

INVESTMENT STRATEGY QUARTERLY

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CHIEF INVESTMENT OFFICER
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Letter from the Chief Investment Officer

Ten Themes for 2020

As someone who needs glasses, I know firsthand that 20/20 vision and the ability to experience the beauty and clarity of life is amazing. As we embark on the start of a new year, clarity and foresight is exactly what investors are seeking, especially with the daily dose of unprecedented headlines we receive. In hindsight, the guidance our team of economists, strategists, and portfolio managers gave last year proved prescient as ~90% of our ten themes for 2019 were accurate. Despite the success, we will not rest on our laurels as 2020 is likely to prove more challenging. By disseminating our bird's eye view on various asset classes, we hope to provide investors with a sharp, reliable lens to help bring their portfolio decisions into focus ...

#1: Keeping a Close Eye on the Economy

The state of the economy is of the utmost importance when evaluating the return potential of the major asset classes. We forecast that US GDP growth will be moderate at 1.7%, but that the current record-setting economic expansion will continue unabated at least through the presidential election. A resilient labour market, robust consumer spending, and a rebound in global growth should be supportive. Although it is rare for recessions to begin in an election year, multiple dynamics will cause us to sharpen our pencils when assessing the economy post-election. Our real-time economic indicators suggest a small probability of a recession over the next twelve months, so keeping a close eye on them will be crucial should the economy meaningfully weaken.

#2: The Fed's Corrective Surgery

When the US economic outlook was clouded by trade tensions and slowing global growth, the Federal Reserve (Fed) performed corrective surgery in the form of three 'insurance' rate cuts. Those actions recalibrated Fed policy and have extended the duration of the expansion thus far. Knowing that the impact of monetary policy lags, and given that the Fed has limited ammunition with the fed funds target rate at 1.50-1.75%, we do not anticipate interest rates will be altered in 2020. The ongoing expansion of the Fed balance sheet will provide stealth easing as it provides further liquidity.

#3: Tunnel Vision on the US Presidential Election

Until 3 November, investors will have tunnel vision when it comes to US politics. While Congressional gridlock (Republican Senate, Democratic House) continues to be the likely outcome, uncertainty remains at the top of the ticket. The determination of the Democratic candidate may last well into the summer with an increasing probability of a 'brokered convention' – the first for the Democratic Party since 1952 – the longer the process lasts. If history serves as a precedent, positive economic data leads to a favourable outcome for the incumbent. But given the level of division across the country, the election may be determined by two key swing states: Pennsylvania and Wisconsin.

#4: A Magnified Look at the Bond Market

Investors searching for yield may need to look through the magnifying glass, as global yields and spreads remain near record lows and continue to reduce the upside return for the bond market overall. Due to more moderate US growth, muted inflation, international demand, and favourable demographics, we do not expect the 10-year Treasury yield to move significantly over the next twelve months (year-end target: 1.75%). While credit market spreads will widen slightly, we do not think this will negate the positive performance of our favoured sectors—investment grade and emerging market bonds.

“We always encourage investors to keep their eyes on the prize and follow a well-thought out financial plan ...”

#5: See the Bigger Picture for US Equities

Following the best year for US equities since 2013, investors need to see the bigger picture. The macroeconomic backdrop remains supportive with muted risk of a recession, easing financial conditions, and lower interest rates. 2019 performance was largely driven by P/E expansion, but 2020 should renew the emphasis on earnings growth, which we forecast at 5%-6%. History will play a role too, as election years have been historically positive for the equity market. Since 1936, in presidential election years, the S&P 500 has rallied 9% on average and was positive 86% of the time. In the case of no recession (our forecast), the trend is more impressive with an average return of 10.7% and positive 94% of the time. Our base case is that the S&P 500 will notch new highs and rally to ~3,350 by year end.

#6: Double Vision of Favourite Sectors

We still favour cyclicals over defensives, with four of our five favourite sectors being Information Technology,

Communication Services, Financials, and Industrials. Our lone defensive choice is Health Care, which lagged the broader market in 2019 due to political risk. This sector selection has us seeing double, as a bias towards these sectors is inherently beneficial to small-cap stocks. From both a market capitalisation and revenue perspective, small cap carries its highest exposures and weightings towards these same sectors.

#7: Near & Far Sights for Technology Sector

We envision the technology sector being a stand out again this year. Our near sights are focused on earnings visibility, which remains strong with the anticipated rollout of 5G. The transition from 4G to 5G is the largest enhancement in wireless technology in a decade, so our far sights believe this will be a multi-year catalyst for everything from semiconductors to phone carriers. The benefits should permeate across other industries, keeping demand for new technologies, applications, services, and software resilient.

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Letter from the Chief Investment Officer (*cont.*)

#8: Blurred Vision for International Equities

Our preference for US equities over international equities was a relatively easy choice over the past several years. However this year, the line between the two is beginning to blur. A possible bottoming in Europe's economic data, attractive valuations on a relative basis, an acceleration in earnings growth, and the possibility of substantial fiscal stimulus packages (especially in Germany) have the potential to propel international equities moving forward. We maintain our view on emerging markets as an appealing allocation for long-term investors.

#9: A Panoramic View of the Dollar and Oil

After rallying six times in the last seven years, a further broad based rally in the US dollar is unlikely. A Fed on hold, decelerating US economic growth and burgeoning twin deficits will likely keep a stronger dollar out of view. A stable, slightly weaker dollar is a positive for commodities. Specifically, we believe that oil prices will recover to six-year highs by the end of 2020 and rally to \$65/barrel. Our expectation that global oil demand will grow slightly faster in 2020 than 2019 (and mark 11 consecutive years of growth) is supportive of this view. Furthermore, the slow upward movement in oil prices has exerted pressure on the capital budgets of US oil and gas companies which should translate into a sharp slowdown in US oil production.

#10: Volatility is Hiding in Plain Sight

With 2019 being the best year for US equities since 2013 and aggregate bonds since 2002, investor complacency and elevated expectations are evident. However, with relatively more expensive markets versus last year, volatility is hiding in plain sight. From trade wars to impeachment, and from growth concerns to geopolitical tensions, there is no shortage of headline risk for 2020. The burden remains on us to decipher if, and when, any of these headlines alter our economic or asset class views in a demonstrable fashion. Increased volatility and the aging bull market make selectivity at the regional, sector, and individual stock level even more important.

We always encourage investors to keep their eyes on the prize and follow a well-thought out financial plan that tailors an appropriate asset allocation in light of specific investment objectives and risk tolerance. While we provide our lens in which to view the economy and various asset classes, wealth managers can provide further insights into portfolio positioning. ■



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



2020 UK Outlook: After the Election, What Next?

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

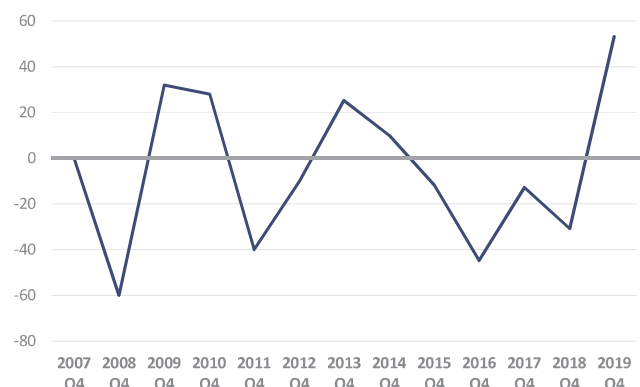
After the dust has fallen on the first December election in nearly a century, what should we anticipate next for both the UK economy and the financial markets in 2020?

