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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, **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 December 24 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 favorable, 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 over the next twelve months. **In fact, April could "legendize" 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 fact, Mike Gibbs' year-end target of 2,946 gives the market **a realistic opportunity of returning to record highs**. Supporting equities is his **expectation of record earnings again in 2019**. Our conservative \$166 2019 S&P 500 earnings estimate is approximately \$4 higher than the record set last year. While earnings growth may struggle during the first quarter, and potentially move negative, Jeff Saut sees earnings expanding in the second half of the year. The average 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.

Internationally, we favor the U.S. over other developed markets, as those economies continue to exhibit signs of weakness. 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. Our year-end target for the EUR/USD is 1.15. Stabilization 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 3.00%, 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 normalization of global interest rates relative to our own and an uptick in inflationary expectations, 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 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. The 2-10 year part of the Treasury curve seems to be pricing in one to two Fed rate cuts, thus giving the potential to steepen the curve from the current mark. Although the Treasury curve remains flat, the municipal and corporate curves are more positively sloped offering opportunities in the intermediate part of the curve.

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.’**

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**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 sulfur 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®**  
Chief Investment Officer, Private Client Group

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# Europe: I Want to Believe

**Chris Bailey, European Strategist, Raymond James Euro Equities\***

When investing beyond the borders of the United States, 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. On the other hand, Europe and Japan are 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. 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 anemic 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 and the United Kingdom. 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

“Believe you can and you're halfway there.”  
– Theodore Roosevelt

GDP, just behind the United States (24.6%) and ahead of China (14.8%).<sup>1</sup> Its currency, the euro, accounts for 34% of global transactions, second only to the U.S. dollar (45%).<sup>2</sup> Given that it also holds four G7 seats and five G20 seats, Europe still carries significant diplomatic clout.

## QUANTITATIVE EASING: ONLY TAPPING THE BRAKES

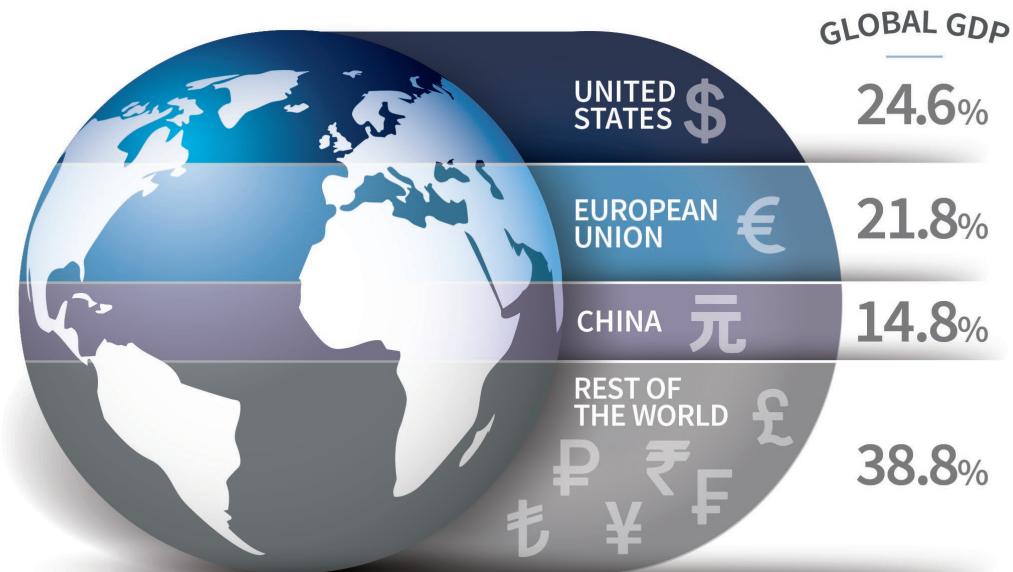
The key question for global investors is whether Europe is stuck in an insurmountable malaise, making its financial markets largely unattractive to external investors. In answering this question, investors might look to certain shifts in monetary policy by the European Central Bank (ECB). At the end 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 lending to local businesses and consumers.

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

<sup>1</sup>Eurostat, EU in the World, 2016; <sup>2</sup>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.



### 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 everyone 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, the UK, Holland, and Scandinavia) is avoiding a broader global trade war (as has occurred 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 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

*"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."*

States trade discussions indicate that pragmatic outcomes are possible. In short, it would appear the bark of negotiating politicians is worse than their bite.

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 inevitably very 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. On the contrary, it would be the European Parliamentary elections that are due to be held between May 23 and 26. It is highly likely that so-called populist parties will make significant gains, though they will still be short of a pan-European

**“In short, it would appear the bark of negotiating politicians is worse than their bite.”**

majority (unlike more centrist, incumbent political parties). Most populist parties inevitably focus on more local and national issues (as in the case of 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 beyond the borders of the United States, 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.

# Global Hotspots

## REFUSING TO RELINQUISH THE REINS: Venezuela's Political Crisis

**Giampiero Fuentes,**  
*Analyst, Investment Strategy*

Venezuela's collapse has been years in the making, with plunging GDP and hyperinflation of over one million percent. Food and medical supply shortages have forced millions of Venezuelans to flee the country, leaving even more malnourished and sick behind. Oil revenues, which account for 98% of the country's export earnings, have been cut in half since 2015. Widespread power outages have compounded the humanitarian crisis, which grows more dire by the day.

On January 10, President Nicolas Maduro started a second term, which many foreign countries refused to recognize due to widespread corruption during the election. Less than two weeks later, opposition leader Juan Guaidó declared himself interim president. Over 50 countries (including the U.S.) now recognize him as Venezuela's rightful leader. Guaidó's top priority is addressing the country's food and medical shortages by facilitating humanitarian aid from a coalition of global powers.

