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Figuring out Europe for the rest of the year

Chris Bailey, Raymond James European Strategist

European equities have generally performed strongly in local currency terms during the first quarter of 2015 boosted by the introduction of quantitative easing stimulus policies but what should investors be thinking now? Here are four key thoughts for the next quarter and beyond.

GREECE IS THE WORD

Impossible not to start with the Hellenic Republic because after the rhetoric, regional tours and game theory extensions of the last couple of months, reality now kicks in. Already in early April fears about non-payment of the IMF loans later in the year have mounted, resulting in an unexpected meeting between the Greek Finance Minister and the IMF on Easter Sunday where the shortness of the resulting communique was in direct disproportion to the seriousness of the subject matter. In short, European policymakers have to make a decision over the next few months to restructure Greek debt or cut them loose. In my opinion a sizeable debt haircut is the best solution, but that results in bond holders sharing some pain and agreement to that is not a given. Failure to get a deal just fast forwards the reality that there are problems in the region.

CHRIS BAILEY
Raymond James European Strategist

" A combination of sustainable yield, pricing power, market share gains and management acumen still feels attractive."

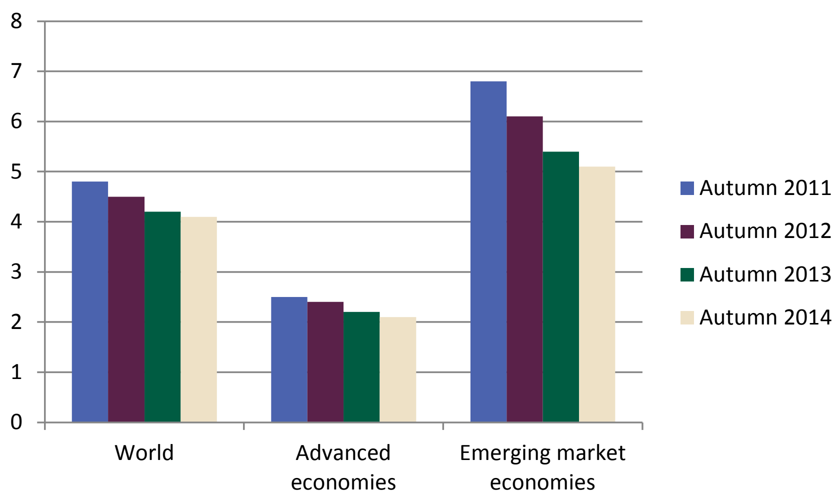
POLITICAL LOW CONFIDENCE AND ECONOMIC CONTAGION

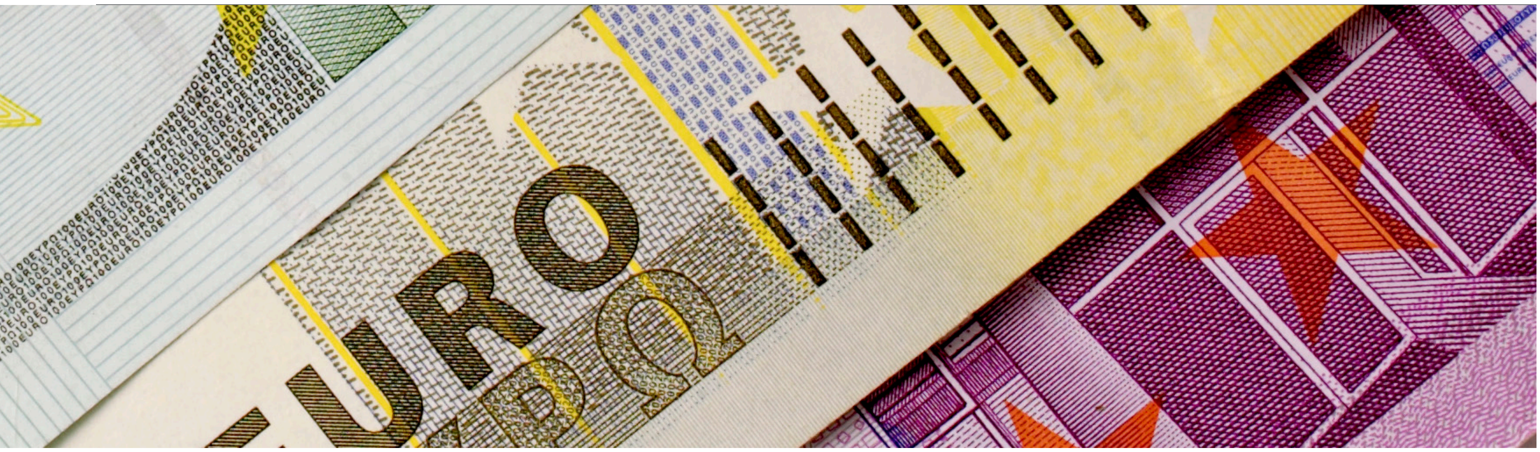
Whilst the pro quantitative easing policy choice was one of the better moves by policy makers over the last few months, the lack of common risk-sharing simultaneously announced reflected an inherent distrust which has spilled over into opinion polls and the electoral booths. The European bond market is currently telling us that the fear of generalised regional contagion from a Grexit is low, but the opinion polls indicate continued distrust and in some countries a surprising lack of pan-regional spirit, which is not good. Bond markets typically used to hate that sort of backdrop in the pre-QE days. They still could do so.

