

INVESTMENT STRATEGY QUARTERLY

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Letter from the Chief Investment Officer

Being in the Right Place at the Right Time

Celebrating the 25-year anniversary of the Academy Award-winning movie *Forrest Gump*, we revisit many of the movie's themes which remain relevant in today's world. Forrest Gump's mother always said that **"Life was like a box of chocolates."** This memorable observation could just as easily be applied to the financial markets, as you never know what volatility-inducing headline you're going to get next.

President Trump's infamous tweets on trade continue to spark serious disputes between the world's most influential superpowers, as a fickle Federal Reserve (Fed), rising recessionary fears, and the upcoming U.S. presidential election top the list of potential domestic risks. Mix in a global economic slowdown, Brexit uncertainty, Italy's budget crisis, escalating tensions with Iran, and the long-running political crisis in Venezuela, and you have the perfect recipe for a volatile market. While most of these headlines serve as daily noise to give investors both sugar highs (and sugar crashes), we still believe that investors must be prudent with their investments and remain committed to their long-term financial plans.

As Forrest reminds us, **"You've got to put the past behind you before you can move on."** That is exactly what we need to do from an economic perspective. With the U.S. economy poised to notch the longest economic expansion in the history of our country in July (121 months), investors can no longer count on tax cuts, quantitative easing, or early-cycle "bounce back" growth to support the market.

Assuming the trade war does not escalate, our Chief Economist Dr. Scott Brown believes this expansion will continue as the Fed is likely to cut short-term interest rates not just once, but twice, before the end of the year. Elevated business and consumer confidence, robust employment conditions, and expectations for healthy consumer spending trends should lead to U.S. Gross Domestic Product (GDP) growth of 1.9% for 2019. While risks have risen, the expectation is that the U.S. economy will not slip into recession over the next 12 months, which is critical in developing our outlook for the capital markets for the next year.

The bond market has us echoing Forrest's question, **"What's normal anyways?"** Given historical precedent, the longevity and

strength of the economic expansion, combined with record budget deficits, should have led to higher interest rates. However, this has not been the case. In fact, global interest rates have continued to grind lower and the yield curve remains flat/inverted, depending on the maturities you examine. According to Managing Director of Fixed Income Research, Doug Drabik, central bank bond purchases (particularly in Europe and Japan) have led to more than \$13 trillion in negative-yielding sovereign debt. Demographics are also playing a part, as retiring investors transition from risk assets to income-generating securities.

U.S. Treasuries have traditionally been the "safe haven" destination for much of the fixed income world. On a comparative basis, would you prefer a 10-year U.S. Treasury bond yielding 2.01% or a 10-year German bund yielding -0.33%¹ The answer is obvious, and the excess demand for U.S. Treasuries will likely keep domestic interest rates lower for longer. The likelihood that the Fed will cut rates in order to preserve the economic expansion, combined with unattractive interest rates overseas, has led us to reduce our year-end target for the 10-year Treasury yield to 2.4% (from 2.75%). From a sector perspective, we still prefer emerging market bonds and investment-grade bonds over high yield.

"Run, Forrest, run" could just as easily be "Run, equities, run!" However, to move higher, the equity markets need to shed the "braces" of negativity surrounding trade fears and recessionary concerns. If this does occur, we believe record earnings should continue to propel the equity markets higher. We reiterate our S&P 500 year-end target of 2946. However, should the trade war with China escalate, Managing Director of Equity Portfolio & Technical Strategy, Mike Gibbs, estimates that S&P 500 earnings will fall by ~4%, leading to more uncertainty and downside

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 July 2019. Material prepared by Raymond James as a resource for its wealth managers.

potential for equities. If there is any progress on the trade front between the U.S. and China, emerging markets should stand to benefit.

Unlike Forrest and Jenny, oil prices and the U.S. dollar are not like “peas and carrots.” In fact, there is typically a negative correlation between commodities and the dollar. Tailwinds that previously supported the dollar continue to fade, particularly as the Fed appears set to cut interest rates before year end. As a result, we forecast the dollar weakening slightly to \$1.15 versus the euro before year end. A weaker dollar, fading global oil inventories, and the new International Maritime Organisation (IMO) standards set to take effect in January 2020 should support oil prices. Our forecast is that oil will bounce back to \$70/barrel before the end of the year.”

Forrest Gump is an inspiration to many, as he overcomes significant tribulations in his life through both hard work and good fortune. Admittedly, you need both as a successful investor! He had a way of being in the right place at the right time, as he ended up being part of many of the most iconic events of the

twentieth century. That is exactly what we aim to do with our investment strategy views: place your portfolio in the best position to succeed over the long term.

Bubba remarks that “**shrimp is the fruit of the sea,**” as he lists the multitude of cooking methods, pairings, and seasonings that make shrimp so versatile. The same could be said of your portfolio, as there are numerous ways to structure your investments to meet your unique goals and objectives. As volatility is likely to increase, and the return environment becomes more challenging, we encourage you to review your portfolio with your wealth manager. ■



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

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Chief Investment Officer, Private Client Group

Chris Bailey European Strategist, Raymond James Investment Services Ltd.

Scott J. Brown, Ph.D. Chief Economist

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

Doug Drabik Managing Director, Fixed Income Research

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

Nick Goetze Managing Director, Fixed Income Services

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

Nicholas Lacy, CFA Chief Portfolio Strategist, Asset Management Services

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

Ed Mills Washington Policy Analyst and Managing Director, Equity Research

Pavel Molchanov Senior Vice President, Energy Analyst, Equity Research

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Taylor Krystkowiak Investment Strategy Analyst, Investment Strategy



Is the Outlook for the UK, Okay?

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

The great Indian novelist Ruskin Bond may have complained about spending four years in the United Kingdom in his younger days but - in today's world - a mere three plus years since the June 2016 Brexit referendum result, has caused material angst for politicians, entrepreneurs, the average family and investment strategists alike.

I do not need to give a blow-by-blow account of the failure of the government to find an acceptable Brexit deal for both the European Union and the UK Parliament, but it is not too controversial to say that another year of paralysis is in nobody's natural interest. After all, despite some positive news about both wage and employment levels, the UK's anticipated 2019 economic growth rate - as currently estimated by supranational organisations such as the IMF and the OECD - is expected to be below the broader European Union average and specifically only above troubled economic actors such as Italy.

