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Letter from the Chief Investment Officer

Reckoning with Records

Despite numerous headwinds, 2019 is gearing up to be a celebratory year with record-breaking achievements on many financial and economic fronts. In particular, in the United States **we just toasted the S&P 500 as it celebrated the ten-year anniversary of the secular bull market in March.**

Following last December's worst equity performance since 1933, concerns of an impending recession, tightening monetary policy, and a trade war with China were muted, allowing risk assets to recover from the 24 December lows.

The U.S. economy and various financial markets are **poised to achieve historic milestones,** some set to take place in the upcoming quarter. Consensus from the Raymond James Investment Strategy Committee is that markets remain favourable, especially for investors maintaining a long-term time horizon. However, given the speed and magnitude of the first quarter rebound, the path ahead is likely to remain challenging.

The U.S. is the beacon of the global economy, with positive growth expected for the year. 2019 growth is expected to be 1.9%, according to Dr. Scott Brown. **Should the expansion continue past June, it will be the longest economic expansion on record.**

Robust job growth, healthy consumer spending, elevated business and consumer confidence, and fiscal stimulus support our positive view. A "patient", flexible Fed leads us to assign a 25% probability of a recession in the U.S. over the next twelve months. **In fact, April could "legendise" the Fed for navigating the longest tightening cycle ever engineered without causing a recession.**

Dr. Scott Brown recently reported that the Fed is on hold for the foreseeable future, reflecting signs of slower-than-expected growth and downside risks. The Fed funds futures are pricing in some chance of a rate cut by the end of the year.

Our expectation of a trade agreement between the U.S. and China should supplement growth globally as trade uncertainty fades. In the absence of an agreement, a softening global economy, that currently shows signs of strain, has the potential to spill over to the U.S.

Despite the slowing ascent of equities, with intermittent periods of downward pressure, we remain unwavering in our expectation of a higher equity market by year end. In the United States, Jeff Saut sees earnings expanding in the second half of the year. The average American stock is still expected to post positive earnings growth for both the quarter and the year, a better barometer of the health of corporate earnings.

Looking at the U.K. and Europe, Chris Bailey believes that the Brexit debate is likely to edge towards a sensible compromise that will avoid a 'no-deal' scenario. Meanwhile, this May's European Parliamentary elections will see populist parties make further gains although not take control.

Looking at emerging market equities, the recent rally is likely to continue, especially if a U.S.-China trade compromise comes to fruition. China is attempting to stimulate its economy via pro-growth monetary and fiscal stimulus with the budget deficit challenging record highs of 4% of GDP. **While the U.S. dollar bull market run has reached a record duration, celebrating its 11-year anniversary,** the rally is likely to see a period of consolidation. More tempered Fed policy and fewer "upside" surprises to U.S. economic growth forecasts are a recipe for a pause in dollar growth. Stabilisation of the dollar is positive for all non-U.S. equities.

Despite healthy U.S. economic growth, record national debt, and a gradual reduction in the Fed's balance sheet, the 10-year U.S. Treasury yield remains well below 3%. Nick Goetze expects rates to be capped through the end of the calendar year at 3%, due, in part, to the wide disparity between domestic yields and developed world sovereign debt creating very strong global demand at current levels and the lack of inflationary expectations. If we see a normalisation of global interest rates relative to those in the United States and an uptick in inflationary expectations,

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a logical next cap on rates, albeit at higher levels, would be the massive demand from underfunded pensions and the Baby Boom generation seeking stable income with lower volatility in retirement.

With slowing global growth and nascent inflationary fears, yields overseas are likely to remain depressed for the foreseeable future. In fact, **the University of Michigan inflation expectations survey for hte U.S. for the next five to ten years recently fell to 2.3%, tying the lowest level on record.** Doug Drabik expects higher interest rates to continue to face major headwinds likely keeping them range bound and low.

Although credit-market spreads have narrowed, we believe companies and countries with modest leverage and strong balance sheets should outperform. Simply buying yield will not work. James Camp* believes that credit fundamentals are paramount as **leverage has increased materially with a record 50% of investment-grade bonds in the BBB-credit rating range – slightly above 'junk.'**

Record oil production in the U.S. is expected to continue, with average daily production forecasted to reach approximately 12 million barrels per day (mm bpd) by year end. While this would normally place a cap on oil prices, two market dynamics are supportive. First, OPEC production cuts have reduced overall supply. In particular, sizable cuts by the largest OPEC producer, Saudi Arabia, are adding to undersupply. In fact, total OPEC production is at its lowest level since 2015.

Second, new global sulphur emission standards taking effect in January 2020 will effectively erase as much as 1.5 mm bpd of supply. This, combined with our expectation that global oil demand growth will remain healthy, could allow oil (WTI) to move north of $70/barrel by the end of the year, according to our energy research team.

Moving forward, it is not feasible for markets to continuously rise or fall, so don't get caught up in the momentary noise. While records can be broken, we can't lose focus on what the long-term trends are telling us. Staying disciplined during times of uncertainty and times of complacency is an essential characteristic of a successful investor.

Lawrence V. Adam, III, CFA, CIMA®, CFP®
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Searching for a Brexit Compromise

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

As the writer and philosopher George Santayana once observed: 'Those who cannot remember the past are condemned to repeat it'. Back in the 19th Century, more specifically between 1815 and 1846, the 'Corn Laws' kept grain prices high via the use of tariffs and other protectionist mechanisms in order to favour domestic producers. However, following vociferous lobbying by urban dwellers motivated by a desire for more plentiful and cheaper food, the Prime Minister of the day - Sir Robert Peel of the Conservative Party - achieved repeal with the support of the Whigs in Parliament, overcoming the opposition of most of his own party (albeit at the cost of ultimately losing his position as Prime Minister).