DOES THE EURO STOP GOING DOWN?

With the first quarter 2015 earnings formally starting in mid-April, one of the key sub-trends is once again going to be the impact of currencies. European exporters are continuing to reap the rewards of a lower euro but the corollary of this is weak American earnings. Logically this should weaken the US dollar – which may surprise some observers given the aforementioned challenges still in the European economy. Europe cannot rely on a weak euro forever – and that moment may be fast approaching. Exporters will find a way to adjust irrespective of the changes, but equity markets overall – which have become used to a weak euro - may find it harder to do so.

World Economic Outlook - 5 year anticipated economic growth levels





SPECIFICS MATTER MORE THAN EVER

Where to hide from political challenges, lower confidence and a potential end to a key policy stimulating tool (the weak euro)? The answer lies more than ever in the specific and idiosyncratic, in my view. While the last couple of years have been challenging for stock pickers, I still believe 2015 will end rather differently. A combination of sustainable yield, pricing power, market share gains and management acumen still feels attractive. I believe the rest of the year will see a discernible shift from the general to the specific.

What I believe we can say with some certainty is that European investment strategy is going to be volatile during the rest of 2015. To paraphrase a recent comment by the ex-Chairman of the Federal Reserve Ben Bernanke: 'complacency is a problem'.

KEY TAKEAWAYS:

- **European equity markets have performed well but challenges remain.**
- **There needs to be a sustainable deal on Greek debt otherwise there is the risk of a spill over into European markets.**
- **The weak euro is impacting the US dollar and American economic progress so despite continued challenges within Europe the currency may stop falling.**
- **European investment focusing on the specific and not the general will make more sense for the rest of 2015.**

INVESTMENT STRATEGY COMMITTEE MEMBERS

The Investment Strategy Committee combines the collective insight of senior thought leaders at Raymond James on market and economic factors affecting individual investors. Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

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Striking a Balance

THE FED NAVIGATES UNCHARTED TERRITORY IN POLICY AMID A SOARING DOLLAR, GLOBAL MONETARY EASING AND CONTINUED POSITIVE MOMENTUM IN THE ECONOMY.

Scott J. Brown, Ph.D., Chief Economist, Equity Research

> "The domestic economic outlook remains promising."

Last year, the growing split between the U.S. and the rest of the world was one of the key themes for investors. The ground has continued to shift, and at a faster pace, in early 2015. Many U.S. firms have cautioned about the impact of a stronger U.S. dollar on earnings. At the same time, the currency improvement has put downward pressure on inflation and boosted consumer purchasing power.

With central banks around the world easing monetary policy and the U.S. Federal Reserve contemplating when to begin tightening policy by raising short-term interest rates, the dollar has continued to strengthen.

THE IMPACT OF EXCHANGE RATES

It's important to note that for most countries exchange rates fall under the jurisdiction of finance ministers – the Treasury Department in the U.S. and the Council of Ministers in Europe – not central banks. The Federal Reserve (the Fed) is not going to delay the initial rate hike to keep the dollar from strengthening. However, central banks do need to consider the impact of currency movements on the outlooks for economic growth and inflation, and that may have some impact on policy.

