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Letter from the Chief Investment Officer

A Time For Finesse

Are you ready for some football? Not American football, but global football—otherwise known as soccer! For the five billion spectators awaiting the start of the 2022 World Cup in Qatar this November, the sport is the epitome of speed and agility. But for the players on the 32 participating teams, it is so much more. The deceptively simple-seeming game requires years of training. It goes beyond the fundamentals of ball control to pitch awareness, anticipation, and making the right decisions under duress quickly. It is knowing when to dribble or pass, press or contain, and shoot with power or finesse.

Like soccer fans following their favourite players, investors have no small amount of anticipation, if not angst, about every move central banks are making on the global economic playing field. In this intense time of soaring inflation and interest rates, what is the Federal Reserve's (Fed's) *game plan*? How aggressive will it be? Can it dribble cautiously down-field, carefully containing rising prices, or will it play a high pressing game that *kicks* the economy into a punishing recession? What, for that matter, is the game plan of other systemic central banks, especially in Europe? As the markets recalibrate expectations and evaluate the plethora of risks on the field, this is a high-pressure time that requires finesse.

This autumn, all eyes will be on one perennial superstar, the Fed, as it pursues its goal of winning against inflation. In the World Cup, the top scorer gets the coveted *Golden Boot* award. If there was an award for tallying interest rate hikes, the Fed, one of the developed economy central banks, would definitely be in contention this year. But for many investors, the goals are slightly different: to control inflation *and* keep the economy growing—in other words, a more delicately balanced approach that requires finesse and a sense of the economy's field position.

By raising rates into restrictive territory (>2.75%) to cool inflation, the Fed may have put the economy *offside*—if not actually scored against itself. It is surely not alone. Rapid-fire, heavy interest rate hikes may not exactly be a winning strategy. In soccer terms, the Central bankers' fancy footwork may end up tripping the economic expansion. The further the Fed raises interest rates above 4% (our forecast is 4.5%), the greater the probability of a recession. A similar outcome would surely await the UK economy too. As a result, our *official call* is for the US economy to experience a mild recession starting early next year (2023 GDP forecast: -0.5%) and the UK economy to contract from this quarter. Also, we're *issuing three yellow cards* (or warnings for potential downside risk) for a lacklustre housing market, elevated energy prices, and weak consumer sentiment.

A balanced *defence* is imperative in the World Cup—and in managing portfolios, too. Yet there have been few investments that have not been *penalised* as both the bond and equity markets have been sidelined with painful losses. In fact, the correlation of bonds to equities is the highest we have seen in nearly 25 years. Going forward, however, bonds ought to provide some defensive buffer if yields fall amid a struggling economy. Importantly, yields are attractive for the first time in years in both Anglo Saxon markets as the economy slows and inflation, hopefully abates. Note that, in the US, Treasury yields historically tend to peak near the end of the Fed's tightening cycle. High quality Treasury securities and municipal bonds remain compelling, but the inverted yield curve and the potential of a recession place riskier high yield bonds and emerging market bonds *offside*.

We are approaching half-time in President Biden's term, with mid-term elections just around the corner. At this point, we expect Congress will be split. The Republicans seem likely to take control of the House due to the historical precedent of the incumbent party losing seats; current polls suggest they just need to *ride out the clock*. On the other hand, polls slightly favour the Democrats retaining control of the Senate in what appears to be another *nail biter*. With gridlock on Capitol Hill, the Biden Presidency will become a *game of two halves* as major *game changing* legislation is unlikely to be passed. If so, political policy risk (specifically the potential for increased taxes) will be reduced until the next election cycle.

The equity crowd has been hushed, stunned as stocks have succumbed to a bear market (a decline of more than 20%). Significant *injuries* have hampered the markets—rising inflation, higher interest rates, a stronger dollar, and tumbling earnings growth revisions. But those realities are likely already priced into the market and the volume of the equity markets' *vuvuzela* (traditional World Cup noise-makers) may soon increase—rallying a turnaround.

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A *hat trick* of three factors could lead to a rebound in equities. First, in the upcoming third quarter earnings season, better-than-feared earnings could spark a rally, as they did in the second quarter. Second, inflation deceleration could halt further Fed rate hikes. Finally, midterm elections have historically had an impact themselves, regardless of the outcome. In fact, in the last 19 midterm elections, the S&P 500 has been positive every time 12 months after the elections (up, on average, ~14%). Even if a mild recession ensues, we should be beyond it by the end of next year and the equity market tends to be forward-looking. That's why we expect the S&P 500 to reach ~4,400 by year-end 2023. From a sector perspective, there is no need for *substitutions*, as Energy, Health Care, and Financials remain our favourites. If you're looking for a *Best Young Player* to add value to your portfolio longer term, consider recruiting small-cap stocks.

World Cup soccer pitches take a beating over the 28-day tournament, so selection of the type of grass is very important. Where does the seed for it come from? Surprisingly, the US! Just as US seed provides the most resilient grass, the US economy and equity markets retain their durable investment advantages. Consider Europe, facing a huge *penalty kick*—an energy crisis as the coldest months approach. There, policymakers are also juggling the need for additional fiscal stimulus—the root of the recent inflationary surge—to help cash-strapped consumers while the European Central Bank Hikes interest rates to fight ongoing inflation. The inflationary impact of the stronger dollar on European imports and energy commodities priced in dollars only complicates the policymakers' task. While the odds for winning this year's World Cup

favour both France and England, their precarious economic conditions lead us to pick the US when it comes to our preferred equity region.

The World Cup can be full of surprises—good and bad. Until inflation abates and systemic central bank policy clarifies, market volatility is likely to continue. But to borrow a saying from Croatian soccer superstar Ivan Rakitic, “The smartest thing I did is I never gave up.” Despite some of the setbacks we've experienced this year, we encourage investors to remain engaged and not *watch from the sidelines*. Patience and sticking with your game plan can be critical to success, and selectivity will be key. Diversification, asset allocation, and a long-term mindset are timeless yet critical skills for any investor. And while this year's performance in most major asset classes has been disappointing, everyone loves a comeback!

The upcoming quarter will move quickly—from the changing colours of autumn, through to winter and the football World Cup before the holiday season beyond that. We wish you and your family health and prosperity in the final months of 2022.



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The UK: Mini-Budget, Massive Ramifications

Jeremy Batstone-Carr, *European Strategist*, Raymond James Investment Services Ltd*

“ It is the absence of facts that frightens people: the gap you open, into which they pour their fears, fantasies, desires ”

– Hilary Mantel, *Wolf Hall*

In October 1973, the British progressive rock band Genesis released an album, the title of which has gone down in popular music legend as one of the all-time greats, “Selling England By The Pound”. The album was the band’s response to the disastrous Anthony Barber Budget of the previous year, which played a substantial part in the eventual unseating of the then Prime Minister, Mr Edward Heath. Fast forward fifty years and the newly installed British premier, Ms Mary Elizabeth Truss, “Liz” and her Chancellor of the exchequer, Mr Kwasi Kwarteng have an equally grand and ultra-high risk plan to reinvent the United Kingdom as a high-growth/high wage economy.

