PAGE 1 INVESTMENT STRATEGY COMMITTEE MEETING RECAP
PAGE 3 US ECONOMIC SNAPSHOT
PAGE 4 IS THE WORLD JUST ABOUT TO HAVE A TRADE WAR?
PAGE 6 THE EUROZONE: WHERE ARE WE NOW & WHERE ARE WE GOING?
PAGE 8 WHAT IS VOLATILITY?
PAGE 9 LOUD NOISES: THE RETURN OF MARKET VOLATILITY
PAGE 11 SHOULD UK ASSETS BE SO OUT OF FAVOUR?
PAGE 13 THE BOND MARKET: A TUG OF WAR

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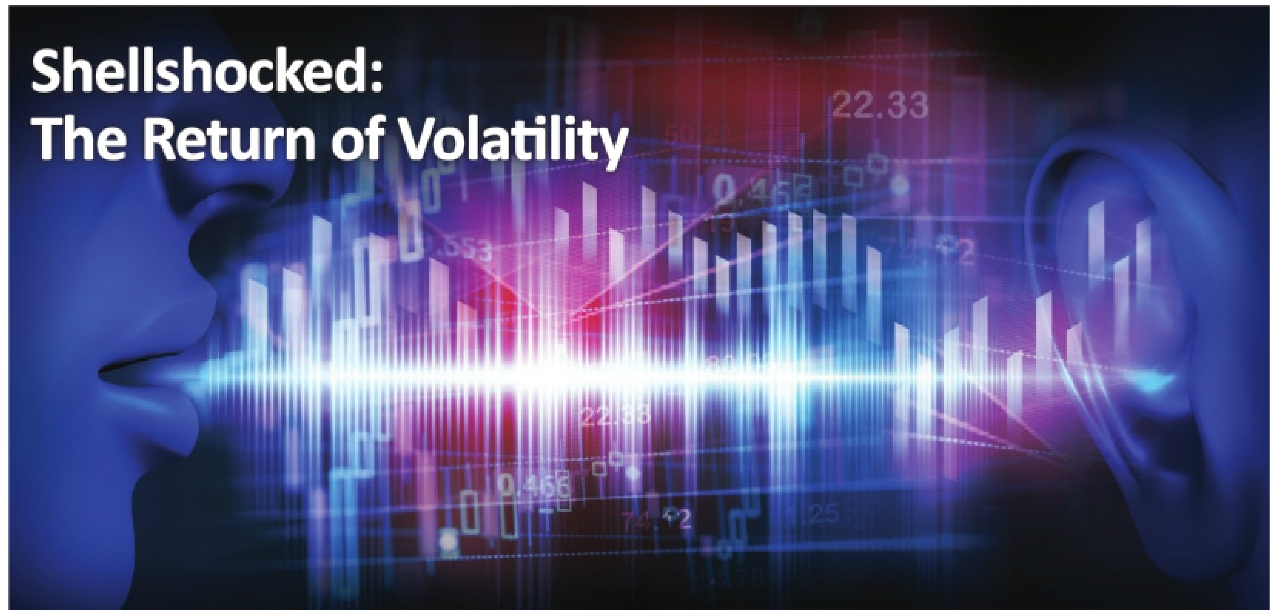
INVESTMENT STRATEGY QUARTERLY



Is the World Just About to Have a Trade War? PAGE 4

The Eurozone: Where Are we Now and Where Are we Going PAGE 6

Should UK Assets be so out of Favour? PAGE 11

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 April 2018. Material prepared by Raymond James as a resource for wealth managers and investors.

RAYMOND JAMES

INVESTMENT STRATEGY COMMITTEE MEETING RECAP – HELD ON MARCH 2, 2018

Major macro factors affecting the economy and financial markets over the next six to twelve months include interest rates, earnings growth, inflation, monetary policy, and global economic growth.

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

The majority of the committee is neutral (2.6%) to somewhat positive (2.7 - 3.0%) on real U.S. GDP growth over the next 6 - 12 months.

- "In a late-cycle economy, the risks of a Fed policy error (raising short-term interest rates too fast or too slow) are increasing, but further gradual rate hikes are to be expected."
- "Economic data for January and February suggests a soft start to the year, but growth is widely expected to remain strong in 2018-19, supported by expansionary fiscal policy."
- "With GDP growth expected to be above its long-term sustainable pace, the unemployment rate is expected to fall further, adding to wage pressures."
- "By themselves, the tariffs on imported steel and aluminum should not have a big impact on the economy. The bigger fear is that we'll see a wider trade war develop, higher input costs, retaliatory tariffs against U.S. exports, and increased uncertainty for global investment."

U.S. EQUITY

77% of the committee is bullish to some degree on U.S. equities over the next six to twelve months.

- "I'm approaching the trade battles as noise items for several reasons. As a reminder, 'noise items' are things that cause equities to pullback but are not extensive enough to derail a bull market."
- "The tariffs are part of the negotiating process. I don't feel either side will be aggressive enough to threaten global growth. For this reason, I think the structural pillars of support for the equity markets- healthy economic and earnings growth- are the two most important variables of a bull market."
- "Other noise items joining trade that are likely to lead to higher volatility in the period ahead include inflation, wage growth, interest rates, and monetary activities."
- "Over half of February's decline was due to systematic trading programs, in my opinion. I don't think a move back to the February low will transpire but should it I don't feel stocks will stay there long. I would be a buyer of weak periods until something changes the prospects for economic and earnings growth."

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

- "As for the markets and tariffs, I think it depends on what kind of retaliatory environment we enter into. It's not a time to panic."

  – **Jeff Saut,** Chief Investment Strategist, Equity Research

- "As we've said, not a lot has fundamentally changed. The market was so extended at the end of January. We had not seen any weakness in so long that the recent pullback used to just be considered a perfectly normal downturn."
- "I think the market's not sure what to focus on right now."

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

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

The entire committee is neutral to bullish on non-U.S. developed market equities.