At the time of this writing, the UK still remains a member of the European Union. However, it is reasonable to assume that this will not be the case for much longer, following the result of the mid-December general election. However - as is the nature of modern-day trade deals - this simply marks the end of the beginning for the Brexit debate. Many additional months of negotiation will be required to finalize the regulations and rules associated with the divorce. Early indications by the newly elected government suggest they see the end of 2020 as a time limit for these discussions in order to completely 'take back control'. Such a timetable though could plausibly create another one of the 'cliff edge' moments - which have populated the Brexit debate over recent years - given the complexity of forging such a trade deal. This is especially true that all this will be happening at a time when other bilateral deals - with other important trading partners or economic blocs - may also be considered or drawn up.

Such fears are maybe why turn-of-the-year economic growth projections are not rampant, with a survey by one leading financial newspaper concluding that a majority of economists they polled predicted that UK economic growth will show 'little

Business Optimism

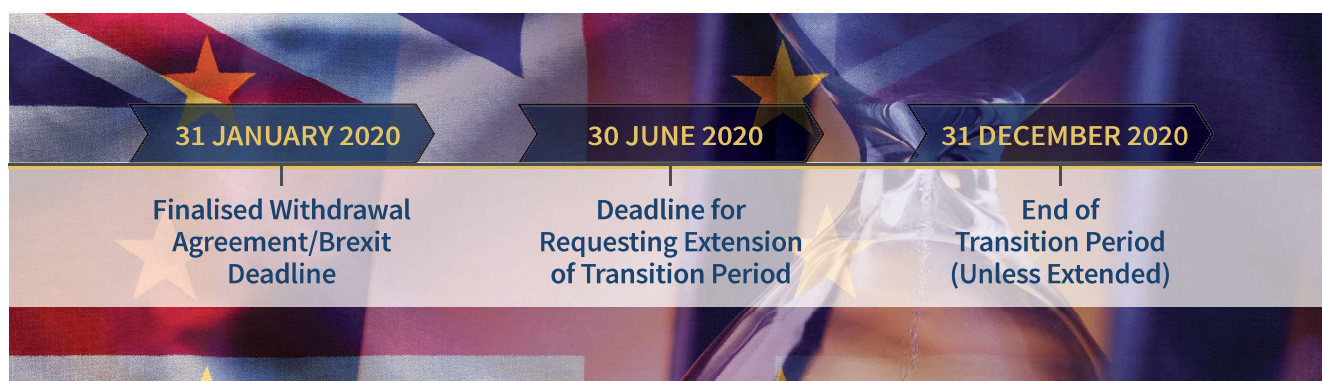
% of CFOs who are more optimistic about the financial prospects for their company than three months ago



Source: Deloitte CFO Survey

or no improvement' in 2020 compared to 2019. Given the relative dullness of likely full year 2019 eventual out-turn of around a 1.2 percent economic growth level, a continuation of this level of performance would be disappointing.

Brexit - The Final Countdown



However - quite literally - there is some hope. December's UK purchasing managers' indices data showed an improvement between the initial 'flash' report released at the end of last year (when most of the polling was undertaken before the general election result) and the 'final' report which had data throughout the month. Similarly, respected measures of consumer confidence showed some tentative hopes of improvement in data published in late December. One survey even observed that 'households said that they were feeling more optimistic about the future and increasingly committed to making large purchases'. Given that consumer spending is typically over two-thirds of an established developed economy such as the UK, this does provide some further hope.

And the Bank of England appear unlikely to upset the apple cart. Consensus expectations are for no change in UK interest rates in the foreseeable future despite the imminent change of Governor from Mark Carney to Andrew Bailey. By contrast, the other classic policy lever - fiscal policy covering government tax and spending initiatives - appears to be in a rude stimulus-friendly health with a number of budget deficit boosting policies being initiated in the first few weeks of the new parliamentary term. Another angle with some reference to fiscal policy which has gained predominance in the last couple of months is regional policy. The new government's 'one nation' focus could encourage some new growth stimulus. Sustainability however is likely to come from the business investment and entrepreneurial zeal that is not solely encouraged by government spending and tax breaks. Nevertheless offering these initially is a start.

Overall, at-the-margin policy remains loose and the Pound - whilst above the levels of last summer - has not risen significantly enough to constrain exporters. Therefore a combination of easy comparisons, some improvement in business and consumer confidence levels plus loose monetary and fiscal policy, is providing a supportive backdrop for global investors to consider closing the significant underweight position they have in UK equity positions in 2020. On

conventional earnings, cash flow or dividend based UK investments look attractive enough, however sustainable inflows will only occur if the lapsing of one Brexit logjam or cliff edge is not effectively replaced by another in the form of a lacklustre conclusion to those very specific ongoing trade discussions. The devil has always been in the details with Brexit - and this will very much remain the case for UK economic and political scene watchers as well as all interested investors in 2020.

In short, have policymakers learnt that a bit of flexibility and pragmatism can go a long way - in combination with a workable Parliamentary majority - in not only providing some clarity but also avoiding the dreaded cliff-edges? Naturally such thoughts apply not only to UK trade policy, but those of other nations around the world too. After all, in the modern global economy, even a post Brexit UK economy would be foolish to have too many isolationist instincts. On balance - and influenced by attractive UK equity valuations versus both the local fixed income market and general global equities - the glass for 2020 should be watched closely but should also be viewed as being half-full. ■

KEY TAKEAWAYS:

- Many additional months of negotiation will be required to finalise the regulations and rules associated with the Brexit divorce.
- Despite dull 2020 economic growth forecasts, there is some hope for the UK economy.
- Overall at-the-margin policy remains loose and the Pound has not risen significantly enough to constrain exporters.
- Overall at-the-margin policy remains loose and the Pound has not risen significantly enough to constrain exporters.



2020 Economic Outlook: US Offers Stability with a Chance of Slowdown

Scott J. Brown, PhD, *Chief Economist*, Raymond James

The US economy is expected to expand moderately in 2020. Many of the 2019 uncertainties seem likely to continue into the first half of the year, but the downside risks to the growth outlook appear to be less worrisome than they did in the summer. Consumer spending is likely to grow at a moderate pace, supported by job gains and wage growth, but limited by slower growth in the labour force. Business fixed investment is likely to be mixed and somewhat restrained, but we ought to see some general improvement. Federal Reserve (Fed) policy is expected to remain on hold until we get a material change in the economic outlook.