If the plan works, it will surprise all those who question the effectiveness of “trickle-down” economics. If it fails, confidence in the UK’s political economy, sovereign bond market and currency will be called into doubt. A “sterling crisis”, if that is what it comes to, would have disastrous consequences as import costs would rise yet further against a backdrop of an already severe terms of trade crisis brought about by sky high energy and food prices, that and the escalating cost associated with servicing debts denominated in overseas currencies.

The Truss-led administration has nailed its colours to the mast; it will pursue growth at all costs. The first of what amounts to a two-pronged approach, as identified by the embattled Chancellor Kwarteng in his mini-Budget, is to borrow aggressively now in the hope that the economy can generate sufficient growth to pay off its debts in the future. The second prong, with electioneering written all over it, is that providing generous hand-outs to the wealthy will ultimately percolate to the less well-off over time. However, this policy has partially backfired, the 45% top marginal tax rate cut now abandoned. It is indeed ironic that US President Biden, doing his bit for the Democratic Party cause ahead of Congressional midterm elections in November, has recently stated that he is “sick and tired of trickle-down economics. It has never worked”.

On the subject of the United States, Ms Truss, like her predecessor before her, seems hell-bent on antagonising the UK’s allies and trading partners whilst standing unswervingly together with regard to Russia and its military (and now political) adventurism in Ukraine. Mr Biden has made clear that a much-vaunted, post-Brexit trade deal with the United States is not going to happen, while simultaneously, the UK administration clearly believes that there are votes to be gained through antagonising Europe by reneging on the trade treaty regarding Northern Ireland. At a time when nations need to

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stand together in the face of profound geopolitical and economic stress, the newly installed Ms Truss is quickly learning how her own, admittedly heavily disguised, political weakness is swiftly evolving into an even more profound economic and financial market fragility.

From the viewpoint of economics, the nub of the problem affecting the UK (and developed Western economies more widely) is that one simply cannot “buy” growth by adding mountains of debt. Indeed, between 1999 and 2019, the year prior to Covid’s onset, the UK economy expanded by £0.72tr whilst adding debt of £2.9tr. Put differently, every £1 of borrowing yielded just 0.25p of growth. Within the growth reported over that period, as much as 69% of it was derived from the cosmetic impact of pouring vast amounts of additional credit into the system. Whilst reported growth may have averaged an annualised 1.8%, borrowing averaged an annualised 7.2% of GDP over the same period. In essence, pretty much all the “growth” achieved by the UK economy since the dawn of the new century has been a mirage. Taking the view that the future will be different is to push back against recent historical experience.

Beyond this, the relentless downward pressure on real household disposable incomes has resulted in a profound affordability compression for the average household. This, if unaddressed, will inevitably lead to an undermined ability to not only make discretionary purchases but increasingly force the paring back of items hitherto deemed essential, including staged payments and subscriptions. This has equally profound consequences for an economy hugely leveraged on the global financial system. The latest available data pertaining to 2020 reveals that the UK has aggregated financial assets – the counterpoint to liabilities (relating to the household, business and government sectors), amounting to an eye-watering 1262% of GDP. For comparison, the equivalent figure in Japan is 871%, Europe 795% and the United States 588%. This is not to say that other regions of the developed world are in rude health, just that the UK is, on this metric, comfortably the most vulnerable to the vicissitudes of the financial markets.

An uncosted exercise in bluster, which is what Mr Kwarteng’s mini-Budget turned out to be, risks severely damaging the UK’s credibility at a time when, to borrow a phrase from the former Bank of England governor, Mr Mark Carney, the country needs all the kindness of strangers it can possibly muster. The UK needs cash from overseas to prevent debt servicing costs from spiralling out of control and to “cover” the sharp widening in the current account deficit. But kindness is not to be confused with charity; there is a price for everything, and financial assets will reprice until such point as the UK’s allure becomes irresistible. The Bank of England, already in the midst of raising

the country’s base interest rate in an attempt to bear down on elevated and “sticky” inflation, may have to redouble its commitment, and fast, if credibility is to be restored and a fully-fledged sterling crisis avoided. It has already been forced into a high-profile U-turn, temporarily returning to purchase even more government bonds instead of selling them as scheduled, to head-off what had threatened to become a disorderly melt-down.

Amidst all the apparent doom and gloom, the hardened investor knows only too well the age-old mantra, “markets stop panicking when officials start panicking!” When all around are losing their cool, then that is the time to look for opportunities. Perverse as it may sound, the more distorted UK financial asset prices appear, the greater the longer-term opportunity. For now, holding the line and being courageous in the teeth of adversity will surely be rewarded in the future. ■

KEY TAKEAWAYS:

- The UK “mini Budget” is a high-risk plan to reinvent the UK as a high growth/high wage economy. An uncosted and aggressive borrowing plan to generate sufficient growth in the future has impacted on the gilt-edged market and sterling.
- “Buying” growth by adding debt does not solve the UK’s long-term productivity problem.
- Persistent high inflation has imparted a significant affordability problem for the average UK household. Energy costs, although rising, have been capped by the new administration.
- The Bank of England has stepped in both to rescue the pension fund sector and restore the UK’s economic credibility, essential to avoid a debt servicing crisis and to “cover” the widening current account deficit.
- The combination of a temporary return to bond purchases and likely yet higher interest rates has averted a sterling crisis and bought time, but more may need to be done.



Q&A: Dollar Dominance—Can It Continue?

Tracey Manzi, CFA, *Senior Investment Strategist*, Investment Strategy

The US dollar has been getting a lot of attention these days. This is not surprising given the greenback has gained over 17% against a basket of currencies this year to levels not seen in over 20 years.* While moves of this magnitude are not unprecedented, the dollar's steady climb is starting to have spill-over effects on the rest of the world. This has implications for the economic performance of various regions and on the financial markets. Sanctions against Russia have also revived investor concerns about whether the dollar can maintain its role as the world's reserve currency. In this Q&A we delve into some of the more pressing questions on investors' minds.

Q: Why is the dollar so strong?

A: The surge in the dollar this year has primarily been driven by the hawkish Federal Reserve (Fed). With inflation running near a 40-year high, the Fed is in the midst of one of its most aggressive tightening cycles in decades—raising rates from near zero at the start of the year to between 3.0% and 3.50% following the