- "I think you buy Brexit fear and anticipate some positive reform efforts across Europe led by the Macron-Merkel nexus. The corporate earnings season seemed consistent with such a view, given that 52% of reported earnings results from Thomson-Reuters, Stoxx 600 companies exceeded analyst estimates. In a typical quarter, 50% beat analyst EPS estimates. That's a good enough backdrop to stay excited."
- "A weakening U.S. Dollar has helped emerging markets, and Chinese reforms are still positive. By contrast – in Asia – Japan remains a poster child for how not to do things: no reforms and a lot of sustained quantitative easing, which seems to have little impact."

U.S. FIXED INCOME

The majority of the committee sees the 10-year Treasury yield staying the same (2.9%) or increasing over the next 12 months.

- "We have a lot of different forces in the bond market. Some are pushing and some are pulling on rates, creating a little havoc. Stocks and bonds actually have been correlated lately, which is unusual, but we're in an unusual time too. Typically, corrections are prompted by a slowdown in the economy, but now there appears to be fear that the economy's doing too well."
- "You see the government trying to boost the economy through fiscal policy. At the same time, the Fed is pushing short-term rates up and is expected to continue to do so this year. There are both headwinds and tailwinds in place, so I see rates remaining range bound. Perhaps the range is slightly higher."

  – **Doug Drabik,** Senior Strategist, Fixed Income

INVESTMENT STRATEGY COMMITTEE MEMBERS

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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 Senior Manager, Investment Strategy

- "Even though the Tax Reform and Jobs Act lowered individual income tax rates, the top tax bracket is 37% v. 39.6% previously. For investors in the top tax bracket, and especially those who reside in high tax states like California, New York, New Jersey and others, the tax equivalent yield advantage of in-state municipal bonds is highly attractive on a risk/reward basis."

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

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

"All the rhetoric about more Fed rate hikes against the backdrop of expansionary fiscal policy has started to push the Dollar back up versus its recent three-year lows. On the margin, that is negative for oil prices, though declining inventories have been supporting higher prices."

- "The other issue is the new steel tariff. Drilling, extraction, and pipeline transportation of oil and gas is a steel-intensive supply chain. Pipes, drilling rigs, tubular goods – all of that requires steel in large quantities."
- "The U.S. oil and gas industry has a cost advantage over much of the world, and that advantage should still remain in place, but clearly the steel tariff is unhelpful in this regard. For example, some of the proposed Gulf Coast energy infrastructure projects may be postponed or even canceled."

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

"We still have the same issues holding back construction: inflation and labor constraints. As long as residential fixed investment isn't taking a dive, meaning that the consumer stops buying or spending on his house, we are in good shape."

- "Look, everything's good in housing. We probably have too much multi-family housing right now. In our research and outlooks for 2018, we went underweight apartments. We have a little too much supply coming at us. This will work itself out on the demand side of the equation, but this is not the year to be owning apartments. It's still the year to own the homebuilders."
- "Steel tariffs will affect the costs of commercial real estate since these buildings are made out of concrete, glass, and steel, whereas residential is primarily built with lumber."

Economic and market conditions are subject to change. Investing involves risk including the possible loss of capital. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI). With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region. Changes in tax laws or regulations may occur at any time and could substantially impact your situation. You should discuss any tax or legal matters with the appropriate professional. Legislative and regulatory agendas are subject to change at the discretion of leadership or as dictated by events.

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US ECONOMIC SNAPSHOT

DR.SCOTT BROWN
Chief Economist,
Equity Research

Economic data reports for January and February were mixed, but generally lacklustre. That's not unusual following a strong quarter and weather may have been a factor. The economic outlook remains strong in the near term, reflecting an expected impact from fiscal stimulus (tax cuts, increased government spending). With the economy at full employment, above-trend growth should further reduce the unemployment rate and push inflation towards the Fed's 2% goal. Barring a substantial pickup in productivity growth, binding labour market constraints will eventually force GDP growth back to a sustainable trend (2% or less). Trade policy adds risk and uncertainty to the outlook.

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	GROWTH	The economy got off to a mixed, but generally lackluster start to 2018, but near-term expectations of growth remain strong. Labor market constraints are expected to restrain GDP growth into 2019.
	EMPLOYMENT	Nonfarm payrolls have continued to expand at a strong pace in early 2018, with overall labor market conditions growing tighter.
	BUSINESS INVESTMENT	Business optimism remains strong. Corporate tax cuts ought to be supportive (but most of that will show up as share buybacks and dividends).
	MANUFACTURING	A strong February following weather-related weakness in January (a moderate pace if you average the two months).
	HOUSING AND CONSTRUCTION	The combination of strong housing demand and continued supply constraints have pushed prices higher. Affordability is expected to remain an ongoing issue.
	REST OF THE WORLD	The global economic growth outlook is strong, but trade policy missteps and uncertainty have the potential to restrain world growth.
NEUTRAL	CONSUMER SPENDING	Retail sales were soft in January and February. Real hourly earnings have risen meagerly year-over-year, but tax with-holding fell in February and gasoline prices have edged somewhat lower.
	INFLATION	Commodity price pressures, while higher, are moderate. Wage pressures are likely to pick up somewhat as the job market tightens further.
	MONETARY POLICY	The risks of a monetary policy error (moving too fast or too slow) rise in a late-cycle economy. Upcoming personnel changes add uncertainty, but the Powell Fed is expected to be more hawkish than the Yellen Fed (that is, more likely to raise rates).
	LONG-TERM INTEREST RATES	Inflation fears are overdone. However, the government's borrowing outlook has shifted dramatically in the last couple of months. Rising budget deficits should put some upward pressure on long-term interest rates.
	FISCAL POLICY	Decreased tax withholding should support consumer spending. The recent budget agreement will boost spending this year and next. Still, there is little scope for action should the economy stumble (later this year or in 2019).
	THE DOLLAR	Tighter Fed policy is usually Dollar positive, but the strengthening global economy has led to greater capital flows away from the U.S. A wider federal budget deficit is also a negative.

