition process.

'Aid for reforms 2' has to be a stronger sequel than the original at both levels, and much more than Angela Merkel's legacy depends on it.

KEY TAKEAWAYS:

- There is much work for Mrs Merkel to do and the next five years is likely to be the crucial epoch to achieve this
- Merkel and Macron have an opportunity to drive forward the debate on the future of the region at multiple levels
- 'Aid for reforms 2' has to be a stronger sequel than the original

Low Volatility: All Quiet on the Market Front?

Kristin Byrnes, *Product Strategy Analyst, Wealth, Retirement & Portfolio Solutions* and
Peter Greenberger, CFA, CFP®, *Director, Mutual Fund Research & 529 Plan Product Management*
share their thoughts on a prolonged lack of volatility and its effects on the market.

The equity markets are the quietest they've been in nearly half a century, prompting industry pundits and investors alike to question why this might be and what it means for the markets going forward. By "quiet," we are referring to a lack of volatility, namely the degree to which markets fluctuate (either up or down) on a daily basis. Generally, more volatile stocks and market indices are perceived to be riskier.

CONVENTION OR CONUNDRUM?

While volatility levels are by no means 'normal' from a historical standpoint, it doesn't necessarily mean they are unwarranted or unprecedented. Keep in mind that volatility doesn't drive the markets; rather, it is merely a byproduct of the market's actions. Understanding the current environment helps to explain this state of complacency.

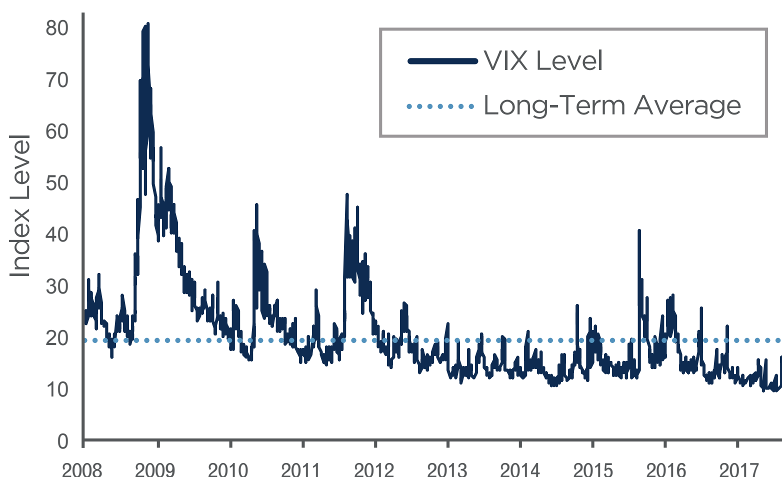
PASSIVE INVESTMENTS

Inflows to passive investments have been on the rise for years now, as longer-term investors seek out lower-cost, tax-efficient, and diversified investment strategies. Index-based strategies allocate assets in proportion to the index, irrespective of individual security analysis. Additionally, increased automated trading by computers and algorithms has reduced the volume of trades marred by human

MEASURING MARKET VOLATILITY

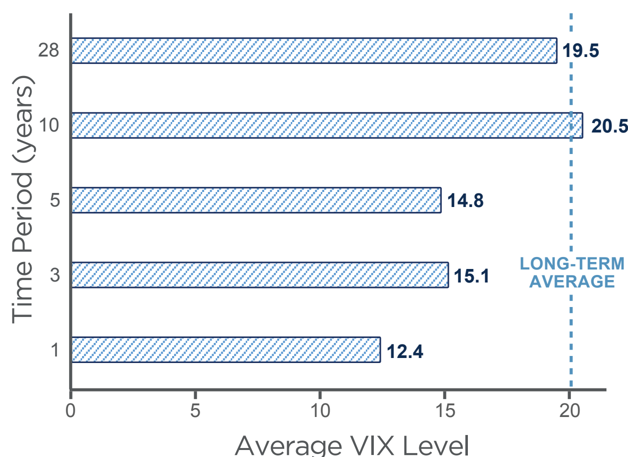
The Chicago Board Options Exchange Volatility Index (VIX), commonly referred to as the investor "fear gauge," measures the market's expectation of 30-day volatility for the S&P 500 Index. It recently neared its lowest level ever, and recent trading has been among the quietest in history.

