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Letter from the Chief Investment Officer

Moving to the Next Stage

This year marks the 110th edition of the Tour de France, the most prestigious bicycle race in the world. And like the markets, the Tour is always challenging—and evolving. The three-week, grueling 2,200+ mile *route* changes every year and, surprisingly, starts in different countries—this year in Spain versus the UK, the Netherlands, Germany, Belgium, and Denmark the previous five years! The point is, just like the Tour, economic and market cycles have different starting points, and no two routes are alike.

Just look at the economic course we are currently on: It began with a historic pandemic and has since snaked through near-record inflation, a war, assorted political tensions, and unprecedented fiscal and monetary policy changes. For investors, the trip has been as exhausting as climbing the iconic Col du Tourmalet in a brutal *mountain stage* this year. But, as we move to the next stage of our investment journey, the goal for cyclists and investors is the same: Be ready, adjust when necessary, and maintain a long-term perspective.

The US economy continues to *pedal* forward, defying predictions it would skid into a recession, thanks in part to the *'doping'* effects of unparalleled fiscal (i.e., the approximately $5 trillion pandemic-related government stimulus) and monetary stimulus (i.e., record-low interest rates and Federal Reserve (Fed) bond-buying program). Many cheered the robust labor markets, strong consumer spending and strong wage gains that resulted. Now we will see how the economy performs without artificial stimulus and on its own merits. Like Tour officials clamping down on 'dopers', the Fed is cracking down on inflation, tightening interest rates by 500 basis points (5%) over the last 15 months, boosting borrowing costs on everything from credit cards to autos. Today, with mountainous interest expenses and excess consumer savings evaporating quickly, consumers can no longer coast. Understandably buyers are showing signs of fatigue. This, combined with credit tightening and job growth slowing, suggests the economy will slide into a mild recession beginning in the fourth quarter. Despite the slowdown, this year's fast start keeps overall 2023 GDP growth positive at 1.3%. But we do expect it to *decelerate* to between 0.5–0.7% in 2024.

Every cyclist's nightmare is a chain-reaction crash, and the Fed is trying to avoid a *pile-up* after its interest rate hikes. Banking turmoil in March may have been the Fed's *flamme rouge*: The red banner that tells cyclists they're close to the finish line. Restrictive rates seem to be doing their job—putting the *brakes* on the economy. There is no question that the economic data (slowing inflation, rising jobless claims and below-trend growth) are moving in the direction the Fed wants, it's just not happening at the *pace* it wants. The big question is how much patience the Fed must have to allow the disinflationary trend to continue before tightening further. Ultimately, we believe the Fed is in the latter stages, if not near the end, of its tightening cycle. We expect the federal funds rate to end the year at 5.50%. However, as the economy downshifts in 2024 and the unemployment rate nears 5%, expect the Fed to cut the fed funds rate to 4.0%.

In fixed income, with Fed tightening nearing the end, inflation *gearing* down, and the economy no longer *'pumped up'* by stimulus, Treasury yields are poised for a *downhill glide*. In fact, we expect the 10-year Treasury yield to reach 3.25% by year end. In cycling, the downhills can be dangerous, and in an environment where growth will be dicey, we prefer to play it safe and focus on high-quality bonds. We recommend Treasurys, investment grade and municipal bonds. They combine healthy coupon yields with an opportunity for capital gains if yields decline. The yield curve is likely to remain inverted—short-term yields higher than long-term yields—until the Fed starts easing. Therefore, it's prudent for investors to balance their bond maturity exposure and lock in some longer maturity yields before they move lower.

Despite market expectations of treacherous *terrain*, our positive equity market outlook entering 2023 paid off: Double-digit gains by the S&P 500 are pushing it near our year-end target of 4,400 and potentially toward our 12-month target of 4,600. The good news is the equity market has technically transitioned into a bull market (up more than 20% from last October's lows). The bad

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news is we've probably entered a new, more volatile stage. We based our early optimism on unwarranted skepticism and pessimism in the markets. Our view proved out: Earnings came in better than expected, inflation is decelerating, the US government didn't default, and the Fed will probably dial back its interest rate hikes. Moving forward, our upside view is tempered; we see potential *blind curves* ahead. For example, the recent surge in investor optimism may set the market up for disappointment. But in the long term, healthy macro *tailwinds*, a 2023 earnings per share (EPS) target on track at $215, a broadening of sector participation, and history keep us optimistic. And there's more potential upside if the Fed pulls off a soft, non-recessionary landing.