Is the World Just About to Have a Trade War?

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

"For all the backlash against globalisation, it's doubled the world 'middle class' in little more than 2 decades to 45%. For all the complaining of jobs lost in the rust belt, how many were created by virtue of the extra 2.3 billion people who can afford to buy made-in-America goods?" David Rosenberg

As any A-Level Economics student will tell you, the 'law of comparative advantage' tells us that every country should concentrate on what they are good at. Maybe they have a plentiful supply of labour to populate manufacturing facilities, they could be blessed with natural resources or a numerate and well-trained population which encourages technology or service sector activities. Real life however, outside the purist Economics textbook, is necessarily much messier. Competitive shifts in the world have real impacts on jobs, wealth and hence politics - leading to a willingness to apply barriers that take the world further away from the ideals contained within the law of comparative advantage.

Such pressures are once again building... and at the centre of it all are the two economies that are singularly the most influential in the world today: the United States and China. The cause of the current trade bickering can be sourced from an event which occurred on 11 December 2001 - the day China joined the World Trade Organisation (WTO) - which opened up its capability to trade globally.

China really loves trade. Go back a generation and the great hope of economic change was to make China the manufacturing hub of the world, taking advantage of the country's plentiful and cheap labour source. And so 'Made in China' became first a more regular sight, and then so much more. However, China's export success has not been costless, and many countries can point to rising trade deficits with the country as their own population's propensity to consume Chinese made products has dwarfed China's additional import needs. Aggregate all this up and most towns and cities in Western Europe or North America can point to an industrial plant or a company who have shifted their location eastwards.

At the centre of it all are the two economies that are singularly the most influential in the world today: the United States and China

Maybe it was always like this. The story of developing economies across Latin America, Asia, Eastern Europe and Africa over the last generation has been centred on their growing popularity as a global manufacturing location. China is not only the biggest, but also has the biggest ambitions.

China's political leadership knows there can be no let-up in the country's economic change lest slowing growth breeds political and social instability among the one billion plus population. So as well as encouraging consumption and urbanisation domestically, there has been a very rapid push behind other initiatives too. The 'One Belt One Road' (OBOR) project envisages a trade zone stretching from China to Western Europe, Africa and even South America. Meanwhile, in anticipation of a swathe of other countries being progressively cheaper places to manufacture, China has set its sights on becoming an important player in all major technology, pharmaceutical and consumer sectors, areas where intellectual know-how rather than the existence of a cheap labour force alone is important.

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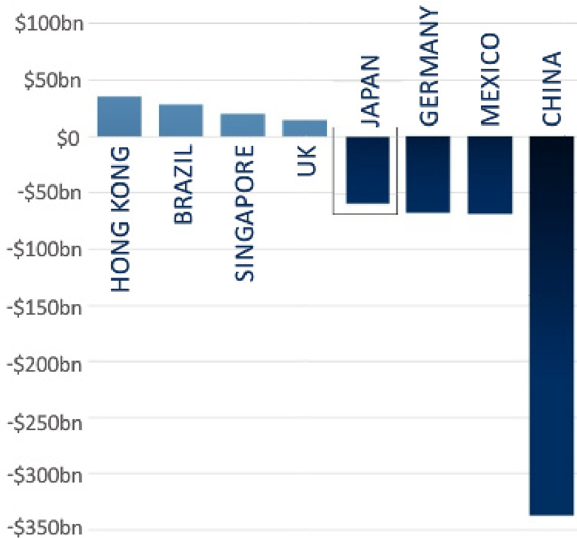
In combination these initiatives have particularly irked the United States who - unlike Europe - are not natural geographic beneficiaries of OBOR whilst the slipping away of manufacturing and more recently some more knowledge-based sector pre-eminence rankles. In short, China appears to be getting stronger economically and diplomatically, whilst the United States is appearing to become weaker.

The United States has a decision to make: to levy new tariffs and other trade impediments with a focus on China to try and shift the balance a little back towards themselves... or to stick with the current trade arrangements and accept a progressively less influential economic and diplomatic role in the world (as Western Europe appears to have concluded). To date they have edged towards the former, but not irrevocably. And the reason why? China is a big purchaser at the margin of US Treasuries issued to help cover the US fiscal deficit. Irking them too much over trade may lead to less Treasury purchasing and higher US interest rates... which never goes down well domestically. Meanwhile China, with an eye on economic growth and domestic political stability, is also wary of antagonising the United States too much, hence so far more of a war of words than any serious trade impediments.

> The history books tell us that more overt trade wars tend to be lose-lose for all concerned over time

So the issue is finely poised and, unsurprisingly, a concern for global capital markets today. Certainly the next step lies with the United States. My instinct remains that the US administration hopes that they can get some concessions on issues like aggressive product dumping at loss-making prices, intellectual property theft and the opening of new sector markets in countries like China, by talking loudly and aggressively. Overplay that hand though and the history books tell us that more overt trade wars tend to be lose-lose for all concerned over time. Just ask an A-Level History student who is looking at the Great Depression in the 1930s if you do not believe me.

2017 US TRADE SURPLUS AND DEFICIT



Source: United States Census Bureau

KEY TAKEAWAYS:

- The source of the current trade bickering can be dated from when China joined the WTO
- China has set its sights on becoming an important player in multiple areas of the economy
- The United States fears becoming weaker economically and diplomatically
- The issues are finely poised and unsurprisingly a concern for global capital markets today

The Eurozone: Where Are we Now and Where Are we Going?

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

"We have a lack of growth in Europe, in Eurozone, and in France, and we are struggling hard to recover and restore this growth"
Emmanuel Macron

You only need to focus on European issues for a while to know that it is rarely plain sailing in the Eurozone. Whilst Southern Europe's economic travails have abated a little and Mrs Merkel has managed to form a new German government, three key issues directly overhang the single currency area even if we assume that the knock-on impacts of the Brexit discussion are manageable.