There is a certain irony that whilst the repeal of the Corn Laws is perceived as a decisive shift toward free trade, the great fear of Brexit is that a messy exit risks unpicking much of the trade flexibility developed over the last generation. And so it passes that another Conservative Prime Minister has reached out in early April to opposition groups in order - potentially - to try to overcome elements of her own party and formal coalition partners who so far have voted in insufficient numbers in favour of her negotiated deal. And of course the net negative voting does not end there as - to date - a good number of indicative votes covering a range of other Brexit scenarios and options have also failed to get a majority in Parliament. The words of Jamie Dimon quoted above may have been uttered about about a different subject, but they certainly ring true as regards Brexit. With the timetable now deep into the twelfth hour (or maybe even beyond it), the uncertainty of a potentially messy 'no-deal' has certainly risen.

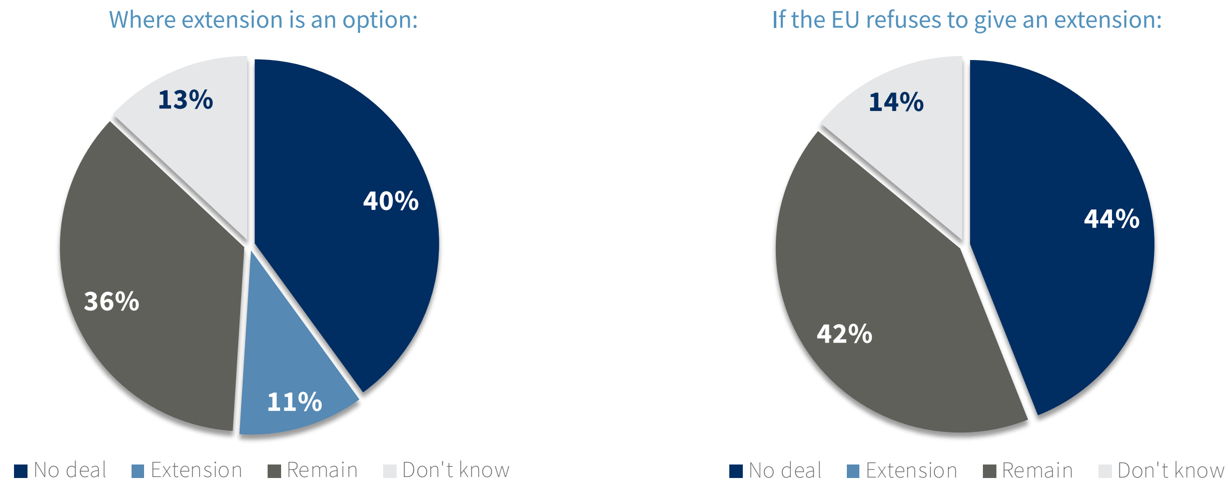
> "You can compromise without violating your principles, but it is nearly impossible to compromise when you turn principles into ideology"
> – Jamie Dimon

In short - much to the chagrin of a growing proportion of the electorate - so much time has elapsed but so little real progress in clarifying the preferred end form of Brexit has been made. Naturally the real energy by now should be going into working out how to make the post Brexit period work given the result of the 2016 referendum was a preference to leave the European Union. When I look at the dynamic but competitive world out there, U.K. businesses must acknowledge the new realities of

Brexit Sentiment: The Latest

You Gov's latest poll asks the question:

"If Britain has not agreed a deal by 12 April, what do you think should happen?"



Source: YouGov polling 31 March - 1 April 2019

world trade, and try to get more competitive regardless of the eventual Brexit realities, be it building new relations in new markets, utilising technology to shorten supply chains, and embedding agile practices throughout their business. Instead all the focus is on a Parliamentary crisis which has raised eyebrows around the world and induced global investors to reduce their exposure to U.K. assets and capped the value of the Pound on the world's foreign exchange markets.

It still strikes me as unusual that after all this time and debate the current closest potential Parliamentary solution to Brexit - or at least the one to date with the closest to majority support - is (re) forging a customs union with the rest of the European Union, a policy that retains many of the trade structures currently available for the U.K. as part of the European Union, but one where the U.K. no longer has a guaranteed seat the table to decide rules and regulations. Maybe this is why options including a range of cross-party members of Parliament presenting a bill ruling out a no-deal scenario, or even a long delay to Article 50, which means the U.K. has to participate in May's European Parliamentary elections are still floating around. However the progress of time and the imminent deadlines later this month and just before the European Parliamentary elections have even made compromise proposals even more of a compromise. Still, even a late in the day effort at a compromise that gives some legislative certainty should be preferred by industrialists, entrepreneurs and consumers alike. The real challenges lay in competing in the big bad world out there - even if inhibited by the range of current trade deals and market access capabilities being impacted.

There is an old joke about U.K.-European relations which observes 'fog in the Channel - Continent isolated'. Certainly the fogs of Brexit introspection, reams of ill-informed statistics, 'red lines' and ideologically held views materially coloured both the referendum back in 2016 and the subsequent political discussion about the nature and style of a deal that can pass Parliament and move the U.K. formally to the post Brexit epoch. Finding a compromise today is not a sign of weakness but a sign of drawing a line under this debate and starting a bigger one about the dynamic future position of the U.K. economy.

KEY TAKEAWAYS:

- We are still awaiting for the U.K. Parliament to agree a way to proceed on Brexit.
- With the timetable now deep into the twelfth hour (or maybe even beyond it), the uncertainty of a potentially messy 'no-deal' has certainly risen.
- Finding a compromise today is not a sign of weakness but a sign of drawing a line under this debate.
- The bigger challenge of the U.K.'s competitive position in the global economy remains to be tackled irrespective of the final form of any Brexit agreement.

Europe: I Want to Believe

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

When thinking about international investment in recent months, emerging markets have stolen the spotlight as of late. In short, their scope for population growth and urbanisation provide them the most potential to "catch up" to their wealthier, developed counterparts. By contrast, Continental Europe ('Europe') and Japan have been seen as the less attractive cousins.

EUROPE: A HARD SELL

The case for investing in Europe is difficult to make at face value. Growth over the past decade has been substantially lower than in the United States or in the United Kingdom. Supranational organisations, such as the International Monetary Fund (IMF), have recently reduced their forecasts for European economic growth. Official interest rates remain negative, per policy that was put in place following the euro crisis of 2013. Given the anaemic growth that has gripped the continent, central bankers have been loath to raise them. Additionally, Europe's much-vaunted political stability has been challenged by a rising tide of populism, most notably in Italy. Unsurprisingly, equity valuations, investor confidence, and general levels of dynamism all remain noticeably lower relative to North American markets.