As it happens, the confused current political backdrop in Italy is replicated in the UK, judging by the unusual nature of recent local council and European Parliamentary election results. Still, with the leadership battle in the Conservative Party - with an aim of not only establishing their new leader but also the next Prime Minister too - close to a finale, there is naturally some hope of new impetus to bringing clarity to the Brexit debate.

“A few years after my father's death, my mother sent me to the United Kingdom for 'better prospects' in 1951. Those four years were not easy”

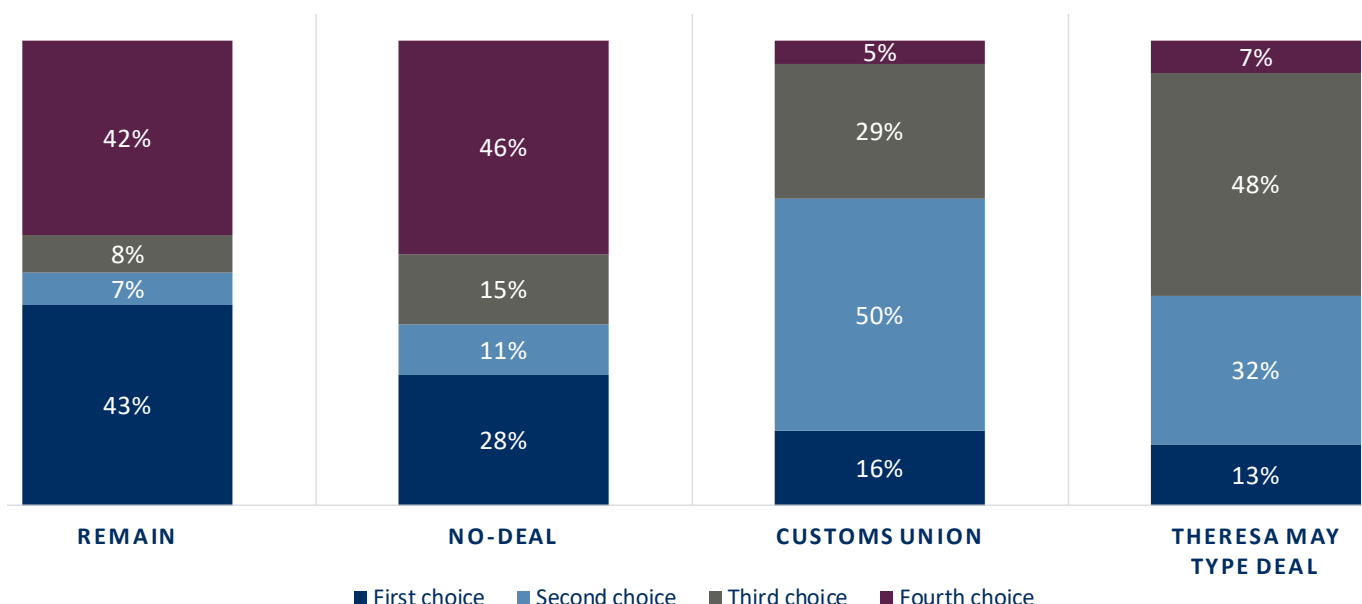
– Ruskin Bond

I have talked on these pages before about my anticipated 'soft Brexit' scenario. When I look at the Parliamentary maths, such a scenario of respecting the direction of the June 2016 vote whilst acknowledging the need to maintain a closer-than-average trade relationship to support integrated supply chains, appears to be the only logical option. However, logic and a range of strongly held views can be strange bedfellows and reluctantly I have to concede that other options, including a second confirmation referendum and even 'no-deal', still linger and could even spill over into an autumn election or even a constitutional crisis around the debate about a potential suspension of Parliament.

The Bank of England have not been shy in highlighting the impact of such uncertainties on economic growth and investment levels and perhaps naturally - despite an inflation rate which remains stubbornly at or even above the targeted 2% level - anticipation of an interest rate cut during the second half of 2019 have risen. Certainly, the recent fall of the ten year gilt yield below the current bank base rate of 0.75% - something which statistically has not occurred for over a decade - is reflective of the market signalling

Ranking of Options to Leave the European Union

You Gov's latest poll gauges popular opinion on the possible final outcome of Brexit



Source: YouGov polling June 2019

this possibility. However such a move, as well as any fiscal boost by the new Prime Minister, in accordance with some of the pledges being made on the leadership campaign trail, is just a stimulus sticking plaster over a lack of defined Brexit deal wound. It is certainly better that the UK has some room for new stimulus but by no means should this be seen as a cure.

We have all seen how a combination of uncertainty and slower economic performance has impacted the value of the Pound over the last three years. On conventional criteria the UK currency looks cheap against its international peers... but even a neophyte foreign exchange analyst knows that a nation's currency value is largely a live financial market referendum on that country's credibility and confidence levels. In short, the only way the Pound is going to start to materially scabble back against the other major currencies of the world is via some form of Brexit plan clarity.

Naturally the UK equity investor is a little less concerned by all these developments given the weighting of non-UK earnings across both the large and mid cap indices, even before mention is made of the significant dividend yield pick-up in many UK listed stocks versus the aforementioned significantly compressed 10 year gilt yield. Certainly it has been noteworthy in the last month or two that the UK has crept off the bottom of recent fund manager allocation surveys as global investors in aggregate have shifted from being very underweight UK stocks to being more modestly so. However, within this, there remains significant reallocation scope to more domestically focused sectors such as the financials, retail and construction in the event of a Brexit deal.

Clearly the outlook for the UK economy - if not UK equity markets - is shorter-term wrapped up with the political enigma that is Brexit and - despite some scope for both interest rate and fiscal stimulus - the real key for the balance of the year is to provide some clarity on this front. And if adept political leadership is likely be required at the top of the UK policymaking tree to achieve this, then such achievements will just bring us to an end of an economic beginning. The 2020s is likely to be a challenging and complex (but not unopportunitistic) decade for all global economies. The time to stop Brexit navel gazing and forging any plan of action is most certainly nigh if we all want at least the potential hope of 'better prospects'.

KEY TAKEAWAYS:

- Multiple Brexit options still exist and are overhanging the UK economy and the Pound.
- The scope for both lower UK interest rates and more fiscal spending are apparent but they alone cannot solve Brexit related malaise.
- UK listed equities are more globally influenced but significant active investment opportunities would come from greater Brexit clarity.
- Lots of challenges and opportunities await in the 2020s but we need to forge a Brexit plan.