Job growth, while uneven, slowed in 2019, reflecting a tighter job market. Firms continue to report difficulties in finding skilled workers. The unemployment rate fell to a 50-year low. Demographic changes (an aging population, slower growth in the working-age population, reduced immigration) imply that the workforce will grow at about 0.5% per year over the next ten years, slower than in previous decades. Workers are also consumers, so the potential upside on consumer spending growth is likely to be limited (labour force growth of 0.5% plus productivity growth of 1.0-1.5% gets you a potential GDP growth rate of 1.5-2.0%).

Trade policy uncertainty and slower global growth, the two negative factors most often cited across manufacturing industries, may continue.

Tight labour markets have led to upward pressure on wages. Over the years, reduced union membership and a greater concentration of large firms have shifted wage bargaining power from workers to businesses. Skilled labour shortages have boosted wage gains for key employees, but firms have also used non-wage incentives to attract and retain workers, including signing bonuses and offering more vacation and other perks. Cost containment remains a key theme for corporate America.

HEADWINDS ON THE HORIZON

Business fixed investment weakened in 2019. Corporate tax cuts failed to deliver as advertised, and economists were surprised by the degree of the shortfall in business investment. A decrease in energy exploration and problems at Boeing restrained capital spending in 2019 and the halt in the production of the 737 Max will be a drag in the first half of 2020. Trade policy uncertainty and slower global growth, the two

“Trade policy uncertainty and slow global growth, the two negative factors most often cited across manufacturing industries, may continue.”

negative factors most widely cited across manufacturing industries, may continue to some extent. In contrast to consumer confidence, which has remained elevated, business sentiment weakened in 2019.

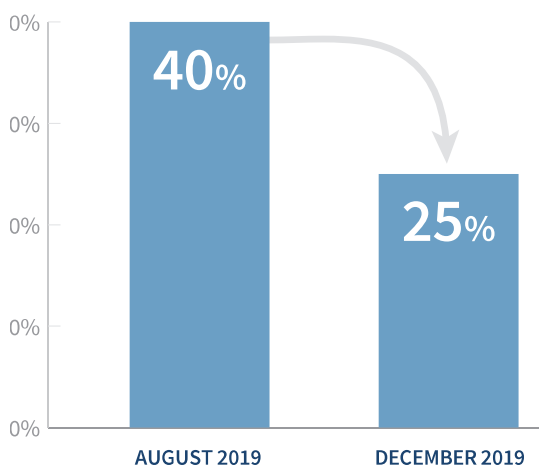
While a full trade agreement that rolls back tariffs appears unlikely, there is hope for a truce in trade tensions between the US and China (i.e., an agreement not to escalate). However, there is a danger of a further separation of the world's two largest economies, and protectionist sentiments have risen around the world. Tariffs raise costs for US consumers and businesses, invite retaliation, disrupt supply chains, and undermine business investment. Moreover, the administration has weakened the World Trade Organization, the arbiter of global trade disputes. Ahead of the 2020 election, there ought to be incentive for President Trump to put trade issues behind him. However, bashing China (and others) on trade plays to his base, and some of the Democratic contenders have adopted similar anti-China rhetoric.

RECESSION ODDS: FROM RISING TO RETREATING

A simple yield curve model of recession suggests about a 25% chance of a downturn within the next 12 months, down from 40% in August, but still a little too high for comfort. The main risk is that the factors that have restrained capital spending will worsen, leading to reduced hiring and increased layoffs, but there are currently few signs of a deterioration in labour market conditions. Consumer debt appears manageable, but business debt has risen significantly (especially for those with greater credit risk, which could make a downturn worse). Investors should focus on corporate layoff intentions and job offerings, two early indicators of labour market conditions.

It is a presidential election year, so political uncertainty will be a factor in 2020. The Democratic platform is expected to center on universal healthcare, climate change, income inequality, tax policy, and antitrust/monopoly regulation – any of which would have repercussions for certain corners of the financial markets. Over the course of the year, investors may begin to fear change in Washington, but it is unlikely that the Democrats will gain a 60-seat super-majority in the Senate, making it extremely difficult to raise taxes or to shift the regulatory environment significantly.