However, such attempts have been consistently blocked by Maduro and members of his armed forces, who deny that the country is facing a humanitarian crisis. Maduro's refusal to relinquish the reins of power despite widespread calls for his dismissal has only worsened and perpetuated the crisis. While he has rejected aid from the U.S. and its allies, Maduro has welcomed the support of Russia, which recently deployed 100 soldiers and cargo to Venezuela.

Meanwhile, the U.S. has stepped up its diplomatic and economic pressure on the embattled Maduro regime, instituting new sanctions and calling for Russia to withdraw its military personnel from the country. By targeting Venezuela's state-owned oil and gold companies (the two major industries that finance and support the current regime), the U.S. hopes to undermine the means by which Maduro retains his power and influence. However, this poses a problem for Russia and China, which have both lent billions of dollars to support the Maduro regime, and therefore regard these lucrative revenues as the primary means by which they will be repaid. What started as a political crisis is fast becoming a geopolitical one. ■



## ELEPHANTINE ESCALATION: Indian-Pakistani Tensions

**Taylor Krystkowiak,**  
*Analyst, Investment Strategy*

In late February, India launched coordinated aerial attacks against Pakistan in retaliation for a deadly terrorist attack that claimed the lives of 40 Indian soldiers. Pakistan mobilized its own air force in response, shooting down and capturing an Indian pilot in the process. While the relationship between India and Pakistan has long been fraught with hostilities, this exchange of fire marked the greatest escalation of tensions between the two nuclear powers in decades.

India has long accused Pakistan of failing to effectively root out terrorist cells operating within its borders. This most recent terrorist attack, for which a Pakistan-based terror cell claimed responsibility, prompted Indian Prime Minister Narendra Modi to respond with the use of martial force. While the specter of outright war has since waned (aided by Pakistan's prompt release of the captured Indian pilot in a gesture of goodwill), heightened tensions between the two powers have yet to fully subside. The international community continues to watch the situation closely.

Much is at stake. Mr. Modi faces a general election in April, and his handling of the current situation could make or break his bid for reelection. While India has recently outstripped China as the fastest growing economy in the world, it struggles to keep pace with its even faster growing labor market; millions of new entrants each year have caused unemployment in India to remain stubbornly high. Given that reducing unemployment was a cornerstone of Mr. Modi's political platform in his last election campaign, this most recent skirmish with Pakistan is a welcome distraction to his record on job creation.

Aided by this showing of martial decisiveness and the fragmented state of the political parties who would oppose him, Mr. Modi and his ruling Bharatiya Janata Party appear poised to win reelection. Yet, hawkish military action is no substitute for sound economic policy, which will be crucial if India is to sustain its rapid growth. The events of the following weeks will determine whether these most recent tensions are simply a flash in the pan or spell cause for greater concern. ■





# 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  $\pm 115,000$ . 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 damped 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 nondefense capital goods are on a softer track. Residential home-building 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 December 18-19 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 normalization, 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

**“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

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.

### 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 labor 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 analyzing 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. We 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.



# 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

“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.”

going to examine this dynamic and discuss some areas where it may not hold.

## WHAT DID WE LEARN FROM THE GOVERNMENT SHUTDOWN?

The longest partial government shutdown in U.S. history (December 22, 2018 to January

25, 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 believe it was the economic worries (and airline travel delays) that prompted the president to relent and allow Congress to

## 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.”**

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 DC's agenda: the extension of the debt ceiling. The debt ceiling was formally reinstated on March 2, at which point Treasury Secretary Steven Mnuchin informed Congress "extraordinary measures" will be utilized 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 develop-

ment 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).

The president's use of the National Emergency Act sets up legal challenges in the courts and by Congress over the next several

**“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.”**

months. Under the act, Congress can pass a joint resolution to attempt to block the president's action. On February 26, 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 height-

ened 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.



OPEC Members

# Q+A

## What's in 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

*"It is important to underscore just how impactful the IMO 2020 policy will be."*

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.

**Q. The International Maritime Organization (IMO) has set regulations to cut sulfur 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-sulfur 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 sizable 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.

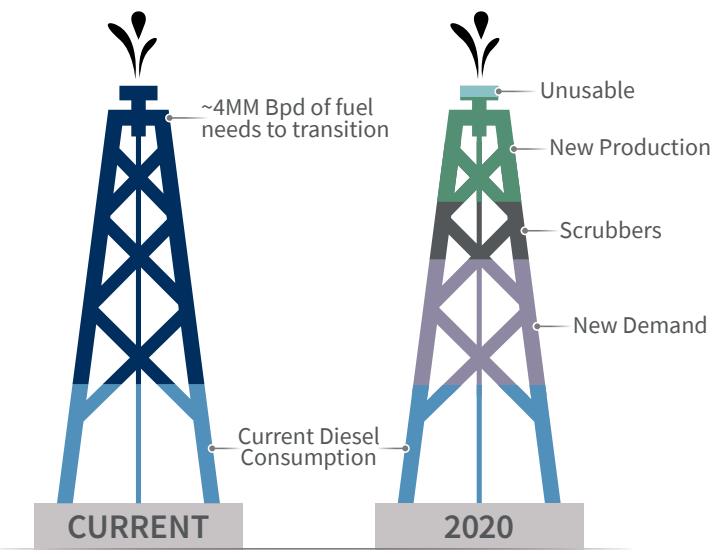
#### **Q. Putting everything together, what is your oil price outlook over the next 12 months and what wild-cards could derail that outlook?**