Entrenched: Trade Warfare

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

Trade tensions between the United States and China have been a hallmark of President Trump's time in office and a major market overhang that threatens to initiate a decoupling of the world's largest economies, disrupting supply chains, and potentially hitting company earnings in the process. It has been over two years since the initial face-to-face meeting between President Trump and China's President Xi at Mar-a-Lago, at which time a 100-day plan to address broad economic concerns was put into action.

ARE WE IN A TRADE OR TECH WAR WITH CHINA?

Initial optimism in early 2017 quickly faded as the two sides could not come to an agreement on key market access, intellectual property protection, and technology transfer requirements that remain at the centre of talks. The back-and-forth nature of these negotiations is tied to a reality that is gaining greater appreciation: the talks are less about overall trade imbalances, and more about safeguarding future U.S. economic, technological, and military interests. In short, we believe the Trump administration views this as a battle for supremacy. We have noticed more attention on the day-to-day or tweet-by-tweet coverage of the fight (rather than a conversation about why we are in a conflict), the objectives of the Trump administration, and whether China could ever agree to

"In short, we believe the Trump administration views this as a battle for supremacy."

these potential changes. In this article, we will attempt to outline some of the key aspects of this trade war.

GAME CHANGER: U.S. TECH CENTRAL TO NATIONAL SECURITY

A government-wide effort to strengthen the defense of U.S. "foundational" technologies began in 2017 under the Trump administration to preserve U.S. leadership in tech that will have future military applications such as advanced robotics, artificial intelligence, and quantum computing. The new approach can be thought of as threefold: enhanced domestic foreign investment reviews, commercial controls on tech exports, and ramped-up criminal prosecutions against the theft of corporate secrets. All three take direct aim at China's efforts to close the gap in technological know-how and begin to challenge the established U.S. tech industry for global superiority. The widely-publicised "Made in China 2025" initiative laid out China's ruling party's plans in this area, establishing domestic and international market share targets for China's firms competing with advanced U.S. tech by 2025 and beyond. In effect, the Trump administration has moved to set defences against access to U.S. tech that is aimed at directly threatening U.S. dominance in the tech space by a foreign competitor, especially if it could have a military application. More broadly, China hardliners in the Trump administration view



“The China trade fight is arguably the most popular policy position of the Trump presidency.”



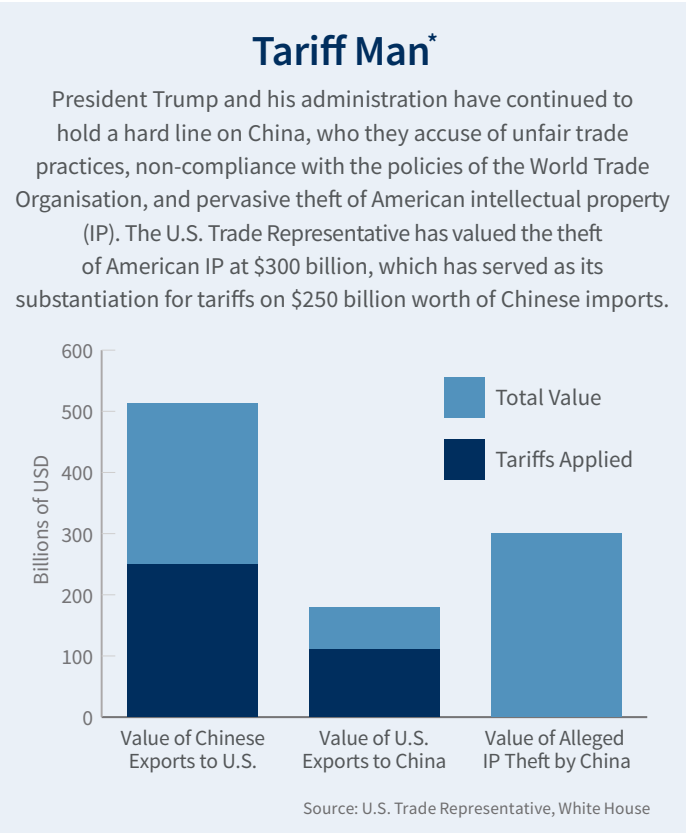
competition in the tech space as the new ideological frontier to determine the values of the emerging tech landscape – a modern day “Cold War” scenario.

The more direct challenge to China’s behaviour came in August 2017 with the administration’s so-called “Section 301” investigation into “any of China’s laws, policies, practices, or actions that may be unreasonable or discriminatory and that may be harming American intellectual property rights, innovation, or technology development.” The investigation led to the tariff imposed on \$200 billion of Chinese imports directly targeting China’s advanced manufacturing industry central to its “Made in China 2025” development goals. The investigation found that China utilises joint venture requirements (U.S. firms need a Chinese partner to conduct business in China), forced tech transfers (business licenses are only granted to firms who agree to transfer critical intellectual property to their Chinese partner), foreign direct investment (Chinese companies invest in U.S. companies to gain access to new technologies), and unauthorised network intrusions (cyber espionage) to cause direct harm to U.S. industry. U.S. companies seeking to enter China’s markets are frequently required to partner with a domestic Chinese partner or detail critical commercial information to government agencies in order to gain licensing approval. These requirements provide crucial access to U.S. tech that can be replicated by Chinese competitors, according to the investigation. The report further details cyber espionage and hacking efforts targeting U.S. companies for theft of trade secrets. A November 2018 follow-up report concluded that China had “failed to make structural changes” and to “adopt U.S. recommendations for reforms” to adequately address U.S. concerns. The tech battle remains a pivotal issue in ongoing talks, and is trending toward escalation for the remainder of 2019.

STAGE SET FOR SIGNIFICANT ECONOMIC RESTRICTIONS TARGETING CHINA

One weapon the Trump administration has floated throughout the trade negotiations is the activation of the International Emergency Economic Powers Act (IEEPA), a set of national security powers that allows for broad restrictions of certain commerce that is deemed a

threat to the U.S. In May, President Trump formally invoked IEEPA to secure emerging 5G networks by banning the acquisition of certain foreign-produced equipment that could allow adversaries to exploit vulnerabilities. Although the order does not name China or Chinese companies directly, it alludes to industrial espionage-type threats that the U.S. has described to allies in its push to restrict the use of Chinese 5G equipment around the world. Under the order, the Department of Commerce has until mid-October to establish regulations on specific restrictions. The activation of IEEPA is yet another warning shot at China showing that we could see this battle move from company-to-company restriction (like Huawei) toward a technology-to-technology restriction in the coming months unless negotiators are able to reach agreement on significant changes to China’s economic practices.