However, Europe is not out for the count. It bears mentioning that Europe still matters, despite its current difficulties. The European Union's 28 member countries still account for 21.8% of global GDP, just behind the United States (24.6%) and ahead of China (14.8%)[1]. Its currency, the euro, accounts for 34% of global transactions, second only to the U.S. dollar (45%)[2]. Given that - even if the UK is excluded - it also holds three G7 seats and four G20 seats, Europe still carries significant diplomatic clout.

> "Believe you can and you're halfway there."
> – Theodore Roosevelt

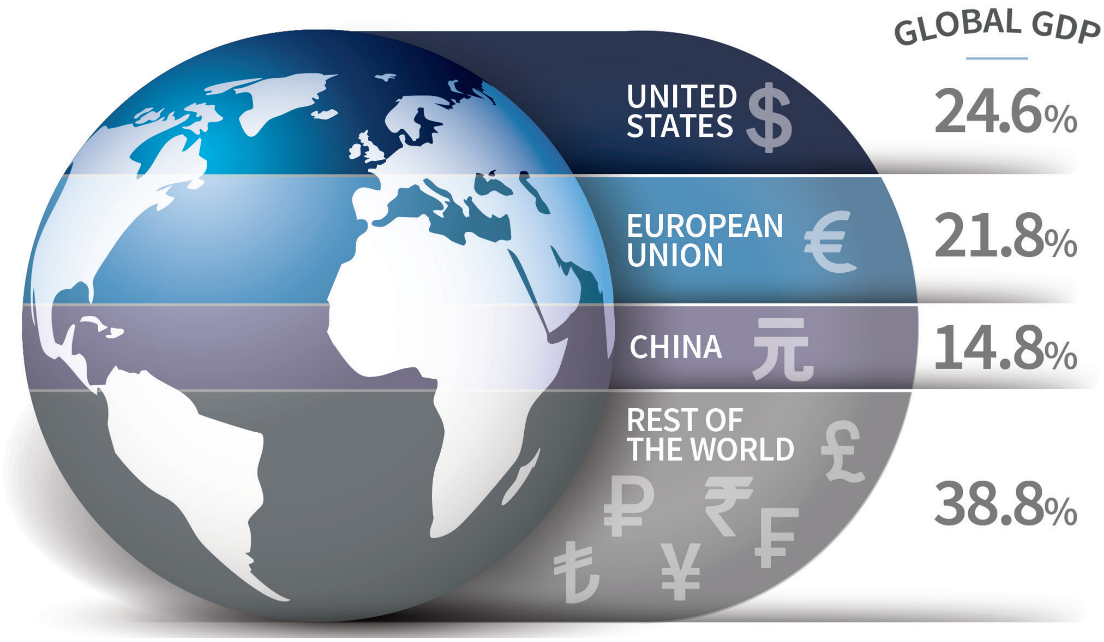
QUANTITATIVE EASING: ONLY TAPPING THE BRAKES

The key question for global investors is whether Europe is stuck in an insurmountable malaise, making its financial markets largely unattractive to external investors. In answering this question, investors might look to certain shifts in monetary policy by the European Central Bank (ECB). At the end of last year, the ECB stepped away from undertaking new quantitative easing (QE). This would seem to indicate an awareness that constant monetary stimulus is not necessarily desirable (as shown in the case of Japan, which has maintained stimulative monetary policy for decades). However, this does not mean that the ECB is done with alternative instruments. The ECB announced new targeted longer term refinancing operations (TLTROs) in early March, offering long-term loans to banks that incentivise them to increase their

[1]Eurostat, EU in the World, 2016; [2]Society for Worldwide Interbank Financial Telecommunication (SWIFT)

European Ensemble

As a bloc, the European Union is second only to the U.S. in its share of global GDP output and currency circulation.



lending to local businesses and consumers. Currently an ability to still undertake stimulus is a net positive. However on its own it is not enough.

CHALLENGES AND OPPORTUNITIES

The biggest impact on much of northern Europe's economic growth rates in 2019 rests on broader concerns. A pragmatic Brexit outcome would be a boost for all regional countries given the high levels of trade between the European Union and the UK. Ultimately, I consider this a likely outcome. The other exogenous issue (specifically for northern European countries such as Germany, Holland and Scandinavia) is avoiding a broader global trade war (as has threatened to bubble over between the U.S. and China). Progress to date in bilateral trade discussions between China and the U.S. have helped buoy global markets, including those across Europe. Part of the reason is that a material part of the region's growth (especially in northern Europe) has come from exports, specifically to the emerging markets (especially China) and the United States. These exports have been boosted by the relatively cheap value of the euro over recent years. However, this also indicates that Europe can be an attractive supplier of a broad range of goods and services for the global market, a view which is at odds with the pessimism surrounding Europe's potential for innovation and productivity.

Avoiding trade tensions is therefore crucial for the immediate outlook for the European economy. Whilst the political leadership of both the European Union and the United States have clashed more regularly in recent years, the United States-Mexico-Canada Agreement (USMCA), and ongoing bilateral China/United States trade discussions indicate that pragmatic outcomes are possible. In short, it would appear the bark of negotiating politicians is worse than their bite.

"Europe can be an attractive supplier of a broad range of goods and services for the global market, a view which is at odds with the pessimism surrounding Europe's potential for innovation and productivity."

Even though outcomes surrounding the ECB, Brexit, and external trade factors appear to offer more opportunity than threat, the average investor remains heavily underweight towards Europe. As such, investors are seemingly also concerned about the status of the European political backdrop, as it appears cursed by the confluence of populism and debt.

POPULISM: NOT SO POPULAR?

If you had to pick the most important date in the European political calendar for 2019, it actually would not be the finale of the Brexit process - it would be the European Parliamentary

> "In short, it would appear the bark of negotiating politicians is worse than their bite."

elections that are due to be held between 23 and 26 May. It is highly likely that in these elections so-called populist parties will make significant gains, though they will still be short of a pan-European majority (in contrast to more centrist, incumbent political parties). Most populist parties inevitably focus on more local and national issues (as seen in recent months in Italy), meaning pan-European coordination between populist parties is likely to remain low. However, the collective threat is real, as it has the potential to undermine efforts to forge pan-European legislation.

