RAYMOND JAMES

VOLUME 13 | ISSUE 1 | JANUARY 2021

INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

The Ten Themes for 2021—Seeking the Thrill of Victory

We wish you a safe, healthy, and prosperous New Year! These words are even more meaningful given the most deadly and economically crippling 'Black Swan' event that we have experienced in the last century—COVID-19. After unprecedented fiscal and monetary stimulus, the record-setting development of multiple effective vaccines has elevated optimism that we will experience the 'thrill of victory' over this nemesis in the upcoming year. The first-ever postponement of the Summer Olympics, scheduled to take place last July in Tokyo, Japan, exemplifies the depths of disruption this pandemic has caused. However, the concept of the torch is associated with hope, light, and strength, an excellent metaphor for the rescheduled start date— 23 July 2021 —likely coinciding with the sustainable reopening of many parts of the world. In fact, in the US, optimistically, more than 50% of the population (the majority of which are among the most vulnerable) could be inoculated from the virus by the opening ceremonies. After more than a year of social distancing, the athletic events are the quintessential celebration for the world coming together once again. As a salute to everyone that has done their part to make this happen—from scientists to frontline workers to the athletes themselves—and to set our sights on a more uplifting time period, we have chosen the Summer Games as the backdrop for our Ten Themes for 2021.

#1: Global Synchronised Economic Recovery – Rowing In The Same Direction

Nineteen of the twenty largest economies in the world experienced a contraction in growth in 2020, but we expect the entire 'crew' to rebound and see positive growth in 2021. The 'coxswain' of the recovery will continue to be global central banks, led by the U.S. Federal Reserve (Fed), as its decisions to keep interest rates low and liquidity robust will ultimately dictate the power and pace of the global economic recovery. With short-term interest rates at or below zero for the foreseeable future and global central banks having the stamina to allow inflation to overshoot temporarily, economies should have a favorable glide path to recovery. Given that monetary and fiscal stimulus actions have a lagging economic impact, we expect all these economic oarsmen to experience a 'swing,' or synchronised forward motion, by midyear.

#2: US Economic Recovery Taking On A Triathlon

While our overall expectation is that the US economy will return to healthy, positive economic growth on an annual basis (2021 US GDP forecast: ~4%), the recovery will be defined by transitional periods with varying paces throughout the year. At the onset, worsening COVID trends and paused reopening processes will prove to be a challenge. Analogous to swimming, the first leg of the triathlon, the pace will be slower than that of the biking and running legs, and the waters may be choppy. However, by the spring, economic growth will accelerate as the dissemination of vaccines 'push the pedal' for more businesses to safely reopen. Pent-up demand, especially for services, a rebuild of depleted inventories, an improving labor market and a resurgent global economy should help the economy notch its 'top speed' through the summer and early fall. However, toward the end of the year, we expect the US economy to reach a steadier 'stride,' finishing at a slower, but more sustainable pace.

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 financial advisor to discuss the content of this publication in the context of your own unique circumstances. Published 13/1/2021. Material prepared by Raymond James as a resource for its financial advisors.

> “With pullbacks still a natural occurrence for the equity market, it is critical that investors have a strategy in place for when the times get ‘rough’ so that emotionally-driven decisions don’t lead portfolios into ‘hazards.’”

#3: Fixed Income – Keeping Portfolios En Garde Despite Low Yields

Fencing is a sport that requires agility, coordination, balance, and timing – the same skill set global central banks displayed when adjusting interest rates in light of the COVID-19 pandemic. At the beginning of 2020, the 10-year Treasury yield was ‘targeting’ the 2% level, but the global health crisis led the Fed to ‘sabre’ yields to record lows, resulting in the yield ‘striking’ a historic low of 0.50% last March. This year, our envisioned acceleration in economic growth should ‘thrust’ the yield back to the 1.50% level by year end; but low inflation, central bank buying, strong foreign demand and the growing economic sensitivity to higher yields will ‘parry’ yields from returning to levels near 2% on a sustainable basis. With the Fed pledging to keep interest rates low until at least 2023, the yield curve will likely steepen, and therefore we encourage investors to limit longer duration bonds. The opportunities for yield will remain restricted, and rather than ‘lunging’ at lower-quality bonds in pursuit of yield, investors should allow bonds to serve their more traditional role in portfolios. In the year ahead, we expect bonds to offset the potential for equity volatility rather than produce the robust capital appreciation returns we have grown accustomed to over the last several years.

#4: Equity Market – Earnings Will Do The Heavy Lifting

In 2020, for the second consecutive year, equity market returns were ‘lifted’ by P/E expansion, as optimism surrounding the eventual economic recovery drove the equity market to record highs in the midst of the outbreak. We remain positive on equities over the next 12 months, but it will be a ‘powerful’ earnings rebound (20% plus EPS growth in 2021) that will ‘raise the bar’. Earnings are often revised higher in the period following a recession, so when combined with tailwinds such as multiple vaccines and additional fiscal stimulus, the S&P 500 is likely to reach 4,025 by year end. We continue to favor the large-cap growth space at this stage of the recovery; however, value and small-cap equities may ‘out-muscle’ the space later this year as the economy fully reopens.

#5: Info Tech – Hitting The Bullseye Of Our Sector Target

The sport of archery incorporates both accuracy and precision, the same qualities we ‘aim’ to possess as we determine our preferred sectors. The Information Technology sector has been the top performing sector for three of the last four years, and we believe the rollout of 5G and the manner in which the pandemic altered the way companies conduct business will be additional ‘arrows’ in the sector’s ‘quiver.’ The COVID-19 outbreak forced businesses to establish an online presence and to reconfigure operations in an effort to meet safety guidelines. It also revealed several efficiencies in the way we live our everyday lives (e.g., e-commerce, streaming, telehealth), and has permeated industries not typically associated with tech due to ongoing innovations related to artificial intelligence (e.g., the use of drones in agriculture). Elevated tech investment has placed the sector at the center of our allocation ‘target,’ but given the tech-based adaptations in other industries, we believe investors can still ‘score points’ with the Health Care, Consumer Discretionary, Communication Services, and Industrials sectors.

#6: ESG – Wave Of Socially Responsible Investment Not About To Break

The sport of surfing began prior to 1770, but it will make its debut in the upcoming games this year! Similarly, the principals of environmental, social, and corporate governance investing have been practiced for decades, but between the Biden administration and the lingering impacts of the COVID-19 pandemic, the ESG ‘wave’ is

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

expected to grow. Throughout his campaign, Biden emphasised the importance of 'clean technology' and his appointment of a climate czar is an early sign that he will follow through on his promise. While affirmative action will be undertaken by the federal government, we expect companies will continue to 'ride the wave' of setting, adhering, and disclosing their ESG-related goals and principles. Whether it be through an exclusion, thematic, or impact approach, we expect investors to have heightened awareness of the sectors better aligned with positive environmental and societal outcomes.

#7: International – Exposure Abroad Will Be A Balancing Act

The 'uneven bars' are one of the four events for female gymnasts, but they are also prevalent in our equity allocation preferences, as our bias toward US equities remains intact. The broad-based global economic recovery would typically lead us to be more 'flexible' with our international exposure, but the sector allocation in Europe (e.g., overweight Financials in the low-rate environment) has garnered the region a few 'deductions.' However, our expectation for a weakening dollar, attractive valuations and our bias toward Info Tech, Communication Services, Consumer Discretionary, and Industrials present a favorable outlook for emerging market equities, as these sectors combine for more than half of the Emerging Markets Index.

#8: US Dollar Will Not Have The Inside Track

The COVID-19 pandemic sparked demand for safe-haven assets, causing the dollar to 'clear a jump' to the highest level since January 2017. However, once the panic associated with the start of the outbreak was subdued, the dollar weakened to its lowest level in two years. The global economy's recovery, ongoing aggressive fiscal and monetary policy action, a growing budget deficit, and more likely than not easing trading restrictions with China and our allies will all serve as 'hurdles' in the dollar's path, preventing it from moving higher. Ultimately, the weakening of the dollar may 'pass the baton' to emerging market equities, emerging market bonds, commodities and US multinational companies.

#9: Oil Demand To Catch The Crosswind Of Economic Activity

2020 was anything but 'smooth sailing' for the oil industry, as the Saudi-Russia oil price war (excess supply) combined with the virus-induced lockdowns (weak demand) weighed heavily on oil prices. As we look ahead to 2021, a sustainable return to normality is expected to cause the best rebound in global oil demand since 1973. The gradual rise in oil prices (WTI Crude $60/bbl year-end target) should put 'wind in the sails' of the industry's lagging recovery, but there may be more 'elements' to face. With the environment a top campaign issue for Biden, a renewable energy 'storm' is on the horizon. The consumption of renewable energy has tripled over the last 20 years, and additional regulatory shifts under the new administration could cause the Energy sector to 'sail' in a new direction.