- 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. ■

<b>Outlook on Prices Looking Ahead</b>		<b>WTI CRUDE</b>	<b>BRENT CRUDE</b>
<b>2019*</b>		\$62/Bbl	\$72/Bbl
<b>2020</b>		\$93/Bbl	\$100/Bbl
<b>2020+</b>		\$75/Bbl	\$80/Bbl

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

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## Economic Snapshot

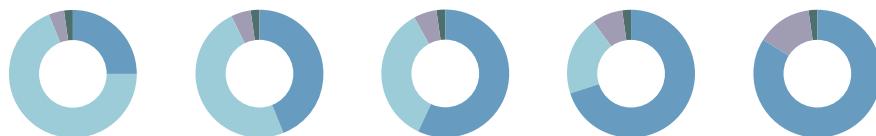
Fiscal stimulus boosted GDP growth in 2018, but the impact was widely expected to fade in 2019, leaving growth at a more moderate pace (consistent with the longer-term labor force demographics). Consumer spending weakened unexpectedly in December, with only a partial rebound in January. The partial government shutdown led to the postponement of several important data releases. More importantly, the spring economic data is going to tell the tale on the job market, housing, and business investment. The inversion of the yield curve points to an increased chance of a recession in the next 12 months – not the most likely scenario, but too high for comfort and the risks to the growth outlook are tilted to the downside.

**DR. SCOTT BROWN**  
Chief Economist

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	EMPLOYMENT	The low trend in unemployment claims suggest a continued strong demand for labor in the near term. Job conditions remain generally tight, putting some upward pressure on wage growth. Weather effects distorted nonfarm payroll figures for January and February.
	CONSUMER SPENDING	Job gains and wage growth remain supportive. Consumer attitude measures slumped at the start of the year, reflecting an impact from the partial government shutdown, but have rebounded to some extent.
	HOUSING AND CONSTRUCTION	Homebuilding weakened over the course of 2018, but the sharp drop in mortgage rates should help support activity in 2019. Affordability remains an issue, but home price appreciation has slowed.
	INFLATION	Input price pressures have been mixed, but generally moderate. Inflation expectations remain well anchored. The ability of firms to raise prices appears to be mixed.
	GROWTH	GDP growth was widely expected to slow in 2019, reflecting the fading impact of the fiscal stimulus. However, growth appears to have slowed more than expected and risks are tilted to the downside.
NEUTRAL	BUSINESS INVESTMENT	Slower global growth and trade policy uncertainty are negative factors. Orders and shipments of non-defense capital goods ex-aircraft were on a softer track into early 2019.
	MANUFACTURING	Slower global growth has dampened export growth, while trade policy has disrupted supply chains and raised production costs. Domestic demand is likely to remain moderate (preventing a broader decline).
	MONETARY POLICY	Most senior Fed officials expect short-term interest rates to remain steady over the course of 2019. However, the federal funds futures market is pricing in an increased chance of a rate cut by the end of the year.
	LONG-TERM INTEREST RATES	Long-term interest rates have fallen outside of the U.S., putting downward pressure on U.S. bond yields. Inflation is expected to remain low.
	FISCAL POLICY	Tax cuts and added spending boosted growth in 2018, but also added significantly to the federal budget deficit. However, the increased issues of government debt has not boosted borrowing costs.
	THE DOLLAR	In the short term, exchange rates are driven by monetary policy. Market expectations of a Fed cut are negative for the greenback, but monetary policy may be seen as easing elsewhere.
	REST OF THE WORLD	The global economic outlook has deteriorated with increased concerns regarding China, Europe, and Brexit.

## High-Net-Worth & Ultra-High-Net-Worth Models

Several changes were made to the HNW/UHNW Strategic Asset Allocation Models in mid-February. These changes are intended to improve the overall risk/return profile of these models. Given the current interest-rate environment and the late stage of the equity market cycle, there was a reduction in the allocation to alternative investments across all models (except Growth) to a neutral position rather than an overweight position. In addition, reductions took place to less defensive equities such as U.S. mid- and small-cap equities as well as non-U.S. developed market equities (Conservative model only) and non-U.S. fixed income. Corresponding increases took place in investment-grade fixed income, both short and intermediate term, defensive U.S. large-cap equities and non-U.S. developed market equities in the more growth-oriented models. This shift reflects the favorability, cost effectiveness, and defensive characteristics of quality stocks and bonds given the current market environment. Additionally, quality fixed income has the potential to offset equity downside risk in a diversified portfolio.