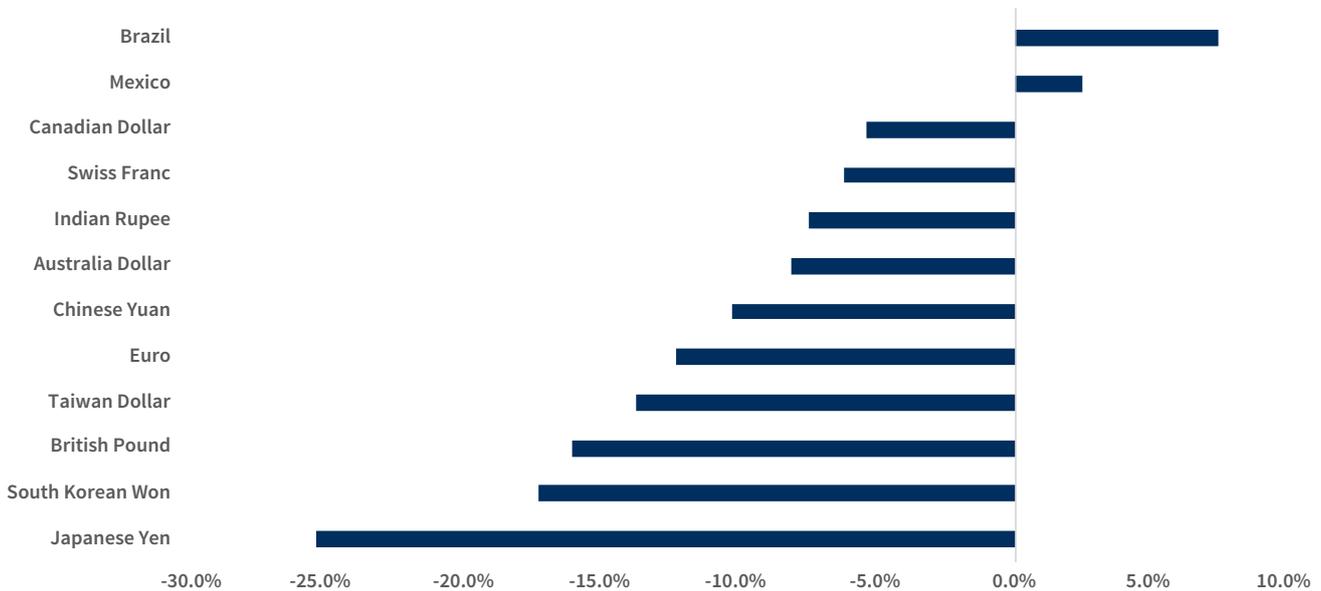
September rate-setting Open Markets Committee meeting. Further rate hikes are expected for the remainder of this year. The Fed's policy stance has been the key factor driving the dollar higher, particularly as the Fed is on track to tighten more aggressively than other central banks. Higher relative interest rates are supportive for the US dollar. The challenging macroeconomic backdrop and uncertain geopolitical climate has also contributed to the ongoing strength of the US dollar. It is not surprising to see investors flock to dollar-denominated assets during periods of economic stress or elevated uncertainty as the US is considered a 'safe-haven'. With no end in sight for the Russia-Ukraine conflict, Europe on the brink of recession and China's zero-COVID policy stance still restraining Chinese economic growth, the dollar's strength seems likely to persist.

Q: What are the implications of a strong dollar?

A: Aside from the obvious—it's cheaper to take a vacation overseas—the US dollar plays an important role in the world economy. That is because it is the currency that powers global trade. The price of nearly every commodity contract traded on the world markets — from oil to copper to wheat — is priced in US dollars. Therefore, when the US dollar is strong relative to other foreign currencies, it drives up the cost of imported goods

*as of 23/09/2022

YTD Foreign Currency Returns against the US dollar



Source: FactSet, as of 20/09/2022

and feeds inflation directly into other economies. This is precisely what is happening today as the strong dollar is contributing to inflation pressures globally. While commodity prices tend to have an inverse correlation with the US dollar, this is not always the case. Commodity prices spiked after the war in Ukraine broke out and remained elevated as supply chain challenges persisted and weather-related issues impacted availability, at least until recently. This only compounds the challenges faced by the rest of the world. While the strong dollar has been problematic for others, it has been beneficial for the US economy as it holds down the price of imported goods and restrains domestic inflation. The dollar's strength can also pose a headwind for US companies that generate a significant portion of their revenue overseas. That's because their overseas earnings are reduced when they are translated back into US dollars. We've already seen some high-profile companies provide negative warnings over the Q2 earnings season. This is definitely something to keep an eye on as the Q3 earnings season approaches.

Q: Is the dollar's role as a reserve currency under threat?

A: When Western governments took the unprecedented step of freezing Russia's foreign exchange reserves following its invasion of Ukraine earlier this year, many started to wonder whether this would accelerate the displacement of the dollar as the world's pre-eminent reserve currency. The logic being that others would

rapidly diversify their reserves away from the dollar to reduce the risk of their assets suffering the same fate. Speculation about the dollar's demise has been ongoing for decades, so these concerns are not new. But, despite these ominous predictions, the reality is there is, as yet, no serious alternative to the US dollar. That is because the US dollar continues to be the most widely used currency in global financial transactions. It is also because the US Treasury market is the largest, most liquid and stable market in the world. And because of this, the US dollar continues to represent the majority of the world's global reserves, which according to the International Monetary Fund, stand at around 59% today. While it is true that the dollar's share of global reserves has decreased over the last two decades, it still remains far above the next biggest market, the euro, which only accounts for around 20% of total reserves. Although there is speculation that China may have ambitions to dethrone the US dollar one day, we do not think it provides a serious threat. Less than 3% of the world's exchange reserves are held in Chinese yuan today. The reason for this is simple. It is because the yuan is still not a fully convertible currency, which means that its exchange rate is still strictly managed by the Chinese monetary authorities. So, for now, we do not think the dollar is at risk of being replaced as the world's reserve currency. ■



Deglobalisation: A Double-Edged Sword

Giampiero Fuentes, CFP®, *Economist*, Raymond James

Globalisation has accelerated the world's economic growth, furthered by technological and transportation advances that allowed the integration of international markets. Since 1950, the world's trade volume has increased by 40 times, reaching a record value of \$28.5 trillion in 2021. A key component that makes all this possible is robust and complex supply chains that allow goods produced by a country to be transported elsewhere in the world. However, trade as a percentage of world gross domestic product (GDP), has been declining since the Great Recession. In fact, over the last few years, these global supply chains have faced a variety of headwinds, ranging from economic nationalism, a pandemic-induced shutdown, and most recently, a major geopolitical conflict.

The relatively mild consequences of the tariffs imposed by President Trump on China in 2018 were just a tiny sample of the shambles brought by the COVID-19 pandemic to what seemed to be a perfectly efficient working model. In fact, the volume of world trade declined by almost 20% in a matter of months, causing a collapse of a similar magnitude to that of the Great Recession. This year's war between Russia and Ukraine only widened the cracks,

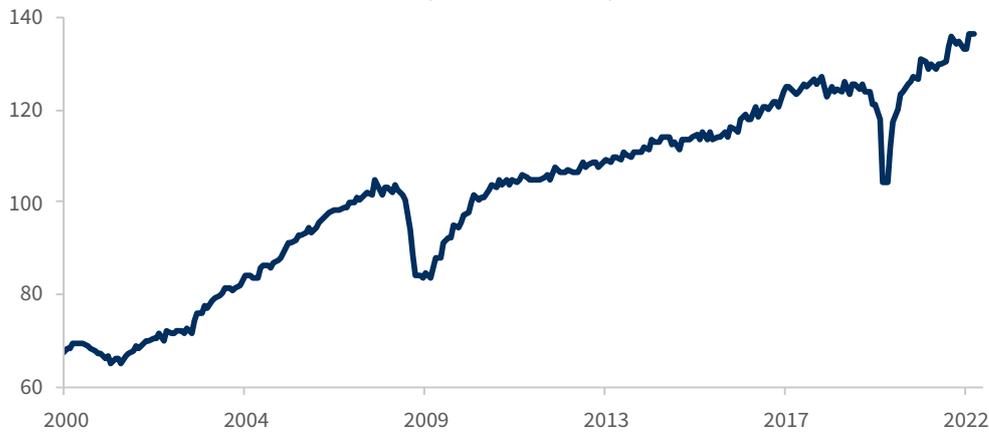
Globalisation has allowed developing countries to grow faster, increase their living standards, and lifted millions of people out of poverty. Developed economies have enjoyed lower inflation for decades, as companies benefited from outsourcing production to areas with lower costs of materials and labour.

exposing the world to just how much nations truly rely on one another for basic needs, with energy prices spiking at one point to the highest level since 2008, and food shortage concerns being top of mind for many countries.