#10: Keeping Asset Allocation Parameters On The Fairway

Fortunately for investors, our expectation is for overall market volatility to be more palatable in the year ahead, driven by the gradual reopening of the economy, more stable monetary policy and less political risk. But just because volatility won't be 'on par' with that of 2020, does not make adherence to asset allocation parameters of any less importance. With pullbacks still a natural occurrence for the equity market, it is critical that investors have a strategy in place for when the times get 'rough' so that emotionally-driven investment decisions don't lead portfolios into 'hazards.' With valuations stretched from a historical perspective, selectivity will be key in 2021, and we expect that active managers will serve as 'caddies,' having insights into potential areas for opportunity.

After a tumultuous 2020, the words spoken by tennis legend and four-time gold medalist Serena Williams—"I've grown most not from victories, but setbacks"—are arguably just as true for investors as they are for athletes. The year reminded investors of the importance of a well-crafted 'game plan,' one that prepares for potential challenges ahead. While your wealth manager can offer in-depth insights more specific to your situation, we hope that our views on the economy and various asset classes serve as a reliable, integral part of this plan, and that our timely commentary throughout the year can help guide your portfolio to the top of the podium.

Again, we wish you all the best for a wonderful 2021!

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

Investment Strategy Committee Members

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

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

Scott J. Brown, PhD Chief Economist, Raymond James

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 Solutions

Nicholas Lacy, CFA Chief Portfolio Strategist, Asset Management Services

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

Ed Mills Managing Director, Washington Policy Analyst, Equity Research

Pavel Molchanov Director, Energy Analyst, Equity Research

Chief Investment Office

Anne B. Platt, AWMA®, AIF®, RICP® – Committee Chair, Vice President, Investment Strategy & Product Positioning, Investment Strategy

Giampiero Fuentes Investment Strategy Manager, Investment Strategy

Kailey Bodine Investment Strategy Analyst, Investment Strategy

*An affiliate of Raymond James & Associates, Inc., and Raymond James Financial Services, Inc.

2021 Economic Outlook: A Return to Normal?

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

Pandemics have often played a significant role in world history – 2020 added another chapter. In past episodes, including the 1918 influenza outbreak, government officials fought over wearing masks and public health guidelines. Some things never change.

> The worst of the pandemic was met by the best in monetary and fiscal policy.

IMPACT OF COVID-19

The COVID-19 pandemic had mixed effects on households. Job losses were more concentrated in low-wage service industries. About 40% of those in the bottom 20% of income earners lost jobs in April and May. White collar workers were more easily able to work from home and experienced a more V-shaped recovery in jobs. Consumer spending fell sharply amid the spring lockdowns, but self-imposed isolation (on health concerns) appears to have had a greater impact. Most of the hit was to consumer services, including leisure and hospitality, tourism, spectator events, and restaurants. With a limited ability to spend on these services, spending on durable goods rose above pre-pandemic levels. However, while spending on consumer services picked up off the April lows, activity remained depressed into the fourth quarter.

There is a trade-off between economic activity and efforts to contain the virus. Locking things down to prevent the spread reduces activity. Conversely, opening up the economy allows the virus to spread more widely. The harsh lockdowns in April and May were critical in preventing hospital overload, allowing time to increase hospital capacity, to distribute personal protection equipment, and to develop treatments. As restrictions were eased, infections increased in the summer months, but mostly for young (healthier) adults. The third wave has hit those aged 60 and above (those more susceptible). This surge has led state and local governments to reimpose restrictions on in-person services, which will dampen the pace of economic improvement in early 2021.

Luckily, vaccines are on the way. The effectiveness of potential vaccines was very good in early trials. Their distribution should lead to better improvement in the economy in the second half of the year. However, many people may not accept a vaccine. Others may be reluctant to resume social contact even after being vaccinated. However, savings of mid- and upper-income households increased during the pandemic and people will be eager to travel, to go to music and sporting events, and to resume their previous lifestyles. Most likely, the level of GDP will match the fourth quarter 2019 level by the middle of 2021, but that will still leave us below trend (that is, without the pandemic, output would have been growing due to population growth and productivity gains).

> "There is a trade-off between economic activity and efforts to contain the virus. Locking things down to prevent the spread reduces activity. Conversely, opening up the economy allows the virus to spread more widely."

POLICYMAKER RESPONSE

The worst of the pandemic was met by the best in monetary and fiscal policy. The Federal Reserve (Fed) quickly lowered short-term interest rates to near 0%, restarted lending facilities that it had employed during the financial crisis and created some new ones along the way. It also expanded the balance sheet (from $4 trillion to $7 trillion) to ensure that there was more than adequate liquidity in the financial system. Lawmakers in Washington passed massive fiscal support, funding healthcare, extending unemployment benefits, offering loans and grants to small business, and aiding state and local governments.

Most Federal Reserve officials expect to keep short-term interest rates low through 2023. The Fed revised its monetary policy goals and strategies in 2020 and signaled that it intends to follow periods where inflation (as measured by the PCE Price Index) is below the 2% target with periods of inflation above 2%. This is no mathematic formula; monetary policy will remain a judgment call. However, it does signal a greater tolerance for somewhat higher inflation. The Fed's employment goal has been made 'broad-based and inclusive.' Low unemployment significantly benefits low-income communities. The Fed will no longer tighten because unemployment falls to a certain level. A key takeaway from the pre-pandemic years is that there is a lot more slack in the labor market than the official figures would suggest. This isn't a major change from the way the Fed has conducted monetary policy in recent years, but writing it down was an important signal for the financial markets.

A key issue for the Fed in 2021 will be deciding when and how much to reduce monthly asset purchases. The financial markets (especially the stock market) have been sensitive to changes in the Fed's balance sheet. As the economy recovers, the Fed should return focus to maintaining an adequate level of reserves in the banking system.

FISCAL SUPPORT VERSUS AUSTERITY

Fiscal support was critical in offsetting the worst of the pandemic, but it added to the federal budget deficit, which had been trending at $1 trillion per year before the pandemic. The government has no problem borrowing and the Fed has placed much of the increased debt on its balance sheet. Interest rates are low and even with the added borrowing, interest payments on the debt over the next decade are projected to be lower than before the pandemic. The real danger with fiscal policy is not doing enough to support growth and removing support too soon. Austerity may be an individual virtue, but the government is not a household. The debt does not need to be paid off. At some point, lawmakers should work to have federal debt rising no faster than nominal GDP, keeping the debt to GDP ratio stable or declining over time; however, now is not the time. Tax increases or spending cuts in an economic recovery make that recovery weaker.

As with any economic downturn, there is generally downward pressure on inflation, reflecting increased slack in resource markets. Some prices fell sharply during the lockdown phase and rebounded sharply as the economy reopened, but have since moderated. Input cost pressures related to the supply chain disruptions have been noticeable, but firms generally have difficulty in passing such costs along to the consumer. Strong demand for durable goods added some pressure, but inflation in consumer services has slowed. The shift to working from home has led to strong housing demand and the supply of available homes for sale has been limited. However, high housing price inflation does not show up in the Consumer Price Index. A house has two functions: it's an asset and it provides shelter. The Bureau of Labor Statistics seeks to measure the price of shelter, not the asset value, and so considers the rental equivalent – and rents have generally risen more slowly in the pandemic.

The labor market is the widest channel for inflation pressure. Average hourly earnings surged during the lockdown, but this was a byproduct of arithmetic. Job losses were concentrated in lower-paying industries and in lower-paying positions within individual firms, which increased the average. For the private sector, the Employment Cost Index (ECI), which is not affected by compositional changes and includes benefit costs, rose 2.4% over the 12 months

> "The Fed's employment goal has been made 'broad-based and inclusive.' Low unemployment significantly benefits low-income communities. The Fed will no longer tighten because unemployment falls to a certain level."

ending in September, vs. 2.7% in the year before. Productivity figures have also been distorted by the loss of low-wage, low-productivity jobs, but assuming a moderate underlying trend of 1.0-1.5% implies little inflation pressure from labor costs.

The incoming administration will likely focus on healthcare issues, preventing the spread of the virus and distributing vaccines. Economic policy efforts beyond that will depend on the makeup of Congress, but we are unlikely to see major tax increases or big spending plans (other than immediate pandemic-related support). If, as expected, social distancing remains elevated in early 2021, economic growth will be weaker. Federal aid should focus on supporting the long-term unemployed and small businesses.

Federal support will also be important for state and local governments, helping to ease budget strains from lost revenue. These strains were a significant issue in the 2008 financial crisis, despite federal aid in that recession, and dampened the pace of growth in the early years of the economic recovery. State and local governments employ about seven times as many workers as the federal government. In the recovery from the financial crisis, we lost teachers, police and fire personnel, and had only reached the pre-crisis level of state and government payrolls in the year before the pandemic.

The Biden administration will have a longer-term focus on issues such as climate change, income inequality, and antitrust regulation. Trade policy was a major issue in the Trump administration. Tariffs are paid by US consumers and businesses. They raise costs, invite retaliation, disrupt supply chains, and add uncertainty, dampening business investment. Tariffs may be rolled back, but bashing China plays well politically, and the folks in Washington will look ahead to the 2022 mid-term and 2024 elections. Still, we should see more cooperation on the world stage.

LESSON LEARNED

The study of past pandemics shows that economic activity eventually recovers after the crisis has passed. Importantly, we should be better prepared for the next one.