For the most part, the specific level of the exchange rate is usually not a concern for policymakers. What matters is the speed of adjustment. Large currency moves in a short amount of time tend to destabilize trade activity and international finances. Trade and capital flows are enormous, and policymakers can usually do little to influence currency movements over time. However, well-timed verbal comments can alter the speed of adjustment in the short term. The Group of Twenty (G20), consisting of finance ministers and central bank governors, will meet mid-April, and we may see them try to slow the dollar's rise.

ECONOMIC IMPROVEMENT

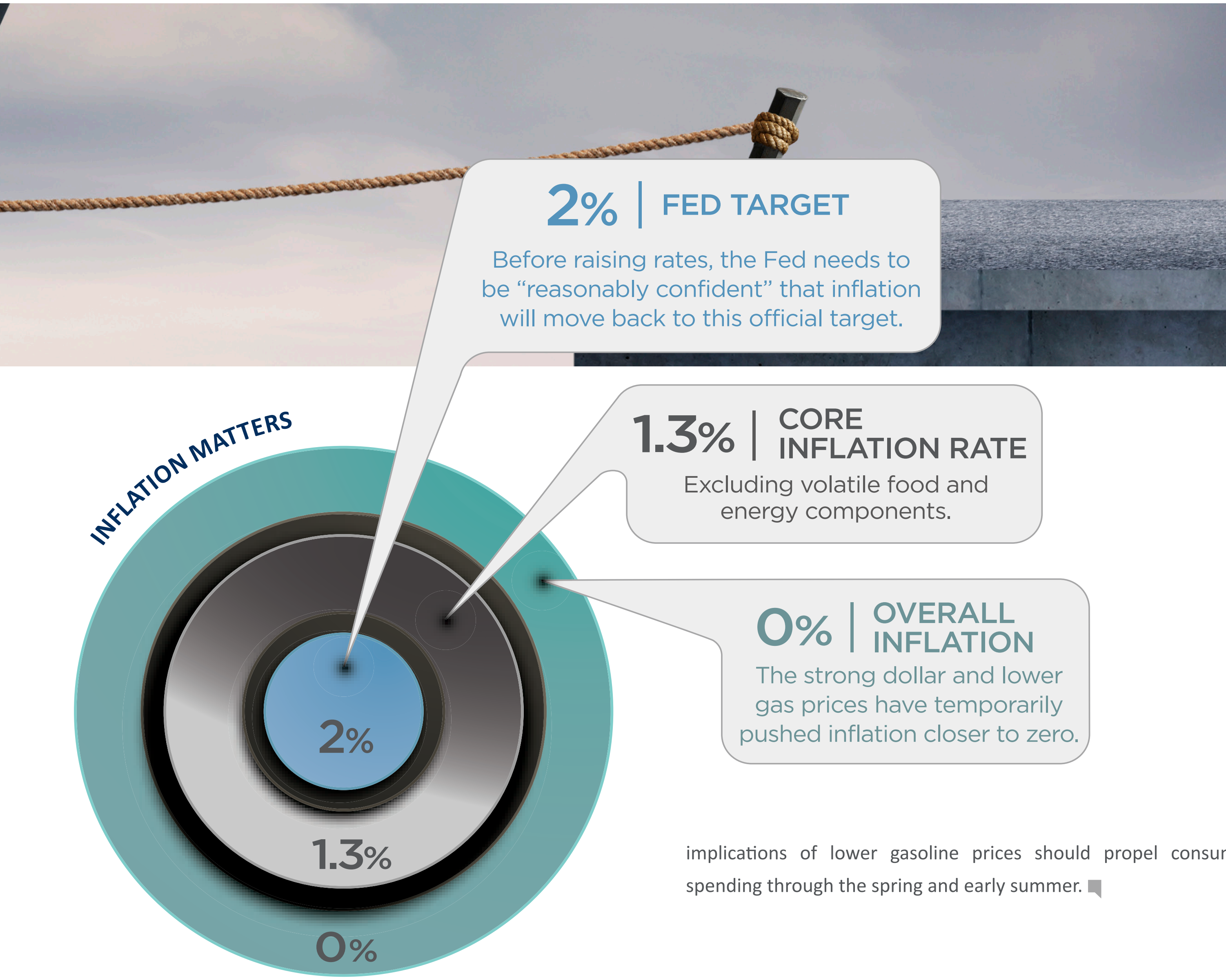
Last year, nonfarm payrolls posted the largest increase since 1999. Job strength has continued into 2015. Typically, small firms account for most of the net job growth during an expansion. While bank credit to small firms remains relatively tight by historical standards, the outlook for the economy has improved significantly. Anecdotally, many of these small firms report that they need to hire more workers to keep up with demand.