The *breakaway* leader of the pack in this equity rally has been the Tech sector, earning the coveted *Yellow Jersey* (best overall performance) with its fastest start to a year in more than three decades. Recently, artificial intelligence (AI) headlines have even given those stocks a second wind to bolster their lead. The question now is whether Tech can sustain its lead or whether other parts of the equity *peloton* will catch up. While we believe Tech will continue to advance, we expect other market sectors will close the gap as time goes on.

Within US sectors, we expect Health Care to earn the polka dot *King of the Mountains Jersey* (best climber). Health Care should navigate expected increased volatility and benefit from its attractive valuations, defensive characteristics, and consistently robust revenue growth. The *Green Jersey* (best sprinter) competition will feature an uphill battle between the Financial and Energy sectors—both of which have fallen well behind year-to-date. These two sectors will quicken their pace if oil prices climb higher (benefits the Energy sector if oil reaches our year-end target of $85/barrel) or if the Fed ends its tightening cycle (benefits the Financial sector). For the *White Jersey* (best rider under 25), we turn to the emerging markets. Look for the long-awaited rebound in the Chinese economy, lifted by more aggressive stimulative policies, to boost Asian economies. India is emerging as a potential strong *all-rounder* on the world stage, with recent adjustments to supply chains that could benefit India-US ties. Expectations of higher oil prices, continued manufacturing 'nearshoring' (away from China), and easing monetary policy should support Latin American equities.

The Tour de France includes 21 stages over 23 days—varying from flat (6), hilly (6), mountains (8) and one individual *time trial*. While individual riders may win different stages of the course, the overall winner is the rider with the lowest *cumulative time*. In fact, three-time US winner Greg LeMond won the race in 1990 without winning a single stage. A balanced, well-rounded, and consistent long-term-focused strategy is essential—as it is for successful investors! Remember that while individual cyclists get the headlines, the race is a team sport. Up to 100 team staff members ensure cyclists get water, food, equipment, and support. Don't go the distance alone. Reach out to your financial advisor for guidance to help you get to the finish line of your financial goals. And hopefully, like most Tours de France, you will have enough of a lead in obtaining your investment goals so that the last few miles are a leisurely procession all the way to the Champs-Élysées!

Enjoy your summer!

Lawrence V. Adam, III, CFA, CIMA®, CFP®
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Long-term Inflation: Will the Fed Get to 2% or Will it Change the Target?

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

Inflation targeting was pioneered by New Zealand in the late 1980s as the country underwent significant economic and financial market reforms. The primary goal was to maintain price stability by targeting inflation between zero and two percent, with the range allowing the country's Reserve Bank (its central bank) to accommodate volatility and external shocks. However, despite the flexibility, the Reserve Bank ultimately changed its targeting goal to two percent, providing more clarity to the public and policymakers. This experience with inflation targeting influenced central banks worldwide, including the Federal Reserve, which declared its two percent inflation target in 2012.

The Federal Reserve (Fed) estimates that two percent for the Personal Consumption Expenditure (PCE) price index over the long run is the most favorable rate of inflation to support one of the institution's dual mandates: price stability. The second mandate is to keep the rate of unemployment as low as possible. But the biggest issue for the Fed is that in general, and over history, there has been an inverse relationship between the rate of inflation and employment. If employment is too strong—that is if the rate of unemployment is too low—the rate of inflation would tend to increase, and vice versa. This is what is normally called the Phillips Curve.