KEY TAKEAWAYS:

- Most likely, the level of GDP will match the fourth quarter of 2019 level by the middle of 2021, but that will still leave us below trend (that is, without the pandemic, output would have been growing due to population growth and productivity gains).
- Fiscal support was critical in offsetting the worst of the pandemic, but it added to the federal budget deficit, which had been trending at $1 trillion per year before the pandemic.
- At some point, lawmakers should work to have federal debt rising no faster than nominal GDP, keeping the debt to GDP ratio stable or declining over time; however, now is not the time.
- Federal aid should focus on supporting the long-term unemployed and small businesses. Federal support will also be important for state and local governments, helping to ease budget strains from lost revenue.

Brexit: A Deal at Last!

Jeremy Batstone-Carr, *Interim European Strategist,* Raymond James

And so, four and a half years to the day after the UK voted to leave the European Union after more than forty years of membership and just seven days before the end of the year-long transition period, a Brexit deal has been agreed and now ratified by both the UK parliament and by EU authorities. By reaching an agreement, a potentially messy and disorderly no-deal departure, in the midst of the pandemic, has been avoided.

Has anything changed? Inevitably, COVID-19 has stolen the show. The pandemic set the narrative throughout 2020 and has dominated the conversation again as the New Year gets underway, relegating Britain's departure to the inside pages. For the intrepid traveller, braving the Eurostar from London St. Pancras to Paris Gare Du Nord (even overseas visits once regarded as routine) now feels like a trip into the unknown.

The first sign of change comes upon arrival in the French capital. No longer can one stroll, expectantly, onto the station concourse. Now, one queues with one's fellow subjects on the platform before being directed to a customs door. Papers are required before being ushered through by somnambulant officials. This, for many, will likely be the first clear indication of Brexit in action. Financial market reaction to confirmation that a deal had, at last, been struck was muted.

“Financial market reaction to confirmation that a deal had, at last, been struck was muted.”

In large part, this had to do with the fact that agreement (on trade at least) had been struck on Christmas Eve when the European stock and bond markets had closed. The pound's reaction proved underwhelming too, this a reflection of the widely, if not firmly, held view that a deal of some description would be reached before the clock ran down at 23.00 GMT on 31st December. Prior to the deal's confirmation, sterling had risen from \$1.33 to \$1.37 and from €1.09 to €1.11. Arguably, the best news of all, for those responsible for crafting the agreement, is that there has been no “sell the news” reversal, or at least nothing outwith the dismal news relating to yet another national lockdown.

The document itself runs to well over 1,000 pages of densely worded legalese and attempts to establish an outline as to how the relationship between the two parties might operate in the future. Last-minute hitches appeared to concern fisheries, a hugely contentious issue on both sides. An indication as to who gave what ground in negotiation might be gleaned from the belief that the UK initially wanted an 80% reduction in the value of the fish caught by EU trawlers in UK waters, but ultimately settled for a mere 25% cut, and phased in over a five-and-a-half-year period, a much shorter period than that which the EU originally bargained for. Once over, the UK will fully control access to its waters, but any exclusion will result in compensation for losses either through tariffs on fish (or other goods) or through the prevention of UK trawlers fishing in EU waters. Dispute resolution, needless to say, will likely take years of negotiation to work through.

More generally, the deal covers a wide range of issues, from law enforcement to transportation. Tariffs and/or quotas will not be imposed immediately upon goods moving between the UK and EU, maintaining the existing arrangement. However, by leaving the EU customs union checks and other procedures will be required, adding to disruption and delay at the border.

In terms of individual travel, visitors to the EU planning on staying for more than 90 days in a 180 day period, will require a visa. European Health Insurance Cards (EHIC) will remain valid until expiry. Both sides have agreed to cooperate regarding international mobile phone roaming charges, but there is nothing stopping UK travellers from being charged by providers for using phones in the EU, and vice versa.

Notably, the deal does not cover financial services. The issue of "equivalence", relating to UK rules governing financial services as roughly equivalent to those in the EU, would make it easier for UK financial firms doing business abroad to continue to do so. The European Commission is seeking additional clarification from the UK before reaching a decision on this matter.

> "Notably, the deal does not cover financial services."

TURNING TO THE ECONOMIC IMPACT

Following agreement on Brexit, the UK economy had been expected to deliver real GDP growth of around 1.0% on the quarter. However, the impact of the third UK lockdown will muddy the water. Given that the latest lockdown will remain in place until at least 22 February, UK real GDP is now thought likely to contract by around 3.5% points over Q1.

Whilst not as severe as the impact of the first lockdown (factories and construction sites will remain open and many service sector employees can now work from home), the level of GDP will still be adversely impacted, especially through the impact of school closures.

In Europe, any adverse impact associated with Brexit is likely to be much more muted and concentrated more in those countries with strong trading links to the UK, or geographic proximity. Indeed, the EU has moved swiftly to negate any long-term negative consequences announcing, with great fanfare, a bilateral investment treaty with China. This latest pivot away from decades of interdependence with the US, whilst celebrated in Beijing will likely be poorly received in Washington DC. The US is thought likely to need European support if it is to strong-arm China into some sort of acquiescence.

In conclusion, notwithstanding the adverse impact that COVID-19 is wreaking in both the UK and Europe, the Brexit deal should help reinforce the belief that 2021 might be a year of two halves, with a strong economic recovery evolving as the year progresses.

KEY TAKEAWAYS:

- A Brexit deal has been agreed and now ratified by both the UK parliament and by EU authorities. A disorderly no-deal departure, in the midst of the pandemic, has been avoided.
- Financial market reaction to confirmation that a deal had, at last, been struck was muted.
- By leaving the EU customs union checks and other procedures will be required, adding to disruption and delay at the border.
- Visitors to the EU planning on staying for more than 90 days in a 180 day period, will require a visa. European Health Insurance Cards (EHIC) will remain valid until expiry.
- The deal does not cover financial services. Negotiations around "equivalence" continue.
- In Europe, any adverse impact associated with Brexit is likely to be much more muted and concentrated more in those countries with strong trading links to the UK, or geographic proximity.
- The Brexit deal should help reinforce the belief that 2021 might be a year of two halves.

2021 Washington Outlook: The Impact of the Biden Administration on the Market

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

Democrats are in position to control the White House, Senate (pending final vote certification as of this writing), and the House of Representatives, completing a Democratic sweep and ushering in a new set of priorities, bound to have an impact on both the economy and market. The policy outlook for the next year, while dominated by the COVID-19 response, will also look to advance a Biden administration's economic priorities in the areas of energy and the environment, manufacturing, trade, and consumer protections with the associated market impact. The very thin Democratic majority margins in the House and Senate will effectively moderate the direction of policy changes, but Democrats do have tools to enact impactful policies in the areas of taxation and spending.

In the near term, policy uncertainty may elevate volatility, but heightened expectations in the longer term of recovery-supporting measures and an increase in federal spending will continue to support positive market sentiment. Thematically, we could see Consumer Discretionary and Financials be two of the best positioned sectors. Technology, on greater antitrust regulations and tax changes, could see weakness, but we believe the sector remains well positioned for the future in a unified Democratic government.

In the near term, policy uncertainty may elevate volatility, but heightened expectations in the longer term of recovery-supporting measures and an increase in federal spending will continue to support positive market sentiment.

BIDEN WITH A DEMOCRATIC CONGRESS: THE FIRST 100 DAYS AND BEYOND

With a 50-50 tie in the Senate, control of the chamber goes to the party of the vice president, which will be Kamala Harris, making a 50-50 Senate a Democratic majority. Senator Chuck Schumer (D-NY) would serve as Senate Majority Leader and would be in control over which bills and nominees receive a vote in the Senate. The Democratic agenda will lead with additional fiscal stimulus and the confirmation of key Biden appointees. Later this year we expect a budget reconciliation bill to pass and include tax changes. The key debate we have observed is a belief that Dems may transition any

> "Aside from the immediate focus on COVID-19 mitigation and recovery, we expect the bulk of Biden's executive actions to be focused on climate and foreign policy."

tax changes and focus on the economic items (market positive) before tax and regulatory changes (market negative). We believe that there is some truth to this assumption and the Democratic agenda will not be as robust than if they had won 53-55 Senate seats in the November election, but it is important not to understate how impactful having control of the Senate will be for control of the Senate agenda.

We expect Democrats to use budget reconciliation in 2021 to enact tax changes and implement other portions of their agenda (i.e., paid sick leave, child care, and/or infrastructure spending). Budget reconciliation is allowed once per budget and only requires a simple majority vote in the House and Senate (no filibuster). It is generally subject to revenue (taxes and spending), but it has limits (current rules do not allow changes to Social Security). With a narrow House majority and the need to get every Senator on board before passage, this debate is likely to have false starts and breakdowns in negotiations. However, with reconciliation the only pathway for legislation with a simple majority, we expect Democrats to do everything possible to find a final compromise.