*Trump’s tweet from December 4, 2018: “... I am a Tariff Man. When people or countries come in to raid the great wealth of our Nation, I want them to pay for the privilege of doing so. It will always be the best way to max out our economic power. We are right now taking in \$billions in Tariffs. MAKE AMERICA RICH AGAIN.”

The Re-election of Least Resistance

Amidst many domestic challenges and political opposition from a divided congress, the Trump administration's hard line on China might be its path of least resistance to re-election.



“Fighting China in a trade war is easier for Trump to defend than a weak deal, increasing the likelihood that this fight lasts beyond the 2020 election.”

PRESIDENTIAL POLITICS AND CLASH OF GOVERNANCE SYSTEMS FURTHER COMPLICATE PATH TO A DEAL

The China trade fight is arguably the most popular policy position of the Trump presidency. Members of Congress may question the style of the negotiations, but few are willing to publicly question the substance of the fight – especially on strengthening protections for U.S. tech. Fighting China in a trade war is easier for Trump to defend than a weak deal, increasing the likelihood that this fight lasts beyond the 2020 election. We believe one of the biggest threats to President Trump's re-election would be a market sell-off or weakening economy. Either could cause the president to soften his stance toward China, but that is not a given and could embolden China to hold out.

Politically, securing a deal in the short term presents advantages for both sides, but opportunity for miscalculation is heightened in the long term. Reaching a deal would provide a market boost in the U.S. and would play well for China's Xi for preserving (for the time being) the relationship with China's largest market. In the longer term, the incentives do not align as well. Xi Jinping's term as China's leader will continue well beyond Trump, but the U.S. may experience a change in administration with the 2020 election. From that perspective, the trade fight may be prolonged if China's leaders decide to “weather the storm” for the time being. A less comprehensive deal or continuously stalled negotiations may result in tariff escalation or other significant economic restrictions. Escalation points could come right in the heat of the 2020 presidential campaign, which can damage Trump's economic message or provide a political incentive to once again increase pressure on China. As we noted earlier, we expect trade relations with China to remain a key theme of the Trump presidency, even in the event of a deal struck sometime in 2019. ■

KEY TAKEAWAYS:

- U.S./China trade tensions have been a hallmark of President Trump's time in office and a major market overhang that threatens to initiate a decoupling of the world's largest economies, disrupting supply chains, and potentially hitting company earnings in the process.
- China hardliners in the Trump administration view competition in the tech space as the new ideological frontier to determine the values of the emerging tech landscape – a modern day “Cold War” scenario.
- The China trade fight is arguably the most popular policy position of the Trump presidency. We believe one of the biggest threats to President Trump's re-election would be a market sell-off or weakening economy. Either could cause the president to soften his stance toward China, but that is not a given and could embolden China to hold out.
- Politically, securing a deal in the short term presents advantages for both sides, but opportunity for miscalculation is heightened in the long term. Reaching a deal would provide a market boost in the U.S. and would play well for China's Xi for preserving (for the time being) the relationship with China's largest market.



Collateral Consequences: The Economics of Tariffs

Scott J. Brown, Ph.D., *Chief Economist*, Raymond James

Many of us tend to think of globalisation and trade with China as recent phenomena, but that's far from true. Ancient empires interacted with each other, trading spices, silver, and gold. The Silk Road, expanded by the Han dynasty in 114 BCE, brought Chinese goods to India, Persia, Greece, and Rome. By the first century CE, the 1% of Rome and Carthage were dressed in silk.

A Tang shipwreck discovered off the coast of Indonesia in 1998, dated to around 825 CE, contained some 60,000 items, mostly Chinese ceramics. The young United States traded with China after it lost its only source for tea (England) following the Revolutionary War. Trade brought an exchange of goods and cultures, but varied over the centuries as empires came and went.

In studying economics, one learns early about the concept of comparative advantage and the benefits of trade. There are winners and losers (as trade with another country picks up), but both benefit overall.

THE MAKING OF THE MODERN DRAGON

After the Maoist Revolution, China was closed off from the rest of the world until the 1970s, but began to open up in the early 1980s, signing a number of regional trade agreements. The country joined the World Trade Organisation (WTO) in late 2001. Expansion of port facilities in China as well as in Los Angeles and Long Beach, California, together with a new, larger class of container vessels,

led to a rapid increase in exports to the U.S., although some of this was taking share from other Asian nations.

Although the U.S. refrained from formally classifying China as a currency manipulator, the country was clearly keeping its currency weak against the U.S. dollar in the early 2000s. To do this, China had to amass large amounts of dollar-denominated assets, mostly U.S. Treasury and mortgage-backed securities. In fact, Chinese purchases of U.S. mortgage debt helped to keep mortgage rates low throughout the decade, partly contributing to the housing bubble. China stepped away from the U.S. mortgage market after Fannie Mae and Freddie Mac were placed in conservatorship, leaving the Federal Reserve (Fed) to take up the slack.

The rapid growth in trade with China had a negative impact on U.S. manufacturing employment. In the 1980s, the rule of thumb was that the U.S. would lose one out of ten manufacturing jobs each year, but that lost job would be replaced by a new manufacturing job. Over time, the U.S. shed low-productivity jobs and replaced them with high-productivity jobs, keeping the level of factory employment roughly constant over time even as output grew exponentially. Trade with China ended that, but it's estimated that about half of the manufacturing jobs lost since 2000 were due to technology (mostly robotics). Job losses were devastating for families and communities. As a country, we failed to ease that transition.

What Lies Below

Much as the tip of an iceberg often conceals its deceptively large size, the impact of past, present, and future tariffs are likely to pose significant costs to American consumers. According to analysis by the New York Fed, the initial 2018 tariffs imposed by the Trump administration on Chinese exports to the U.S. ultimately cost the average American household \$419, which increased to \$831 per household when those tariffs were increased by 15% in 2019. Additional tariffs are likely to have a similar effect should they be put in place, the cost of which will be proportionate to their magnitude and the length of time they remain in place.