Recession Odds Over the Next 12 Months



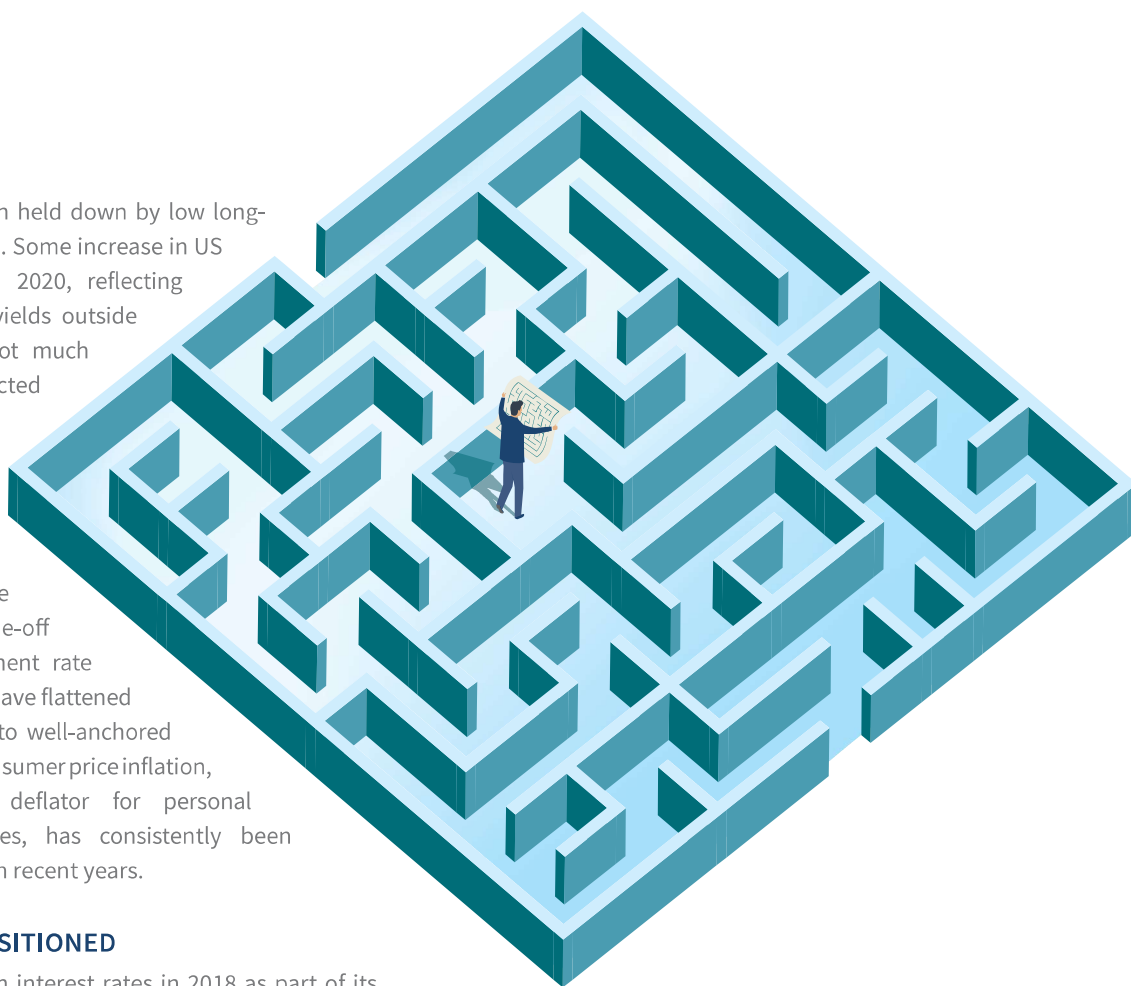
EMERGING EXPECTATIONS

Outside of the US, the advanced economies face the demographic challenges of aging populations and slower growth in workforces. Disruptions from Brexit are a risk. Emerging economies were weaker than anticipated in 2019, but are likely to pick up in 2020. These countries face the same demographic challenges as the advanced economies. However, many have made significant strides in education and have more room for improvement in living standards. Over the last decade, emerging economies have become increasingly sensitive to US Federal Reserve policy. The Fed's 2019 rate cuts will help. China's current problems go far beyond trade policy issues; growth has been fueled more by debt in recent years, there has been a greater reliance on state-owned enterprises, and the Chinese economy appears to be less sensitive to fiscal and monetary policy stimulus.

Data-Dependent Diagnosis

The Fed holds that its monetary policy is well positioned to support economic growth, a strong labour market, and near-2% inflation in 2020. However, the Fed remains ready to deploy further monetary support should economic data deteriorate further.

US bond yields have been held down by low long-term interest rates abroad. Some increase in US bond yields is likely in 2020, reflecting somewhat higher bond yields outside the US, but probably not much given that inflation is expected to remain relatively low. Firms have generally had difficulties in passing along the added costs of tariffs and higher wages. The Phillips Curve, the trade-off between the unemployment rate and inflation, appears to have flattened significantly, largely due to well-anchored inflation expectations. Consumer price inflation, as measured by the deflator for personal consumption expenditures, has consistently been below the Fed's 2% goal in recent years.



FED POLICY WELL POSITIONED

The Fed raised short-term interest rates in 2018 as part of its policy normalization. In December 2018, officials thought that monetary policy was still accommodative and most expected one or two further rate increases in the year ahead. Instead, the Fed lowered the federal funds target rate range three times in 2019 (to 1.50-1.75%) as it reacted to increased downside risks from trade policy uncertainty and slower global growth. These cuts were viewed largely as insurance against downside risks in 2020. Fed officials believe that monetary policy is currently well positioned to support economic growth, a strong labour market, and near-2% inflation in 2020. No change in rates is anticipated through the first half of the year, but the Fed will respond if conditions warrant (that is, if we see deterioration in the labour market). The Fed values its independence and its policy decisions will not be influenced by political pressure.

The Fed was unwinding its balance sheet at the start of 2019, but expected to end that in October. In February, the Fed shifted its balance sheet policy framework from a specified size goal to one of maintaining an adequate level of reserves in the banking system, and anticipated that the balance sheet would eventually expand in line with that goal. The Fed ended the unwinding of the balance sheet in July, three months early. In September, a squeeze developed in the repo market. The Fed stated that this was a technical issue, but the central bank seemed caught off guard and followed up with efforts to insure liquidity in the money markets into early 2020.

“ In contrast to consumer confidence, which has remained elevated, business sentiment weakened in 2019.”

In 2019, the Fed made a comprehensive review of its monetary policy strategies, tools, and communication practices. This review included academic conferences and town hall meetings. Some changes may be announced in 2020, but probably nothing major. One possibility would be a ‘catch-up’ policy, where inflation would be allowed to move above the 2% target for some specified period if it had fallen below 2%. However, comments from officials make this doubtful. The Fed has also been reviewing its strategies for fighting a recession. The Fed normally lowers the federal funds target rate by 500 basis points during a recession. Given the proximity to the effective lower bound (0-0.25%), the central bank should be more aggressive in lowering short-term interest rates, moving sooner and making larger cuts than it would otherwise. Officials have ruled out negative interest rates, but would rely on forward guidance and further asset purchases if warranted.

In town hall meetings, Fed Chair Powell was particularly impressed with the comments of those from low-income communities. These communities had been largely bypassed during the economic recovery, but were now seeing increased opportunities and the benefits of a tight labour market. With inflation below the Fed’s 2% goal, monetary policy is expected to remain accommodative for an extended period. ■

KEY TAKEAWAYS:

- Many of the 2019 uncertainties seem likely to continue into the first half of the year, but the downside risks to the growth outlook appear to be less worrisome.
- Trade policy uncertainty and slower global growth, the two negative factors most widely cited across manufacturing industries, may continue to some extent. In contrast to consumer confidence, which has remained elevated, business sentiment weakened in 2019.
- Fed policy is expected to remain on hold until we get a material change in economic conditions.



2020 International Outlook: The Prospects of Positive Progress

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

A recent asset allocation study suggested that, over the last ten years, a portfolio with maximized risk-adjusted returns would have been fully allocated to US equities.*

Since the end of the global financial crisis, the US market has indeed been the standout. Other markets around the world remain its poorer cousins. Yet, as we enter a new decade, it is high time to reevaluate US-centric positioning.

Lower earnings multiples, higher dividend yields, and an overvalued US dollar are, on their own, insufficient reasons to invest abroad. The catalysts that will cause international markets to roar back to recovery will be found in bona fide developments. With that said, can we be truly positive about the prospects in Europe, Asia, and elsewhere around the world for the upcoming year? Certainly, the global trade tone will be heavily influential (especially with most international economies more open and, hence, dependent on trade than the US). While any trade angst is unlikely to be a helpful backdrop either in the US or abroad, the prospects of positive progress remain encouraging.

Outside of trade matters, what else can we discern? Let us start our global tour away from America in Europe.

As we enter a new decade, it is high time to reevaluate US-centric positioning.

DOWN, BUT NOT OUT

There is change in the air in the eurozone. Not only have new appointments been made to the top of the European Commission (EC) and European Central Bank (ECB), but the dwindling of German Chancellor Angela Merkel's political clout has created a vacuum (which has only been partially filled by President Macron of France). Whilst political crisis often appears only a short step away in the eurozone, the message that members are stronger together has seemingly stayed the hand of populist political parties. Expect new ECB President Christine Lagarde to lobby regional governments more successfully than her predecessor for greater use of fiscal policy levers. However, as Japan has demonstrated, such actions are not a standalone solution. The eurozone still needs to decisively, and dynamically, enter the competitive global economy of the 21st century. 2020 is likely to be another transitional year, and, fortunately, expectations are low (as shown by the preponderance of negative-yielding government bonds and recent quantitative easing policy extension).

Watching the eurozone bond markets will provide many insights into the magnitude of regional change. Whilst it is unlikely that either the level of eurozone interest rates or the quantum of quantitative easing will change during 2020, look out for the conclusions from the ECB's review of its inflation targeting. It is possible that this may become unsymmetric, that is more concern will be attributed to an inflation level below the current two percent target, rather than one above. If this does become a new policy conclusion then expect influential regional bond yields such as the ten year German bund to move back into positive yield territory.