This would appear to spell disaster for the EU. How can Europe get more competitive or dynamic if its ability to pass pan-European legislation is being challenged by a greater focus on more populist concerns? And this can be doubly dangerous if a country – as infamously is the case in Italy – has material debt levels that encourage economic sclerosis and credit downgrades. This could, in certain circumstances, increase pressure to leave the European Union. The better news for Europe is that in today's financially-interrelated world, policies launched by populist parties that do obtain power in specific countries struggle to get traction. We have seen historically in Greece and more recently in Italy (which had to give in to demands to curtail its ballooning fiscal deficit), bond markets are often remarkably effective in battering governments into submission. It is always easier to talk than govern.

And a populist approach focusing on local and national issues that resonate with voters is possibly not all bad. As seen recently in France, Germany and the UK, incumbent governments might very well adopt initiatives to quell such populist concerns. In this sense, Italy will be a fascinating political experiment in 2019. We will see how an instinctively populist government fuses their policy platforms with a need to remain fiscally prudent and market friendly. With current low expectations there could be surprises. If so, this would change European politics for the better.

Given the past decade's poor economic growth, a bit of change can at least offer some different opportunities. So do not be too worried about the populists. Their rising popularity may just be the nudge that more conventional politicians need to really step up and inspire.

2019: IT'S ALL ABOUT BELIEF

Europe's biggest issue in 2019 is belief. Investors struggle to see a way through. The perception remains that both the ECB and incumbent governments are out of ideas. However, dig a little below the surface and Europe is not without hope. Mix in a pragmatic Brexit deal, avoiding trade tensions, new TLTROs, addressing some of the populists' more pressing concerns, and a bit more fiscal spending, there just might be a recipe for success. Given the general levels of global investor pessimism and lower than-average valuations, Europe may prove to have more potential than we think.

Drawing it all together, I think Teddy Roosevelt's quote puts it rather well concerning the outlook for European financial markets in 2019. For investors and regional economic actors alike, it is all about belief.

KEY TAKEAWAYS:

- When investing internationally, emerging markets have stolen the spotlight as of late. In short, their scope for population growth and urbanisation provide them the most potential to "catch up" to their wealthier developed counterparts.
- The biggest impact on much of northern Europe's economic growth rates in 2019 rests on broader concerns. A pragmatic Brexit outcome would be a boost for everyone given the high levels of trade between the European Union and the United Kingdom. Ultimately, I consider this a likely outcome.
- Do not be too worried about the populists. Their rising popularity may just be the nudge more conventional politicians need to really step up and inspire.
- Europe's biggest issue in 2019 is belief. Investors struggle to see a way through. The perception remains that both the ECB and incumbent governments are out of ideas. However, dig a little below the surface and Europe is not without hope.

Making Sense of Noisy Economic Data

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

Economic data is critical to the financial markets. It helps to drive earnings expectations and is a key factor in Federal Reserve (Fed) policy decisions. However, economic figures are noisy and reports often conflict with one another. How do we make sense of it all?

MANY SOURCES OF U.S. DATA

Unlike in other countries, the responsibility for collecting and publishing U.S. economic data is spread across several agencies. The Bureau of Economic Analysis reports on Gross Domestic Product (GDP), household income, and consumer spending, while the Bureau of Census covers things like retail sales, residential construction, new home sales, and durable goods orders. The Bureau of Labor Statistics reports on the job market, but it also publishes the Consumer Price Index (CPI) and other inflation gauges. The Fed produces the index of industrial production. In addition to the government figures, there are a variety of private-sector data sources, including the Institute for Supply Management (monthly purchasing managers' surveys) and the Conference Board (consumer confidence and the index of Leading Economic Indicators).

SOURCES OF UNCERTAINTY: STATISTIC SAMPLING AND SEASONAL ADJUSTMENT

There are two major sources of uncertainty in the economic data. The first is statistical error. The government can't observe all of the particular activity it is interested in, so it measures a sample. Choosing that sample is a science and the various agencies generally do an excellent job, but that still means there will be some uncertainty in the data.

For example, the monthly change in nonfarm payrolls is reported accurate to ±115,000. That means if the monthly change is reported as +160,000, there is a 90% chance the true monthly change is between +45,000 and +275,000.

The other major source of uncertainty is due to seasonal adjustment. There is a significant seasonal pattern in most unadjusted data. For example, we normally lose about three million jobs each January following the end of the holiday shopping season. The government does a good job with seasonal adjustment, but it's difficult to get it exactly right.

Economic data are subject to two kinds of revisions. Figures are often revised in the following month, reflecting more complete information. Annual benchmark revisions seek to tie the data back to more comprehensive sources, such as nonfarm payrolls to actual payroll tax receipts.

For those using the economic data, uncertainty means one should take any reported number with a grain of salt. It's best to look at a three-month average, which reduces much of the noise (but does not eliminate it) and is a better gauge of the underlying trend.

The Economic Outlook: Slower, With Downside Risks

As delayed economic data releases arrive and fresh figures pour in, the 2019 growth outlook has appeared somewhat softer than anticipated a few months ago. Fiscal stimulus (tax cuts and increased government spending) was a major force propelling overall growth in 2018. However, the impact was expected to fade in 2019, with GDP growth slowing to a more sustainable pace (one driven by the natural growth in the working-age population).

Consumer spending slumped in December, with only a partial recovery in January, when confidence was rattled by the partial government shutdown. Still, the fundamentals of the household sector remain in good shape. Mild weather helped boost job gains in January, while poor weather dampened job growth in February – the underlying trend remains moderately strong. Wage growth has continued to pick up and lower gasoline prices have added to consumer purchasing power. Consumer sentiment rebounded following the end of the government shutdown.

Slower global growth and trade policy uncertainty appear to have dampened business fixed investment in early 2019. Orders and shipments of non-defence capital goods are on a softer track. Residential homebuilding weakened over the course of 2018, but a sharp drop in mortgage rates should help in 2019.