1ST TRANCHE - 25% Tariff

\$50 Billion of Chinese exports
\$419 annual cost per household

2ND TRANCHE - 10-25% Tariff

\$200 Billion of Chinese exports
\$831 annual cost per household

3RD TRANCHE - 25% Tariff

\$300 Billion of Chinese exports
\$? annual cost per household

Source: Federal Reserve Bank of New York

A DEFICIT OF UNDERSTANDING

China's foreign trade is not out of line with the rest of the world. The country imports raw materials and exports intermediate and finished goods. Its trade surplus is about 1% of its GDP. The U.S. trade deficit is also manageable, currently about 2.0-2.5% of GDP (it rose to over 6% of GDP in 2005). The reason the U.S. runs a trade deficit is that we consume more than we produce, or equivalently, we don't save enough. Economists think it is foolish to focus on the bilateral trade deficit. After all, I have a significant trade deficit with my grocery store. I buy more from them than they buy from me.

A trading partner's bad behaviour can be addressed through the WTO or through coordinated international pressure (if other countries have similar complaints, as they do with technology transfers and intellectual property). Applying tariffs hurts the exporting country, but also damages the economy of the importing country.

A tariff is a tax, but one paid by U.S. consumers and businesses, not by China. Tariffs raise costs, disrupt supply chains, invite retaliation in the form of increased tariffs against U.S. exports, and dampen business fixed investment.

"There is growing evidence that tariffs are having a negative impact on U.S. economic growth, but to date, they appear unlikely, by themselves, to push the U.S. economy into a recession."

RATCHETING UP TRADE TENSIONS

Tariffs on Chinese goods can be separated broadly into three rounds. The first was a 25% tariff on \$50 billion, mostly intermediate industrial inputs and capital equipment. The second was a 10% tariff on an additional \$200 billion in Chinese goods, including intermediate goods, such as computer and auto parts, and consumer goods. This tariff was raised to 25% on May 10. The third is a potential 25% tariff on the remaining \$300 billion or so in Chinese goods, mostly consumer items.

A U.S. importer need not pay a tariff if there is an alternative, but supply chains are complicated and it takes time to make alternative arrangements. U.S. trade with Vietnam is now rising

“While there is still hope that a trade deal with China can be reached, the worldwide rise of protectionism is a discouraging development as we look ahead to the next decade or so.”

rapidly. However, the one thing that production in China gives you is scale – and in that, there are no easy offsets. None of this means that production will return to the U.S.

FOCUSING ON THE FALLOUT

The Federal Reserve Bank of New York estimates the 2018 tariffs imposed an annual cost of \$419 for a typical household. The 10 May escalation of tariffs imposed an additional annual cost of \$831. Together, that amounts to over 2% of average household income. The impact will fall harder on lower-income households, and the damage will increase substantially if the third round of tariffs is imposed. Douglas Irwin, a trade economist at Dartmouth, estimates an average tariff of 3% on Chinese goods before 2018. Last year’s tariffs raised that to 12%, and the 10 May escalation brought it to 18%. If Trump imposes a 25% tariff on the remaining \$300 billion in Chinese goods, the average tariff will be 29%.

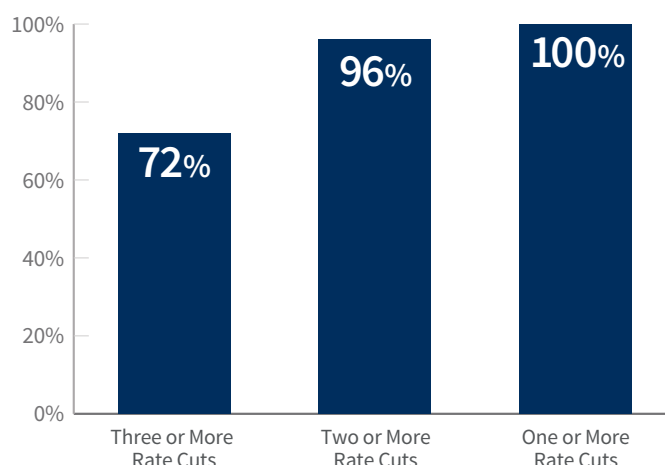
There is growing evidence that tariffs are having a negative impact on U.S. economic growth, but to date, they appear unlikely, by themselves, to push the U.S. economy into a recession. The potential third round of tariffs would have a greater impact.

Some Fed officials may fear the inflationary implications of tariffs. However, that impact would be transitory. The bigger concern should be the drag on growth. Hence, the Fed could lower short-term interest rates by the end of the year. Such an outcome is already anticipated in the federal funds futures market, which is pricing in a 100% chance of one or more rate cuts by the end of this year.

Following two world wars, the countries of Europe felt that war could be prevented by reducing tariffs and other trade barriers. The General Agreement on Tariffs and Trade eventually morphed into the WTO. We had 70 years of peace and cooperation. While there is still hope that a trade deal with China can be reached, the worldwide rise of protectionism is a discouraging development as we look ahead to the next decade or so. ■