CBOE VOLATILITY INDEX (VIX)



Source: St. Louis Federal Reserve and Raymond James

AVERAGE VIX LEVEL OVER TIME



Low Volatility: All Quiet on the Market Front? (cont.)

error and emotion, thus decreasing the impact of these traditional (and sometimes irrational) forces behind market fluctuations.

Another school of thought claims that the growth of passive investing has reduced the volume of trades by 'stock-pickers' driven by fundamental analysis, contributing to increased correlations between securities across the board. However, given that intra-stock correlations are now at their lowest levels since the Great Recession, this theory may warrant additional scrutiny.

TECHNOLOGY STOCKS

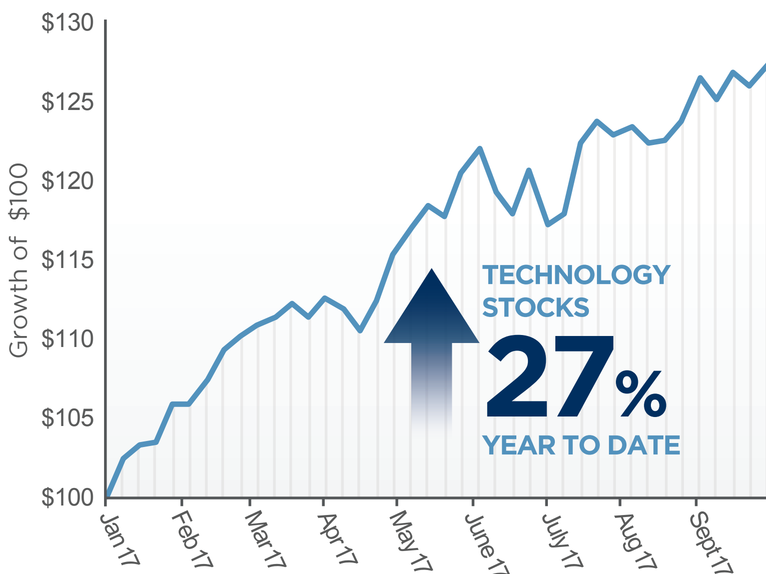
It should come as no surprise that technology stocks have been one of the key drivers of recent U.S. market performance – earning over 27% so far this year.[1] Amongst other areas of the market, investors are treating price declines in this sector as investing opportunities, buying the dips before any negative impact is felt. While it has been most pronounced in the technology space, the willingness of investors to put cash to work during minor drawdowns in the market has helped stabilize and limit some downside that the market would otherwise have experienced.

MARKET FUNDAMENTALS

Despite the fear that markets are overvalued and a pullback or correction is inevitable, we can't ignore the general health of the equity markets. Healthy earnings growth, positive economic growth, and an extended period of low interest rates have fuelled the uptrend in prices for quite some time. Positive earnings estimates going forward are also supportive of further appreciation.

While equity prices certainly are not cheap at the moment, the markets seem to have experienced some structural changes that should be considered when assessing valuations. For instance,

S&P 500 INFO TECH SECTOR PERFORMANCE



"While it has been most pronounced in the technology space, the willingness of investors to put cash to work during minor draw-downs in the market has helped stabilise and limit some down-side that the market would otherwise have experienced."

Source: S&P 500 Info Tech Sector Index

The chart is not indicative of any individual security's performance. The S&P 500® Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector. The index is unmanaged and cannot be invested in directly. The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence. Past performance may not be indicative of future results. There is no assurance these trends will continue. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs which would reduce an investor's return.

[1] Performance as of 9/30/2017.

companies in the U.S. large-cap space with higher margins, more growth opportunities, and a shift from tangible to intangible assets are gaining more and more market share. This begs the question: to what degree are they overvalued? Additionally, is history the most appropriate basis to make this call given these changes?

CENTRAL BANK POLICY

Following the financial crisis of 2008, central banks around the world have been passing out healthy doses of quantitative easing (which injects cash into the system), producing an accommodative, low interest-rate environment flush with cash. Where has much of that cash gone? To the global equity markets, which has resulted in its best performance run since 1998 according to the MSCI All Country World Index.