Despite solid gains in jobs over the last several months, average hourly earnings (before adjusting for inflation) have remained on a lackluster trend. However, the drop in gasoline prices has pushed inflation-adjusted wages higher. Retail sales results were disappointing in January and February, but that should not be viewed as troublesome – these are transitional months for most retailers and spending in March and April should be a lot stronger.

FEDERAL RESERVE POLICY

For the last several months, the Fed has made plans to normalize monetary policy, setting out the tools and the order in which they will be used. Still, the timing of the first rate increase and the pace of policy tightening are uncertain. Fed officials have made it clear that monetary policy will be data-dependent. Additionally, the broad range of labour market data suggests that slack is being taken up at a fairly rapid pace, but a large amount remains. By June, the Fed is expected to return to "business as usual" – that is, less reliance on forward guidance. Policymakers will consider raising short-term interest rates on a meeting-by-meeting basis. However, that doesn't mean that they will.

In her monetary policy testimony to Congress, Fed Chair Janet Yellen



said that Fed officials need to see further improvement in the job market before beginning to raise short-term interest rates. However, the Fed also needs to be "reasonably confident" that inflation, as measured by the PCE Price Index, will move back to the official 2% target. Lower prices of gasoline have helped push overall inflation close to zero. The core inflation rate, which excludes volatile food and energy components, was 1.3% over the 12 months ending in January. The strong dollar has put downward pressure on import prices, and there appears to be disinflationary pressure "in the pipeline." However, the Fed views many of these factors as temporary.

Uncertainty about the future path of monetary policy and world events are likely to remain ongoing concerns for investors. The stronger dollar may further restrain earnings of U.S. multinationals. However, the domestic economic outlook remains promising. Strong job growth and the purchasing power implications of lower gasoline prices should propel consumer spending through the spring and early summer.

KEY TAKEAWAYS:

- **Many U.S. firms have cautioned about the impact of a stronger U.S. dollar on earnings. At the same time, the currency improvement has put downward pressure on inflation and boosted consumer purchasing power.**
- **The Federal Reserve is not going to delay the initial rate hike to keep the dollar from strengthening.**
- **Last year, nonfarm payrolls posted the largest increase since 1999. Job strength has continued into 2015. Typically, small firms account for most of the net job growth during an expansion.**
- **Strong job growth and the purchasing power implications of lower gasoline prices should propel consumer spending through the spring and early summer.**

HERD MENTALITY:
Is your portfolio under the influence?

AVOIDING THE PITFALLS OF HERD BEHAVIOR

Nicholas Lacy, CFA, Chief Portfolio Strategist, Asset Management Services
Peter Greenberger, CFA, CFP®, Director, Mutual Fund Research & Marketing

Every year investors are bombarded with predictions on hot topics from analysts and portfolio managers.

Currently, there are a number of predictions coming from the investment industry.

> "We believe a methodical approach to investing is always in favour."

- Prior to the latest Federal Open Market Committee meeting, it was expected that the Federal Reserve (the Fed) would begin raising rates in June 2015. Following the March meeting, consensus pushed that date back to late 2015 with a lower rate.
- The U.S. dollar will continue to strengthen throughout 2015, even though it's already at an 11-year high compared to the euro.

Furthermore, the majority of domestic investors continue to believe that the U.S. equity markets offer the best investment choices. This behavioral bias, known as home bias, is prevalent all over the world.