> Three key issues directly overhang the single currency area even if we assume that the knock-on impacts of the Brexit discussion are manageable

The first of these is just what exactly the aforementioned Mrs Merkel and President Macron of France are going to do with their collective political power. The German-French nexus is hugely critical for the future of the Eurozone because it dominates both the financial and emotional heart of the region. Simply put, for anything to really 'work' in the Eurozone, this relationship has to be very tight and cohesive.

The signs since the ascendency of President Macron have been good. His commitment to economic reform - which is currently receiving the obligatory test via a series of public and private sector strikes - has struck a chord in Germany, who have long called for such actions. Meanwhile, Mrs Merkel's weakened position as she enters her highly likely last few years as German Chancellor has meant she is naturally more engaged with talk about strengthening core Eurozone institutions. Both these broad initiatives are long overdue and, if momentum is kept up, puts the Eurozone on a much better footing going forward. An upcoming conference in June appears to be a critical juncture.

The benefits of both these actions will have a direct impact on the second key issue overhanging the Eurozone: Italy. The third most important Eurozone economy continues to have a difficult time with inconclusive elections and sluggish (although at least now positive) economic growth. The ongoing complex and drawn-out negotiations to form the next Italian government, after a General Election where a populist party initially set up to protest against the political establishment of both the right and left gained the biggest share of the vote, appears to say it all. However, some progress has been made in recent months with the important banking sector on a firmer footing and the quelling of any debate concerning Italy leaving the Eurozone. More needs to be done. Italy - and the other southern Eurozone countries - need to be inspired by French and German efforts to make the Eurozone more dynamic, to help form a virtuous economic and political circle with more jobs, confidence, investment, economic reform and ultimately, votes for more mainstream political parties.

Fortunately for both the above matters, the third key issue - the policy position of the European Central Bank (ECB) - appears to continue to be very helpful, at least for this year. The Eurozone currently has negative interest rates and an ongoing expansive quantitative easing stimulus policy which is helpful in boosting economic growth potential.

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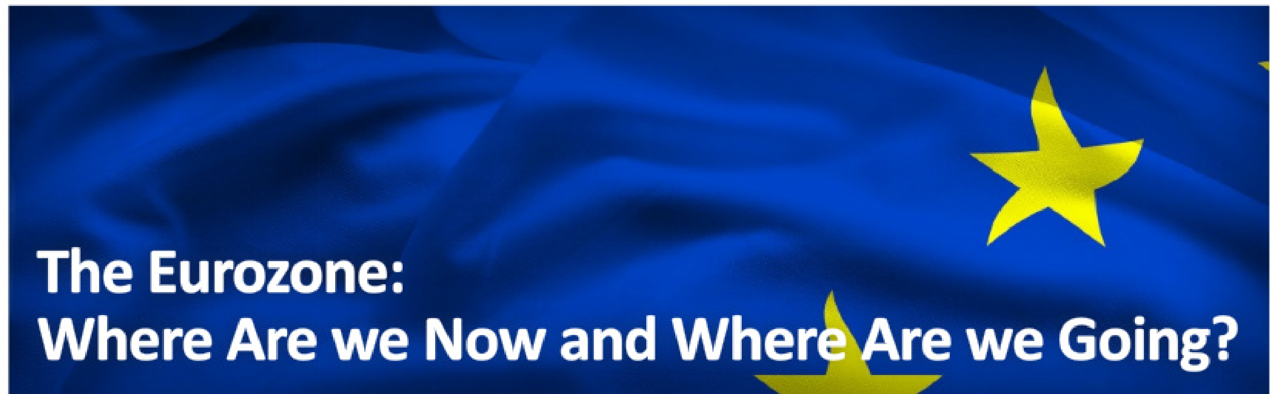
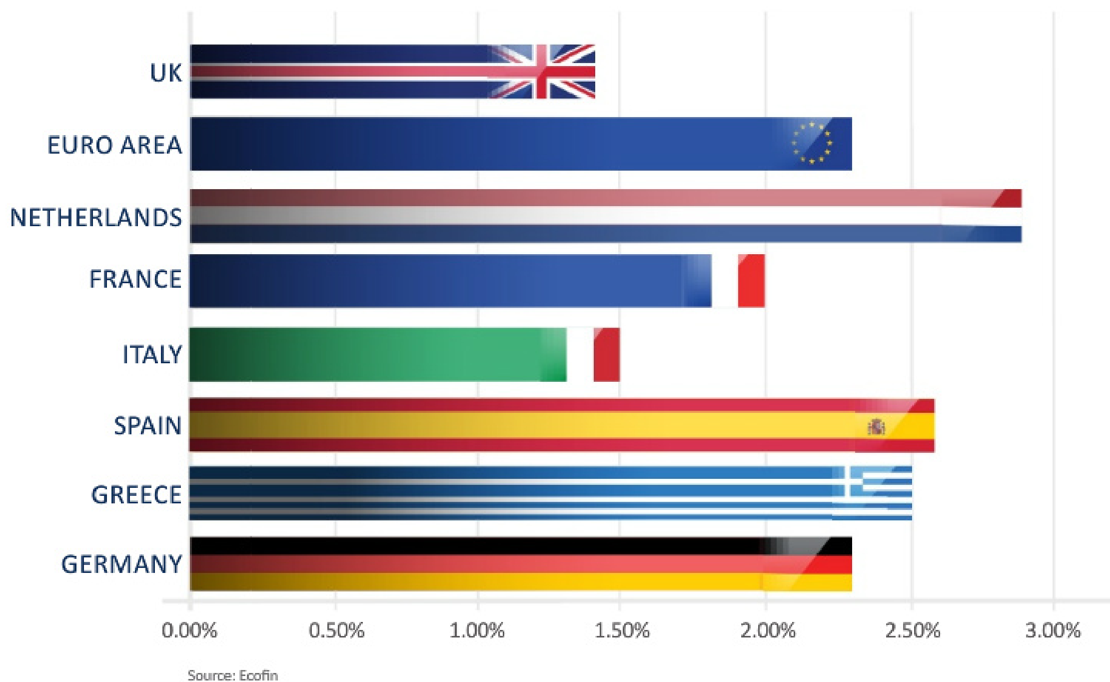


This expansive backdrop will not be around forever with my forward expectations that no new quantitative easing will be applied in 2019, which will also be a year when Eurozone interest rates push back above zero. By historical standards, this would still represent a very loose policy backdrop but would not be quite as helpful at the margin.