Whether it's a pandemic, a war, or any other unpredictable event, they're likely to have severe consequences, and the world could potentially be hit by another "black swan" event at any point. However, there is a common denominator among these events, and that is the interdependence among countries that years of globalisation has brought to the world. Unquestionably, globalisation has allowed developing countries to grow faster, increase their living standards, and has lifted millions of people out of poverty. Developed economies have enjoyed lower inflation for decades, as companies benefited from outsourcing production to areas with lower costs of materials and labour. However, the events mentioned above could start pushing nations and companies to begin to prioritise security over efficiency and lower costs.

World Trade

(2010 = 100 Index)



Source: FactSet, as of 20/09/2022

THE FOURTH TAIWAN STRAIT CRISIS

Natural disasters, cyberattacks, or simple accidents are daily occurrences that can temporarily disrupt supply chains. However, the potential for a long-lasting conflict between Taiwan and China could develop into a cataclysmic supply chain disruption. Taiwan is only just bigger than the state of Maryland, and it contributes ~1% to global GDP. So, how can a country so small, that contributes so little to global GDP, be so important to China, the US, and the world economy? Taiwan is renowned worldwide for its semiconductor industry, being responsible for manufacturing almost two-thirds of global microchips and over 90% of high-value integrated circuits. Essentially, most electronics we use every day have at least some

components that were developed and manufactured in Taiwan. However, what's less known is the importance of its waterways for global trade, as one-third of the world's seaborne traffic passes through the Taiwan Strait. While there are alternative routes around the channel, the Taiwan Strait can be described as the gateway to access all the important ports in Northeast Asia.

From an economic standpoint, a blockage of the Taiwan Strait or Taiwanese airspace for an extended period of time would likely result in worse consequences than those which the world experienced during the COVID-19 pandemic in terms of supply chain disruptions. Additionally, due to its small size, it is fair to assume



Source: Bloomberg, as of 09/2022

S&P 500 Companies Mentioning ‘Offshoring’ During Earnings or Conference Calls



Source: FactSet, as of 20/09/2022

that if attacked, Taiwan would, at the very least, reduce its production and export of goods and if factories were to be damaged, it could take a while for them to come back online. This is not to say that a war between these two nations is about to erupt, as we believe it is in neither country’s best interest. However, we saw how quickly the situation precipitated in Europe earlier this year, and that’s why investors need to be prepared for all sorts of outcomes.

A conflict between Taiwan and China, and the probable involvement of other global superpowers, would have all sorts of negative consequences, and its repercussions would likely be felt for years if not decades. In addition to the countless lives that could be lost, a conflict of this size and scope could have tremendous inflationary impacts worldwide, as costs would soar, and profit margins would be squeezed. The US is the world’s largest importer of goods, of which approximately one-fifth comes from China, and

while the US and other developed economies will likely be able to shift their trading needs to other countries, the impact of this transition would surely be substantial. In fact, an adjustment of this nature would be certain to take time, and, in simple economic terms, limited competition would ultimately lead to higher prices.

MADE IN AMERICA

With two massively disruptive events in just over two years and the potential for a multitude of unpredictable events brewing in the future, nations are starting to consider options to mitigate future potential supply chain disruptions. The goal is to regain control over the end-to-end supply chain by reducing exposure to external risks, which would otherwise not be present if the manufacturing process wasn’t outsourced. This issue is not new, but only ~30% of companies in the S&P 500 are discussing ‘offshoring’ in their

Reshoring

The practice of transferring a business operation that was moved overseas back to the country from which it was originally relocated.

PROS:

- CONTROL OF SUPPLY CHAIN
- REDUCED LEAD TIMES (less distance traveled)
- FEWER IMPORT TARIFFS
- LOCAL JOB CREATION

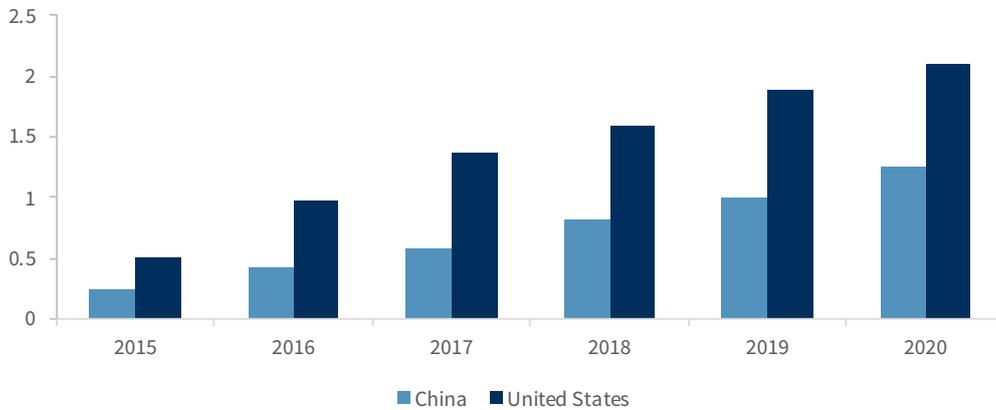
CONS:

- LACK OF SKILLED LABOUR
- LABOUR COST
- RESOURCE SCARCITY
- INITIAL INVESTMENT REQUIRED
- HIGHER COST

Source: Raymond James Investment Strategy

Cumulative Foreign Direct Investments

(in Trillions of \$)



Source: FactSet, as of 20/09/2022

earnings transcripts and conference calls, compared to over 75% of them only a decade ago.

Governments have started to offer incentives to reshore production to prevent future disruptions. For instance, to move away from its reliance on Taiwanese-made semiconductors, the US has announced the CHIPS and Science Act, which includes a \$52 billion package aimed at incentivising US production of semiconductor chips. Reshoring certainly has its perks, but it also comes with an array of risks.

Outsourcing manufacturing has worked for decades, and has allowed companies to both be more cost effective and to boost profit margins while holding product prices down for clients. This economic interconnectedness has allowed developed nations to take advantage of emerging economies' lower cost of labour, while emerging economies have benefited from an inflow of foreign investments. Additionally, the US and other developed economies have benefited for a long time from foreign direct investments, such as foreign automotive manufacturers' building modern plants in the United States and elsewhere. While these numbers are very volatile on a yearly basis, the US alone has received over \$2 trillion in foreign direct investments in the last five years. Thus, it is clearly in neither China's nor the developed West's interest to lose such a large inflow of investments in their respective economies.