When it comes to predictions, does it make sense to follow the crowd? In our experience, consensus is seldom correct. In the not-so-distant past, many experts forecasted short-term interest rate increases to begin in 2011. When that didn't happen, the consensus was that rates would move upward in 2013 and, when that year ended with no changes, 2014 was the clear choice for the Fed to raise rates. Yet, here we are in 2015 with rates still pegged at zero.

Furthermore, a quick look at last year's more general predictions highlights additional inaccuracies. According to the Wall Street Journal Economic Forecasting Survey, published in January 2014, the 10-year Treasury note should have yielded 3.52% at the end of 2014, but instead it yielded 2.17%, a 38% difference. Similarly, crude oil ended last year at $53.27 per barrel, while analysts predicted $94.65, a 44% difference. Over the same time frame, the actual inflation rate was 1.3%, versus the 1.9% that was expected. As investors who follow the markets may notice, there can be significant differences between expectations and actual results, which can have an important impact on their portfolio. So, does this mean that they should be contrarian investors and go against the consensus? Not necessarily.

HOW TO KEEP FROM GETTING TRAMPLED

What's important is that investors consider both sides of potential outcomes. The possibility of the consensus being right or wrong can push investors to overreact, and emotional investing is often damaging to their overall financial goals. The best course of action is to assign probabilities to possible outcomes. For example, if we assign a 65% probability that the consensus will be correct, an investor should allocate a larger portion of his or her portfolio to work effectively if the majority prediction holds true. And, what if the consensus is wrong? An astute investor can overcome by allocating the remaining percentage of the portfolio to assets better positioned to perform well in that instance.

Regardless if the consensus is right or wrong, we believe a methodical approach to investing is always in favour. When considering which investments to include in your portfolio, you should not only look at those you believe have the highest likelihood of success, but also allocate a portion of your portfolio to those less likely outcomes. Doing so can help alleviate losses in case current expectations prove to be incorrect, as they often are.

Since emotions can often overcome reason, discipline and conviction play important roles in formulating your investment strategy. Even

those investments that may seem contrarian in foresight could turn out to be brilliant in the end. As always, working with your wealth manager can help position – and diversify – your portfolio appropriately to help reach your specific goals.

KEY TAKEAWAYS:

- **There can be significant differences between expectations and actual results, which can have an important impact on portfolios.**
- **When considering which investments to include in your portfolio, you should not only look at those you believe have the highest likelihood of success, but also allocate a portion of your portfolio to those less likely outcomes.**
- **Since emotions can often overcome reason, discipline and conviction play important roles in formulating your investment strategy.**

THE PREDICTIONS WERE OFF

There can be significant differences between expectations and actual figures.

	10-YEAR TREASURY NOTE	CRUDE OIL	INFLATION RATE
PREDICTED (2014)	3.52%	$94.65	1.9%
ACTUAL (12/31/2014)	2.17%	$53.27	1.3%
DIFFERENCE	38%	44%	32%

THE VAST DIVIDE

Thoughts on navigating polarization in emerging markets

Q&A with Stacey Nutt, President & Chief Investment Officer, ClariVest Asset Management*

Q. Evaluating emerging market equities as a single asset class is viewed by many as outdated and, perhaps, unwise. What makes this space so dynamic relative to other areas of the equity markets?

A. A common refrain in recent years is that emerging markets have decoupled from one another, taking varied approaches to dealing with economic challenges resulting from slowing growth rates. Prognosticators conclude that the various markets within this group can no longer be viewed as a monolithic whole. We would argue that this has always been the case.

The idea that emerging markets are somehow part of a single market is in itself a simplified assumption. This is based on investors' overreliance on a narrow time frame of rapid growth during the first decade of this century. The rapid globalization experienced over that decade led to an inflated assumption among investors regarding the long-term "connectedness" among these economies. The reality is that these countries have often decoupled from one another as they face, and react to, various local and global challenges.

Q. How should investors approach emerging market exposure in their portfolios?

A. The realisation that various emerging markets are distinct can tempt investors to employ a dangerous heuristic when investing across the space. Specifically, they may be drawn to segregate the various markets, only investing in those deemed to be sufficiently attractive on a relative basis. Painting all constituents of each market in a singular way makes the same type of mistake we argue against at the overall emerging markets level.