Pulling it all together, there is no time like the present for the Merkel-Macron double act to really step up. The good news is that they seem to understand the need for action, but they need to start delivering and inspiring. If they can step up, Eurozone equities - and the Euro - should set fair for the rest of the year versus, for example, their nearest big regional peer: the American market and the US Dollar.

KEY TAKEAWAYS:

- The German-French nexus is hugely critical for the future of the Eurozone
- An upcoming conference in June appears to be a critical juncture
- Southern Eurozone countries need to be inspired
- The policy position of the ECB will be very helpful, at least for this year



Source: Ecofin

Peter Greenberger, CFA, CFP®, *Director, Mutual Fund Research & 529 Plan Product Management,* explains volatility – the degree to which an investment or market value changes over time.

Equity markets are inherently more risky than bond markets, meaning they are more likely to experience large price swings at any given time, whereas high-quality bonds typically see more muted price movements.

Volatility is the degree to which an asset's price fluctuates. So, how do investors measure volatility in order to identify periods of heightened perceived risk in the market?

The Chicago Board Options Exchange (CBOE) Volatility Index (VIX), commonly referred to as the 'investor fear gauge,' is a popular measure of the stock market's expectation of volatility implied by S&P 500 Index options. The index measures the expected range of price movement in the S&P 500 Index over the next 12 months. A VIX reading of 10 indicates an expected annualized change of 10%.

A high VIX reading is not necessarily a bad thing as prices can move in either direction. In other words, high VIX readings mean investors see significant risk that the market will move sharply, whether downward or upward. General consensus views a VIX reading over 30 as high perceived risk, whereas levels below 20 are viewed as low perceived risk.

Loud Noises: The Return of Market Volatility?

Nicholas Lacy, CFA, *Chief Portfolio Strategist, Asset Management Services,* reflects on how markets adjusted to increased uncertainty in the first quarter; not all assets performed as one would have expected.

U.S. equity markets soared to record highs at the end of January only to reverse course into a freefall over the next several days. The remainder of the first quarter was choppy as investors grappled with increased uncertainty following an extended period of steady gains against a quiet market backdrop.

The sudden increase in volatility led to the largest one-day decline in the history of the stock market on an absolute point basis with the S&P 500 dropping over 115 points on Monday 5 February. However, the move only represented a 4.16% decline on a relative basis. It was strikingly similar to the crash on 19 October 1987 (also known as Black Monday), as leveraged products and computerized trading programs, not individual investors, were triggered to sell off equities.

In fact, individual investors remained relatively calm throughout the quarter as lingering memories of the 2008 financial crisis and subsequent recovery had them thinking twice about hastily exiting the market. Backed by a healthy global economy and increasing revenues and earnings expectations for U.S. companies, the noise of the headlines seemed to be just that. Noise.

NOT SO DEFENSIVE EQUITY

While the market correction may have caught some off guard, even more surprising was the underperformance of defensive equities that have historically held up in down markets. Various sectors including Real Estate Investment Trusts (REITs), Energy, and Telecom typically pay higher dividends, which should have cushioned prices relative to the overall market. However, downward pressure on bond prices escalated losses for these stocks due to their natural sensitivity to interest rates.

WHAT DIVERSIFICATION?

While one would expect bonds to rally during a market downturn, investment-grade bond prices slowly declined throughout the quarter as interest rate pressures prevailed. We should not be surprised that bond prices are falling as interest rates have been on the rise since the end of 2015, and we have yet to see longer-term yields rise much. This can be problematic as the Federal Reserve (Fed) is expected to continue raising short-term rates this year, potentially causing further flattening of the yield curve.

A flattening yield curve has traditionally been viewed as an indicator of negative market sentiment toward long-term growth of the economy. With long-term rates inching up and the yield on the 10-year Treasury approaching the 3% mark, this issue could very well be a moot point. So, what is the market telling investors?

CONFIDENCE IS KEY

Looking ahead, the market may have more confidence in both economic growth and inflation expectations, and global equity markets appear poised for another above-average year in market returns. A steeper yield curve (the difference in the 2-year and

10-year Treasury rates) has historically been a positive signal for equities and may help boost corporate earnings, especially within the Financials sector.

FIXED INCOME: DUE FOR ITS OWN CORRECTION?

> "The market may have more confidence in both economic growth and inflation expectations, and global equity markets appear poised for another above-average year in market returns."

U.S. investment-grade bonds have rarely lost money in the past 30 years. The most significant loss was in 1994, when the Fed unexpectedly increased the Fed funds rate by 50 to 75 basis points each time. Lack of transparency in the magnitude and timing of these increases led to a negative reaction from the markets.

On the other hand, post-financial crisis policy has been openly and clearly communicated by the Fed, minimizing the surprise element of Fed actions. While it is likely that bond prices will finish the year lower than they started, fixed income remains a foundational element of a diversified portfolio and should continue to serve as a ballast amidst turbulent equity markets.

> "'Don't try to market time the diversification benefit of bonds.'[1] Investors need to understand why they own certain asset classes. Bonds are for the stability they create in the portfolio, and the cash flow they create for the investor."
>
> – Ted Ruddock, Head of High Net Worth, Fixed Income Services.