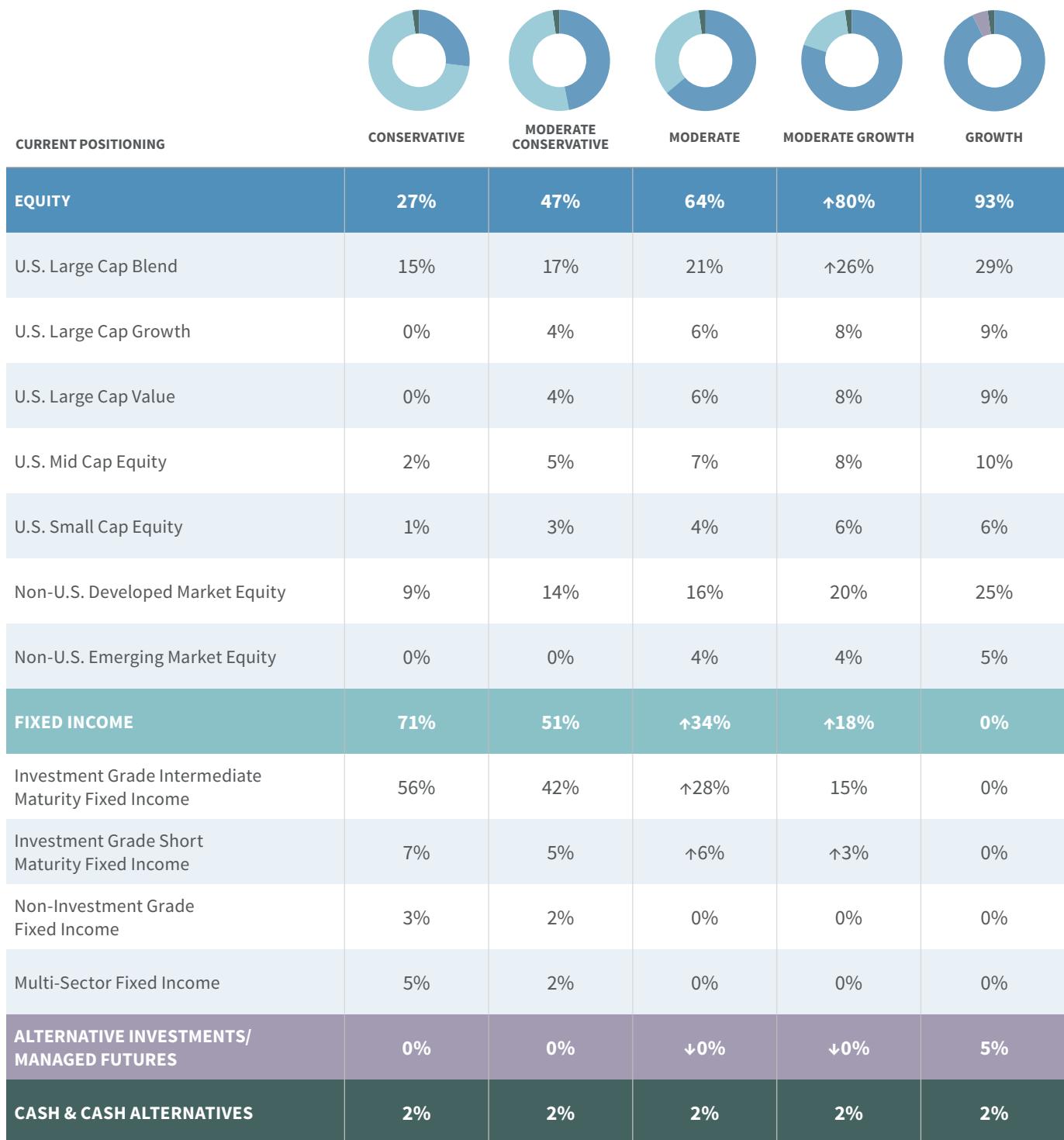


CURRENT POSITIONING	CONSERVATIVE	MODERATE CONSERVATIVE	Moderate	Moderate Growth	Growth
<b>TOTAL EQUITY</b>	<b>↓25%</b>	<b>↓44%</b>	<b>57%</b>	<b>70%</b>	<b>84%</b>
Total U.S. Equity	↑15%	↑27%	↓34%	↓42%	↓50%
Large Cap	↑12%	↑21%	23%	30%	35%
Mid Cap	3%	↓4%	7%	↓7%	↓9%
Small Cap	↓0%	↓2%	↓4%	↓5%	↓6%
Total Non-U.S. Equity	↓10%	17%	↑23%	↑28%	↑34%
Non-U.S. Developed Market Equity	↓8%	14%	↑19%	↑23%	↑28%
Emerging Market Equity	2%	3%	4%	5%	6%
<b>TOTAL FIXED INCOME</b>	<b>↑69%</b>	<b>↑49%</b>	<b>↑35%</b>	<b>↑20%</b>	<b>0%</b>
Core Fixed Income	↑61%	↑43%	↑32%	↑20%	0%
Investment-Grade Intermediate Maturity	↑51%	↑35%	↑25%	↑14%	0%
Investment-Grade Short Maturity	↑10%	↑8%	↑7%	↑6%	0%
Plus Fixed Income	↓8%	↓6%	↓3%	0%	0%
Non-Investment Grade FI (High Yield)	3%	2%	0%	0%	0%
Non-U.S. Fixed Income	↓0%	↓0%	↓0%	0%	0%
Emerging Market Debt (Local+USD)	↑5%	↑4%	↑3%	0%	0%
<b>ALTERNATIVE INVESTMENTS</b>	<b>↓4%</b>	<b>↓5%</b>	<b>↓6%</b>	<b>↓8%</b>	<b>14%</b>
<b>CASH &amp; CASH ALTERNATIVES</b>	<b>2%</b>	<b>2%</b>	<b>2%</b>	<b>2%</b>	<b>2%</b>

Refer to pages 22 and 23 for asset class and model definitions.