This approach has the potential to greatly limit investment opportunities. Within any single emerging market there are almost always a significant number of companies performing well, despite their geography. It's often these strong performing companies within poor performing markets that create the best investment opportunities. In addition, overreliance on macro-level trends with little to no realised fundamentals is dangerous since making favourable calls on a specific country consistently over time is difficult, if not impossible. We strive to avoid overstating our ability to forecast the future for any single country and believe that building a portfolio of diversified fundamental growth across the entire set of emerging markets is a more robust, and therefore more prudent, investment approach.

"Building a portfolio of diversified fundamental growth across the entire set of emerging markets is a more robust, and therefore more prudent, investment approach."

An interesting corollary is the maxim that the best approach is to pick stocks from the bottom-up, but to worry from the top-down. This is the perfect time to apply such an adage and look for bottom-up stock picking opportunities across the entire breadth of emerging market possibilities, while being cognisant of risk as it applies to overall portfolio positioning.

Q. What opportunities and challenges surround some of the primary emerging markets in the near term and over the long run?

A. In the near term, emerging market economies are going to face a number of challenges. The positive expectations around reform in India have reached such high levels that it may be difficult for Modi, India's prime minister, to live up to them – perhaps disappointing investors who look at India through a single, positive lens.

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

Brazil, on the other hand, may end up being a positive surprise next year as it is difficult to see how sentiment could deteriorate any further. The Brazilian government has taken significant steps towards damage repair, including improving relations with the United States, electing a serious central banker to combat currency and recessionary problems, and making initial spending cuts to its bloated budget.

While these two countries may see market reversals in the coming year, we believe Russia is likely to continue to fulfill already low expectations. Continued soft oil prices and Putin's stubbornness seem likely to provide a strong one-two punch to an economy already on the brink of a deep recession. Finally, China continues to transition its economy from infrastructure-focused to consumer-focused. To be successful, they will have to balance acceleration on the consumer side and offset deceleration on the infrastructure side. So far there have been signs of stress, but not fracture in this balance.

Despite near-term challenges, long-term growth demographics in this space are undeniable. Over the next 10 to 30 years, these markets are poised to move forward economically. Much more than half of the world's population lives in emerging market economies, and these populations are connected to the rest of the world like never before – electronically, economically, politically and socially. This connectedness makes it difficult to believe that these countries, except possibly in isolated incidences, will make a permanent retreat to the economic wreckage of earlier decades.

While we should never forget that such progress typically involves a "three steps forward, two steps back" experience, progress will be made. Overall, we believe in a long-term, diversified approach to investing in emerging markets.

"I would be careful not to check the box of emerging markets as a single investment because these countries are anything but the same. Places like India have a lot of positive things happening while places like Brazil have numerous problems to face right now."

– NICHOLAS LACY, CFA

Chief Portfolio Strategist, Asset Management Services

KEY TAKEAWAYS:

- **The idea that emerging markets are somehow part of a single market is in itself a simplified assumption based on investors' overreliance on a narrow time frame of rapid growth during the first decade of this century.**
- **Despite near-term challenges, long-term growth demographics in this space are undeniable. Over the next 10 to 30 years, these markets are poised to move forward economically.**
- **Building a portfolio of diversified fundamental growth across the entire set of emerging markets is a more robust, and therefore more prudent, investment approach.**

UK ELECTION:
FRIEND OR FOE TO THE FINANCIAL MARKETS?

Chris Bailey, Raymond James European Strategist

Every fledgling investor learns very quickly that one trait financial markets never like is uncertainty…and there are few uncertainties as large or important as the composition of a country's government.

It does not matter where you sit on the political spectrum the only current certainty is that there is material uncertainty ahead of the UK General Election on 7 May. Whilst the current coalition government has surprised many observers by lasting for a full-term, the sheer range of potential outcomes risks heightening fear in UK financial markets.

There have already been some cautionary signs. Non-UK resident holders account for just under 25% of the gilt market and they have been net sellers during the first couple of months of 2015. The Pound has also slipped on the foreign exchanges to levels against the US dollar not seen since 2010. One well known financial media publication also recently ran an alarming looking graphic showing the recent sharp pick-up in anticipated Sterling volatility derivative contracts.