Similar policy conclusions could be made about Japan, albeit their policy malaise has been ongoing for over a quarter of a century now. Expect a small boost from the country hosting the Olympic games this summer. However, it will take more than the world's most famous sporting gathering to shift the Japanese economy out of dullness dominated by debt and demographics. Yet, below the surface, Japanese companies are becoming more shareholder friendly (similar to some recent trends in their European peers), with both return on equity and buyback statistics up sharply. Again, an unappreciated market with some value characteristics may provide some attractions for suitably specific global investors.

TO IMPROVE IS TO CHANGE...

Elsewhere in Asia, it is all a question of managing change. The Chinese economy will continue to grow impressively from an international perspective, as the prowess of the local consumer continues to build. However, policymakers are increasingly having to manage new pressures across areas such as the local government, the banking system, and the property market. These are undoubtedly the unsurprising outputs from change and reform, which continue at a magnitude which puts other countries and regions to shame. However, greater global focus on political-led pressures in Hong Kong and Xinjiang are also likely to continue rumbling on.

Diplomatically, this is a crucial time for China. Its Belt and Road initiative was launched with great fanfare, but has not yet had the impact that Beijing had hoped. Watch out for the potential that China further deepens its ties with Europe in 2020, a synergy which would provide both sides with a boost.

Elsewhere, markets in South America and Africa will hope for a firm Chinese economy given their important trade relationships. Reform initiatives in countries such as Brazil as well as a number of East African nations bode well. Although, the backdrop is far from flawless (as the recent fall in value of

Caught in the Vortex

The trade war between the US and China has caused collateral damage abroad, with many developed economies caught in the crossfire. However, recent positive progress remains encouraging.



“The Chinese economy will continue to grow impressively from an international perspective, as the prowess of the local consumer continues to build. However, policymakers are increasingly having to manage new pressures.”

the Brazilian currency has shown). Both zones also have their fair share of troubled nations, struggling with debt and citizen discontent. Meanwhile, firmer commodity prices would aid Russia, the Middle East, and Australia, an outcome relatively dependent on bigger discussions about global trade and the speed of the opening of the Chinese economy.

... TO PERFECT THE PORTFOLIO

Aside from the fallout from trade wars, there remains burgeoning pressure for countries around the world to forge new diplomatic allegiances and strengthen trade ties. Both could be boons for investors. Yet, methodical and disciplined asset selection remains paramount. Actively-managed strategies and sufficient diversification are certainly warranted when investing abroad. Though an exclusive allocation to US assets has been rewarding over the past decade, international assets may yet provide untapped potential in the next decade ahead. ■

KEY TAKEAWAYS:

- Lower earnings multiples, higher dividend yields, and an overvalued US dollar are, on their own, insufficient reasons to invest abroad. The catalysts that will cause international markets to roar back to recovery will be found in bona fide developments.
- While any trade angst is unlikely to be a helpful backdrop either in the US or abroad, the prospects of positive progress remain encouraging.
- The Chinese economy will continue to grow impressively from an international perspective, as the prowess of the local consumer continues to build. However, policymakers are increasingly having to manage new pressures.
- Aside from the fallout from trade wars, there remains burgeoning pressure for countries around the world to forge new diplomatic allegiances and strengthen trade ties.



2020 Europe Outlook: Can Lagarde Inspire Change?

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

For over a decade Angela Merkel has not had much competition as the most important woman in pan-European political and economic circles. However with the long-serving German chancellor in her political twilight, investors with a view towards the mid or later years of this decade may now look towards her fellow German - the recently elected new European Commission president Ursula von der Leyen - as being of more prospective influence. By contrast, my choice would be somebody else: the recently appointed President of the European Central Bank (ECB) Christine Lagarde.

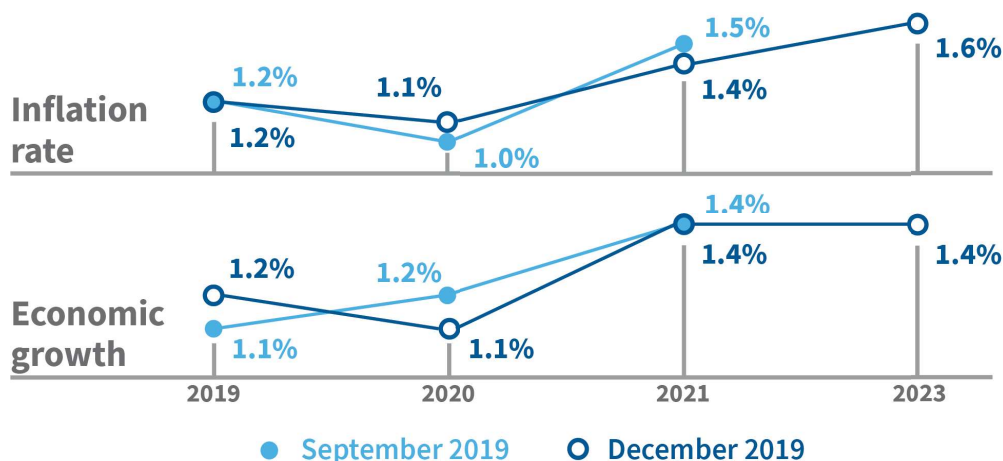
It was just one of those unfortunate timing juxtapositions that President Lagarde's first ECB press conference was on the same day as the UK general election. Nevertheless, it was good to hear that she is 'going to be myself' and certainly there were some hints about stylistic presentation differences compared to her predecessor Mario Draghi, which ECB watchers will no doubt pore over in upcoming months. Unsurprisingly there was no change to policy and - in an utterance akin to Draghi's own refrain pushing the need for

eurozone government-level initiatives - Christine Lagarde observed that 'other policy areas must contribute'. This includes 'governments with fiscal space should be ready to act' - which felt like an overt hint to the government of Angela Merkel - and that 'structural policy areas must be substantially stepped up'. This was despite a little hint that the lagged benefit of a long period of loose ECB policy is positively impacting with the observation of 'some initial signs of stabilisation', the updated growth and inflation analysis up to 2022 still shows at the end of the period only a 1.7% inflation rate (below the 2% target) and a 1.4% economic growth rate, which Lagarde herself admitted was below potential.

The other noteworthy aspect of Christine Lagarde's first ECB press conference was her confirmation of a monetary policy strategic review, which will conclude by the end of the year. As we have seen with other central banks, such musings can impact ongoing policy perceptions, and no doubt there will be much debate over the next few months what this will mean for ECB policy. Watching the eurozone bond markets will provide many insights into the magnitude of any change. Whilst it is unlikely that either the level of eurozone interest rates or the quantum of quantitative easing will change during 2020, look out for the conclusions from the ECB's review of its inflation targeting. It is possible that this may become unsymmetrical,

Eurosysteem Staff Macroeconomic Projections

Euro area, annual figures



Source: European Central Bank, Eurosysteem

that is, more concern will be attributed to an inflation level below the current two percent target, rather than one above. If this does become a new policy conclusion then expect influential regional bond yields such as the ten year German bund to move back into positive yield territory, reflecting a real push back against the forces of disinflation which have gathered - Japanese-style - progressively over the last decade. After all, a real sign that the eurozone is on a sustainable recovery path is when the region's interest rates finally return to not just zero but positive levels again.