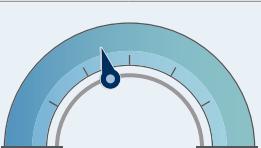
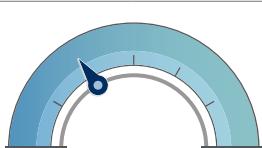
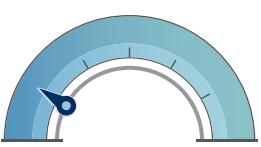
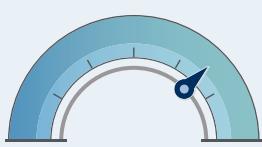
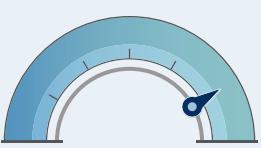
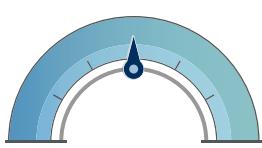
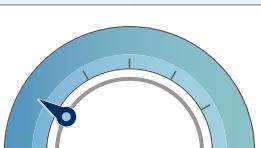
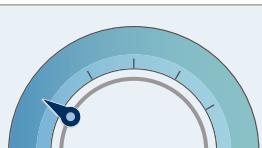
## Strategic Asset Allocation Models

Several changes were made to the Moderate and Moderate Growth Strategic Asset Allocation Models in mid-February. These changes are intended to improve the overall risk/return profile of these models. Given the current interest-rate environment and the late stage of the equity market cycle, there was a reduction in the allocation to alternative investments and a corresponding increase to investment-grade fixed income, both short and intermediate term, and defensive U.S. large-cap equities. This shift reflects the favorability, cost effectiveness, and defensive characteristics of high-quality stocks and bonds given the current market environment. Additionally, high-quality fixed income has the potential to offset equity downside risk in a diversified portfolio.



## Tactical Asset Allocation Outlook

For investors who choose to be more active in their portfolios and make adjustments based on a shorter-term outlook, the tactical asset allocation outlook below reflects the Raymond James Investment Strategy Committee's recommendations for current positioning. Your advisor can help you interpret each recommendation relative to your individual asset allocation policy, risk tolerance, and investment objectives.

 <p><b>EQUITY</b>      <b>FIXED INCOME</b></p> <p>Global equity prices remain more attractive relative to bonds. We favor them slightly as earnings pressures are expected to lessen in the second half of the year. Still, downside volatility is likely to continue. Headwinds for fixed income include a potential rise in interest rates, currency volatility, and credit concerns.</p>	 <p><b>U.S. EQUITY</b>      <b>NON-U.S. EQUITY</b></p> <p>U.S. companies benefited from 2017 tax cuts, but this tailwind has subsided. Non-U.S. economic growth is slowing in many areas, earnings revisions are weak, and geopolitical concerns, particularly around the Brexit deal, tensions between Italy and Ireland, a slowdown in Chinese growth, and trade policy, keep us slightly favorable to U.S. equities as they tend to hold up better during times of uncertainty.</p>
 <p><b>U.S. LARGE-CAP EQUITY</b>      <b>U.S. SMALL-CAP EQUITY</b></p> <p>Large-cap fundamentals are relatively expensive compared to the last 10 to 15 years. Still, these companies tend to better hold their value relative to smaller companies during market selloffs. Once the market finishes repricing, this may be an opportunity to rebalance assets into higher beta, small-cap strategies.</p>	 <p><b>NON-U.S. DEVELOPED MARKET EQUITY</b>      <b>EMERGING MARKET EQUITY</b></p> <p>We are more favorable on emerging markets as the potential for downside loss has decreased substantially while non-U.S. developed markets are struggling with political uncertainty and slowing economic growth. Emerging markets are oversold, have reasonable valuation and fundamentals, and a pause in Fed policy tightening supports both debt and equity for these markets. Headwinds include appreciation of the U.S. dollar, earnings pressure, and concerns over trade negotiations. Active management is recommended in this space.</p>
 <p><b>VALUE-ORIENTED EQUITY</b>      <b>GROWTH-ORIENTED EQUITY</b></p> <p>We favor growth-oriented strategies as the Federal Reserve's language regarding a potential 'pause' in policy tightening (raising short-term rates and decreasing their balance sheet), bodes well for growth relative to value, making cyclical sectors more favorable than their defensive counterparts. This could start to change if margin pressure from growth stocks damped earnings outlooks.</p>	 <p><b>LONG-MATURITY FIXED INCOME</b>      <b>SHORT-MATURITY FIXED INCOME</b></p> <p>Longer-duration bonds should provide better support for equities during a significant equity down market, however, if the selloff is muted/contained, a spike in the yield curve could prove very harmful to longer-duration holdings. While some duration is necessary for diversification, investors may not be appropriately compensated for duration risk at this time. We don't foresee any rate hikes in the next quarter or two which should help with bond prices.</p>
 <p><b>INVESTMENT GRADE FIXED INCOME</b>      <b>NON-INVESTMENT GRADE FIXED INCOME</b></p> <p>While spreads have widened some, we still favor IG bonds over high yield as investors are still not being fully compensated for the credit and equity risk. This would also include senior bank loans as they tend to act like high yield when spreads widen. IG bonds continue to provide ballast to equity market risk and strategic positions should be maintained for this reason.</p>	 <p><b>U.S. DOLLAR FIXED INCOME</b>      <b>NON-U.S. DOLLAR FIXED INCOME</b></p> <p>The probability of the U.S. dollar rallying in the near term is low, but could happen if global markets continue to sell off. Appreciation of the dollar would negatively impact dollar-denominated debt held abroad. This, coupled with the additional credit risk associated with non-U.S. debt, leaves us slightly favorable to U.S. dollar-denominated fixed income in the near term.</p>