Hike, Hike, Cut

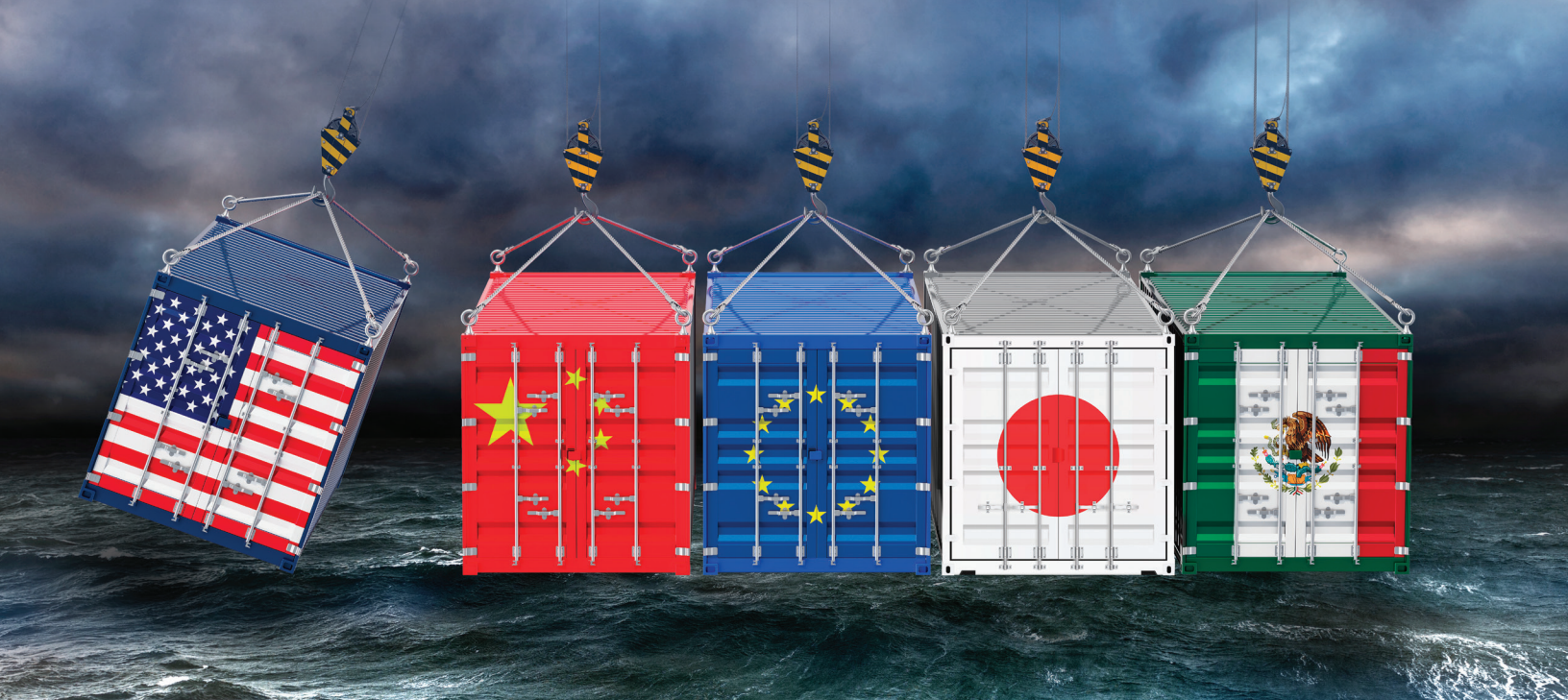
The probability of one or more rate cuts in 2019 by the Federal Reserve has risen dramatically



Source: Bloomberg as of 20/06/19

KEY TAKEAWAYS:

- Tariffs raise costs, disrupt supply chains, invite retaliation in the form of increased tariffs against U.S. exports, and dampen business fixed investment.
- There is growing evidence that tariffs are having a negative impact on U.S. economic growth, but to date, they appear unlikely, by themselves, to push the U.S. economy into a recession. The potential third round of tariffs would have a greater impact.
- The Fed could lower short-term interest rates by the end of the year. Such an outcome is already anticipated in the federal funds futures market, which is pricing in a 100% chance of one or more rate cuts by the end of this year.



Beyond Borders and Bilateralism: The Import of Trade

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

There is no word more dangerous (in finance) than ‘extrapolation’ and anyone but the most neophyte of investors has grown up with a backdrop of progressively liberal global trade rules. The General Agreement on Tariffs and Trades (GATT) in 1947 led to the creation of the World Trade Organisation (WTO) in 1995. The WTO, which boasts a membership of 164 countries, may now preside over services and intellectual property, as well as more traditional manufactured goods, but new challenges have arisen in recent quarters. The threat of trade wars typically tops any investor’s list of current global risks.

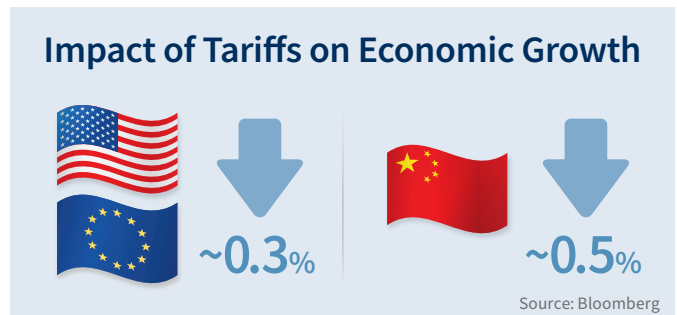
COOPERATION IS CRUCIAL

Any fledgling economics student knows economic growth is made up of consumption, investment, government spending, and a net trade (exports minus imports) contribution. Trade angst that leads to less interaction between economies, in most circumstances, leads statically to lower economic growth as supply chains are interrupted and more expensive alternatives are less cost-efficient. A few studies in recent months have

“We must become more comfortable with probability and uncertainty.”