MONETARY POLICY: MINOR SHIFTS ARE A MAJOR DEAL FOR THE MARKETS

The partial government shutdown delayed a number of important economic data releases in early 2019, but the shift in the Fed policy outlook from mid-December to late-January was driven by other factors. Fed Chairman Jerome Powell noted the economic outlook hadn't changed much since the 18-19 December policy meeting. However, the downside risks and uncertainties had increased substantially. These "cross-currents," noted Powell, included the partial government shutdown, trade policy uncertainty, Brexit, and evidence of slower economic growth outside the United States, "especially in China and Europe."

The Federal Open Market Committee had a mild tightening bias in December, with market participants generally anticipating a rate increase in June 2019 and perhaps another in December. In January, the Fed moved to a more neutral stance, indicating it could be "patient" in deciding its next move. For seasoned Fed watchers, this was a relatively modest shift, but it proved to be a much more important development for the financial markets.

During the financial crisis, the Fed conducted three large-scale asset purchase programs (quantitative easing or QE), adding more than $3.5 trillion to its balance sheet. As part of monetary policy normalisation, the Fed has been allowing some of these securities to roll off the balance sheet as they matured. The Fed now expects to end the unwinding of the balance sheet later this year, sooner and with the balance sheet at a higher level than previously expected. The unwinding of the balance sheet was meant to be background, not active, monetary policy. Fed officials do not believe it was the catalyst for the stock market weakness last year. However, many market participants believe otherwise. The Fed based its decision to end its balance sheet unwinding on considerations of bank reserves.

> "If we could first know where we are and whither we are trending, we could better judge what to do and how to do it."
> – A. Lincoln

THE JOB MARKET IS A FOCUS

Which data releases does the Fed consider in setting monetary policy? Basically, all of them. The Fed also pays a lot of attention to the anecdotal evidence. However, its main focus is on the job market and inflation. Based on the demographics, job growth in recent years has been well beyond a long-term sustainable pace. That's not a problem in the short term. In his monetary policy testimony to Congress in February, Chairman Powell said there is likely more slack in the labour market than what is suggested by the unemployment rate. Firms continue to report difficulty in finding qualified workers, but they remain reluctant to raise wages enough to attract those workers. In addition, firms generally appear to have a limited ability to pass higher costs along.

The Case for Price-Level Targets

Inflation is the rise in the general price level (the Consumer Price Index or PCE Price Index) over time. It can be too low as well as too high. By law, the Federal Reserve (Fed) is tasked with price stability, but that doesn't mean 0% inflation. Having sought a generally low level of inflation for many years, the Fed formally adopted an inflation-targeting framework in 2012, setting a goal of 2% per year for the PCE Price Index.

Inflation is driven by inflation expectations and by the amount of slack in the economy. The Fed's success in anchoring inflation expectations appears to have reduced inflation's sensitivity to the amount of slack in the economy. A low unemployment rate has not pushed inflation significantly higher, as it had in the past. Moreover, financial market participants may have come to view the 2% goal as a ceiling on inflation, rather than as a target, pushing inflation expectations below 2%. In any case, the Fed has consistently undershot its 2% inflation goal in recent years and there is some concern that the U.S. may join Japan and Europe in battling low inflation, or even deflation, on an ongoing basis. A shift to a price-level targeting system would help, as the Fed would seek a period of higher inflation if we experience a period of sub-2% inflation.

A DEBATE ON THE MONETARY POLICY FRAMEWORK

Powell also said the Fed is considering whether to move to a price-level targeting framework when analysing inflation. The Fed has consistently undershot its 2% target in recent years and market participants may view that as a ceiling rather than a goal, pushing inflation expectations below 2%. In a price-level targeting system, the Fed would seek to hit an inflation target on average. Hence, a period of sub-2% inflation would be followed by a period of above-2% inflation. All else equal, that implies the Fed would be less inclined to raise short-term interest rates in the short run.

PUTTING IT IN PERSPECTIVE: THE TREND TRUMPS THE NOISE

Many of the uncertainties we faced at the start of the year have abated. The government shutdown is behind us. The U.S. may get a trade deal with China. The Fed seems in no hurry to raise short-term interest rates and has plans to finish the unwinding of its balance sheet. The question then is what to look for next. Partisan politics and congressional inquiries could rattle investors' nerves. However, the market focus should eventually get back to the economic data. Yet, the markets often use the economic data as an excuse. What's more important is how the data fits into the overall narrative.

KEY TAKEAWAYS:

- Economic data is critical to the financial markets. It helps to drive earnings expectations and is a key factor in Federal Reserve policy decisions.
- There are two major sources of uncertainty in the economic data: statistical error and seasonal adjustments. The government does a good job with seasonal adjustment, but it's difficult to get it exactly right.
- For those using the economic data, uncertainty means one should take any reported number with a grain of salt. It's best to look at a three-month average, which reduces much of the noise (but does not eliminate it) and is a better gauge of the underlying trend.
- The Fed pays a lot of attention to the anecdotal evidence. However, its main focus is on the job market and inflation. Based on the demographics, job growth in recent years has been well beyond a long-term sustainable pace. That's not a problem in the short term.
- The market focus should eventually get back to the economic data. Yet, the markets often use the economic data as an excuse. What's more important is how the data fits into the overall narrative.

Optimism, Pessimism and Today's Bond Markets

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

I remember being taught about the reverse yield gap, the notion that existed before 1959 that riskier equities should yield more than safer bonds, during my days as an Economics undergraduate. Back then the weight of over thirty years of empirical realities that investors were seemingly prepared to accept much lower yields on equities versus bonds due to the former's scope to grow had become gospel. However, for much of the last decade, fixed income markets have had their own *Back to the Future* moment and, at least in the developed world, have gone back to pre-1959 norms offering typically much lower yields than local equity markets.

Now this poses a bit of a conundrum for the typical multi-asset investor. The bond markets have been the default lower volatility stalwart of portfolios for a long time now and the steady downward march of yields over the last generation has led to total returns that can look equity markets straight in the eye. However, the risk is that what has gone up so much may prospectively struggle. After all, bond products are fixed principal in nature.