THE GLOBAL ECONOMY

It's not just financial market volatility experiencing these summer doldrums; global economic volatility has been low as well. Key drivers in the United States include reduced volatility in the job market, smoother corporate profits, and smoother government spending, which has historically been choppy.

Increasing market share of the service sector has contributed to the longer-term trend of quieter economic growth, which has traditionally been one of the less volatile sectors. Additionally, manufacturing is experiencing more consistent growth as advancements in technology continue to improve inventory controls.

WHAT DOES THIS MEAN FOR THE MARKETS GOING FORWARD?

Some market experts do not see this extended period of complacency as the 'new norm' and warn that investors are not accurately accounting for tail risks, or 'black swan' events. While there are valid reasons which support the lack of activity, volatility is likely to return at some point. Whether due to tightening central bank policy or a major geopolitical shock, volatility tends to spike following an unforeseen event, leading to significantly more bearish market responses as opposed to a more controlled increase in activity.

The direction and timing of the markets are anyone's guess, particularly when it relates to unanticipated shocks. Since it seems likely that we just won't know until we know, it's important to manage your investments to the appropriate risk profile to ensure that proper safeguards are in place to protect your assets if and when the equity markets unexpectedly turn.

KEY TAKEAWAYS:

- While current volatility levels are by no means 'normal' from a historical standpoint, it doesn't necessarily mean they are unwarranted or unprecedented.
- Despite the fear that the markets are overvalued and a pullback or correction is inevitable, we can't ignore the general health of the equity markets.
- It's important to manage your investments to the appropriate risk profile to ensure that proper safeguards are in place to protect your assets if and when the equity markets unexpectedly turn.

Diversification does not guarantee a profit nor protect against a loss. The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence. The returns mentioned do not include fees and charges which would reduce an investor's returns. Past performance may not be indicative of future results. Investing involves risk including the possible loss of capital.

Thinking about Q4: Should we Expect the Usual Seasonal Strength?

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

"Good seasons start with good beginnings" Sparky Anderson

For most investors 2017 has been a bumper year versus benchmarks such as cash in the bank. This point was reinforced by year-to-date data up to the end of the third quarter, which showed across mainstream multi-asset class markets in Sterling terms only if you were invested in silver, Brent/crude oil or the Russian stock market did you make a loss.

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So what should we expect for the fourth quarter? History suggests for the equity market 'more of the same' as October and December are two of the top three months using a data set since 1980 for generating a positive return. And if you go back even further, the data is even more compelling as, in the 27 years since 1970, the UK stock market has only seen negative returns in October in six years with only December having a smaller number of losses observations.

That sounds like good news. However, two other elements need to be considered which are often interlinked: events and October's penchant for volatility.

There are many factors which induce volatility in stock markets and also, at any one time, many potential worries for investors. Issues such as tensions building in the Korean Penisular do cast a long shadow but are difficult to predict. Meanwhile, matters such as the potential for the Bank of England to raise interest rates have been not only flagged, but also in terms of the magnitude of the shift, are unlikely to be especially material or influential per se.

Far more impactful are the twin combinations of fundamental company data and general investor sentiment. As always, the big corporate quarterly earnings disclosures in the six weeks from mid-October will provide multiple insights on individual corporate names, and collectively the broader markets. There remains a clear dichotomy in anticipated UK corporate reporting, between the muted expectations for more domestic centred businesses and the more upbeat anticipation for more internationally centred companies. Value investors may spy a relative investing opportunity but this will only close if sentiment - as best reflected by the value of the Pound on the international foreign exchange markets - continues to rise back closer to the levels it was at before the Brexit referendum.

A fuller renaissance of the Pound is inevitably interwoven with the Brexit negotiations, which appear to be proceeding more along of the lines of both embracing some element of 'transitional arrangements' and being 'bespoke'. Optically this is better as moving away from a very rigid two year timetable for Brexit is considered, by most market participants, as likely to reduce shorter-term risks to trade, jobs and economic growth. However, the grey cloud of political uncertainty still lingers and, whilst the UK government retains only a slim majority, multiple scenarios still exist. Historically, one observation would be that politicians rarely vote for their own demise, and this provides the opportunity for the current government to continue deep into its Parliamentary tenure.