> " 'The UK's politically driven uncertainties would come quite well down any list of global asset allocator's list of concerns."

A weak minority government, unstable coalition and/or slippage on recent fiscal consolidation efforts are all potential reasons justifying the above moves in the gilt, foreign exchange and derivative markets and there is little doubt that even further minor moves will be jumped upon as indicators of further impending doom.

However there are two aspects of the current environment which investors should draw some relative comfort from.

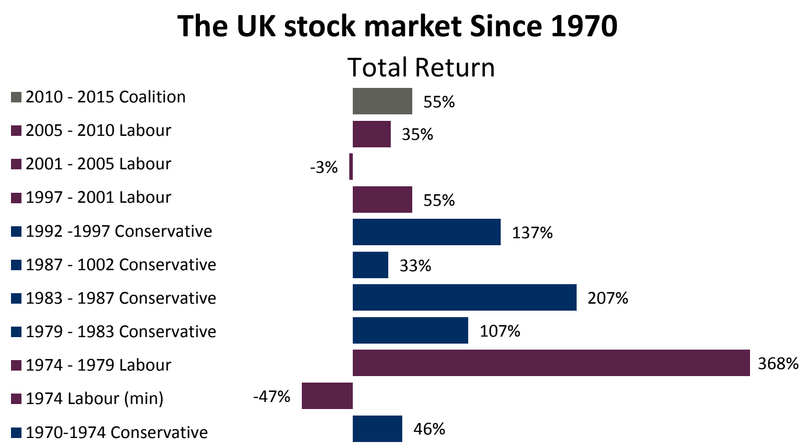
The first is that none of the above moves so far have been hugely dramatic. This reflects the reality that the global economy has a number of challenges including the need for structural reform to boost the recent moribund European and Japanese economies, a potentially stuttering US economy crimped by a resurgent dollar, the impact of weak energy prices and political scandal in various emerging markets and an ongoing tricky transition in the Chinese economy. The UK's politically driven uncertainties would come quite well down any list of global asset allocator's list of concerns.

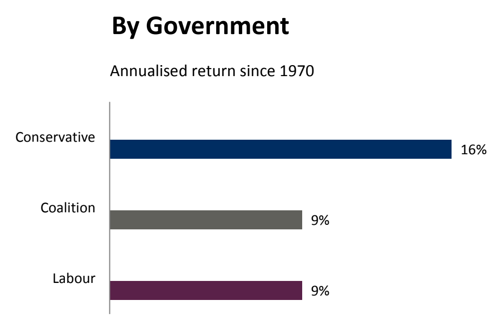
And then there is the very global nature of the UK stock market too which despite all the headlines about political uncertainty has quietly – in the form of the FTSE 100 index - crept to new record highs over the last few weeks. How can this happen in the midst of such uncertainties?

The simple answer is that there is always two sides to any argument and whilst there are a number of clear challenges for the global economy from a glass half full perspective the loosening in monetary policy seen across many geographies, an improving real wage growth dynamic aided by low energy prices and a high level of merger and acquisition corporate activity has boosted many global equity indices including the FTSE 100. To imagine a scenario where the fortunes and profitability of many of the UK largest listed companies rests more on the outlook for economic growth levels in the US or China is not ridiculous at all. Ironically the perceived value of profits generated overseas could actually rise if the Pound fell or investors decided to look for alternatives to gilts.

So is the upcoming UK election a friend or a foe to the financial markets? Globally even a messy minority government or unstable coalition would barely register whilst in the UK shifts such as higher bond yields or a lower value of the Pound may ironically raise the relative attractiveness of selected globally-centric UK listed large cap investments.

Uncertainty is a cautionary outcome for the financial markets but given they are also wonderful discounting mechanisms much will be priced in by around polling day. Investors should view any such volatility as an opportunity especially for potential investment into a number of globally-centric UK listed large cap stocks which dominate the FTSE 100. The key is to stay specific and not to panic…and to particularly remember that whilst governments govern the greatest source of return from equity investment comes from skilled company management with a strong set of products.





Statistics sourced from Bloomberg, dividends re-invested as compiled by Hargreaves Lansdown

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