The filibuster (the 60-vote threshold for votes in the Senate) is not expected to be eliminated for legislation. Changing the filibuster is a change to Senate rules, which only requires a simple majority, so it is within their power to change the threshold, if they have unanimous support. Currently they do not have the support to change the filibuster, but we will be watching to see if there are incremental changes that place more requirements on the minority to sustain a filibuster or eliminate the filibuster for appropriations bills. Pressure may build on Democratic lawmakers to change the filibuster if it is effectively used to block key agenda items.

As is typical with discussions on increasing spending, there will also be negotiation on how to pay for it. This is where we expect tax adjustment considerations to come into play, and a Biden administration supported by Democratic lawmakers has a clearer path to raise certain taxes through the budget reconciliation process. Biden's tax plan broadly calls for raising the corporate tax rate to 28% and tightening tax rules on overseas income, which we expect could be paired with extending middle class tax cuts on the personal side on a permanent basis. There is a big debate in DC over timing on any potential tax changes. Legislation is not allowed to be retroactive, with the exception of tax law, which can be retroactive to January 1 of the year passed. We believe that Democrats would take a staggered approach, if given the opportunity, but some changes would begin in 2021. As highlighted earlier, compromise will be necessary to achieve this goal and with zero margin for error, we can expect false starts and potential breakdowns in the process – further heightening policy uncertainty.

EXECUTIVE ACTION IN A BIDEN ADMINISTRATION: EXPECT CLIMATE AND FOREIGN POLICY AS THE FOCUS

A very thin majority Congress elevates the prominence of executive action as a driver of policy change in the Biden administration. Aside from the immediate focus on COVID-19 mitigation and recovery, we expect the bulk of Biden's executive actions to be focused on climate and foreign policy. Specifically, we expect a Biden administration to use executive authority to drive a clean energy transition in the federal government through procurement and modernisation of federal facilities toward increased energy efficiency. Biden's newly-created White House Climate Coordinator position, to be held by former Obama EPA administrator Gina McCarthy, is a clear sign of executive climate action as a key priority for 2021. A longer-term area to watch is the Biden trade agenda, especially the direction of economic ties with China. Biden has signaled there will be no quick action on Trump-era China tariffs, but we ultimately expect the administration could explore tariff adjustments for widely-available goods or goods tied to climate policy objectives as a further economic boost.

AS FOR THE REGULATORY AGENDA, PERSONNEL IS POLICY

Biden's picks to lead regulatory agencies are another factor impacted by the Georgia Senate outcome flipping Senate control to Democrats. Biden has largely avoided polarising picks, however, there are still key positions without a nominee. Democrats would have control over setting confirmation votes and would ensure many more of

Biden's picks receive a confirmation vote. This likely alters some of the individuals that Biden nominates to the final key positions and will have a significant impact on the agencies with boards. Senate rules still allow delays in confirmation votes, which were used effectively by Democrats in the minority to slow the confirmation process during the Trump administration.

Generally speaking, Biden's cabinet picks to date have signaled a prioritisation of economic recovery and growth over a robust regulatory rulemaking agenda. However, a Biden administration will have significant regulatory levers at its disposal – even before nominees are confirmed by the Senate.

We expect a significant focus in the early part of 2021 will be on an agenda of consumer protection. The Biden administration's authority in this area is greater following the Supreme Court's ruling in the *Seila Law v. Consumer Financial Protection Bureau (CFPB)* which gives the president immediate authority to fire and replace the Consumer Financial Protection Bureau Director at will. We expect this will be one of the earliest opportunities for the Biden administration to demonstrate a consumer protection focus to progressive lawmakers.

THE 2022 MIDTERMS ARE OFFICIALLY UNDERWAY

It's never too early to look to the next election. We expect a further moderating factor in terms of policy will be the greater than expected losses suffered by Democrats in the House in the 2020 cycle. Republicans are now within striking distance of taking back the majority in 2022 – requiring five net seats gained to flip the chamber. To conclude, while a Democratic sweep may raise fears of sweeping policy changes, we expect moderate policy adjustments with a focus on economic recovery that supports markets over the long term.

KEY TAKEAWAYS:

- The policy outlook for the next year, while dominated by the COVID-19 response, will also look to advance a Biden administration's economic priorities in the areas of energy and the environment, manufacturing, trade, and consumer protections with the associated market impact.
- With a 50-50 tie in the Senate, control of the chamber goes to the party of the vice president, which will be Kamala Harris, making a 50-50 Senate a Democratic majority. Senator Chuck Schumer (D-NY) would serve as Senate Majority Leader and would be in control over which bills and nominees receive a vote in the Senate.
- Generally speaking, Biden's cabinet picks to date have signaled a prioritization of economic recovery and growth over a robust regulatory rulemaking agenda.
- While a Democratic sweep may raise fears of sweeping policy changes, we expect moderate policy adjustments with a focus on economic recovery that supports markets over the long term.

2021 US Equity Outlook: Turning the Page

J. Michael Gibbs, *Managing Director,* Equity Portfolio & Technical Strategy
Joey Madere, CFA, *Senior Portfolio Analyst,* Equity Portfolio & Technical Strategy

As the calendar turns to 2021, we maintain a positive view on the equity markets. This stance stems from our expectation for an economic recovery, fueled by the likelihood of at least three vaccines with stated 90% plus efficacy rates. This increases the chances that enough of the population (essential workers and those most at risk) gets vaccinated to allow for an economic reopening as 2021 progresses in our quest for a return to normality. Economic data and corporate earnings have recovered well above feared expectations from six to nine months ago, momentum that we believe will continue over the intermediate term. We also believe the Federal Reserve (Fed) will remain accommodative and on hand to support the economic recovery as needed.

The Democratic sweep raises the odds of higher fiscal stimulus and spending, however it is also likely that Democrats will want to pay for this stimulus with higher taxes down the road. The slim majority may temper the ability for the full agenda to be completed and may make the battles tougher, but we do believe the majority of President-elect Biden's agenda ultimately gets accomplished. The result is a net positive for potential economic growth this year, and consequently enhances the reflation trade already underway on vaccine optimism. However, while the short-term outlook (six to twelve months) is bolstered due to the likelihood of increased stimulus, the longer-term outlook (beyond six to twelve months) is murkier given the potential for higher taxes, higher interest rates, and lower valuations. The prospect of higher taxes will be a headwind to earnings growth in 2022 and 2023 in our view. This will also likely be a headwind to valuation multiples later this year, as investors position over time for the coming changes.

> "Economic data and corporate earnings have recovered well above feared expectations from six to nine months ago, momentum that we believe will continue..."

> “... we maintain a positive view on the equity markets. This stance stems from our expectation for an economic recovery ...”

Additionally, questions remain about the ongoing virus surge, vaccine capacity and distribution, timing and size of stimulus, and the pace of the economic recovery. So while we are positive on equities over the next 12 months, we would not be surprised for the road to be bumpy along the way.

S&P 500 TARGETS (BASE/BULL/BEAR CASE SCENARIOS)

Our base case S&P 500 target for 2021 is 4,025 ($175 EPS, 23x P/E). We use $175 in earnings, above the current consensus estimate of $166, due to our positive expectation on the economic and fundamental recovery in the year ahead. It is also normal for estimates to be revised higher coming out of recessions, as analysts historically set the bar too low in dire economic times. This is the exact opposite of normal times when analysts typically set estimates too high and have to revise lower into the actual results. For example, coming out of the last two recessions, S&P 500 earnings estimates for the following year (2004 and 2010) trended higher from the bear market low to year end by 3-5% and continued in the following year by another 8-10%. In the current timeframe, 2021 estimates have been revised higher by 4% so far (in line with those previous periods), and our earnings estimate of $175 reflects just a 4.5% further move upward. This $175 estimate is a 27% snap-back in growth from 2020’s pandemic-depressed earnings (and 9% above 2019 earnings).

2021 Year-End Outlook

S&P 500	EPS ESTIMATE	P/E	PRICE
Bull Case	$190	22x	4,180
Base Case	$175	23x	4,025
Bear Case	$160	20x	3,200

Source: Raymond James Equity Portfolio & Technical Strategy

We also believe valuation multiples can remain elevated given the low inflationary and interest rate environment. The current S&P 500 P/E of 27.5x is well above the historical average of 16.5x. However, when taken in conjunction with still low interest rates, the current valuation is more reasonable in our view. For example, the equity risk premium (S&P 500 earnings yield vs. US 10-year Treasury yield) is currently 2.6%. This remains well above the long-term average of 0.6% (since 1954) and just marginally below its pre-pandemic level last January. Moreover, the S&P 500 dividend yield of 1.5% is 0.5% higher than the US 10-year Treasury yield. Despite equities being at all-time highs, this is still in line with the highest spreads on record prior to COVID-19- reflecting a still attractive environment for equities versus bonds in our opinion. It is also normal for valuations to elevate coming out of recessions due to depressed earnings as investors discount the eventual recovery. As earnings rebound in 2021, we expect the S&P 500 P/E multiple to contract. However, the Fed has stated its intent to keep interest rates lower for longer in order to support the economic recovery, which also supports above-average multiples in our view. Therefore, we use a 23x P/E in our base case 2021 scenario which, combined with our $175 earnings estimate, produces a S&P 500 target of 4,025.