Politics and Brexit resonate with global investors looking at the UK. Concerns have been high for over a year now and regularly, in well-renowned global fund management surveys, the UK has consistently been at or near the bottom of allocation tables versus historic norms. Such low sentiment of course can be as much an opportunity as a

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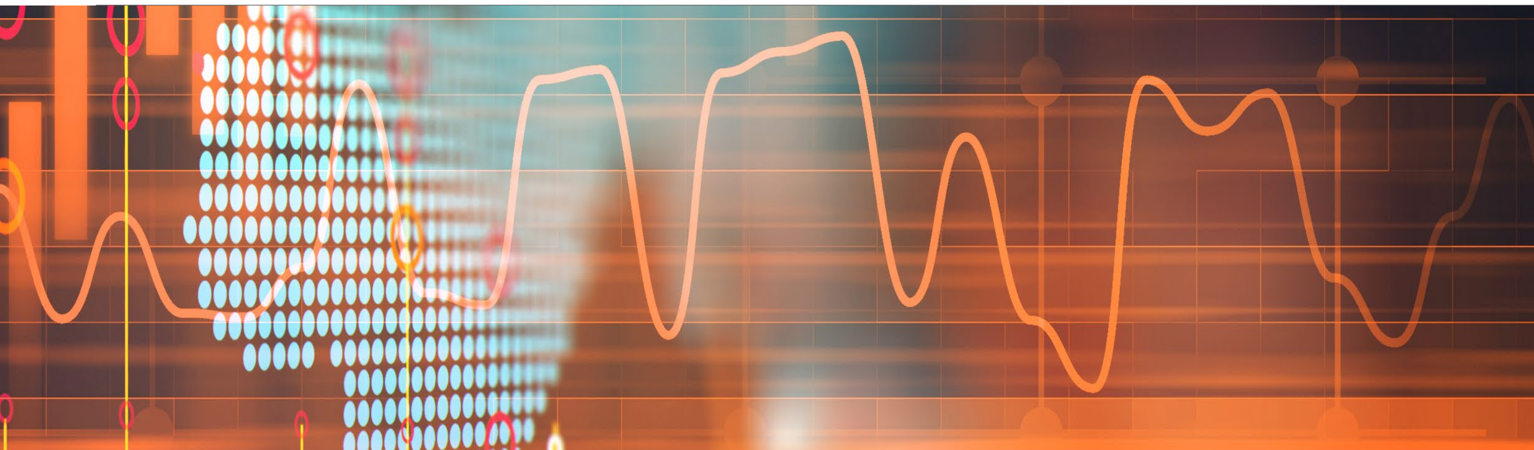

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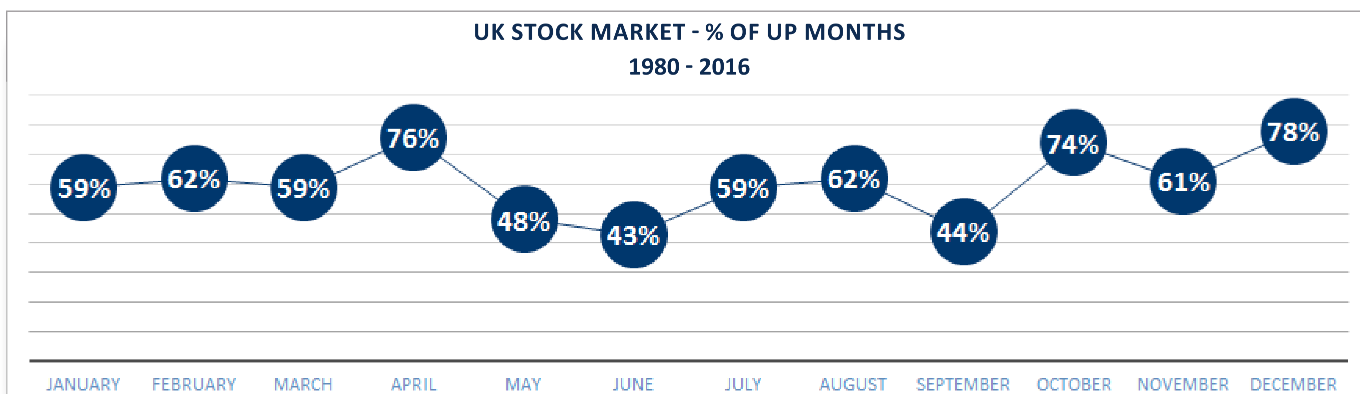
threat, as any signs of positive progress in Brexit discussions and/or enhanced domestic political certainty can help induce current very underweight positions to become... less underweight. We have already seen the Pound lifting against many global currencies - apart from the Euro - as a worrisome world starts to develop different shades of grey. These heavy global sentiment underweights are maybe the most compelling reason to be looking for opportunities in the UK.