Phillips Curve

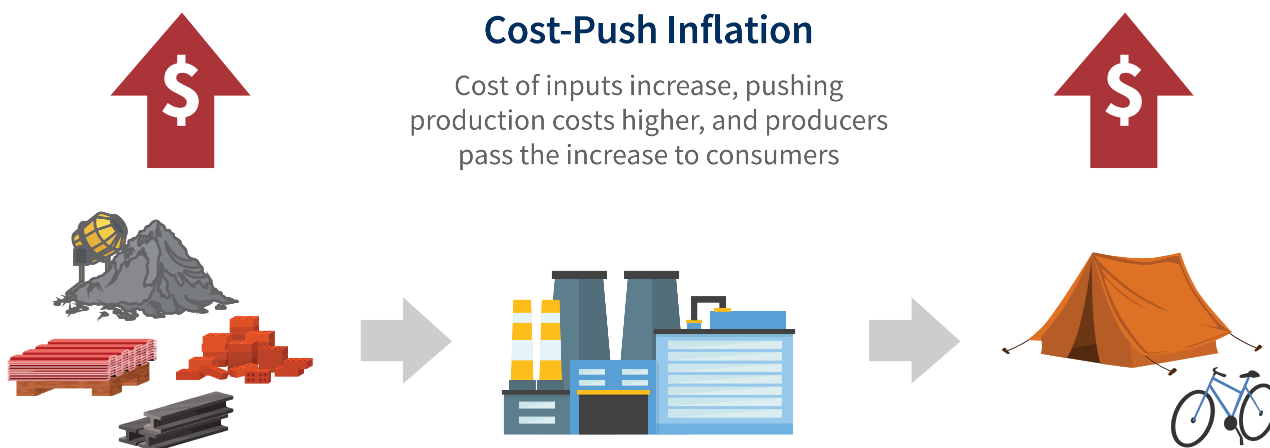
But this relationship has broken down over the last several decades. During the pre-COVID-19 pandemic years, the US was able to keep inflation under the 2% target while at the same time keeping the rate of unemployment at uncharacteristically low levels compared to the historical Phillips Curve relationship. Thus, the question for the Fed today is whether we will go back to a pre-pandemic relationship between inflation and unemployment or if the Phillips Curve relationship will once again apply.

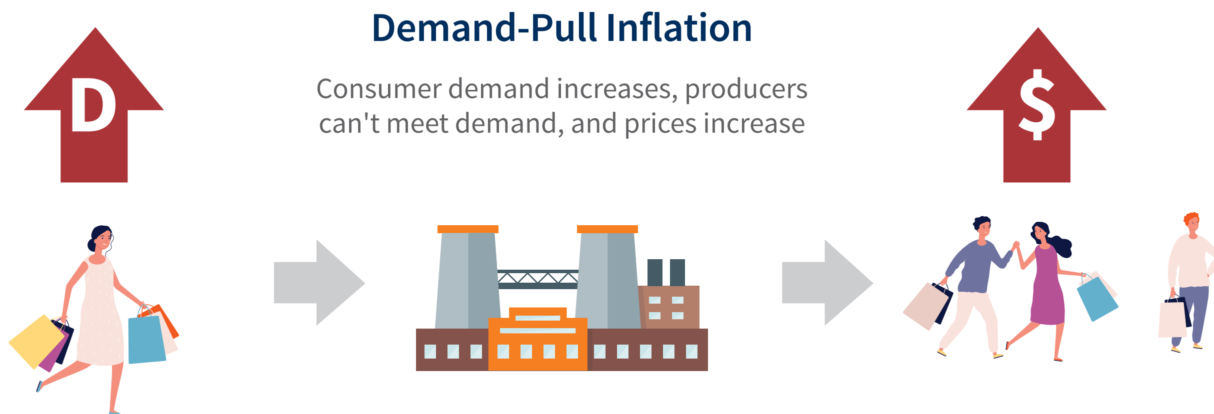
Inflation occurs when there is a generalized increase in the level of prices in an economy. There are, in principle, two processes by which inflation occurs. The first one is called 'cost-push inflation,' which occurs when there is an increase in the cost of production in an economy; that is, when the aggregate supply curve shifts to the left. The second one is called 'demand-pull inflation,' which occurs when the aggregate demand curve shifts to the right.

The issues that occurred during the COVID-19 pandemic, like the reduction in production due to the closing down of the economy plus the supply chain issues, are part of the cost-push inflation argument. As the supply of goods decreases (i.e., the aggregate supply curve shifts to the left) the price of the goods/services affected increases, if other things stay constant. In the second process, which is called demand-pull inflation, the demand for goods increases (i.e., the aggregate demand curve shifts to the right) and this pushes some prices higher while others remain constant. This process occurs if there is anything happening in the economy that shifts the aggregate demand for goods (and/or services) to the right. In this case, what happened was that the US government transferred large amounts of income to individuals and businesses to help them survive the pandemic, and this shifted the aggregate demand curve to the right.

Inflation occurs when there is a generalized increase in the level of prices in an economy.