BOTTOM LINE:

While headline global inflation rates are expected to come down in due course, the broader consequences of either another geopolitical conflict or further deglobalisation could be an issue

going forward. Unfortunately, there isn't a one-size-fits-all solution to fix global supply chains, but some companies with longer-term strategies are attempting to expand their supplier base to spread the risk despite adding layers of complexity to their supply chains. However, in the event of a global economic shutdown such as that witnessed in 2020, this solution would not make a difference. Globalisation is both a blessing and a curse, but a development that has hitherto generated more benefits than costs from across the industrialised economies of the West. However, just as successful investors diversify their portfolios through asset allocation to maximise returns for a given level of risk, companies and nations should aim to find a balance between complexity and security. ■

KEY TAKEAWAYS:

- Complex and robust supply chains were a key component in the development of globalisation.
- Over the last few years global supply chains have faced a variety of headwinds, ranging from economic nationalism, a pandemic-induced shutdown, and most recently, a major geopolitical conflict.
- The Russia/Ukraine conflict has shown the world just how interdependent we are and has increased awareness of the dangers of that interconnectedness.
- Globalisation is both a blessing and a curse, one from which developed economy such as the US reaps more benefits than not.



Economic Outlook: The Fed's Conundrum

Eugenio J. Alemán, PhD, *Chief Economist, Raymond James*

The Federal Reserve (Fed) and the financial markets are going to have a tough time during the last quarter of the year with the economy showing no signs of slowing down. The strength of the employment recovery after the COVID-19 pandemic ended has continued unabated and has been the reason why we still contend that the US economy did not experience a recession during the first half of 2022, even though GDP numbers showed two consecutive negative prints. And this strength continued during the first two months of the third quarter of the year with employment growing by 526,000 in July and by another 315,000 in August.

In fact, some economists are calling the current environment, or the path that the Fed should follow in the coming quarters, a 'growth recession.' That is, an economy growing very slowly but shedding jobs along the way, so wage pressures start to recede and help push inflation back to the 2% for the personal consumption expenditures deflator the Fed has established as its inflation target.

An increase in the labour force participation rate would be a best-case scenario for both the Fed and the markets, as the rate of unemployment would increase, reducing pressures from higher wages on inflation which, today, is at the top of Fed officials' concerns.

TO RAISE OR NOT TO RAISE

However, there isn't a unique path to this new scenario. Certainly, the preferred path for the Fed is one it has some relative control over. That is, to continue to increase interest rates until the economy falls into a recession. The second path, however, is to have patience and allow the current increase in rates, plus the ones baked into market expectations for the rest of the year, to do their job. However, for this strategy to be successful, it will need help from the labour force participation rate, or something like what we saw in the August jobs report.

The August jobs report saw employment up by a very strong 315,000. However, this number of jobs was much weaker than in July, when employment surged by 526,000. Strength in employment in August was broad based, according to the establishment survey of employment. Even retail trade employment was very strong in August after several months of relatively weak numbers and speculation of large inventory accumulation weighing down the sector over the summer months. Furthermore, construction employment was very strong, up 44,000 in August, even though the sector has seen its share of weakening because of higher mortgage interest rates. However, there has been a pickup in public construction activity that seems to be helping the employment side of the construction market even though public construction is only about 20% of total construction spending in the US economy.

But the most important detail of the August employment number was the increase in the labour force participation rate, which pushed the rate of unemployment from 3.5% in July to 3.7% in August. This was the result of a 786,000 increase in the civilian labour force after several months of decline.

BEST CASE

An increase in the labour force participation rate would be a best-case scenario for both the Fed and the markets, as the rate of unemployment would increase, reducing pressures from higher wages on inflation which, today, is at the top of Fed officials’ concerns. But wishing for this strategy to work its magic is close to asking for a fairy-tale ending for this highly unusual business cycle.

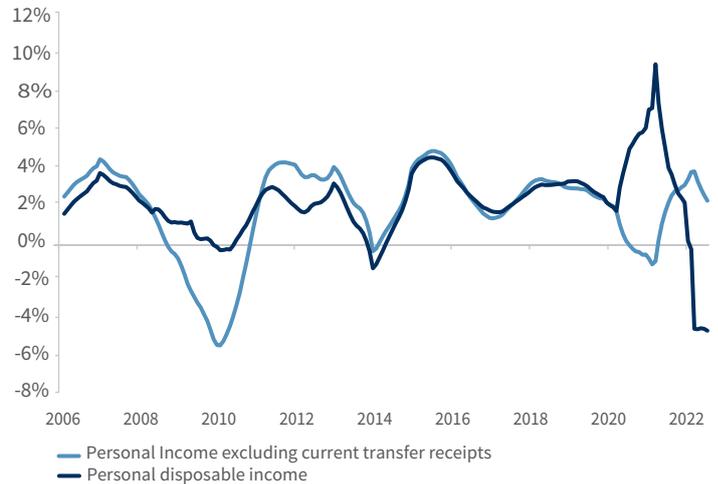
Thus, the risk is that the Fed overplays its hand and increases the federal funds rate more than what would be necessary to bring inflation down if it had more time.

If we look at incomes (see graph at top right), real personal disposable income is declining due to the after-effects of the large fiscal effort made during the COVID-19 pandemic. However, a closer look at the composition of income shows that although personal disposable income is declining, personal income excluding transfer receipts is still increasing, albeit at a much lower rate than before because of higher prices. This could indicate that the Fed may have some more work ahead in terms of slowing down the economy.

But the Fed will have to be careful as we also expect consumption to continue to slow down in the coming quarters as incomes continue to deteriorate. As we have been pointing out over the last several months, real wages and salaries, as measured by the employment cost index, have been coming down due to the increase in inflation (see graph at right). This means that it is expected that consumption will continue to slow in the coming quarters, helping to moderate inflation in the future.

Personal Income & Personal Disposable Income

(% change, 12-month moving average)



Source: FactSet, as of 20/09/2022

Furthermore, what the graph below shows is that the US economy can generate higher real wages and salaries (i.e., from 2015 until early 2020) without triggering higher inflation. Perhaps the biggest issue today for the Fed is whether we will go back to a pre-pandemic economic environment in which inflation is an afterthought; or whether inflation is going to persist once the special conditions created by the pandemic are finally out of the system.

Real Wages and Salaries

Inflation has almost taken away all the gains workers accrued over the last eight years or so in terms of purchasing power of wages.