## Alternative Investments Snapshot

<b>ALTERNATIVE INVESTMENTS</b>	In a period in which volatility persists and markets appear to be late cycle, alternative assets that provide exposure to unique return streams become more attractive. On a forward-looking basis, manager execution in the space will be vital as dispersion across strategy types and managers has picked up broadly.
EQUITY LONG/SHORT	Equity long/short becomes more attractive in an environment that includes greater dispersion in stocks, increasing the potential for managers to create alpha both long and short. For advisors and clients that believe more volatility is on the horizon, and would like to attempt to reduce equity risk, long/short equity may represent an opportunity to meet that objective.
MULTI-MANAGER/MULTI-STRATEGY	Multi-manager/multi-strategy funds that are diversified across strategy types and asset classes provide investors with differentiated exposure relative to traditional markets. For investors seeking investments with limited correlation and beta to traditional markets, multi-manager/multi-strategy funds represent a potential solution.
MANAGED FUTURES	Managed futures seek to profit from price movements and trends across a wide range of trading markets. Although managed futures in general have failed to meet investor expectations during recent bouts of volatility, historically the asset class maintains limited correlation to equity and bond markets, providing diversification benefits to a broader portfolio.
EVENT-DRIVEN	Event-driven strategies aim to identify catalysts around corporate situations to generate investment returns. While there has been a limited opportunity set for distressed strategies in recent years, a core discipline for many distressed investors, dislocations in credit and a late cycle environment potentially create additional opportunities for managers going forward.
EQUITY MARKET NEUTRAL	Equity market neutral strategies strive to maintain a limited degree of exposure to equity markets. The strategy should outpace broader equity markets during periods of increased volatility as short equity exposure limits losses.
GLOBAL MACRO	Trading across a range of asset classes, geographies, and sectors, global macro strategies provide investors with a return stream that features limited correlation to traditional asset classes. These strategies tend to benefit from divergent moves across markets and, as such, are poised to outperform when volatility presents itself.
CREDIT	Trading across a range of asset classes, geographies, and sectors, global macro strategies provide investors with a return stream that features limited correlation to traditional asset classes. These strategies tend to benefit from divergent moves across markets and as such, are poised to outperform when volatility presents itself.

This report is intended to highlight the dynamics underlying major categories of the alternatives market, with the goal of providing a timely assessment based on current economic and capital market environments. Our goal is to look for trends that can be sustainable for several quarters; yet given the dynamic nature of financial markets, our opinion could change as market conditions dictate.

Investors should only invest in hedge funds, managed futures, distressed credit or other similar strategies if they do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

## Sector Snapshot

This report is intended to highlight the dynamics underlying the 11 S&P 500 sectors, with a goal of providing a timely assessment to be used in developing your personal portfolio strategy. Our time horizon for the sector weightings is not meant to be short-term oriented. Our goal is to look for trends that can be sustainable for several quarters; yet given the dynamic nature of financial markets, our opinion could change as market conditions dictate.

Most investors should seek diversity to balance risk versus reward. For this reason, even the least-favored sectors may be appropriate for portfolios seeking a more balanced equity allocation. Those investors seeking a more aggressive investment style may choose to overweight the preferred sectors and entirely avoid the least favored sectors. Investors should consult their financial advisors to

formulate a strategy customized to their preferences, needs, and goals.

**J. MICHAEL GIBBS**  
Managing Director of Equity  
Portfolio & Technical Strategy

These recommendations will be displayed as such:

**Overweight:** favored areas to look for ideas, as we expect relative outperformance

**Equal Weight:** expect in-line relative performance

**Underweight:** unattractive expectations relative to the other sectors; exposure might be needed for diversification

For a complete discussion of the sectors, please ask your financial advisor for a copy of *Portfolio Strategy: Sector Analysis*.

	SECTOR	S&P WEIGHT	TACTICAL COMMENTS
OVERWEIGHT	INFORMATION TECHNOLOGY	21.2%	Technology scores high as favorable fundamental and technical momentum outweigh elevated relative valuation. Additionally, with many companies exposed to China, a tailwind will be added for the sector if our base case for a favorable outcome on U.S./China trade materializes.
	HEALTH CARE	14.6%	Last year's best performing sector continues to lag in 2019 as political attacks on multiple fronts (drug pricing, Medicare for all, and a White House push to nullify the ACA) intensify. Although a passage of Medicare for All and nullification of ACA are unlikely, investors are still leery of adding to exposure. Headlines are likely to linger with 2020 being a presidential election year. We concur certain areas in the food chain may see lower revenues or profits depending on the outcome. Nonetheless, there remains numerous attractive subsectors within the sector immune to the political landscape. Couple the attractive valuations created in the areas potentially negatively impacted, along with the immune verticals, leaves the overall sector attractive for investors that can stand the current headline headwinds. We stay Overweight for now.
	CONSUMER DISCRETIONARY	10.1%	With the job market remaining healthy and asset prices not far from all-time highs, the consumer remains in good shape. Retail sales figures suggested muted consumer spending in Q1. However, seasonal factors along with the government shutdown cause us to wait for additional readings before rushing to judgment. Relative to other sectors, consumer discretion is attractive based on technical trends and reinforces our Overweight stance.
	INDUSTRIALS	9.3%	We remain Overweight Industrials. The industrials lost relative strength gains garnered year-to-date over the past 30 days as global macro fears weigh on investors. We feel it is too soon to become overly concerned with the macro, and therefore view the pullback as a buying opportunity. Valuation is attractive and the Industrials have seen the most stable earnings estimate revisions this year.
	COMMUNICATION SERVICES	10.3%	This month we increase our opinion to Overweight from Equal weight. Given our market opinion of consolidation in the near term, we feel this sector will outperform. Several of the heavily-weighted defensive holdings are benefiting from the move lower in interest rates while some of the growth components are experiencing strong fundamental trends.
EQUAL WEIGHT	FINANCIALS	12.7%	The tight correlation with bond yield spreads is weighing on the sector. Oversold conditions, attractive valuation, and strong consensus earnings growth expectations for 2019 (subject to downward revisions if the yield curve continues to flatten) keep us Equal weight for now.
	REAL ESTATE	3.1%	After a brief consolidation, the interest-sensitive sector moved higher as bond yields declined after the Fed became more dovish. After the sharp move in interest rates, a short-term counter move is likely. With the Real Estate sector overbought, we suggest patience but accumulation during any pullback or consolidation periods.
	ENERGY	5.4%	The waiting game is on for Energy. Technical traders are waiting for the next price break (up or down) before acting. Recent slowing global economic data and a more cautious U.S. Fed will have fundamental analysts questioning global demand. More aggressive actions by OPEC to contain production has bullish undertones, but the rest of world continues to produce. The fast-approaching IMO 2020 has the potential to produce supply-demand imbalances, but we remain Equal weight in the sector as we too await additional data.
UNDERWEIGHT	CONSUMER STAPLES	7.3%	We remain Underweight. Numerous companies and subsectors are facing fundamental challenges-ranging from sluggish end market volume trends to rising operational input costs. Below market earnings growth expected in 2019 reflects the weak business fundamentals. Technical trading is also weak with relative strength negative and trendless.
	UTILITIES	3.4%	Falling bond yields after the U.S. Fed turned more dovish allowed prices for this interest-sensitive sector to rally. Valuation is elevated and fundamental trends are less than impressive (only 2.9% earnings growth expected in 2019). Despite valuation and fundamental trends, if interest rates continue to move lower, the sector will do well. Nonetheless, after the rapid decline in the 10-year bond yield, we choose to remain Underweight, for now.
	MATERIALS	2.6%	We maintain our Underweight opinion on materials. Slowing macro trends will weigh on fundamentals across the sector. Consensus earnings estimates for 2019 were revised 7.5% lower since 12/31/18 and now project a 1.4% decline. Technical trading trends are unattractive as well with relative strength negative and trending lower.