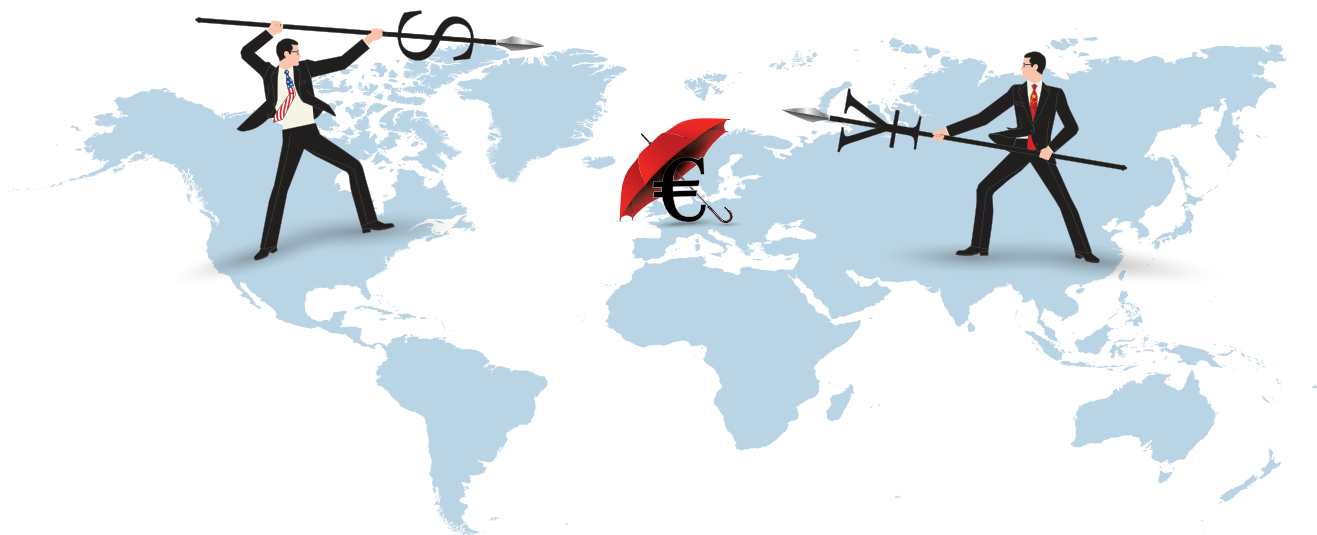
– Nate Silver

attempted to quantify the impact of new tariff actions from countries such as the U.S. and China. These studies have suggested an economic growth level reduction of around 0.3% in 2020 for both the U.S. and the pan-European economy compared to the previous status quo of no new tariff implementation. The suggested negative impact on Chinese economic growth levels is a little higher at over 0.5%, but in the wider scheme of things, this is a nudging down of economic growth rates, not an immediate precursor to economic recession.



The Art of the Trade War

In the protracted trade war between the U.S. and China, each has its own sources of ammunition. On the one hand, the U.S. has exceptional leverage over China with the tariffs it can apply on China's significantly higher exports relative to the U.S. On the other hand, China can counter such measures with fiscal stimulus and the depreciation of its currency. Suffice to say, each side can dig in. Meanwhile, the EU, Japan, and other developed markets have been caught in the crossfire.



Trade policy, however, tends not to have quantifiable, static effects on its own. The lengthy period of progressive trade liberalisation following World War II led to an increasingly complex and inter-related global economy which benefited from the application of the law of comparative advantage. And as is the nature of economic systems leaning towards capitalism, the incentives and informational insights created from the positive benefits of trade create new and dynamic benefits that allow economic growth to advance further. Unfortunately, any regression in such trends threatens a negative reversal in this mirror image of trade. And the transmission mechanism for this? Retaliatory tariffs.

“Trade policy, however, tends not to have quantifiable, static effects on its own.”

PYRRHIC PROBABILITIES

Any student of world trade trends over time knows that the ‘tit-for-tat’ retaliatory tariff measures, apparent during much of the 1930s, both deepened and prolonged the economic depression at that time. Certainly, such insights from economic history remain highly applicable to today’s global economy and may actually occur more quickly and more powerfully due to higher levels of trade, interdependence, and integrated supply chains. Such outcomes bode particularly poorly for economies that have placed emphasis on export success and typically being important parts of the global supply chains for corporations and governments around the world. The three best examples of this today are China, Germany, and Japan.

Starting with China, global investors became accustomed to the Middle Kingdom dominating at-the-margin consumption growth statistics. With an urbanising and wealthier population of over one billion, this should not be surprising; however much of the heavy lifting in the thematic development of the Chinese economy over the past generation has been undertaken by its ever-stronger capability as a producer of intermediate goods for export. China may no longer be the cheapest country to manufacture many goods, but a sharp slowdown in the country’s exports due to trade war angst threatens much more than just a reduction in the country’s economic growth level. In a static sense, slower economic growth rates can be offset by more stimulus efforts and this has been apparent over the past few months with a loosening in both monetary and fiscal policy, which has helped keep headline economic growth rates close to quoted targets. However, such a focus threatens progress with the country’s all-critical domestic reform and change programme, which is attempting to improve the efficiency, dynamism, and longer-term growth potential of the Chinese economy by reforming the banking sector and reducing excesses in areas such as local government debt levels and an over-reliance on the property sector. With the maintenance of stability (and no need to worry about re-election), an overriding objective of the Chinese government, a risky but politically nationalistic dynamic push back, would be a continuation of recent policy of tariff and technological ‘tit-for-tat’

“Any progress in the world trade backdrop is likely to lead to a lower value of the dollar which should help reduce inflamed trade tensions.”

retaliation. This, however, would slow Chinese economic growth with implications for every country or company selling into the country while inducing material friction into the global trade and diplomatic backdrop, which is why the recent talks in Osaka were quite conciliatory.

Another policy option would be to let the Chinese yuan depreciate to help offset higher tariffs and boost price competitiveness at the margin. Currencies, over recent months, have certainly heightened trade tensions, but recent shifts feel more like a reaction to world trade concerns. Any progress in the world trade backdrop is likely to lead to a lower value of the dollar which should help reduce inflamed trade tensions.

THE GERMAN QUESTION

One area that would be negatively impacted by many of the issues noted above is Europe, Germany in particular, the region's largest economy, whose economic growth has also been assisted over the last couple of generations by export success, especially in a variety of automotive and industrial sectors. Thus far, global trade angst has been focused on the bilateral relationship between the U.S. and China; however, these developments have both static and dynamic risks for all European economies, particularly Germany.

The static implications can already be seen with recent German economic growth levels being closer to those of the struggling Italian economy than those of other leading European economies such as France and Spain. To date, however, there has been little dynamic impact apart from a slight softening in demand from China.

STRESS TESTING ALLIANCES

In a scenario of 'tit-for-tat' and retaliation between the U.S. and China, Europe will not be able to stand aside. Already, discussions concerning issues around WTO decision-making and dispute resolution have thrown up divisions, particularly between Europe and the U.S., supplementing some early-stage trade disputes between the two regions. Simultaneously, the European Union leadership, supported by Chancellor Merkel of Germany, has

criticised the actions of the populist Italian government in overtly supporting the Chinese 'Belt and Road' initiative. More trade frictions create further pressures and incentives for Europe to choose a side, or face new tariffs or sanctions from everyone else. Certainly it was fascinating to see at the recent Osaka conference the lack of pan G-20 cooperation apparent in the summary communiqué published.

By contrast, Japanese relations with the U.S. have remained more cordial, despite the potential for trade related disputes in areas such as the automotive sector. The reason for this may be linked to the relatively close defence relationship between the two countries, along with Japan's instinctive regional caution toward China. Recent manufacturing sector data in the country has shown an impact from the worsening global trade backdrop, at a time when Japanese domestic economic growth dynamism remains muted (as reflected by continued use of quantitative easing policy). ■

KEY TAKEAWAYS:

- Trade angst that leads to less interaction between economies, in most circumstances, leads statically to lower economic growth as supply chains are interrupted and more expensive alternatives are less cost-efficient.
- China may no longer be the cheapest country to manufacture many goods, but a sharp slowdown in the country's exports due to trade-war angst threatens much more than just a reduction in the country's economic growth level.
- More trade frictions create further pressures and incentives for Europe to choose a side, or face new tariffs or sanctions from everyone else.
- Recent manufacturing sector data in Japan has shown an impact from the worsening global trade backdrop, at a time when Japanese domestic economic growth dynamism remains muted.