(2005 = 100 index)

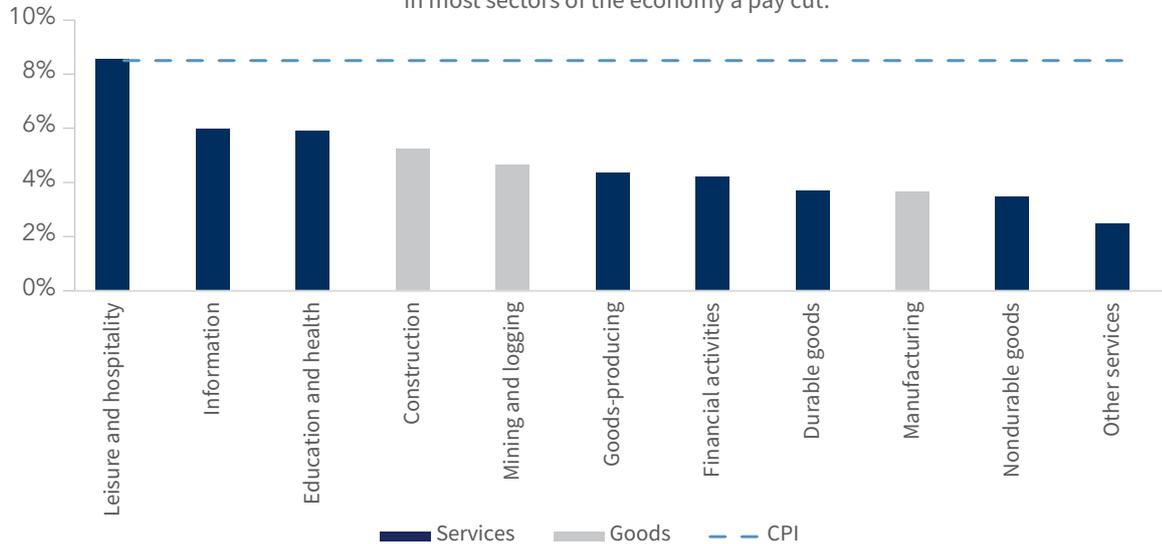


Source: FactSet, as of 20/09/2022

13 *Transfer Receipts: Transfer receipts are benefits received by persons for which no current services are performed. They are payments by government and business to individuals and non-profit institutions.

Sector Wages and Inflation

Despite higher wages, the impact of inflation gave workers in most sectors of the economy a pay cut.



Source: FactSet, as of 20/09/2022

As we have written in the past, reforming our immigration system will also be of great help in moving both the rate of unemployment and the labour force participation rate higher because the pool of available workers will increase. This is especially true for the service sector, specifically for the leisure and hospitality sector of employment, which has seen the largest increases in nominal wages and salaries during the last year or so. This should help reduce the pressure on wages, which is one of the reasons why inflation has remained higher for a longer period.

BOTTOM LINE

These issues are not small and are very difficult for only one institution like the Fed to tackle, because some of them are not within its sphere of influence. However, the way in which these issues are solved will ultimately determine how high the Fed must go in terms of interest rates, and for how long as well as how deep a recession will be needed to tamp down the inflation monster. We believe that the US economy could go back to pre-pandemic conditions with lower rates of inflation once all the supply conditions come back to more normal levels. ■

KEY TAKEAWAYS:

- The Fed and the market are going to have a tough time during the last quarter of the year with the economy showing few signs of slowing down.
- The most important detail of the August employment number was the increase in the labour force participation rate, which pushed the rate of unemployment from 3.5% in July to 3.7% in August.
- The best-case scenario, for both the Fed and the markets, is for the labour force participation rate to continue to go up so unemployment continues to increase. An increase in the labour force participation rate will help reduce the pressure from higher wages on inflation which, today, seems to be at the top of Fed officials' concerns.
- The risk is that the Fed overplays its hand and increases the federal funds rate more than that would be necessary to bring inflation down.
- We believe that the US economy could go back to pre-pandemic conditions with lower rates of inflation once all the supply conditions come back to more normal levels.



The State of the Midterm Elections: Red Wave or Blue Wall?

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

The political set up at the beginning of 2022 carried significant warning signs for Democrats with a political prognosis that a ‘Red Wave’ is coming, favouring the election of Republicans. Democrats, now holding the White House and both houses of Congress (five seats in the House and tied in the Senate) are not only battling history (the party controlling the White House has lost an average of 23 seats in the midterms over the last 40 years), but they are also battling a macro environment that traditionally is a political albatross for the party in power.

Polling shows near record levels of dissatisfaction with the direction of the country among voters, historically low approval ratings for President Biden, and inflation concerns dominating the headlines. Looking at the data, voters’ minds regarding midterm elections have traditionally been effectively made up around the spring of a midterm election year. In fact, presidential approval has not been shown to materially improve in the past 40 years from the spring into the fall of a midterm election.

While we continue to expect that Democrats are likely to lose the House, prospects for Democrats retaining the Senate have materially improved into the autumn.

However, while there are still significant structural factors that favour Republican candidates in this midterm cycle, we are seeing signals that the floor is rising in terms of expected Democratic performance that could present an unexpected ‘Blue Wall’ of resistance for Republicans’ chances of significantly altering control of Washington. Recent electoral surprises favouring Democrats in Kansas, New York, and Alaska highlight that the race is more fluid than many had expected at the start of this year. The traditional voter enthusiasm behind challengers is in part being matched by voters responding to the recent Supreme Court decision in *Dobbs v. Jackson Women’s Health Organisation*. Additional factors motivating Democratic voters and Democratic-leaning independents include a string of high-profile legislative victories, including domestic technology manufacturing incentives and a finalised reconciliation bill that directs new funding toward clean energy

production and extends healthcare coverage for many Americans. Further, the announcement of action on student debt relief will also be weighed as a motivating factor for younger voters. In all, while we continue to expect that Democrats are likely to lose the House (and with it, their Congressional majority), prospects for Democrats retaining the Senate have materially improved into the fall. This will have an important market impact in terms of the Biden administration’s regulatory agenda and confirmation ability for key posts if Democrats ultimately maintain or expand their Senate majority.

A LOOK AT THE RACE FOR THE HOUSE

The clearest opportunity for a change in power in Congress rests with control of the House of Representatives. Democrats are currently holding onto a slim five seat majority in an environment that favours challengers following the 2020 redistricting process and notable tailwinds behind Republican candidates. The magic number for a House majority is 218 seats. Looking at a seat-by-seat analysis, Republicans are currently favoured in at least 213 Congressional districts (seats rated as solid, likely, or lean Republican) and Democrats are favoured in 190. The battle for the majority will likely be decided by the 32 remaining ‘toss-up’ seats. Of these 32 seats, 24 are currently held by Democrats and 8 by Republicans. Republicans flipping just 5 of the 24 Democrat-

ic-held seats flips control of the chamber. Supporting Republican tailwinds and expectations for significant wins, retirements among Democratic lawmakers in this cycle have hit a recent historical high, and Republicans are seeing the most candidates running for seats compared to recent cycles. Both metrics often correlate with a change in control of the House.

With expectations high for a Republican victory in the House, it is worth asking what factors could limit the Red Wave potential. Given the national political setup, some may be expecting an expansive Republican victory along the lines of recent ‘wave’ elections that saw the party in power lose 42 seats in 2018 and 64 seats in 2010. Those elections were preceded by an election where the party that won the majority outperformed and picked up the marginal seats, providing easy targets to the opposition party in the following election. The opposite happened in 2020, when Republicans delivered an unprecedented result of winning 100% of the seats rated ‘toss-up’ (plus several rated lean Democratic/likely Democratic) but fell short of winning the majority. The Republican ‘out-performance’ in 2020 could cap the ceiling in terms of seats Republicans can win this fall. Conversely, for Democrats to win, they would have to deliver another ‘unprecedented’ sweep of the seats rated ‘toss-up.’

Presidential Approval and Midterm Results

Biden fighting history to improve approval rating and limit midterm losses

In cycles where a president’s approval is below 50%, significant House and Senate seat losses have occurred since 2006 (the 2018 Senate race being an exception, where Republicans picked up two seats).