This is some way off... which brings us nicely back to Christine Lagarde's relationship with Angela Merkel and Ursula von der Leyen. I note Lagarde's words during December's press conference that 'my ambition is to... bring the best out of the members of my monetary council'. This speaks to the consensus-building skills which were apparent during her tenure at the International Monetary Fund. But surely to rank her presidency of the ECB a success by the middle part of this decade, making Angela Merkel feel comfortable with signalling a subtle shift away from recent German balanced budget (and in reality budget surplus) dogma is going to be important. After all, Germany is the biggest and most influential economy within the region. Additionally, in the last year or so - impacted by global trade matters as well as specific industrial malaise - the German economy has flirted with recession. Therefore any notion of eurozone recovery would be given a big boost if Germany was to be seen to be getting on the front foot from a fiscal stimulus perspective. As 2019 turned into 2020 there were a few signals that maybe this shift is not impossible in the upcoming few quarters. Merkel's coalition remains very fragile and public angst over economic growth and infrastructure issues remain high. As the long-serving

Chancellor ponders her political legacy - and the likelihood (or not) that her chosen successor will be elected later on this decade - Lagarde's diplomatic skills are going to be critical.

So the real value-add that Christine Lagarde can bring is - using the ECB Presidency platform - to channel the experiences she garnered at the IMF and effectively encourage highly influential eurozone governments to complement the continuing ultra-loose ECB policy with expansionary fiscal policy boosts and flexibility improving structural shifts. In short, the best contribution Lagarde can make in her new job... is to start highlighting its limitations. ■

KEY TAKEAWAYS:

- The appointment of Christine Lagarde as the new President of the European Central Bank (ECB) could be a tipping point.
- There is much to do across eurozone policymaking given continuing relatively dull economic data forecasts for 2020.
- Watch not just the ECB policy review but also the ability of Lagarde to encourage influential economies such as Germany to undertake extra stimulus policy.
- Any successes in changing the debate will be seen in the eurozone bond markets first before eventually spilling over into higher formal interest rates.



Charting the Course for the 2020 US Presidential Elections

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

2020 kicks off an election campaign cycle that will determine the trajectory of the Trump policy agenda and its associated impact on the market. We believe Trump's reelection campaign will center on a message of positive economic and market performance — a virtual necessity from a historical standpoint for the reelection of an incumbent president. Democrats will be looking to see if they can continue the momentum from the 2018 and 2019 elections, where suburban voters have swung away from Republicans and toward Democratic candidates.

THE PROOF IS IN THE NUMBERS

Before we get to the general election, Democrats will first need to choose a nominee, which could lead to increased volatility in the first half of 2020. With a large field of candidates swapping frontrunner status and party rules that disburse delegates on a proportional basis, there is an elevated probability than none of the candidates are able to achieve a majority of delegates prior to the convention. Alternatively, the battle to win the majority could reinforce some divisions within the Democratic Party. Should Democrats fail to produce a candidate that the party can rally behind, or should a contested primary process give rise to a legitimate third party candidacy, both could be seen as benefiting the reelection chances of President Trump.

While the race for the presidency will dominate the headlines, the ultimate market and economic impact will be decided based upon the outcomes of the majorities in the House and Senate.

While the race for the presidency will dominate the headlines, the ultimate market and economic impact will be decided based upon the outcomes of the majorities in the House and Senate. The ability for any candidate to enact his or her agenda, especially through the confirmations of key cabinet and regulatory posts, runs through the Senate.

In the Senate, Republicans will be on the defensive as they are defending 23 of the 35 seats on the ballot in 2020, but are viewed as being well-positioned given the geographical distribution of races. Democrats will need to net three or four seats, depending upon the outcome of the presidential election, to win the majority. Adding significant intrigue to the Senate fight is the future of the filibuster, which maintains a 60 vote (out of 100) threshold for the passage of legislation. Should either party control the House, Senate, and presidency, we expect a significant debate on lowering the threshold to a simple majority. This becomes more likely if the Democrats are able to secure a two-three seat edge in the Senate, which would increase the probability of major reform passing into law.

“ Democrats will first need to choose a nominee, which could lead to increased volatility in the first half of 2020.”

In the House, Democrats built a solid majority in the 2018 midterm elections and Republicans would need to net 20 seats for the House to flip. Recent Republican retirements point to more potential pickup opportunities for Democrats, a sentiment that indicates rank and file members believe Democrats will maintain their majority after the 2020 election. However, Republicans have plenty of pickup opportunities themselves, given that 31 Democratic incumbents are from a congressional district that President Trump won in 2016.

RACE FOR THE DEMOCRATIC NOMINATION – LIBERALS AND MODERATES GO HEAD TO HEAD

The Democratic race appears to be coalescing into a two faction race – moderates (led by Joe Biden and Pete Buttigieg) vs. the liberal wing (led by Bernie Sanders and Elizabeth Warren). While countless external events can and will happen between now and election day, we believe that the market under-appreciates a liberal candidate's ability to capture the nomination and win the presidency. We believe market volatility is likely to reemerge, should a candidate from the liberal wing start to pick up delegates (especially given that any candidate who wins the nomination, by definition, has a solid chance of winning the presidency).

However, a resurgence of the moderate wing is an emerging storyline as we inch closer to the first primary votes in Iowa in early February. As of December, Joe Biden leads the national polls, and Pete Buttigieg has risen to first place in polling in the first primary states (Iowa and New Hampshire). Concurrently, two late contenders have recently entered the race that further boost the moderate lane – Michael Bloomberg and Deval Patrick. The entrance of Bloomberg and Patrick is a clear manifestation of concerns that Biden cannot ultimately win the nomination, in addition to the potential emergence of a ‘Never Warren/Never Sanders’ contingency. Bloomberg will not have Biden's money issues and both Bloomberg and Patrick will try to undercut Biden in the ‘logical liberal’ lane during the primary.

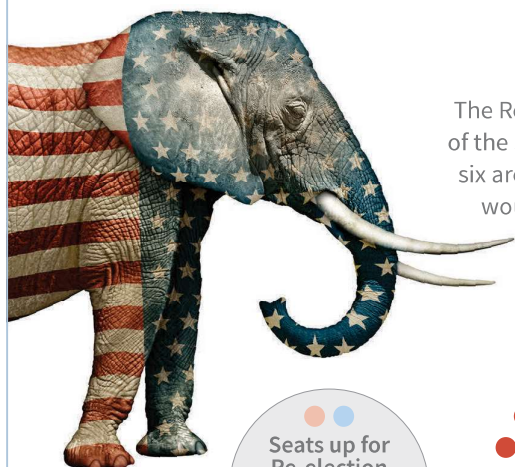
That said, Biden is still leading in many national polls and has little incentive to exit.

The entrance of two new moderate-leaning candidates will only further split the moderate/slightly liberal vote. In addition, the entrance of another billionaire will allow Warren to keep the message on the disparity between the wealthy and the ‘rest of us’ and away from Medicare for All. A potential complication for a liberal nominee is the continued strength of Senator Sanders among the liberal wing of the Democratic Party. A united Warren-Sanders front could be necessary for either to capture the nomination.