In a bull case scenario, we believe the S&P 500 can trade to 4,180. In the event that the virus spread subsides and COVID-19 vaccinations allow a quicker reopening process (in conjunction with fiscal stimulus) that results in upside to growth expectations throughout 2021 (i.e., GDP growth is closer to ~6.5% than ~4.5%), we believe S&P 500 earnings could potentially reach $190. With this stronger growth backdrop, it is likely that inflation and interest rates are marginally higher than under our base case scenario, resulting in a slightly lower valuation assumption. We use a 22x P/E in this scenario as valuation also normalises at a quicker rate. Applying this 22x P/E to $190 earnings results in a bull case S&P 500 target of 4,180.

In a bear case scenario, we see the S&P 500 downside at 3,200. If virus concerns linger for longer and hamper the reopening process and pace of economic recovery (i.e., GDP growth is closer to 3% in 2021), we believe earnings revisions could break from their historical upward trend out of recessions and finish near $160. In this scenario, tax increases also become an overarching theme for the longer-term outlook and outweigh the benefits of spending increases. As investors discount the impact from these tax changes to 2022 earnings, the result is a lower P/E. We use a 20x P/E, over 10% lower than our base case P/E assumption of 23x, in this scenario- resulting in a S&P 500 bear case target of 3,200.

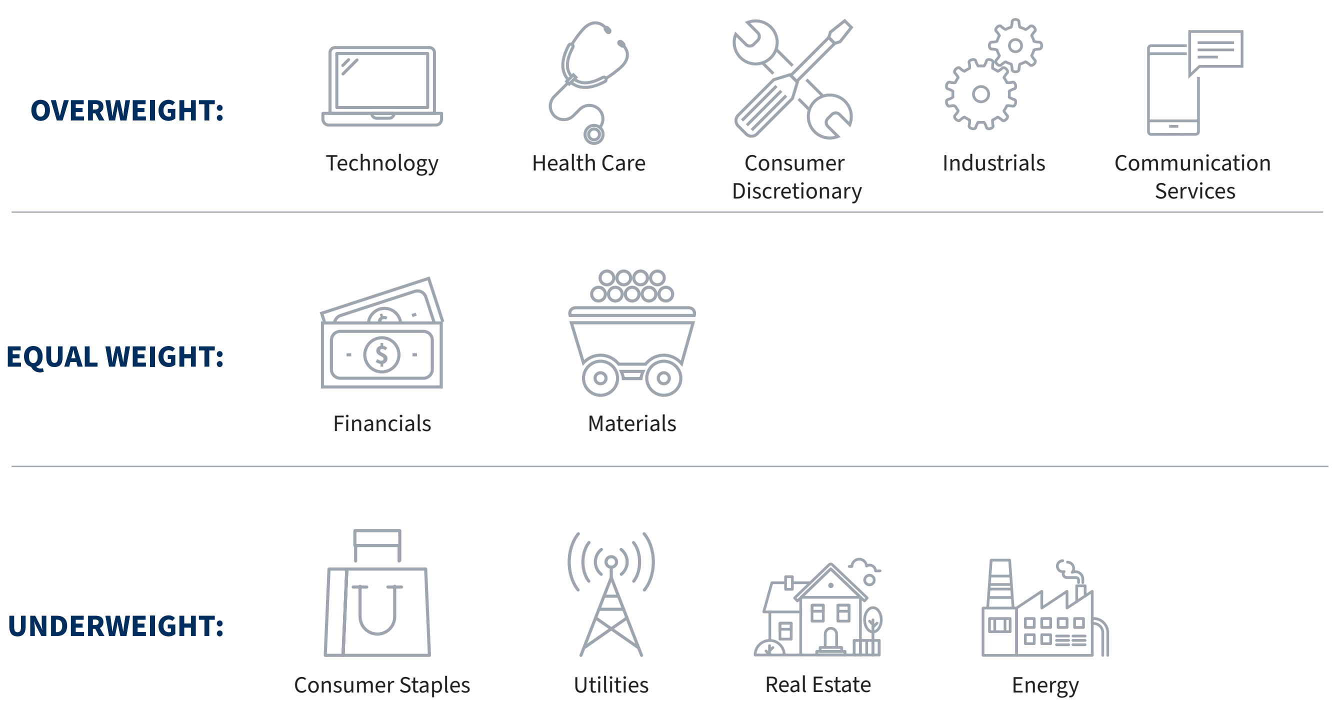
PORTFOLIO POSITIONING

At the sector level, the pandemic created a bifurcated market in which roughly half of companies saw positive earnings growth this year (i.e., Technology-oriented, Health Care, Consumer Staples), while the other half saw their fundamentals decline substantially (i.e., small caps, Energy, Industrials, Financials, and select consumer areas). Also, this spread was wide with a median earnings growth rate of 10% for the 'winners' and a median earnings contraction of 19% for the 'losers.' As the economic reopening gains momentum in 2021, the more economically-sensitive areas that were beaten up the most by the pandemic should generally see the greatest upside. Many of these areas have seen sharp outperformance since early November on vaccine and stimulus optimism, so from current levels we recommend a pragmatic approach to portfolio repositioning.

For this reason, we believe it is important to maintain a healthy allocation to the areas operating best through the pandemic while also accumulating areas with the greatest leverage to the economic recovery. Thus, our current overweight sector recommendations — Technology, Communication Services, Health Care, Consumer Discretionary, and Industrials — reflect a combination of this strategy. We maintain equal weight recommendations to the also cyclical Financials and Materials sectors, and continue to underweight Energy for now.

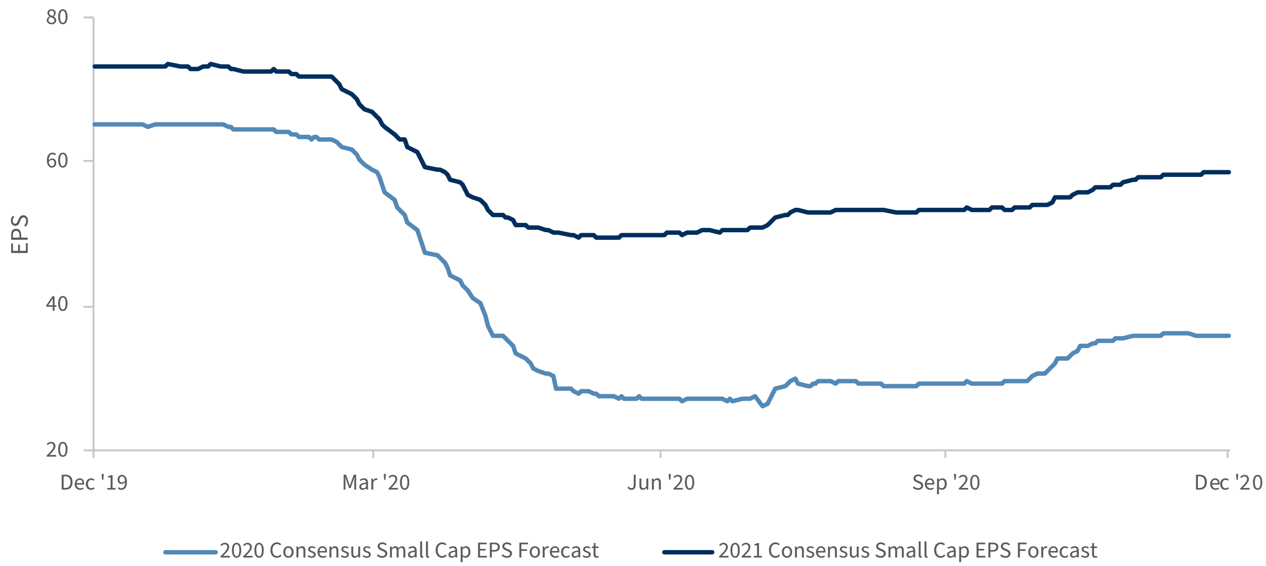
> "…leads us to a constructive view on small caps as they have more leverage to the economic recovery that we believe will transpire in 2021."

Sector Views



Source: Raymond James Equity Portfolio & Technical Strategy as of 28/12/2020

2020 vs. 2021 Small Cap Earnings Per Share (EPS) Forecast



Source: Investment Strategy, as of 28/12/2020

We also recommend underweight exposure to the more defensive Consumer Staples, Utilities, and Real Estate sectors given our positive stance on the recovery in 2021.

This thinking also leads us to a constructive view on the small caps as they have more leverage to the economic recovery that we believe will transpire in 2021. After underperforming in 2020 due to the economic shutdown (resulting in a 40% earnings contraction), valuation is fairly attractive with respect to an expected snap-back of earnings growth in 2021. The group trades in line with its 15-year average relative P/E (vs. the S&P 500) despite much stronger growth expectations in 2021- resulting in a P/E to Growth ratio of just 0.5x. However, markets do not often move in straight lines. Following an enormous 34% move since October, we recommend building your allocation to the small caps over time from current levels, taking advantage of consolidations or pullback periods. In sum, we recommend pro-cyclical exposure to portfolios, and would stick with fundamental leaders while accumulating the recovery areas.