And talk of the Euro and Europe per se highlight another important factor. After a number of years of strong financial market performance, further change and reform by governments in the Eurozone, Asia and the Americas can also be influential as a rising global tide can help lift most boats. Watching the progress of governments and reform initiatives across the world will be highly influential for the UK market during the fourth quarter as this is one method how already firm valuations can rise further.

Recent history suggests the fourth quarter will be friendly to investors, but for this to occur again keep watching corporate earnings, global government reform initiatives, UK political stability and the Brexit discussions. In short... keep watching everything. It remains a financial market backdrop where active participation is both sensible and necessary.

KEY TAKEAWAYS:

- Recent history suggests the fourth quarter is a stronger-than-average period for returns
- Watching fundamental company data and general investor sentiment will be particularly important
- Keep actively engaged with markets - there is a lot going on at the moment



Source: UK Stock Market Almanac

Q&A: US Company Consolidation

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

Q. IS THE US STOCK MARKET EXPERIENCING A CONSOLIDATION OF POWER AMONG A FEW OF THE LARGEST COMPANIES AND, IF SO, WHY?

A. The US stock market is shrinking in terms of the number of publicly traded companies, a fact that is both a result of, and contributing factor to, the increasing importance of a select few, large companies. Since 1996, the total number of listed stocks in the U.S. has been cut in half – from 7,322 to about 3,600 – as annual mergers and acquisitions have doubled and the average number of initial public offerings per year has dropped considerably. Meanwhile, the share of gross domestic product (GDP) generated by America's 100 biggest companies rose from about 33% in 1994 to 46% in 2013, meaning not only are there fewer firms in total these days, but a small number of them are taking a greater piece of the pie.

The concentration at the top is, of course, primarily weighted toward the big technology companies, all of which have seen their products and services become increasingly integrated into the lives of their loyal customers. Through innovation, acquisition and the power of so-called 'network effects,' these modern-day conglomerates have built dominant, industry-controlling brands that continue to gain value as their huge user bases expand. The digital age has witnessed data evolve into the most important commodity in the world, and much of the success of these large tech companies is due to the ever-widening 'data moat' that exists between them and up-and-comers lacking that established network of billions of existing customers.

Q. SHOULD INVESTORS AND CONSUMERS BE WORRIED ABOUT THE GROWING IMPORTANCE OF MEGA-CAP COMPANIES?

A. Despite the growing importance of these technology companies, the impact of the ten largest stocks in the S&P 500 has not really changed much over the last 40 years, even if the specific names on that list have changed. The ten biggest stocks currently make up a shade over 20% of the index's market capitalization, which is right around the average since 1980 when the more cyclical energy sector helped the ten largest companies represent a dominating 25% of the S&P 500. Today's large tech companies also happen to be some of the most profitable, with Apple, Google, Facebook and Microsoft alone accounting for about 10% of the S&P 500's total profits. As such, technology's place at the top of the market is not unwarranted. Moreover, roughly 23% of the S&P 500 that technology represents today is nothing compared to the 34% it comprised back in March 2000 at the peak of the dot-com bubble. Considering American corporate profits (as a percentage of GDP) are higher than they have been any time since 1929, elevated valuations in the stock market are warranted and investors don't appear overly concerned.

Consumers have also benefited in a big way, with technological innovation throughout history helping to bring down costs and prices, while making lives more convenient and requiring less manual labour. As per *The Economist,* tech companies provide Americans and Europeans with an estimated $280 billion-worth of "free" services per year, such as search results or directions. Even the stuff customers purchase provides tremendous bang for each respective buck. In their book *Abundance,* authors Peter Diamandis and Steven Kotler estimate that modern smartphones contain roughly $900,000 worth of applications based on each piece of technology's original manufacturer's suggested retail price in 2011 dollars (video conferencing, GPS, video camera, etc.), which illustrates the value being created by tech's game-changing companies. It's no wonder these disrupting forces are raking in the profits and the cash.