THE SECRET LIES WITH THE SENATE

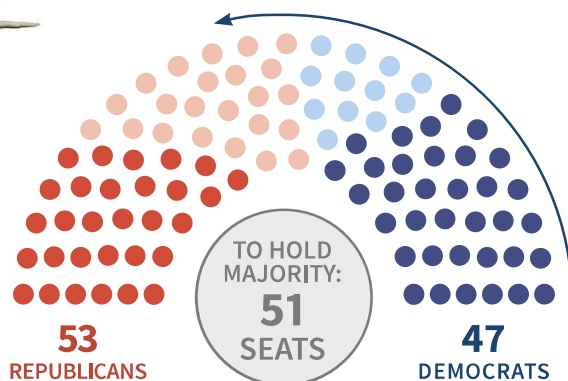
35 total seats are up for grabs in 2020. Republicans currently hold a 53-47 majority, which sets up Democrats for an uphill battle in order to make significant gains. Of the 35 races, 11 are currently considered ‘safe’ Democratic and 18 ‘safe’ Republican. This leaves only 6 ‘competitive’ seats. The last time that control of the House or Senate flipped during a presidential election year was in 1980. Much attention will focus on the six races currently deemed to be most competitive and most likely to change party control. In our assessment, the seats most at risk in order of their potential to flip are as follows: 1. Alabama (D); 2. Colorado (R); 3. Arizona (R); 4. Maine (R); 5. North Carolina (R); and 6. Iowa (R).

The increasingly polarized political climate has generated greater emphasis on party affiliation/overlap between the outcome of the Senate and presidential elections in individual states. In 2016, for the first time since the direct election of Senators, 100% or 34 of 34 Senate races matched the state's preference in the presidential election. This is a dramatic shift over the last several decades when as recently as the 1988 presidential elections, 50% of the Senate races did not match the presidential preference of the state. This could partially



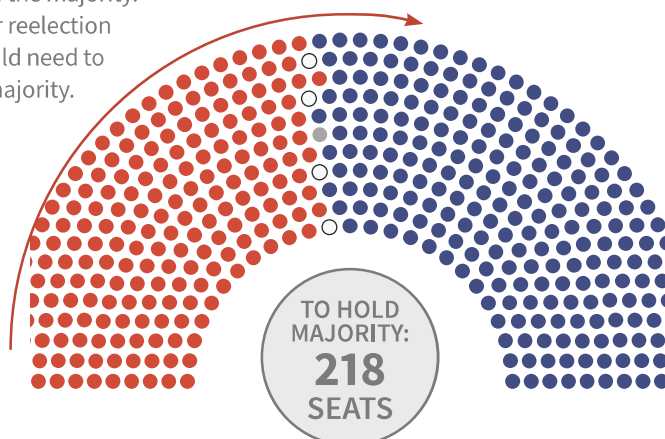
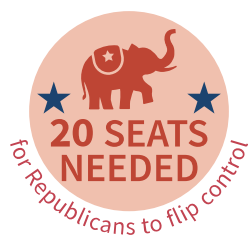
The Senate

The Republicans currently hold the majority. One third of the Senate is up for reelection in 2020. Of these seats, six are considered to be competitive seats. Democrats would need to net four seats to secure a majority.

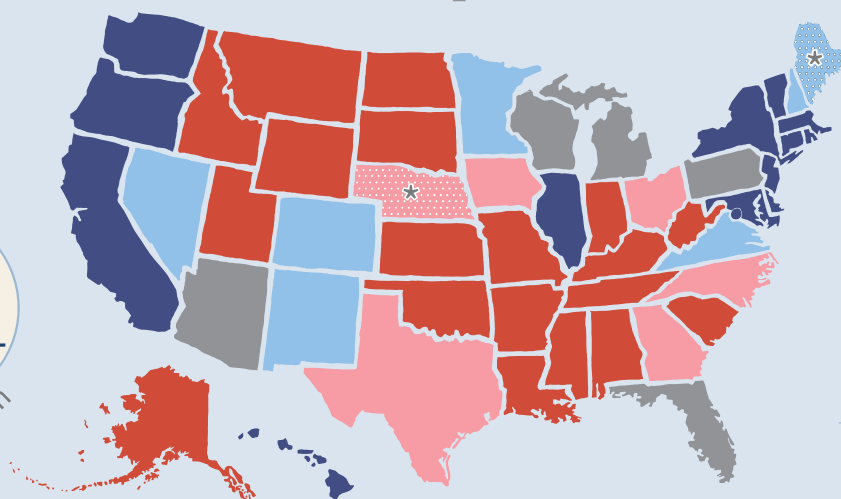


The House of Representatives

Democrats currently hold the majority. The entire House is up for reelection in 2020. Republicans would need to net 20 seats to secure a majority.



The Presidential Election



GENERAL ELECTION MAP

- Solid Republican
- Leans Republican
- Toss-up
- Leans Democratic
- Solid Democratic

★ Congressional District Method

Source: Raymond James Equity Research

“The increasingly polarized political climate has generated greater emphasis on party affiliation/overlap between the outcome of the Senate and presidential elections in individual states.”

explain the outcome of the 2018 midterm Senate elections in which Democrats won a majority in the House, but Republicans were able to flip the Senate seats of incumbent Democrats in North Dakota, Missouri, Indiana, and Florida – all states won by President Trump in 2016. Democrats were able to pick up a seat in Nevada (Clinton win) and Arizona (narrow Trump victory). In light of this factor, Arizona and North Carolina are set to be highly competitive given that Trump’s 2016 victory in those states came with less than 50% of the vote. Doug Jones (D-AL) (Trump +27.7%), Cory Garner (R-CO) (Clinton +4.9%), and Susan Collins (R-ME) (Clinton +2.9%) could also get caught up in the national trend.

The top-tier candidate status of Senators Elizabeth Warren (Massachusetts) and Bernie Sanders (Vermont) may have a significant impact on the Senate math should they be elected as either president or vice president. Massachusetts and Vermont do not require a replacement to be of the same party as the outgoing Senator, meaning the current Republican Governors of both states could appoint a Republican interim replacement – taking away a Democratic seat until the special elections conclude. This could have important consequences on cabinet appointments and an initial legislative agenda as late as five months into the first term of a potential Democratic administration (if the Democrats net a thin majority in the Senate). Per Massachusetts state law, the outgoing Senator files a letter which triggers a 145-160 day period (roughly five months) until a special election is held for a replacement and the governor makes an interim appointment to fill the vacated seat. Vermont’s special election is held within three months of the vacancy.