KEY TAKEAWAYS:

- Our base case S&P 500 target for 2021 is 4,025 ($175 EPS, 23x P/E).
- We believe it is important to maintain a healthy allocation to the areas operating best through the pandemic while also accumulating areas with the greatest leverage to the economic recovery. Thus, our current overweight sector recommendations — Technology, Communication Services, Health Care, Consumer Discretionary, and Industrials — reflect a combination of this strategy.
- Following an enormous 34% move since October, we recommend building your allocation to the small caps over time from current levels, taking advantage of consolidations or pullback periods.

2021 International Outlook: Younger Economies Catching Up

Giampiero Fuentes, *Investment Strategy Manager,* Investment Strategy

The blackest of 'Black Swan' events — COVID-19 has dominated the 2021 global equity market narrative. However, despite negative earnings growth across the globe, equity markets have rebounded from their early-year lows and rallied into positive territory. Aggressive policy actions and optimism over effective vaccines have catapulted the equity market higher.

So what will the next year hold for global equity investors? Global equities should remain well supported by a significant rebound in economic growth around the globe. Fostering economic growth is continued aggressive policy action. For example, in Europe, the European Central Bank has confirmed that it will persist with its asset purchase program until at least March 2022, and agreed to a €750 billion emergency relief package forming part of the forthcoming seven-year, region-wide €1.8 trillion budget package.

So does that mean that Europe will outperform the US for the first time since 2015? We believe that remains an uphill battle on three fronts. First, our favorite sectors favor US equities. In fact, one of the more heavily weighted sectors in European indices is Financials (currently neutral), which tend to be negatively impacted by negative interest rates that are expected to persist. Similarly, Europe has little exposure to sectors that benefit from the current environment, such as Technology and Communication Services. These sectors combined have over 25% more exposure in the S&P 500. Second, a strengthening euro could potentially hamper earnings growth as many of the largest companies in Europe are reliant on exports. Third, politics remain a threat to the European economic recovery. Elections in both Germany and Italy in 2021, and in France in 2022 will likely increase volatility in the euro zone.

Can emerging markets outperform in the upcoming year? Assuming the global pandemic fades and the global economy accelerates, emerging market equities could be a big beneficiary. Asian equities have been the best performing regional equity market in 2020 as they were impacted by the pandemic earlier in the year, and dealt with it in a remarkable way that allowed both their economies and equity markets to promptly rebound. Asian emerging markets offer great opportunities as the region has over two-thirds of its market capitalisation in our favourite sectors which, together with our expectation of a declining dollar and secular trends such as demographics (younger population, wealth creation), should propel their equities higher. Commodity-based emerging markets could benefit as well if commodities such as oil and industrial metals continue to move higher.

Ultimately, we continue to favour the US over international, but emerging market Asia seems to be the clear runner up.

International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

2021 Fixed Income Outlook: Lower for Longer

Doug Drabik, *Managing Director,* Fixed Income Research
Nick Goetze, *Managing Director,* Fixed Income Services

Thirty-nine plus years of general interest rate decline, twenty-three years of moderate inflation, five recessions, and the longest expansionary period ever preceded 2020's pandemic-triggered recession, unprecedented central bank intervention, and historically low interest rates. Fixed income total returns have benefitted for years (if not decades) from general interest rate decline. There is an inverse relationship between rates and price. As rates decline, prices increase. The year 2020 was no exception as Treasury, corporate and municipal bonds all boasted solid total returns.

MARKET CONDITIONS

Just as all corners of the world have been impacted by the global pandemic, so have all corners of the fixed income market as spreads, volatility, and rate levels have been affected. The pandemic-induced recession officially began in February and prompted significant central bank (Federal Reserve (Fed)) and government response through fiscal and monetary actions. The Fed's balance sheet, which had begun the year with ~$4.1 trillion in asset size, has ballooned to over $7.2 trillion via implemented emergency lending facilities, bond purchase programs, and other stimulus-related bills. Treasury yields have declined 30% on the long end and over 90% on the short end of the Treasury curve, creating an even flatter sloped curve during 2020.

Just as all corners of the world have been impacted by the global pandemic, so have all corners of the fixed income market as spreads, volatility, and rate levels have been affected.

Pre-pandemic market conditions included record low unemployment along with moderate growth, and although poor economic conditions did not trigger the recession, isolation, slowed consumer confidence and outright business shutdowns initiated an economic ambush pushing 20+ million job losses, small business collapses and a general sense of fear and uncertainty. The reliability and sureness of a COVID-19 vaccine may largely dictate the pace of the recovery and the level of consumer confidence that leads us back to measurable growth.

LOOKING FORWARD

The variables are numerous and atypical thereby challenging forecasts on how the markets emerge in 2021. The base case scenario presumes that the vaccine is indeed effective and, equally as important, easy to quickly disseminate. This will initiate a rise in consumer confidence and allow businesses to gravitate toward their normal and intended business plans. Assuming much of the recovery begins taking shape in the second half of the year, the intermediate and longer end of the curve will push higher in yield. The 10-year Treasury, which will likely end 2020 around 1.00%, will creep higher in yield in 2021 to ~1.50%. The shorter end of the curve is directly influenced by the Fed. The implied Fed funds target rate is projected to keep its lower band at 0.00% through 2023, thus influencing 2021 where the 2-year Treasury rate projection will remain relatively low at around 0.25%. These combined moves point to a slight steepening of the yield curve over the course of 2021.

We believe a more bullish scenario also exists for bonds (prices higher/yields lower). The world's central banks (including the Fed) have clearly taken the helm in controlling rates and driving economies. Four primary central banks (Federal Reserve, European Central Bank, Bank of Japan, People's Bank of China) have ballooned their balance sheets from a combined total assets of ~$6 trillion before the Great Recession (2008-2009) to over $27 trillion today. This year alone, they have increased their combined asset size over 36%. The flood of money has helped to keep rates down. Increasing domestic debt, which comes with higher interest expense, is an incentive for the Fed and the government to keep interest rates down. In addition, world interest rates continue to exhibit great disparity versus US rates, which are significantly higher than many European and Asian rate environments. There is over $17.1 trillion of negative yielding debt worldwide. This helps to drive demand for higher quality, higher yielding US securities, thus contributing as a headwind to higher rates. The thought that the US would ever enter the world of negative interest rates has shifted from 'never' to 'conceivable' as global rates continue to drift apart. The Fed and government are likely to continue with additional stimulus packages and persistence in keeping Fed funds at zero. In addition, there is a possibility that the COVID-19 vaccine takes much longer to distribute and the hangover effects that have crushed certain businesses take much longer to recover. Under these circumstances, we see a bullish scenario that could keep the 2-year closer to 0.00%, the 10-year Treasury lower to ~0.50% and higher stock and bond prices.

Spreads have tightened across many product areas including investment-grade and high-yield securities. We anticipate that any recovery will not begin until the second half of 2021 and we anticipate spreads to remain tight. It is worth noting that spread widening, and recovery in general, is likely to be segmented. There are many businesses and corporations that have actually benefitted from COVID-19 consequences. These include companies like Amazon and FedEx, which speaks to the increase in at-home shopping while consumers self-restricted their outside activities. There are an equal number of industries that the pandemic trampled on regarding employment and revenue numbers, such as airlines, entertainment, transportation and health clubs. This supports an argument for a more fragmented recovery.