KEY TAKEAWAYS:

- Individual investors remained relatively calm throughout the quarter as lingering memories of the 2008 financial crisis and subsequent recovery had them thinking twice about hastily exiting the market.
- The underperformance of defensive equities was surprising. Various sectors including Real Estate Investment Trusts (REITs), Energy, and Telecom, have historically held up well in down markets since they typically pay higher dividends, which should have cushioned prices relative to the overall market.
- Global equity markets appear poised for another above-average year in market returns. A steeper yield curve has historically been a positive signal for equities.
- Fixed income remains a foundational element of a diversified portfolio and should continue to serve as a ballast amidst turbulent equity markets.

REITs involve risks such as refinancing, economic conditions in the real estate industry, changes in property values and dependency on real estate management. Bond investments are subject to investment risks, including the possible loss of the principal amount invested. The yield curve is a graphic depiction of the relationship between the yield on bonds of the same credit quality but different maturities. U.S. Treasury securities are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and guaranteed principal valueThe S&P 500 is an unmanaged index of 500 widely held stocks. It is not possible to invest directly in an index.

[1] Tony Crescenzi, PIMCO

Should UK Assets be so out of Favour?

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

"A weed is but an unloved flower" Ella Wheeler Wilcox

You always get interesting results when you regularly ask the opinions of fund managers around the world who collectively manage hundreds of billions of Pounds of assets. In a particularly popular recurring monthly survey, one of the most interesting insights is in which sectors, countries or asset classes the fund managers are currently overweight or underweight today versus their allocation norms. Among the more recent most overweight areas have included technology and banking stocks as well as emerging market and Eurozone regional equities. However, the most out of favour area for over a year has consistently been UK assets.

We can trace the origins of this unpopularity to the aftermath of the Brexit referendum vote in mid-2016, where the closeness of the vote raised concerns about both the economic impact of this decision as well as the political cohesion of the country. By the time of the much tighter than anticipated General Election of nine months ago, these fears had materially grown. There is little that investors fear more than uncertainty and both events buoyed such concerns.

Is the degree of these concerns still so valid however? If you look dispassionately at the Brexit debate, the big concern of fund managers would be that the UK leaves the European Union and falls down a cliff edge of uncertain trade relationships and new/higher tariffs. Clearly many issues still need to be decided upon before we have clarity on trade relations between the UK and the continuing European Union, let alone the rest of the world. Fortunately, recent discussions have introduced a further transition period of twenty-one months beyond the late March 2019 Article 50 period, allowing a longer period of time to conclude the still continuing discussions. Many issues - for example the practicalities for trade over the land-based Irish border - remain to be finalised, but the key conclusions from the last few months would be that some progress has been made, the negotiating teams do now have a little more time and hence, the cliff edge fear should not be so acute.

We then move to UK domestic politics. Again looking dispassionately, the biggest fear after the General Election of last June was political paralysis and/or another General Election. Both factors have become less likely in recent months with the ruling Conservative coalition not only in the lead of some recent opinion polls but also showing no current signs of an imminent fracturing, despite rigorous debate on issues such as the aforementioned Brexit.

A week - famously - is a long time in politics, and key decisions in the Brexit negotiations can spill over into political volatility and vice versa, however I would observe that this interplay between political strength and reform/change programmes exists in most other countries too. Admittedly, a return to Congressional gridlock in the United States after the mid-term elections later in the year, or a failure by the French President to get traction for his country's reform plans, may not have such a material impact on economic growth potential - but then the United States or the Eurozone (or other parts of the world) are not as already disliked as the UK is. In short, material uncertainty is already factored in.

A good way to gauge this is to look at the Pound. After a year when it sparred with the Argentine Peso to be the worst performing major global currency, Sterling has had something of a renaissance in recent

> The big concern of fund managers would be that the UK leaves the European Union and falls down a cliff edge of uncertain trade relationships and new/higher tariffs

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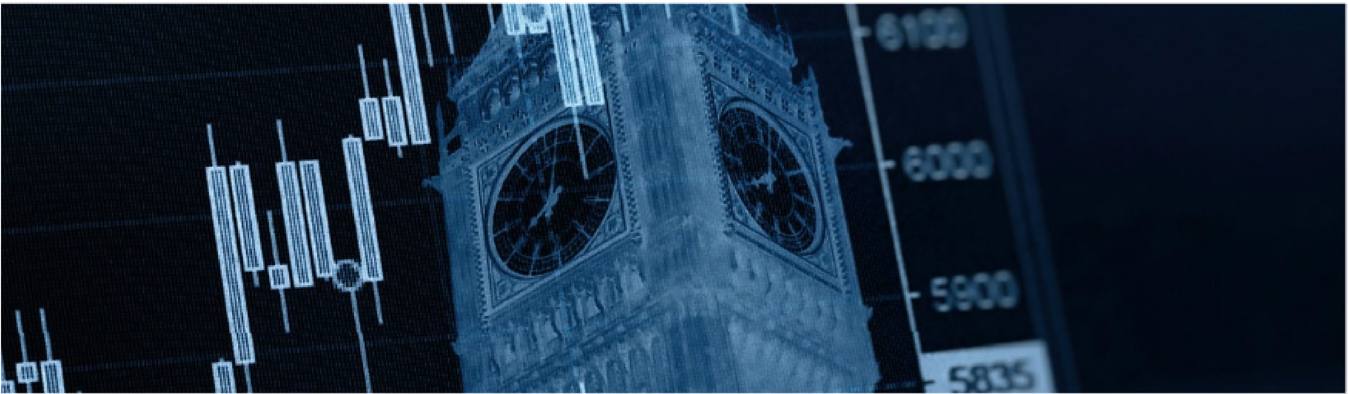


months, rising smartly against the US Dollar and holding in a tight range against the revitalised Euro. I have always thought that a currency's performance offers a good insight into how a country is perceived by global investors... and this better performance augurs well for a perception improvement in UK assets.