## ASSET CLASS DEFINITIONS

**U.S. Mid Cap Equity:** Russell Midcap Index: A subset of the Russell 1000 index, the Russell Midcap index measures the performance of the mid-cap segment of the U.S. equity universe. Based on a combination of their market cap and current index membership, includes approximately 800 of the smallest securities which represents approximately 27% of the total market capitalization of the Russell 1000 companies. The index is created to provide a full and unbiased indicator of the mid-cap segment.

**U.S. Small Cap Equity:** Russell 2000 Index: The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Russell 2000 Index is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

**U.S. Large Cap Blend:** The Russell 1000 Index. An index of approximately 1,000 of the largest companies in the U.S. equity market. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. It is considered a bellwether index for large cap investing.

**U.S. Large Cap Growth:** The Russell 1000 Growth Index. A composite that includes large and mid-cap companies located in the United States that also exhibit a growth probability. The Russell 1000 Growth is published and maintained by FTSE Russell.

**U.S. Large Cap Value:** The Russell 1000 Value Index. A composite of large and mid-cap companies located in the United States that also exhibit a value probability. The Russell 1000 Value is published and maintained by FTSE Russell.

**Non U.S. Developed Market Equity:** MSCI EAFE: This index is a free float-adjusted market capitalization index that measures the performance of developed market equities, excluding the U.S. and Canada. It consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

**Non U.S. Emerging Market Equity:** MSCI Emerging Markets Index: A free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of December 31, 2010, the MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

**Investment Grade Long Maturity Fixed Income:** Barclays Long US Government/Credit: The long component of the Barclays Capital Government/Credit Index with securities in the maturity range from 10 years or more.

**Investment Grade Intermediate Maturity Fixed Income:** Barclays US Aggregate Bond Index: This index is a broad fixed income index that includes all issues in the Government/Credit Index and mortgage-backed debt securities. Maturities range from 1 to 30 years with an average maturity of nearly 5 years.

**Investment Grade Short Maturity Fixed Income:** Barclays Govt/Credit 1-3 Year: The component of the Barclays Capital Government/Credit Index with securities in the maturity range from 1 up to (but not including) 3 years.

**Non-Investment Grade Fixed Income (High Yield):** Barclays US Corporate High Yield Index: Covers the universe of fixed rate, non-investment grade debt which includes corporate (Industrial, Utility, and Finance both U.S. and non-U.S. corporations) and non-corporate sectors. The index also includes Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-A and pay-in-kind bonds (PIKs, as of October 1,

2009) are also included. Must publicly issued, dollar-denominated and non-convertible, fixed rate (may carry a coupon that steps up or changes according to a predetermined schedule, and be rated high-yield (Ba1 or BB+ or lower) by at least two of the following: Moody's, S&P, Fitch. Also, must have an outstanding par value of at least \$150 million and regardless of call features have at least one year to final maturity.

**Multi-Sector Fixed Income:** The index for the multi-sector bond asset class is composed of one-third the Barclays Aggregate US Bond Index, a broad fixed income index that includes all issues in the Government/Credit Index and mortgage-backed debt securities; maturities range from 1 to 30 years with an average maturity of nearly 5 years, one-third the Barclays US Corporate High Yield Index which covers the universe of fixed rate, non-investment grade debt and includes corporate (Industrial, Utility, and Finance both U.S. and non-U.S. corporations) and non-corporate sectors and one-third the J.P. Morgan EMBI Global Diversified Index, an unmanaged index of debt instruments of 50 emerging countries.