Year	President	Approval: August	Approval: November	House Outcome	Senate Outcome	Control of Congress
1982	Ronald Reagan	41%	43%	-26	+1	Status Quo: Split Congress
1986	Ronald Reagan	62%	63%	-5	-8	Democratic Congress
1990	George H.W. Bush	74%	58%	-8	-1	Status Quo: Democratic Congress
1994	Bill Clinton	39%	46%	-54	-8	Republican Congress
1998	Bill Clinton	64%	59%	+5	0	Status Quo: Republican Congress
2002	George W. Bush	68%	63%	+8	+1	Republican Congress
2006	George W. Bush	37%	40%	-31	-6	Democratic Congress
2010	Barack Obama	45%	45%	-64	-6	Split Congress
2014	Barack Obama	41%	40%	-13	-9	Republican Congress
2018	Donald Trump	41%	40%	-42	+2	Split Congress
2022	Joe Biden	44%	TBD	TBD	TBD	TBD

Source: Raymond James Equity Research, Gallup “Presidential Job Approval Center” data

Our base case remains that the House is likely to flip toward Republicans, but the margin of victory may be smaller than anticipated, which may impact any legislation that the House may ultimately be able to pass with a smaller Republican majority in 2023-2024.

THE BATTLE FOR THE SENATE

Political support for the Biden administration’s regulatory agenda and the ability of the White House to confirm selections to top government posts (including the Supreme Court) will rest with control of the Senate. As such, we are likely to see significant financial resources and political capital devoted to the key Senate races, which we currently view to be Arizona, Georgia, New Hampshire, Nevada (current Democratic-controlled seats); and North Carolina, Pennsylvania, and Wisconsin (current Republican-controlled seats). Swing seats include Florida (Republican incumbent) and Colorado (Democratic incumbent).

Looking at the seats Democrats are defending, Democratic incumbents currently have both the funding and polling advantage across AZ, GA, NV, and NH. However, the 2020 Senate race showed that these metrics should be viewed with some caution in terms of their predictive power. Particularly, 2020 polls significantly underestimated Republican candidates, who saw surprising over-performance in final votes. On average, final vote totals saw an almost six percentage-point variance in favour of Republican candidates when compared to polls, with some individual results swinging as much as 14 points compared to polling averages.

The optimistic case for Democrats retaining or even expanding their Senate majority rests on the following: backlash to the Supreme Court’s Dobbs decision, a roster of untested/unconventional challengers in key races, and the historical consistency of states’ preferences between presidential and Senate elections serving as tailwinds for Democrats in the race for the Senate. We have also observed a trend of Senate candidates significantly over-performing the national approval rating of incumbent presidents of the same party, which limits the potential drag of an unpopular presidency on the prospects of Democrats retaining control of the Senate.

Diving deeper into these factors, we see the potential impact of the Dobbs decision rippling through the key Senate races of AZ, GA, NC, PA, and WI in terms of voter turnout, enthusiasm, and support from Democratic-leaning independent voters. While these states do not have high-profile ballot initiatives similar to Kansas, the down-ballot state-level policy impact may influence voter behaviour. The Republican nominees in some of these key races (particularly AZ, GA, and PA) are first-time candidates, which has proven to be risky in past high-profile elections with the possibility of gaffes and missteps in the final stretch. We have also observed a trend of states maintaining consistent party preference across presidential and midterm Senate races. Going back to 2008, only once has an incumbent of the president’s party running for re-election lost in the midterms in a state that voted for the president’s party in the previous election cycle. If this trend holds, states that voted for Biden in 2020 with current Democratic incumbents (AZ, GA, NV) could see Democratic victories that maintain the 50-50 Senate split. In this case, PA and WI could offer

Several Tailwinds at Notable Levels that Favour GOP

Multiple tailwinds, such as *inflation*, *presidential approval*, *confidence in Congress*, *consumer sentiment*, and *dissatisfaction with the direction of the US* are at their highest/lowest levels at this point in time compared to previous recent midterms in ways that *favour the Republican Party*.

WITHIN THE LAST 40 YEARS:

Inflation	in July of a midterm year is at its highest (8.5%)
Presidential Approval	around July of a midterm year is at its lowest (38%) <i>(and presidential approval is even lower in many contested areas)</i>
Confidence in Congress	during a midterm year is tied with 2014 for the lowest (7%)
Index of Consumer Sentiment	in June of a midterm year is at its lowest (50)
Dissatisfaction with the US	around June of a midterm year is at its highest (87%)

Source: FactSet, as of 20/09/2022

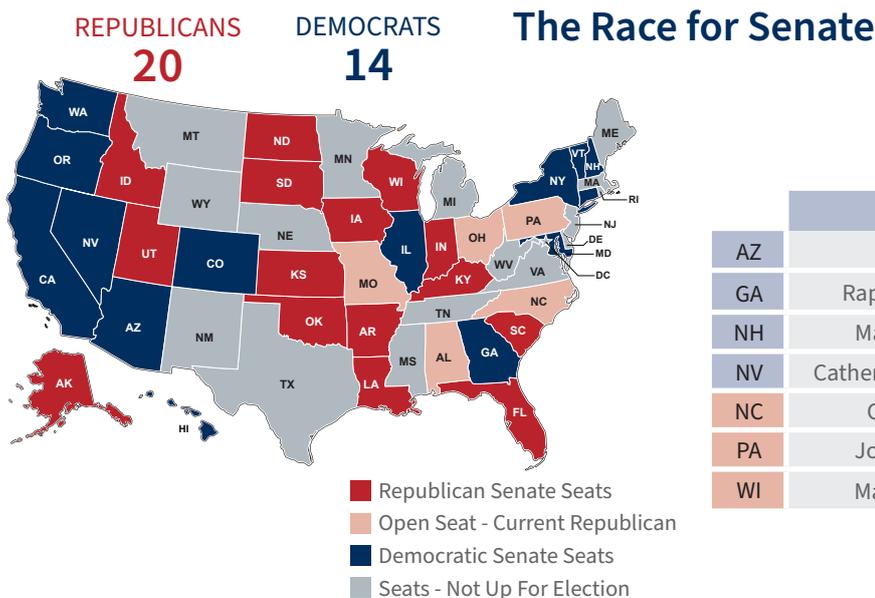
Democrats pickup opportunities, as both states voted for President Biden in 2020 and are currently seats held by Republicans. Overall, the Senate should be viewed as a true battleground this fall, with prospects for its control likely coming down to individual race factors rather than serving as a referendum on the direction of the country.

IN SUMMARY, REPUBLICANS SEE FAVOURABLE NATIONAL ENVIRONMENT, BUT DON'T DISCOUNT DEMS

The overall trend in national political factors has been one of a Democratic recovery relative to the national environment seen earlier this year. The increased prominence of social issues, sustained labour market recovery, and the potential peak of inflation (if the downward trend in domestic energy prices holds) alleviate some of the pressure that has capped Democrats' prospects. While we continue to see material Republican gains (most likely in the House), the likelihood is growing that the earlier forecasted 'Red Wave' is dampened by a reinforced 'Blue Wall', particularly when it comes to improved chances for Democrats to hold the

Senate. In effect, the result of a split Congress following the mid-term elections may be the Goldilocks outcome for markets. With this setup, any further threat of significant tax adjustments will be off the table until 2025. Headline risk regarding budget/debt ceiling battles will also be less of a factor, as these fights are likely to stay within Congress can be resolved there, rather than pit a disunified Republican Congress against a Democratic White House.