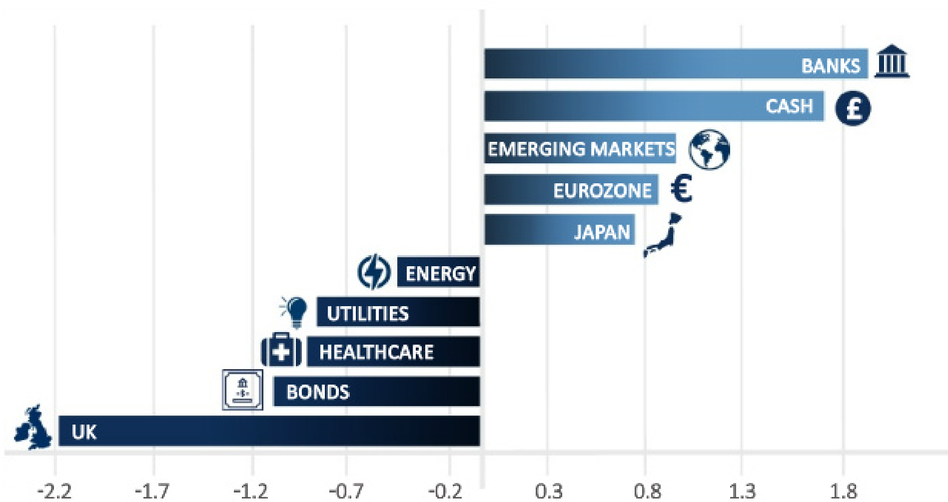
Certainly Sterling's interplay with large cap UK equity performance could fill another article, but in combination it is no barrier for global investors to become more appreciative of UK assets. For me, when I consider the issues of the day, UK assets should not be as unloved as they currently are by global investors.

Legendary investor Warren Buffett once urged others hoping to follow his path to 'Be fearful when others are greedy. Be greedy when others are fearful'. I know which part of his investment aphorism is the more applicable to UK assets today relative to other global opportunities.

KEY TAKEAWAYS:

- For global fund managers the most out of favour area is UK assets
- However, the Brexit cliff edge fear should not be so acute
- Some uncertainty on domestic political matters is already factored in
- The Pound's better performance augurs well for a perception improvement in UK assets

MOST OVERWEIGHT AND MOST UNDERWEIGHT AREAS VERSUS HISTORY



Source: BoA-ML Fund Manager Survey March 2018 - The number of standard deviations from the mean point generated by the data gathered over at least the last 12 years

The Bond Market: A Tug of War

Doug Drabik, *Senior Strategist, Fixed Income Services,* and **Nick Goetze,** *Managing Director, Fixed Income Services,* share how interest rates are influenced by the competing forces of inflation, fiscal policy, global demand, and the Federal Reserve.

The bond market has not experienced volatility to the extent that the stock market has in recent months. Instead, it appears to be suspended in a tug of war between competing forces, balancing healthy economic data and uncertainty of the future fiscal landscape.

After an extended period of low interest rates, pundits have inaccurately prophesied a reversal in interest rates for years. However, current economic conditions are revealing valid factors supportive of higher rates. But how high, how quickly, and how robust of a rate movement is probable? It is very much up for debate.

HEADWIND FORCES

Plenty of headwinds for higher interest rates still exist. If interest rates move too high, too quickly, the economy could promptly halt its healthy pace of growth. High rates will affect borrowing adversely, diminishing business and consumer participation.

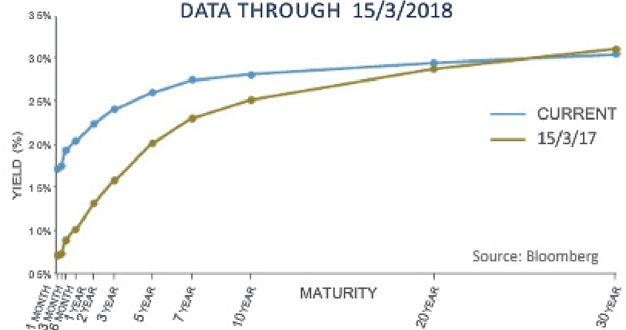
CENTRAL BANK INTERVENTION

Global central bank intervention comprises over $20 trillion in assets, up from pre-recession levels of $6 trillion in November 2007. This collective sum includes the balance sheets of the four major central banks: the Federal Reserve (Fed), the European Central Bank, the People's Bank of China, and the Bank of Japan. At the current pace, aggregate balance sheet assets could top $24 trillion by year's end.

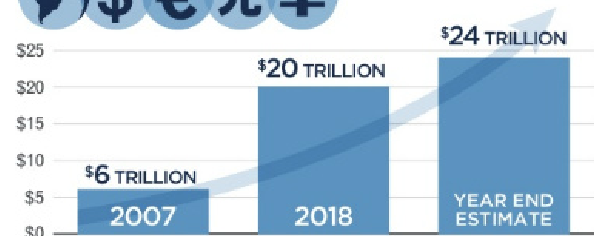
Despite the proclamations of other central banks, the Fed is the only central bank that has stopped open market purchases and is slowly reducing its balance sheet. The importance of these actions cannot be overstated. It is worth noting that the money that the Fed injected into the economy via quantitative easing and open market purchases largely did not fund the production of goods or services rendered. Rather, these sums flowed into the global stock and bond markets, fueling their rise in recent years. Even if other central banks halt their open market purchases, the significant influence of this newly created money persists.