The Multi-Sector Fixed Income category also includes nontraditional bond funds. Nontraditional bond funds pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe. These funds have more flexibility to invest tactically across a wide swath of individual sectors, including high-yield and foreign debt, and typically with very large allocations. These funds typically have broad freedom to manage interest-rate sensitivity, but attempt to tactically manage those exposures in order to minimize volatility. Funds within this category often will use credit default swaps and other fixed income derivatives to a significant level within their portfolios.

**Alternatives Investment:** HFRI Fund of Funds Index: The index only contains fund of funds, which invest with multiple managers through funds or managed accounts. It is an equal-weighted index, which includes over 650 domestic and offshore funds that have at least \$50 million under management or have been actively trading for at least 12 months. All funds report assets in US Dollar, and Net of All Fees returns which are on a monthly basis.

**Cash & Cash Alternatives:** Citigroup 3 Month US Treasury Bill: A market value-weighted index of public obligations of the U.S. Treasury with maturities of 3 months.

## KEY TERMS

**Long/Short Equity:** Long/short equity managers typically take both long and short positions in equity markets. The ability to vary market exposure may provide a long/short manager with the opportunity to express either a bullish or bearish view, and to potentially mitigate risk during difficult times.

**Global Macro:** Hedge funds employing a global macro approach take positions in financial derivatives and other securities on the basis of movements in global financial markets. The strategies are typically based on forecasts and analyses of interest rate trends, movements in the general flow of funds, political changes, government policies, inter-government relations, and other broad systemic factors.

**Multi-Strategy:** Engage in a broad range of investment strategies, including but not limited to long/short equity, global macro, merger arbitrage, statistical arbitrage, structured credit, and event-driven strategies. The funds have the ability to dynamically shift capital among the various sub-strategies, seeking the greatest perceived risk/reward opportunities at any given time.

**Event-Driven:** Event-driven managers typically focus on company-specific events. Examples of such events include mergers, acquisitions, bankruptcies, reorganizations, spin-offs and other events that could be considered to offer "catalyst driven" investment opportunities. These managers will primarily trade equities and bonds.

**Market Neutral:** A hedge fund strategy that seeks to exploit differences in stock prices by being long and short in stocks within the same sector, industry, market capitalization, country, etc. This strategy creates a hedge against market factors.

**Managed Futures:** Managed futures strategies trade in a variety of global markets, attempting to identify and profit from rising or falling trends that develop in these markets. Markets that are traded often include financials (interest rates, stock indices and currencies), as well as commodities (energy, metals and agriculturals).

## INDEX DEFINITIONS

**Barclays U.S. Aggregate Bond Index:** A broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS. Securities must be rated investment-grade or higher using the middle rating of Moody's, S&P and Fitch. When a rating from only two agencies is available, the lower is used. Information on this index is available at INDEX-US@BARCLAYS.COM.

## DISCLOSURE

All expressions of opinion reflect the judgment of Raymond James & Associates, Inc. and are subject to change. Past performance may not be indicative of future results. There is no assurance any of the trends mentioned will continue or forecasts will occur. The performance mentioned does not include fees and charges which would reduce an investor's return. Dividends are not guaranteed and will fluctuate. Investing involves risk including the possible loss of capital. Asset allocation and diversification do not guarantee a profit nor protect against loss. Investing in certain sectors may involve additional risks and may not be appropriate for all investors.

International investing involves special risks, including currency fluctuations, different financial accounting standards, and possible political and economic volatility. Investing in emerging and frontier markets can be riskier than investing in well-established foreign markets.

Investing in small- and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor.

There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

U.S. government bonds and Treasury bills are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. U.S. government bonds are issued and guaranteed as to the timely payment of principal and interest by the federal government. Treasury bills are certificates reflecting short-term obligations of the U.S. government.

While interest on municipal bonds is generally exempt from federal income tax, they may be subject to the federal alternative minimum tax, or state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Municipal bonds may be subject to capital gains taxes if sold or redeemed at a profit.

If bonds are sold prior to maturity, the proceeds may be more or less than original cost. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revisions, suspension, reduction or withdrawal at any time by the assigning rating agency.

Commodities and currencies are generally considered speculative because of the significant potential for investment loss. They are volatile investments and should only form a small part of a diversified portfolio. Markets for precious metals and other commodities are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Investing in REITs can be subject to declines in the value of real estate. Economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of your portfolio.

Beta compares volatility of a security with an index. Alpha is a measure of performance on a risk-adjusted basis.

The process of rebalancing may result in tax consequences.

Alternative investments involve specific risks that may be greater than those associated with traditional investments and may be offered only to clients who meet specific suitability requirements, including minimum net worth tests. Investors should consider the special risks with alternative investments including limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements. Investors should only invest in hedge funds, managed futures, distressed credit or other similar strategies if they do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

The companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence.

The performance mentioned does not include fees and charges which would reduce an investor's returns. The indexes are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities. The Shanghai Composite Index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

## MODEL DEFINITIONS

**Conservative Portfolio:** may be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses yet want to achieve some capital appreciation. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which has a higher weighting in bonds than in stocks, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.

**Moderate Conservative Portfolio:** may be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of the financial markets. The portfolio, which has an equal weighting in stocks and bonds, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has return and short-term loss characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.

**Moderate Portfolio:** may be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in stocks, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has return and short-term loss characteristics that may deliver returns lower than that of the broader equity market with lower levels of risk and volatility.

**Moderate Growth Portfolio:** may be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in stocks seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration. The portfolio has return and short-term loss characteristics that may deliver returns slightly lower than that of the broader equity market with slightly lower levels of risk and volatility.

**Growth Portfolio:** may be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has 100% in stocks, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio has return and short-term loss characteristics that may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

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