World Bond Markets

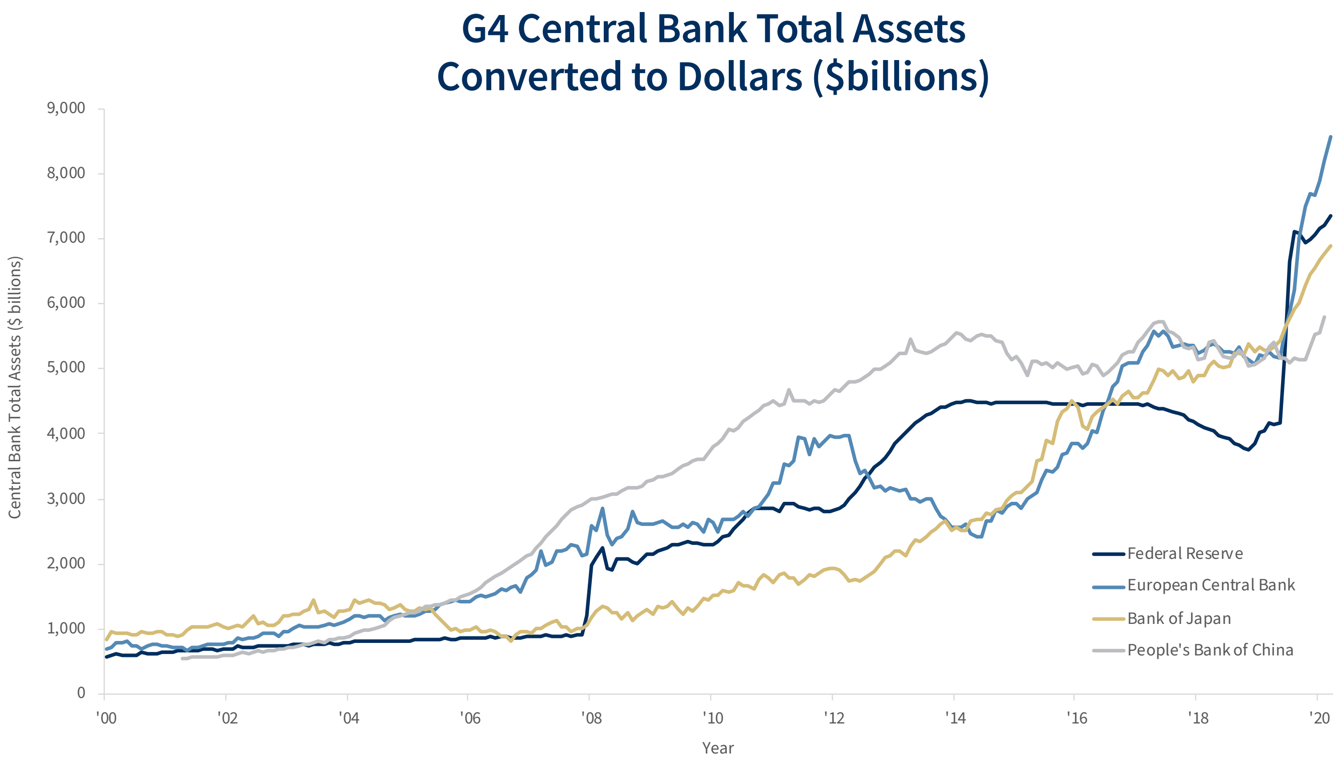
	2-Year	5-Year	10-Year	30-Year
United States	0.119	0.354	0.923	1.659
Canada	0.221	0.432	0.721	1.264
France	-0.707	-0.648	-0.331	0.377
Germany	-0.705	-0.732	-0.565	-0.156
Greece		0.107	0.651	
Ireland		-0.609	-0.294	0.313
Italy	-0.421	-0.017	0.539	1.408
Japan	-0.119	-0.112	0.025	0.647
Netherlands	-0.690	-0.700	-0.482	-0.087
Spain	-0.625	-0.410	0.050	0.862
Sweden	-0.364	-0.293	0.038	
United Kingdom	-0.123	-0.046	0.257	0.829

Source: Bloomberg LP, Raymond James: as of 28/12/2020

OPPORTUNITIES IN FIXED INCOME

The emerging market space may experience a slower recovery. The logistics for vaccine distribution include very specific temperature controls, a technology that may not be easily met for simple distributions in less high-tech equipped countries. That being said, emerging markets that are strongly positioned possess an opportunity to benefit greatly from a pandemic turnaround. Flows will likely remain very strong as investors seek opportunities to add any kind of yield in an overall low-rate environment. Emerging market oil companies may be one of the few sectors where spreads could still narrow, creating a positive total return chance. Higher risks will accompany 2021 emerging market opportunities and, although there will be pockets of dislocation, opportunities will exist for more aggressive investors to capture higher yields, especially relative to the low interest rate strapped high-quality bond alternatives.

Although fixed income total return prospects will be muted due to historically low interest rates with lessening bullish prospects, many of our investors allocate to individual bond positions to meet the primary purpose of principal preservation. Nothing changes here and this component remains a vital allocation to continue to protect hard earned wealth. Municipal and corporate issuance will likely remain robust as corporations and municipalities take advantage of leveraging a low rate environment. The Fed has allowed a view into the future with their proclamation of a zero interest rate policy through 2023. High demand for quality securities of the shortest maturities will continue to present the opportunity to reinvest those



Source: Raymond James: as of 28/12/2020

short maturities prior to their actual maturity. A modest extension into the steeper part of the municipal and/or corporate curves can provide modest yield increases. At the same time, we suggest that overall durations be kept in check. To meet cash flow needs, look to buy premium high- coupon bonds, which will also perform better in a rising rate environment. Avoid chasing minimal increases in yield through significant maturity extensions or excessive credit risk. The market is not rewarding investors to take on these excessive risks. 2021 will be a year to upgrade credit quality and keep durations in check, a sort of holding period in anticipation of better positioning for an eventual economic turnaround. Reduce market risk (long duration) and solidify credit risk, but also take advantage of the information the Fed is providing (move to the four to ten year part of the curve).

KEY TAKEAWAYS:

- Assuming much of the recovery begins taking shape in the second half of the year, the intermediate and longer end of the curve will push higher in yield. The 10-year Treasury, which will likely end 2020 around 1.00%, will creep higher in yield in 2021 to ~1.50%.
- The implied Fed funds target rate is projected to keep its lower band at 0.00% through 2023, thus influencing 2021 where the 2-year Treasury rate projection will remain relatively low at around 0.25%.
- Emerging markets that are strongly positioned possess an opportunity to benefit greatly from a pandemic turnaround.
- 2021 will be a year to upgrade credit quality and keep durations in check, a sort of holding period in anticipation of better positioning for an eventual economic turnaround.

2021 Energy Outlook: Oil Market Recovery in 2021 Will Follow Vaccine Ramp-Up – And in the Meantime, Global Energy Transition Is Accelerating

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

It is not often that we reference the World Health Organization when writing about oil, but this is one of those times. The past year's epic oil market crash was precipitated by the most severe fall-off in global oil demand in modern history. This was a direct result of the COVID-19 pandemic and ensuing lockdowns.

For oil demand to get back to the pre-pandemic run-rate of 100 million barrels per day – which implies a more than 5% rebound from year-end 2020 levels – there must be overall economic normalisation, and that depends on widespread vaccine availability for the general population: billions of people around the world.

Because the pace of vaccine production and distribution remains uncertain at this early stage in the process, it is impossible to put a precise timetable on when, for example, schools will be open across the board, or large in-person events and entertainment venues can resume. Broadly speaking, we anticipate that, after the tough wintertime period with the return of numerous lockdowns in Europe and elsewhere, demand recovery should resume in the spring and summer of 2021. While some segments of the oil market (notably aviation) are unlikely to fully recover until 2023 at the earliest, there is a plausible scenario of overall demand reaching 100 million barrels per day in 2022.

While some segments of the oil market (notably aviation) are unlikely to fully recover until 2023 at the earliest, there is a plausible scenario of overall demand reaching 100 million barrels per day in 2022.

> “… the most important structural underlying trend in the energy sector is a shift away from petroleum and other fossil fuels.”

SUPPLY AND DEMAND

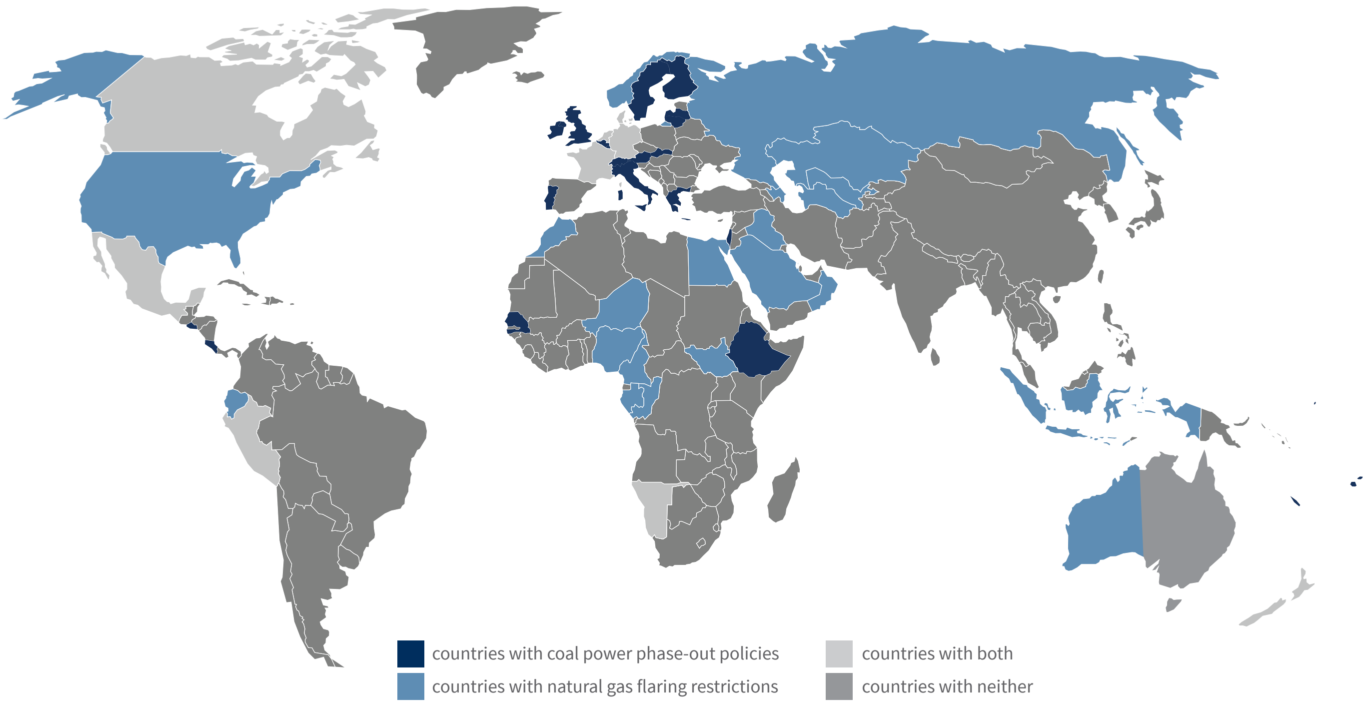
Public health developments will drive the demand side of the oil market equation, whereas supply will be influenced by more ‘standard’ variables with which energy investors have long been familiar. Having slashed production in the early days of the pandemic, OPEC and Russia can be expected to gradually move toward higher output levels, in parallel with demand recovery. US production, on the other hand, would continue to trend lower on the assumption of pricing in line with commodity futures (West Texas Intermediate (WTI) crude in the $45 to $50 per barrel range), and the same applies to some other non-OPEC countries such as China, Mexico, and Colombia. Because demand and supply are heading in opposite directions, we forecast hefty global inventory drawdowns in both 2021 and 2022 – which, by definition, is bullish for prices. The bottom line is that the industry will ultimately need prices much higher than what the commodity market is signaling. Specifically, we forecast WTI ending 2021 upwards of $60, which implies an average of more than $50 for the year.