U.S. TREASURY YIELD CURVE

DATA THROUGH 15/3/2018



AGGREGATE BALANCE SHEET ASSETS



INTEREST RATE DISPARITY

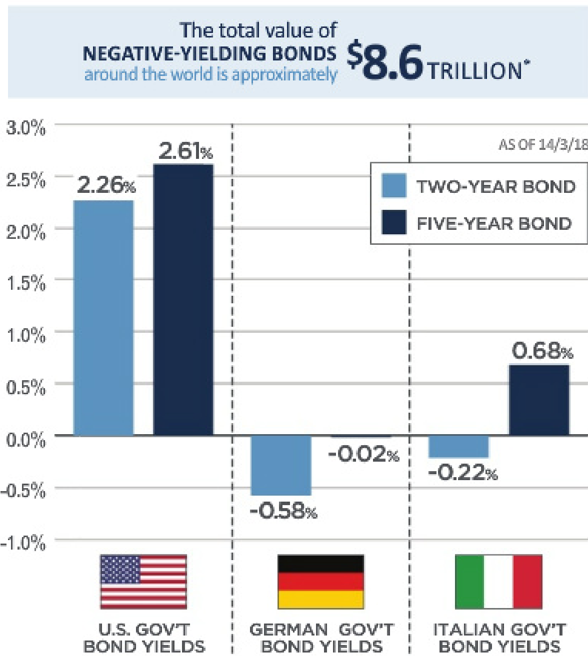
In addition, interest rate disparity continues. Five-year government bonds currently yield 0.68% in Italy and -0.02% in Germany, while they fetch 2.61% in the United States. Moreover, many bonds currently carry negative yields. As counterintuitive as it may seem,

investors are willing to pay to lend money to governments around the world whereas traditionally investors would receive interest from the borrowers.

For example, the yield on the two-year government bond in Germany is currently -0.58%. In other words, investors pay the German government 0.58% to hold their two-year bonds. The total value of negative-yielding bonds around the world is approximately $8.6 trillion. When investors can achieve a positive 2.61% yield from an economic leader such as the U.S., demand for U.S. government bonds will likely be a noteworthy headwind to rising interest rates.

GLOBAL SOVEREIGN BOND YIELDS

With many sovereign bonds having negative yields, demand for U.S. government bonds continues to be a noteworthy headwind to rising interest rates.



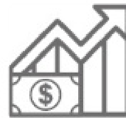
Source: Bloomberg and Raymond James

DEMOGRAPHICS

Finally, an aging population that controls a majority of wealth may prove to be less of a spirited consumer and more of a saver. If interest rates rise, it will encourage a more normalized transition from growth assets to fixed income.

TAILWIND FORCES

Unsurprisingly, the tailwinds behind higher interest rates have captured both headlines and momentum. However, investors should proceed with caution. Equities move much more on momentum than interest rates and bonds. In terms of economic metrics, inflation remains the central focus (as it has for the past several years).



INFLATION

The Fed has sought to bring inflation to 2% as measured by the Personal Consumption Expenditures Price Index (PCE). The index has been rising slowly, leading to an unbalanced amount of volatility and slightly higher interest rates. However, the most recent release on March 1 came in at 1.5%, still well below the 2% target.

The Fed is attempting to balance full employment with its long-term stable inflation target of 2%. Its belief is that by observing the data and slowly hiking short-term rates (potentially two to three more times in 2018), it can reach this balance without the economy overheating. As inflation has inched up, the market reaction has been clear: if the market believes inflation is trending up, it will drive interest rates higher.

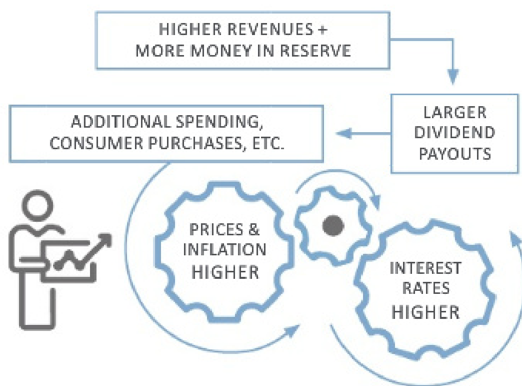
FISCAL POLICY

Fed Chairman Powell has pointed to the reversal of a headwind with fiscal policy. The Tax Cuts & Jobs Act has clearly created substantial change. The bill is likely to free up capital for both businesses and individuals. Higher revenues, larger profits, and lower price/ earnings ratios are all potential benefits.

Higher revenues may show up in a variety of ways: larger dividend payouts, stock repurchases, plant or equipment improvements, and consumer purchases. More money in reserve

*Barclays Global Aggregate Negative Yielding Debt Index as of 22/3/18.

(for both individuals and corporations) may translate to additional spending, which in turn may push prices and inflation higher, eventually driving interest rates higher.



THE FED

Although central bank open market purchasing activity has clearly been a headwind to higher interest rates, the mere suggestion that this policy will change has been enough for some investors to anticipate a directional rate change. The Fed has been much more direct in communicating and executing its strategy of raising short-term rates. The Fed raised short-term rates four times since the beginning of 2017, for a total of six times since December 2015. It is anticipated that it will hike rates two to three more times this year. While these hikes only impact short-term interest rates, rising short-term rates influence overall rate sentiment.

FISCAL VS. MONETARY POLICY

The Fed's desire to raise interest rates is conflicting with the U.S. government's desire to encourage economic activity. While this tug of war between the U.S. government and the Fed continues, global interest-rate disparity and global central bank action will continue to exert peripheral influence. As long as these forces continue to clash, interest rates are not likely to be pulled dramatically in either direction. Rather, rates will likely be range bound, albeit in a slightly higher range.

RECENT FED ACTIVITY

The Fed has been more direct in communicating and executing its strategy of raising short-term rates.

KEY TAKEAWAYS:

- Global central bank intervention comprises over $20 trillion in assets, up from pre-recession levels of $6 trillion in November 2007. Even if other central banks halt their open market purchases, the significant influence of this newly created money persists in the financial markets.
- As inflation has inched up, the market reaction has been clear: if the market believes inflation is trending up, it will drive interest rates higher.
- Relative to other central banks, the Fed has been much more direct in communicating and executing its strategy of raising short-term rates. While these hikes only impact short-term interest rates, rising short-term rates influence overall rate sentiment.
- Interest rates are not likely to be pulled dramatically in either direction. Rather, rates will likely be range bound, albeit in a slightly higher range of 2.65%-3.45%.

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