The companies engaged in the technology industry are subject to fierce competition and their products and services may be subject to rapid obsolescence. Dividends are not guaranteed and will fluctuate. Past performance may not be indicative of future results. Investing involves risk including the possible loss of capital.

Q. HOW ARE THE BIG COMPANIES USING ALL THAT CASH?

A. The success of the mega-cap stocks has not only produced extraordinary profits, but it has also left the big tech companies with unprecedented levels of cash. As of June 2017, Apple, Alphabet, Microsoft, Amazon and Facebook together held $330 billion in cash (net of debt), and the S&P 500's corporate cash as a percentage of current assets has basically doubled since 2000. Naturally, companies have had to find effective ways to use this cash; there has been a clear uptick in dividends, share buybacks, merger & acquisitions activity, and capital expenditures over the last several years. The share buyback policies have come under some criticism since they can help artificially boost earnings and sales per share numbers. However, buying back stock has been shown to help shareholders, and that is not the only way companies

SMARTPHONES CONTAIN ROUGHLY

$900,000

WORTH OF APPLICATIONS

Q&A: US Company Consolidation (cont.)

have been able to grow their businesses. The five aforementioned tech firms alone spent $100 billion last year on research and development (three times more than half a decade ago). These firms are definitely investing in the future. Finally, there is an estimated $2.4 trillion in cash held by U.S. companies overseas that is just sitting there not contributing much. Should tax reform occur next year and overseas cash comes home, Raymond James estimates share buybacks and the repatriated cash could improve S&P 500 earnings by an additional 1% - 2.5%.

KEY TAKEAWAYS:

- The stock market is shrinking in terms of the number of publicly traded companies.
- Consumers have benefited in a big way, with technological innovation helping to bring down costs and prices, while making lives more convenient and requiring less manual labour.
- Should tax reform occur next year, and the $2.4 trillion in cash overseas comes home, Raymond James estimates share buybacks and the repatriated cash could improve S&P 500 earnings by an additional 1% - 2.5%.

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TEN BIGGEST STOCKS
CURRENTLY MAKE UP OVER 20%
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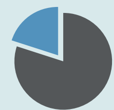
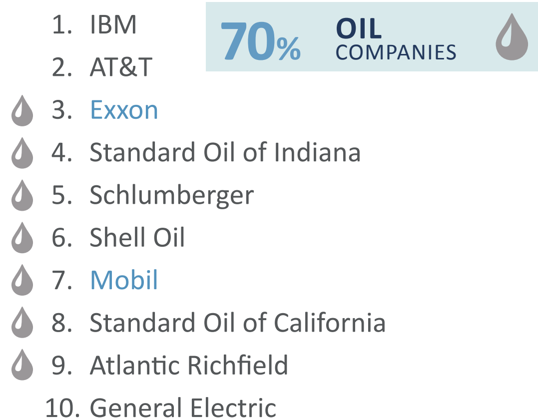
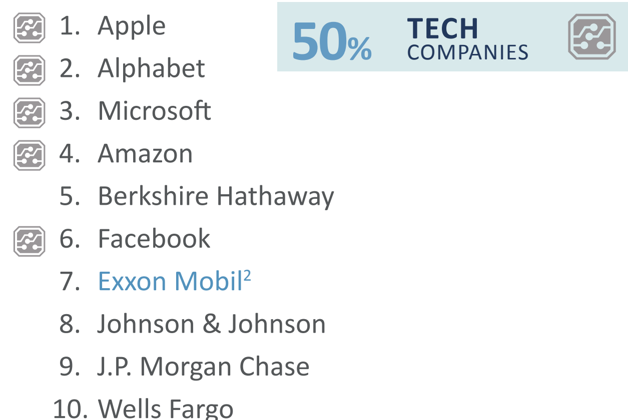
ROUGHLY THE SAME AS IN 1980



THE 10 LARGEST COMPANIES IN 1980 VS. THE 10 LARGEST NOW (BY MARKET CAP)





Source: *Fortune* 500
[2] Merged in 1998

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