While we view a scenario of Democrats controlling both the House and Senate in 2023 as the possibility with the lowest odds, this would also be the scenario that would drive an out-sized market reaction. Legislative risk driven by tax increases as part of the Democratic reconciliation and social policy agenda is now largely viewed as a non-factor by the market given the current political setup but would be poised for a resurgence on the off-chance that Democrats over-perform and maintain control of both chambers of Congress. We caution that the electoral landscape will continue to be fluid up until the election, and that recent cycles have shown that 'unprecedented' results cannot be fully discounted. ■



BATTLEGROUND RACES

	DEM	GOP
AZ	Mark Kelly*	Blake Masters
GA	Raphael Warnock*	Herschel Walker
NH	Maggie Hassan*	Donald Bolduc
NV	Catherine Cortez Masto*	Adam Laxalt
NC	Cheri Beasley	Ted Budd
PA	John Fetterman	Mehmet Oz
WI	Mandela Barnes	Ron Johnson*

*Incumbent

Source: Raymond James Equity Research

KEY TAKEAWAYS:

- In the midterms, Democrats are battling history and an unfavourable macro environment.
- There are signs that the floor is rising in terms of expected Democratic performance that could present a 'Blue Wall' of resistance.
- Political support for the Biden Administration's regulatory agenda and the ability of the White House to confirm candidates for top government posts rests with control of the Senate.
- Dobbs decision impacts key Senate races in terms of turnout, enthusiasm, and support from Democratic-leaning independent voters.
- The result of a split Congress following the midterm elections may be the Goldilocks outcome for the markets.



Europe: Playing Sheriff Means Accepting “Black Hats” And A Lot Of “High Noons”!

Jeremy Batstone-Carr, *European Strategist*, Raymond James Investment Services Ltd*

“ This is a watershed moment in global politics...the time to invest in the power of democracies ”

– Ursula von der Leyen,
Commission President.

September has historically been the most difficult month of the year for financial assets, and 2022 has proved no exception. The month in Europe has been “bookended” by a severe energy crisis which, with winter just around the corner, may yet serve as the catalyst for both political and economic instability.

Profoundly aware of the pressures facing regional unity, Commission President Ms Ursula von der Leyen has given a forceful speech emphasising the importance of togetherness in the face of myriad challenges. “The months ahead of us will not be easy”, the President warned, “Be it for families who are struggling to make ends meet or businesses that are facing tough choices about their future”. With regard to Russia’s invasion of Ukraine, Ms von der Leyen stated, “This is not only a war unleashed by Russia against Ukraine. This is a war on our energy, a war on our economy, a war on our values and a war on our future”. As metacrisis goes, that sounds like the full works.

Ms von der Leyen’s speech was heavy on regional values but much lighter on specifics. This prompted one commentator to

observe that what the EU is promising is not simply a semi-war/planned economy, from energy and environmental awareness upwards, but muscular liberal-democratic mercantilism from the top down. Well said! The problem is that Europe does not yet have the muscular clout to enable it to brandish its flash sheriff’s star with authority.

Indeed, what was proposed amidst the lectern thumping would likely have been considered the very opposite of what passed for democracy just a few years ago. Governments should impose a ceiling on energy producers’ revenues and add a windfall tax on the profits entitled a “solidarity contribution”. The plan, very obviously, is to try and manage energy costs in a high inflation environment sufficient to distribute additional money to those who most need it. The risk is, of course, that the plan discourages oil and gas companies from investing against a backdrop of already profoundly curtailed capital expenditure in the dash for “green” credibility.

Importantly, such a windfall tax is merely a proposal, not a compulsion. Admittedly, the proposal comes from the highest levels of the administration, but it still requires ratification by

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all EU members. According to Mr Laurent Ruseckas, executive director of S&P Global, the proposals are extremely complex in practicality and impossible to work through in time for winter, even if there were a political consensus behind them.

Politically speaking, the successful functioning of the EU has been constructed on two pillars. The first is German growth (the regional engine room), and the second is a combination of low-cost debt, highly supportive regional budgeting and a TARGET 2 regional bank clearing system aimed at ensuring that the region's weaker economies can survive without being forced into politically (and socially) unacceptable reforms.

The present-day reality reveals that the sharp slowdown in the global economy, coupled with a profound energy crisis, threatens both regional industrial activity and standards of living. This, in turn, limits the scope and desire for multilateral economic support whilst simultaneously increasing the desire for political self-determination at home. Nowhere is this more apparent than in Italy.

Irrespective of pledges made on the campaign trail by the victorious right-of-centre coalition, yields on Italian debt have edged higher. Whilst the spread between Italian government bond yields and core (German) counterparts has risen, implying that investors are seeking a risk premium for Italian bonds, they have not blown out to the levels of the past, at least not yet. That being said, Italy's indebtedness is very high at around 150% of GDP, while its maturity profile is also unfavourable (35% of outstanding debt will fall due for repayment in 2024 and 50% within five years). Without the latent support in the form of the, as yet unutilised, European Central Bank's newly minted anti-fragmentation Transmission Protection Instrument yields would likely have blown out even further than is currently the case.

Elsewhere, both Poland and the Czech Republic have made clear their objection to plans to cap the price of Russian energy, a proposal which seems unlikely to be enforced. Beyond this, much-needed disbursements from the regional Recovery Fund are increasingly being made conditional on adherence with Ms von der Leyen's "European values", a list of essentially political requirements aimed at subjugating regional nation states to an unelected cadre in Brussels. This is not popular. Poland's governing Party secretary-general has recently warned that "without a clear change in the actions of Brussels, we will have no choice but to pull out all the cannons in our arsenal and open fire".

In response to these and other threats, the Commission may have to announce a second regional Recovery Fund, much larger in size than the current €800bn Fund. This, in turn, may ultimately require the regional central bank already raising key interest rates and actively looking to shrink the size of its balance sheet to recommence its earlier quantitative easing programme. It is this expectation that seems likely to limit the scope for regional sovereign bond yields to rise too far beyond prevailing levels. The region's stock markets, with a clear cyclical bias, are thought unlikely to perform until evidence of an economic upturn starts to emerge, that or the US dollar starts to depreciate on the foreign exchanges. ■

KEY TAKEAWAYS:

- Europe's energy crisis has dominated investor sentiment and determined political initiatives and exacerbated regional inflationary pressures and growth slowdown.
- Apparent acts of sabotage on the Nord Stream gas pipelines have refocused attention on Europe's lack of energy security, whilst ensuring that the Ukraine conflict remains front of mind.
- Commission plans to manage energy costs carries the risk that suppliers may not invest in additional capacity and do little completely to protect households from rising energy bills.
- Political disunity threatens to fracture regional cohesion. The Italian election result being merely the highest profile indication of popular discontent.
- The ECB has embarked on a rate hiking programme in an effort to contain regional inflationary pressure, whilst standing ready to utilise its new anti-fragmentation tool were peripheral sovereign bond yields to rise too sharply, too fast.

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