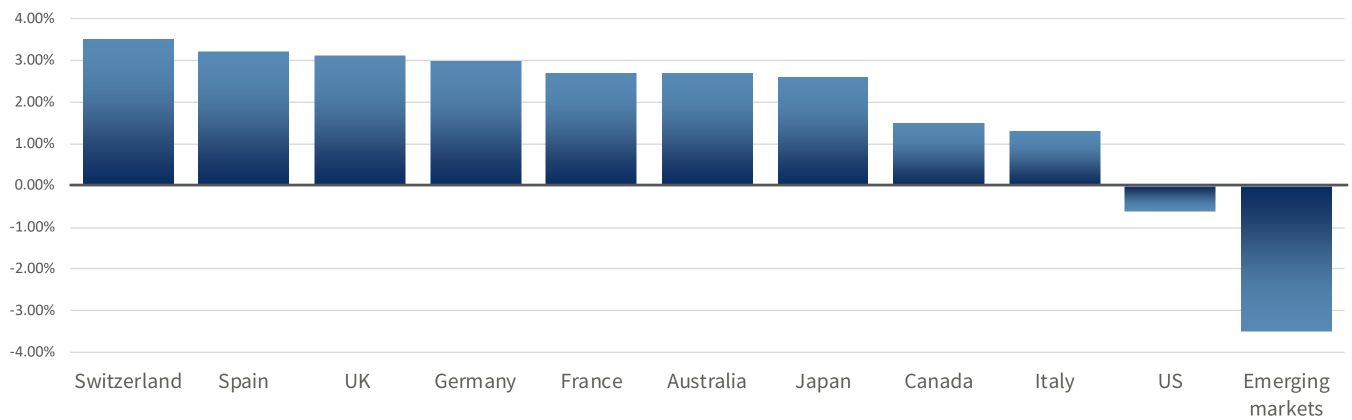
> "Surprise is the greatest gift which life can grant us"
> – Boris Pasternak

There are three key reasons why bond yields have compressed so much in recent years. The first is the improved demand-supply equation courtesy of another dusty economics textbook concept - quantitative easing. This has more than soaked up any higher government deficits. The second is that inflationary concerns at all major global central banks are currently deeply suppressed, leading to an elongation of the 'lower for longer' interest rate cycle. This is good news for any fixed principal investment. The third aspect is linked to one reason why there is a lack of overt inflationary concerns currently - anticipated economic growth rates have been compressing, especially in Europe.

I have heard it said that a fair value guide to a medium duration government bond yield can be discerned by adding together the anticipated inflation rate and the economic growth rate of an economy. Pull down future expectations for both of these two

Equity 'Pick-up' Yields

Local dividend yield minus local 10 year bond yield (2019e)



Note: share buybacks are not included
Source: Citigroup, Datastream

aspects and mix in a lower anticipation of any significant quantitative tightening and the result should be lower bond yields, just not this low.

Take the ten year U.K. government gilt yield as an example which, at the time of writing, is standing at just over one per cent. Brexit concerns may have impacted anticipated local economic growth rates but currently they remain positive... at a time when inflation levels are running above 1.5%. Such analysis draws similar conclusions in the vast majority of other major bond markets and have helped pull down many corporate bond yields materially too.

Now, all of this is fine if the bond market is playing a sober anticipatory game - although the implications are for an imminent global recession, a point augmented by recent bond yield curve shifts either at or close to an inverted structure. The trouble is such fears appear a little pessimistic especially if sensitive and important world trade talks between countries such as the United States and China continue to progress. This combined with a lower dollar gives potential for the world economy to positively surprise, a point potentially picked up by global equity markets which had a strong start to 2019 - generally unsurprisingly to an even more positive extent than any fixed income market. Perhaps those aforementioned big dividend yields currently available in many global equity markets are starting to prove suitably attractive.

Certainly staying overweight equities versus bonds in multi-asset portfolios remains attractive to us from both an income and a total return perspective.

Whilst the fixed principle nature of bond investments naturally retain some multi-asset class diversification attractions, the absolute low level of many prevailing yields across government and corporate fixed income markets makes specific bond selection all-critical. More generally, the attractions of plain old cash versus fixed income alternatives, should continue to build given the yield trade-off has compressed and the scope for bond yields to squeeze back up (meaning capital losses) is very apparent.

In short, bonds are a historically popular lower volatility investment that suddenly looks a lot less predictable. Research with care.

KEY TAKEAWAYS:

- The return of the reverse yield gap over the last ten years has changed the performance profile of bonds versus equities.
- The compression of bond yields can be explained by the application of quantitative easing and reduced anticipated inflation and economic growth levels.
- Staying overweight equities versus bonds in multi-asset portfolios remains attractive to us from both an income and a total return perspective.
- The scope for bond yields to squeeze back up is apparent especially if global growth hopes are boosted by a China-US trade deal and a lower value for the dollar.

Washington Policy Update: Is There A 'Trump Put' On The Market?

Ed Mills, *Washington Policy Analyst, Equity Research*

When trying to determine the outcome of a variety of Washington D.C.-related events, we seek to understand the motivation and goals of President Trump and his administration. We believe that it is important to understand these negotiating tactics to best gauge the potential market impact of the President's decisions. One of the biggest debates we are having with investors has focused on his willingness to threaten actions that could have significant economic and market consequences versus the President's repeated use of the stock market and economy as a gauge of his success.

SHUTDOWNS, TRADE FIGHTS, DEBT CEILINGS, AND MORE TO COME

We have seen this play out during the recent partial government shutdown and, debatably, we are seeing it with the China trade fight. We believe this dynamic is going to be an important factor to consider during the upcoming policy fights in Washington, especially the need to increase the debt ceiling later this year.

However, we also caution that this does not necessarily factor in the very real potential of a policy miscalculation or external event that is not within the President's control. In this article, we are going to examine this dynamic and discuss some areas where it may not hold.

> "Many believe this dynamic, while producing plenty of volatility at times, represents a potential 'Trump put' on the market – limiting the potential negative market impact of his policy decisions."

WHAT DID WE LEARN FROM THE GOVERNMENT SHUTDOWN?