At this time, we believe the most likely scenario for the Senate is a continued Republican majority, but the stable national support for impeachment and the strength of the candidacies

of Senators Sanders and Warren (and their accompanying policy positions) should direct more attention on these elections. Going back to 2006, the most competitive races in presidential years have gone decisively in favour of one party in the range of 73-80%. If the 2020 cycle continues the 2018 trend of a Democratic ‘wave’ election and 80% of the current competitive Senate races are won by Democrats, this produces a 51-49 Democratic Senate. The Senate factor will have important market implications in the event of a change in administration post-2020, and could serve to temper or amplify market concerns around more impactful legislation finding a path to becoming law. ■

KEY TAKEAWAYS:

- While the race for the presidency will dominate the headlines, the ultimate market and economic impact will be decided based upon the outcomes of the majorities in the House and Senate.
- The ability for any candidate to enact his or her agenda, especially through the confirmations of key cabinet and regulatory posts, runs through the Senate.
- 35 total Senate seats are up for grabs in 2020. Republicans currently hold a 53-47 majority, which sets up Democrats for an uphill battle in order to make significant gains. Of the 35 races, 6 are considered ‘competitive.’
- At this time, we believe the most likely scenario for the Senate is a continued Republican majority.



2020 Energy Outlook

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

After fixating on demand throughout 2019, the oil market is likely to start trading on bullish supply dynamics in 2020.

For most of 2019, oil prices traded rather aimlessly, averaging approximately \$57/Bbl (WTI) and \$64/Bbl (Brent), well below their averages in 2018. While basic economic theory suggests that commodities trade on both supply and demand, demand seemed to drive oil price movements last year.

Amid two major sources of macroeconomic uncertainty (i.e., the US/China trade war and the Brexit process) headlines pertaining to global oil demand played a dominant role in influencing prices. Consequently, the market essentially ignored the supply side of the equation, which augured a much more bullish outcome. Ultimately, oil prices were largely dictated by demand.

2020: FUNDAMENTALS WILL PREVAIL

With 2019 in the rearview mirror, we forecast that oil prices will recover to six-year highs by the end of 2020. Fundamentals matter; both supply and demand matter in equal measure. Even with the lingering US/China and Brexit headwinds, we anticipate that global oil demand will grow slightly faster in 2020 than this past year, marking 11 consecutive years of growth.

Due to the implementation of IMO 2020 low-sulfur fuel regulations, demand for diesel is likely to be particularly robust. More

With 2019 in the rearview mirror, we forecast that oil prices will recover to six-year highs by the end of 2020.

importantly, there is an unusually bullish combination of supply-side factors.

Saudi Arabia is showing a degree of production discipline that has been a historical rarity. This was true before the recent initial public offering (IPO) of Saudi Aramco, the state-owned oil company. Cynics would say it was an effort to smooth the IPO process; by this logic, Saudi Arabia will presumably want to continue propping up Aramco's stock price by supporting oil prices. The persistent issues curtailing supply from Iran (US secondary sanctions), Venezuela (internal economic collapse), and Nigeria (local militancy) seem likely to continue for the foreseeable future. Meanwhile, as backwarddated (downward-sloping) oil futures exert pressure on the capital budgets of US oil and gas companies, and thus shale drilling activity slows, domestic production growth is set to slow sharply in 2020.

WILDCARDS FOR OIL

Whenever making forecasts about the global oil market, it is important to discuss potential wildcards. Barring a severe global recession, demand is unlikely to present much uncertainty, whereas supply is more of a proverbial 'black box.' In the wake of this past September's stunning drone

Propping up Prices and Production

OPEC and Saudi Arabia have continued to cut their oil production in a bid to prop up global oil prices. This comes amid the initial public offering of Saudi Arabia's state-owned oil company, Saudi Aramco.



attack against Saudi energy infrastructure, which caused the world's largest oil supply disruption since 1991, there remains potential for future instability. Even though we are not assuming additional attacks in our baseline forecast, the possibility cannot be ruled out. An even more dramatic scenario - outright war between Saudi Arabia and Iran, with or without US involvement - looks unlikely based on current geopolitical dynamics (but not impossible). Regime change in Venezuela and escalation of fighting in Libya are other issues to watch.

“Barring a severe global recession, demand is unlikely to present much uncertainty, whereas supply is more of a proverbial ‘black box’.”

Outlook on Prices: Looking Ahead

Our 2020 forecast of \$65/Bbl WTI and \$70/Bbl Brent is back-end-weighted, with the bulk of the gains likely to come in the latter half of the year.

2020			
	WTI CRUDE	BRENT CRUDE	NATURAL GAS
	\$65/Bbl	\$70/Bbl	\$2.30/Mcf

Source: Raymond James Equity Research

Closer to home, we will be tracking the presidential campaign and its potential effects upon drilling activity, especially shale. Generally, commodity prices matter much more to the US oil and gas industry than who is in the White House. But with two of the top three Democratic presidential contenders - Sens. Elizabeth Warren and Bernie Sanders - pledging to ban hydraulic fracturing (fracking) on federal lands, a regulatory shift along these lines could have a meaningful impact on the industry in 2021 and beyond.

NATURAL GAS: SUPPLY ON THE RISE

In contrast to our upbeat view on the global oil market, we are less enthused about North American natural gas due to its ‘inverse’ relationship with oil prices. As recovering oil prices eventually incentivize more oil-focused drilling activity, it will spur an increasing supply of associated gas (whether or not there is demand). Improving takeaway capacity from the



Permian Basin will only exacerbate this, along with increased access to Northeast markets from the Marcellus and Utica Shale formations.

The supply side of the gas equation outweighs the mostly upbeat story on the demand side, led by the ongoing ramp-up of US liquefied natural gas (LNG) exports. Pipeline exports to Mexico are also a growth driver, whereas the power sector is a mixed picture. Retirements of coal-fired power plants are disproportionately being replaced by wind and solar rather than gas.

Meanwhile, the European gas market is also rather weak, with demand near 20-year lows. Wind and solar are capturing market share in the electricity mix to an even greater extent than in the US. Led by China, gas demand in Asia is growing, but not as much as the industry would have hoped.

ESG INVESTING IMPACTS PRICES

Finally, when thinking about the performance of oil and gas stocks - beyond the commodity fundamentals themselves - it will be increasingly vital to consider the environmental, social, and governance (ESG) dimension. ESG investing represents a major long-term trend for institutional and retail investors alike. It is a striking yet under-appreciated fact that 26% of all US professionally-managed assets - equity and debt combined - are already covered by some kind of ESG criteria. Broadly defined, total ESG assets are near \$12 trillion, triple the amount in 2012.

Within the ESG 'pie', the largest 'slice' pertains to climate change. To state the obvious, this trend is more positive for renewable and other low-carbon energy technologies as compared to oil and gas (to say nothing of coal). However, it is possible for oil and gas companies to make operational changes that will make their stocks more appealing for ESG-centric funds. Only a few ESG funds have a blanket exclusion of all oil and gas stocks. Whether it is deploying solar instead of diesel generators, reducing methane flaring, investing in carbon capture, or improving water conservation, the industry is able to adapt to ESG pressures. ■

KEY TAKEAWAYS:

- We anticipate that global oil demand will grow slightly faster in 2020 than this past year.
- We forecast that global petroleum inventories will reach historically-low levels, a recipe for higher prices.
- We forecast that WTI will reach \$65/Bbl and Brent will reach \$70/Bbl in 2020.
- Barring a severe global recession, demand is unlikely to present much uncertainty, whereas supply has many more 'wildcards.'

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