GLOBAL ENERGY TRANSITION

Oil market recovery is an important energy story to track in 2021, but by no means the only one. From a very long-term perspective, in fact, the most important structural underlying trend in the energy sector is a shift away from petroleum and other fossil fuels. This is what’s referred to as the global energy transition. Reflecting a potent combination of economic/technological factors and political/regulatory support, the energy transition is accelerating. Examples of technological innovation include more scalable wind turbines, more efficient solar panels, electric cars and buses with longer battery range, and energy-efficient building materials. This spurs plenty of demand, independent of government policy. For example, more than 250 multinational companies, ranging from banks to automakers, have committed to source 100% of their electricity from renewable sources – and dozens have already achieved this target. Even more impactful, a dozen of the top-tier oil and gas producers have committed to reorient their operations toward renewable and low-carbon

Renewable Resources

Growing demand for sustainable energy sources such as solar panels and wind turbines is driven by the increased utilisation of clean energy by governments, corporations, and individuals.



Source: Raymond James Equity Research

energy over the next 20 to 30 years. To clarify, these companies are doing it **not** because they are forced to by governments, but rather because they see it as good business and advantageous for Environmental, Social and Governance (ESG) ratings, thus increasing interest from a growing portion of investors.

The role of governments in the energy transition varies a great deal from country to country, and even within countries. For example, this past December the European Union approved the European Climate Law, thereby becoming the world's largest carbon emitter to impose a legally binding mandate for net zero CO_2 emissions by 2050. To clarify, net zero does **not** mean literally zero, but all emissions will need to be captured and sequestered, or offset via projects such as forestry. President-elect Joe Biden has proposed the same policy for the US, but the ultra-divided, 50/50 Senate makes it highly unlikely that such transformative legislation would be able to pass. The Biden administration will need to use executive action to incrementally boost decarbonization. In the meantime, politically progressive states such as California and New York will continue their own climate reforms, which are more ambitious than what Congress is willing to do. Other examples of relevant policies include coal power phase-outs (in 34 countries, including Germany and the UK) and natural gas flaring restrictions (in 31 countries, including the US, Russia, and Saudi Arabia).

KEY TAKEAWAYS:

- For oil demand to get back to the pre-pandemic run-rate of 100 million barrels per day – which implies a 5% rebound from year-end 2020 levels – there must be overall economic normalisation, and that depends on widespread vaccine availability for the general population: billions of people around the world.
- Because demand and supply are heading in opposite directions, we forecast hefty global inventory drawdowns in both 2021 and 2022 – which, by definition, is bullish for prices.
- Specifically, we forecast WTI ending 2021 upwards of \$60, which implies an average of more than \$50 for the year.
- From a very long-term perspective, in fact, the most important structural underlying trend in the energy sector is a shift away from petroleum and other fossil fuels.

All that Glitters is Gold

Jeremy Batstone-Carr, *Interim European Strategist,* Raymond James

Amidst all the extraordinary action in the world's financial markets over 2020 there were many stand-out performances amongst the various asset classes and individual investments. But while many will have a mere moment in the spotlight before flickering and burning out, one ultra-long term asset stands out, its lustre undiminished, gold. The yellow metal price increased by 24% over the past twelve months, its best annual performance, in US dollar terms, in a decade.

There are other assets regarded generally as safe-havens. Those which during times of uncertainty, or insecurity, or economic and political hardship and even war provide somewhere safe for investors to protect their wealth, but none has the unique appeal of gold. This is nothing new. Gold has been regarded the world over as an investable asset for more than 4,000 years. As long-term track records go, there can be few alternative assets capable of maintaining their purchasing power so well.

Over and above its value as a store of wealth, gold is widely regarded as a truly global currency. It possesses intrinsic value, in addition to which it is both beautiful and durable, undiminished as other currencies are by some alien alloy. These attributes have, throughout time, served to render gold superior to all other mediums of exchange. Furthermore, and importantly, it is not "backed up" or in some way diminished by any government or central bank.

As all must be aware, gold has enjoyed a special place in people's hearts for centuries. It has been hoarded and stolen. People have killed for it and wars have been started over it. They still are. Egyptian Pharaohs were entombed with their golden treasure. The Spanish conquistadors came to get rich under Mayan skies, pillaging the New World as they did so. The Californian gold rush prompted people from around the world to chase the dream of boundless riches. Those who sold the picks and shovels to prospectors grew wealthy for sure, but for those who really did strike lucky also struck rich, very rich.

In the modern era, gold's story really begins back in 1971, the year the US dollar departed from the gold standard.

> "In the modern era, gold's story really begins back in 1971, the year the US dollar departed from the gold standard."

Prior to this, the price of gold had been deliberately pegged for many years. At a stroke, the gold price was free, Bretton Woods lying smouldering as the price began an inexorable ascent.

In the decade to 1981, the gold price increased by a massive 2,329%, from $35 per ounce to $850. It then receded, lying dormant for twenty years, to 2001. Whilst not a perfect fit, gold's return to the spotlight since then has coincided closely with the intervention of the Federal Reserve, the US central bank. The Fed's intention, then as now, was attempted altruism, propping up the financial markets in an effort to prevent collapse and in so doing preclude financial collapse morphing into an economic Armageddon.

The 2007/08 financial crisis brought the global financial markets to the very brink. Hard decisions had to be taken, and extremely swiftly.

Quantitative Easing was born in a moment of desperation. It continues to this day. Quite literally, trillions of dollars, pounds, euros, yen and other so-called fiat currencies have been electronically "minted" to save the economy. In so doing, and as a welcome aside, the financial markets have boomed. Sovereign bond yields have collapsed to epochal lows while stocks have hit a series of all-time highs.

And so, to today. The world is held in the vice-like grip of a global pandemic. Systemically significant global central banks have, yet again, risen to the challenge and done their bit to ward off disaster. More than $15tr worth of global currency has been created out of thin air over 2020 alone in an attempt to limit lasting damage from COVID-19.

In addition to relentless money printing, global central banks have been persistently cutting base interest rates. In Japan and Europe, base rates are negative. The proportion of negatively yielding global government bonds, once regarded as economic heresy, now regarded as economic normality, has skyrocketed to levels never seen before in 4,000 years of recorded history. The switch from central banks being simply "accommodating" to going "all-in" has proved the primary driving force behind the gold price' latest ascent, peaking as it did at one point in 2020 at more than $2,000 per ounce.

But what of the future? In the short-term, at least demand for gold is likely to hold strong while supply remains limited to what is said to equate to just two Olympic-sized swimming pools of physical stock. Were inflation to pick-up, or worse, a hyperinflationary event to materialise, the direct consequence of relentless electronic money printing and consequent currency debasement, gold's safe-haven status would surely be sealed. Whilst a possible US dollar recovery in 2021 would likely push the gold price lower, could that be said to be the same when pricing gold in sterling, or euros? For long-term investors keen on diversifying portfolios and happy to ride-out short term fluctuations in financial markets, whilst building-in some safe-haven protection, gold's unique appeal should make it extremely alluring.

KEY TAKEAWAYS:

- During 2020 there were many stand-out performances amongst the various asset classes and individual investments.
- The price of gold increased by 24% over the past twelve months, its best annual performance, in US dollar terms, in a decade.
- The price of gold peaked at one point in 2020 to more than $2,000 per ounce.
- Whilst a possible US dollar recovery in 2021 would likely push the gold price lower, could that be said to be the same when pricing gold in sterling, or euros?

DISCLOSURE

RAYMOND JAMES

Head Office Ropemaker Place 25 Ropemaker Street London EC2Y 9LY

www.RaymondJames.uk.com

Raymond James Investment Services Limited is a member of the London Stock Exchange and is authorised and regulated by the Financial Conduct Authority Registered in England and Wales number 3779657 Registered Office Ropemaker Place 25 Ropemaker Street London EC2Y 9LY