The longest partial government shutdown in U.S. history (22 December 2018 to 25 January 2019) highlights some of the potential risks to high-stakes negotiations for at least the next two years. The President was willing to keep the government shut down in pursuit of $5.7 billion, which was a non-starter for Democrats who saw their recent midterm election victory in the House of Representatives as a mandate to serve as a check on the President's actions. In-person negotiations between President Trump and senior Democratic leaders, along with prime-time addresses and clashes over the State of the Union did not move either side toward compromise, further prolonging the shutdown.

The potential negative political consequences did not seem to move either side and the debate was deadlocked. Ultimately, we

Wall Blocked?

Given that Congressional funding for border security was ultimately lower than requested ($1.375 billion vs. $8 billion requested), President Trump declared a national emergency by executive order. In doing so, he hopes to secure additional funds from the Department of Defense and the Treasury to cover the $6.625 billion shortfall for the construction of a border wall.

> “Ultimately, we believe it was the economic worries (and airline travel delays) that prompted the president to relent and allow Congress to come up with a bipartisan compromise package.”

believe it was the economic worries (and airline travel delays) that prompted the President to relent and allow Congress to come up with a bipartisan compromise package. The market sold off hard in December around and during the shutdown, recession concerns had hit the market, and there were repeated warnings that if the shutdown continued for much longer, there was real risk of a negative gross domestic product in the first quarter.

WHAT ABOUT THE DEBT CEILING?

The dynamics around the government shutdown demonstrated both Democrats and Republicans are willing to take negotiations to the edge before finding a resolution. This raises concerns about the next fiscal challenge on Washington's agenda: the extension of the debt ceiling. The debt ceiling was formally reinstated on 2 March, at which point Treasury Secretary Steven Mnuchin informed Congress "extraordinary measures" will be utilised to maintain U.S. borrowing below the limit until Congress acts. A recent Congressional Budget Office analysis estimates the Treasury can sustain borrowing through early fall. If raising the debt limit becomes an avenue for a broader fight on domestic spending, especially as we hit the September 30 deadline for the fiscal year 2020 spending bill, its passage would become more complicated – a development Federal Reserve Chair Jerome Powell describes as having "possibly large negative effects." We will be watching to see how the market reacts if the debt limit becomes the next fiscal battle. In the past, we have seen markets react negatively the first time the Obama administration and Congressional Republicans needed to strike a deal, but largely ignored the subsequent debates. A potential wild card is the political climate surrounding the 2020 Presidential primaries.

NATIONAL EMERGENCY DECLARATION – WHAT DOES IT MEAN?

Bipartisan Congressional negotiators successfully reached a deal on a spending package to avert a second government shutdown over border security. However, the agreed $1.375 billion for border barrier construction was not seen as sufficient by the President and prompted a declaration of a national emergency to tap into unallocated government funding sources. The Congressional spending package was seen as politically damaging for the President because it did not deliver the win he sought on border security, prompting a national emergency declaration. According to administration sources, the White House plans to use reserve military construction, Defense Department, and Treasury funds to access up to $8 billion for border barrier construction (up from the $5.7 billion initially requested by President Trump from Congress).

> “Politically, the advantages of securing a deal in the short term are there for both sides, but opportunity for miscalculation is heightened in the long term.”

The President’s use of the National Emergency Act sets up legal challenges in the courts and by Congress over the next several months. Under the act, Congress can pass a joint resolution to attempt to block the President’s action. On 26 February, the House passed a resolution to rescind the President’s emergency declaration 245-182, sending a significant message. Somewhat surprisingly, all Democratic House members voted in favor, being joined by 13 Republicans. This is a significant development considering many of the newly-elected Democrats come from previously Republican-held districts where immigration/border security issues are an important voter matter.

The act required the Senate to vote on the measure within 18 days of passage, which it passed 59-41. 12 Republican Senators disapproved of a move to activate national emergency powers, and the Senate vote allowed them to challenge the President on-record. However, the Congressional resolution had to be signed by the President to become effective, and Congress did not have the numbers to overturn the Presidential veto on this issue by a supermajority vote. This will likely lead to a long court challenge on the use of executive powers to allocate funds without Congressional approval, which may ultimately stall any planned construction indefinitely.

HOW DOES THIS PLAY INTO U.S.-CHINA NEGOTIATIONS?

There has been a major shift in the U.S.-China trade dynamic since the market sell off in December, which has once again led to a debate on how much the market plays into President Trump’s deal making. As the market was hitting new highs throughout 2018, President Trump and others within his administration were repeatedly taking a hardline stance with China, pushing for major structural reforms and threatening an ever growing list of tariffs and other punitive actions. More recently, there has been a push to strike a deal and ease some of the trade tensions.

Politically, the advantages of securing a deal in the short term are there for both sides, but opportunity for miscalculation is heightened in the long term. Reaching a deal provides a market boost in the United States and plays well for China’s Xi Jinping for preserving (for the time being) the relationship with China’s largest market. In the longer term, incentives do not align as well. Xi Jinping’s term as China’s leader will continue well beyond Trump, but the United States may experience a change in administration with the 2020 election. From that perspective, the scope of China’s concessions and commitment can be limited if they decide to “weather the storm.” A less comprehensive deal or a backing away from certain commitments may take us right back to tariff escalation or even significant other economic restrictions down the line. This fight could re-emerge right in the heat of the 2020 Presidential campaign, which can serve to damage Trump’s economic message or could provide a political incentive to once again increase pressure on China. We expect China trade headlines and the interplay with domestic politics to remain in focus for the foreseeable future, even with an initial deal struck.

KEY TAKEAWAYS:

- One of the biggest debates we are having with investors has focused on the president’s willingness to threaten actions that could have significant economic and market consequences versus his repeated use of the stock market and economy as a gauge of his success.
- The Congressional spending package was seen as politically damaging for the president because it did not deliver the win he sought on border security, prompting a national emergency declaration.
- We expect China trade headlines and the interplay with domestic politics to remain in focus for the foreseeable future, even with an initial deal struck.

Q+A

What’s on the Cards for Oil?

Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research*

Q. OPEC and Russia agreed late last year to cut crude production by a collective 1.2 million barrels per day (bpd) for the first half of 2019. To what extent has the group been fulfilling its promises?

A. By way of historical background, OPEC generally has a mixed track record for member compliance with its production decisions. The smaller oil producers in the group rarely cut production in accordance with the official pledges. However, as a practical matter, only a handful of OPEC countries truly matter when it comes to managing global oil supply. Saudi Arabia is by far the most important, and for the past two years it has played a very proactive role in this regard.

Based on data from the past several months, we estimate that Saudi production in the first quarter of 2019 is tracking to be nearly 600,000 bpd less than in the fourth quarter of 2018. This alone represents half of the total pledged production cut across all of OPEC and Russia. So, it is clear that Saudi Arabia is serious about propping up oil prices – it is not just lip service!

Beyond Saudi action, let’s also bear in mind that several OPEC countries are experiencing organic production declines even without deliberate curtailments. Case in point: Venezuela. This country has already had the world’s steepest drop in oil production since 2015, for purely domestic reasons. Amid the current political and economic crisis, the national oil company, Petróleos de Venezuela, S.A. (PdVSA), continues to suffer from mismanagement and severe cash flow shortages. Meanwhile, production in Libya and Nigeria is perennially choppy due to recurring violence around oilfields. Looking past this choppiness, the longer-term trend in both countries is downward due to insufficient foreign investment given the hazardous conditions.

> “It is important to underscore just how impactful the IMO 2020 policy will be.”

Q. The International Maritime Organization (IMO) has set regulations to cut sulphur in fuel used by the marine industry starting in January 2020. How are shipping firms and refiners preparing for this? How do these regulations affect the global oil market?

A. It is safe to say the oil market, for the time being, is not remotely focused on what will happen in 2020. However, it is important to underscore just how impactful the IMO 2020 policy will be. We estimate it will effectively erase 1.5 million bpd (or 1.5%) of global oil supply, a very meaningful supply reduction. Put another way, this is as much supply impact as what Venezuela has caused over the past four years. Some of this, in fact, will likely be felt toward the end of 2019.

To clarify, the total amount of high-sulphur fuel used in long-distance marine shipping is currently around 4 million bpd. Of this amount, a portion will be processed in newly built units at refineries and another portion will be handled by shipboard scrubbers, which ship owners are in the process of installing. There will be some "cheating," at the risk of facing sizeable fines from regulators, and, as noted earlier, some fuel will simply be rendered unusable.

Another concern, given the dislocations that this may cause, is that some countries could try to back out of the new rules. That, to clarify, is not legally possible because of the binding nature of the underlying treaty known as the International Convention for the Prevention of Pollution from Ships. Moreover, the IMO has made it clear that implementation will not be delayed past January 2020.

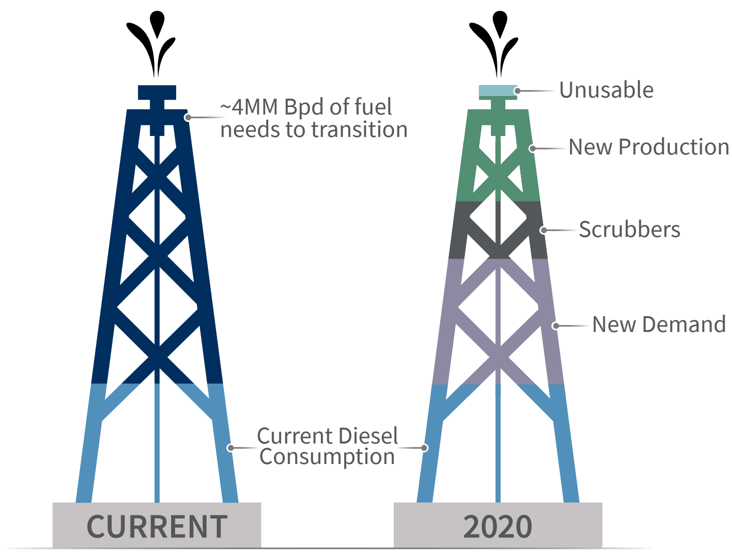
Q. Putting everything together, what is your oil price outlook over the next 12 months and what wildcards could derail that outlook?

A. Oil prices have already bounced back year-to-date from their recent lows but remain well below their 52-week highs. The oil futures curve is relatively flat, indicating minimal upside from current levels over the next five years. We tend to stay away from making short-term (weekly or monthly) commodity calls, but we are of the view that prices will be meaningfully higher in the second half of 2019.

Our forecast for the second half of 2019 is for WTI to average $70/Bbl and Brent $80/Bbl. Looking out to 2020, we think oil will reach cyclical highs, with WTI averaging $93/Bbl and Brent $100/Bbl. To be clear, such prices would be unsustainably high given the adverse impact on global demand (for example, consumers shifting to smaller cars and electric vehicles). That, in fact, is the whole point. We believe that oil prices in 2020 will have to rise to levels that begin to put a damper on demand, in large part because IMO 2020 will create a temporary situation of inadequate supply.

IMO 2020

Oil to Benefit from Structural Changes in Marine Transportation Regulations



Source: Raymond James Equity Research

While visibility beyond 2020 is limited, our long-term forecast of $75/Bbl WTI and $80/Bbl Brent reflects a "happy medium" of prices that are high enough to enable the industry to sustain supply growth but not so high as to sharply curtail demand.

As always, there are plenty of wildcards of which we need to be mindful. For example, a sudden spike in the U.S. dollar would, all else being equal, put downward pressure on oil prices. Similarly, a wide-ranging economic slowdown would naturally have a negative effect on demand. On the flip side, there is always the risk of unforeseen supply disruptions, such as what we mentioned earlier vis-à-vis Libya and Nigeria. Finally, geopolitical uncertainty swirling around Iran (U.S. sanctions, etc.) could potentially lead to an even higher-impact disruption.

Outlook on Prices
Looking Ahead

	WTI CRUDE	BRENT CRUDE
2019*	$62/Bbl	$72/Bbl
2020	$93/Bbl	$100/Bbl
2020+	$75/Bbl	$80/Bbl

Source: Raymond James Equity Research; *Full year price forecast

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