2019 Global Investment Markets: Six Months In

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

There are many pleasures to be found in early July. Warm weather is not unheard of even in the UK, offices relax both dress codes and typically their level of intensity as the heavy annual leave season approaches, and sporting fans have a cornucopia of delights to cheer. As for investment strategists... we just look over all the first half multi-asset performance statistics and try to read the tea leaves as best as we can for the balance of the year.

We entered 2019 - after a not particularly easy 2018 for global markets - positive about risk assets and this faith has been rewarded. In fact, it has been a complete turnaround as in 2018, 14 out of 15 major asset classes finished lower, with cash outperforming everything. Meanwhile this year, all 15 are positive with cash underperforming everything. Unsurprisingly, equity markets are generally leading the way with some surprising individual countries - such as Greece, Argentina and Russia - in the vanguard of this move.

So chalk one up for optimism and good times then? Well hardly so, especially with the backdrop over recent months of growing trade angst, falling export volumes, worsening purchasing manager indices and cuts in growth expectations for many countries as estimated by supranational organisations such as the IMF and the OECD. After all, there has to be some reason why fixed income

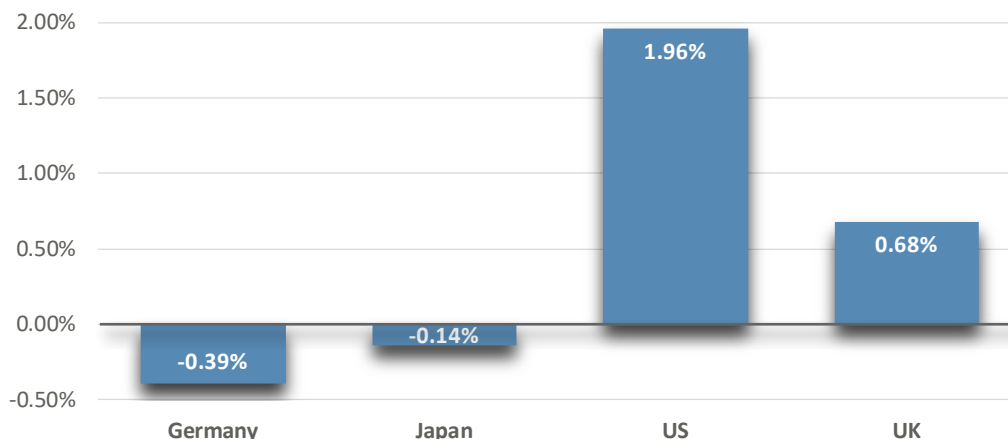
“Knowledge is only one half.
Faith is the other.”

– Novalis

markets have also typically performed in such a positive fashion so far in 2019. This has been best reflected in the scale of negative yielding bonds in Europe - now even including short-dated Italian paper - whilst in America, the entire US Treasury curve is now at yields below the Federal Reserve's overnight rate. This sounds collectively like a growing fear of an incipient recession, supplemented by the switch around in the monetary policy focus of a number of global central banks from expected interest rate increases to actual interest rate decreases. And just to further underline the unusual split of global markets in 2019, many investors' ultimate safe haven asset of gold has moved to a multi-year price high.

How should the global investor interpret all of this? Equity markets after all appear positive and continue to offer in many cases significant absolute and relative (to cash and local bond markets) yields. Meanwhile, fixed income markets have pessimism writ large. This feels like a bit of a fulcrum moment for global investment markets.

10 Year Sovereign Bond Yields



Forward MSCI P/E ratios (next 12 months):

All Country World	x15.1
EAFE	x13.6
Emerging Markets	x12.1
US	x17.1

Source:
yardeni.com
(03/07/19)

For investors looking into the second half of 2019 and beyond, the key is undoubtedly the outlook for world trade and whether current discussions between the main protagonists makes some progress or alternatively deteriorates further. The tone from these discussions plays into almost everything and investors will look through patchy short-term corporate earnings trends if the outlook coming up is better. As a transmission mechanism the US dollar is likely to play a big potential role, with any fade in the value of this currency improving both the attractiveness of overseas equity assets to American investors, and simultaneously reducing trade tensions by making the United States a bit more competitive at-the-margin. In short, the default position should be to still prefer equity facing assets for the second half of 2019.

But there is something else bubbling below the surface too. As the world prepares to formally enter the 2020s in just under six months time, I think the secret fear embedded in global fixed income markets is that the next ten years cannot be as excitable as the last ten. Clearly, history tells us that the progressive implementation of quantitative easing and other stimulus policies by many global central banks from early 2009, laid the core foundations for not just the economic recovery that followed, but also provided the thrust behind the extremely strong capital market performance too. With talk of quantitative tightening by central banks completely off the table, just what future are markets from the United States to Europe and including China heading towards? Japan's continuing travails despite seemingly perma-stimulus after all provides little comfort.

The key is likely to be with policymakers looking to reform and change economies to boost productivity, innovation and dynamism and - to this end - for example China's continuing efforts to evolve and open up their economy should both be noteworthy and helpful for the world. The trouble comes in such a world that winners and losers - at both a macroeconomic and stock/sector level - become progressively more differentiated. That sounds as if the 2020s is likely to be a more volatile (although not unopportunitistic) world... which should make different asset classes start to perform again more differently. As always with the investment world, when something feels like a constant then it is likely to soon change. This however is why even on a balmy July day the investment world still attracts and interests. ■

KEY TAKEAWAYS:

- All major asset classes are outperforming cash so far in 2019 in contrast to 2018.
- Equity and fixed interest markets appear to be giving different signals.
- World trade and related matters will be the most influential factor for H2 2019 markets.
- Looking into the 2020s new challenges will emerge including greater asset class performance differentiation.

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RAYMOND JAMES®

Head Office Ropemaker Place 25 Ropemaker Street London EC2Y 9LY

www.RaymondJames.uk.com

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