In fact, what happened during the COVID-19 pandemic, both in terms of 'cost-push inflation' as well as 'demand-pull inflation,' could be considered a perfect storm for inflationary pressures, and the Fed was slow to react.





High inflation hasn't been a concern since the 1980s as inflation has averaged approximately 3%, and over the last decade, the Fed has been undershooting its inflation target. In fact, the rate of inflation from the end of the Great Financial Crisis until the beginning of the pandemic in 2020 was ~1.8%. While it is hard to precisely explain what has kept inflation so low, especially while employment has remained healthy, we believe among the reasons are the strength of the US dollar as well as globalization. The increased strength of the US dollar over the last decade made imports more affordable. Technological advances have also likely had an impact on inflation, not only due to the ability of companies to outsource labor but also due to the ability of consumers to quickly discover and compare competitor prices.

THIS TIME IS NO DIFFERENT

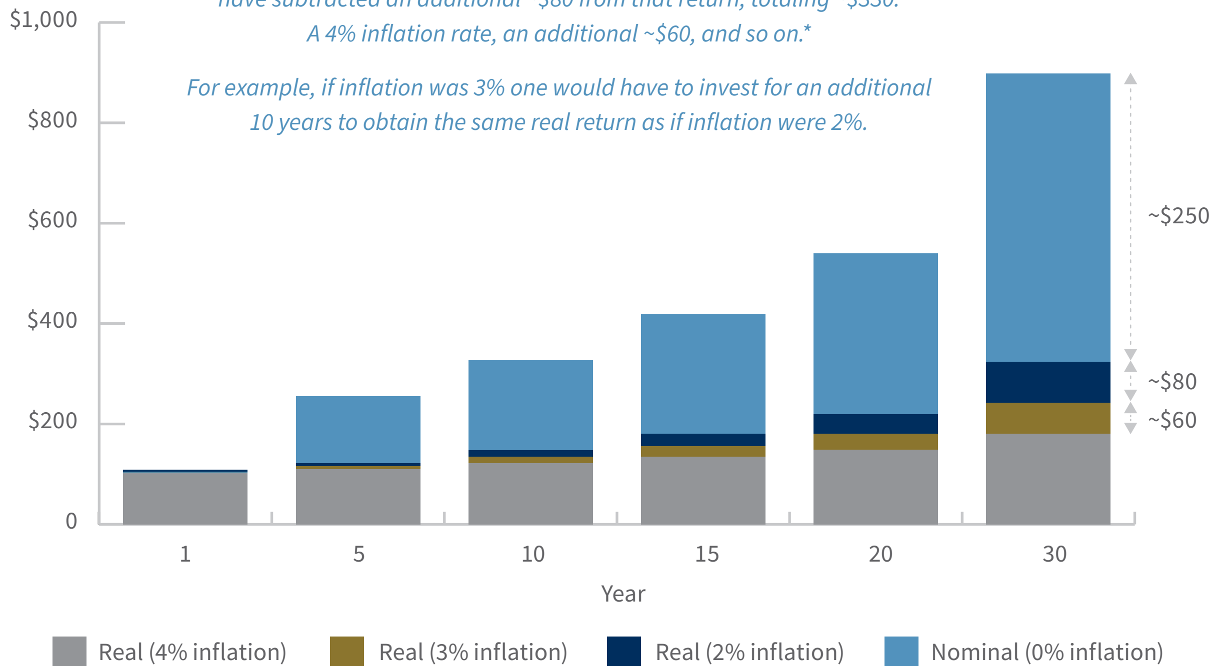
Over the last two years, inflation has increased to the highest level in 40 years mostly due to consequences of the pandemic, including product shortages, supply chain disruptions, highly expansive fiscal policy, and strong consumer demand. However, once all of the above return to somewhat normal levels, inflation should return to the Fed's long-term target. Perhaps one of the biggest issues affecting inflation is immigration, which was severely curtailed due to COVID-19 but has returned to somewhat normal levels over the last year or so. Although the labor force participation rate overall collapsed during the COVID-19 pandemic, the recent improvement in labor force participation will help normalize the US labor market going forward.

> What happened during the COVID-19 pandemic, both in terms of 'cost-push inflation' as well as 'demand-pull inflation,' could be considered a perfect storm for inflationary pressures, and the Fed was slow to react.

The Impact of Inflation on the Return of a 60/40 Portfolio

*Over the last decade, a 60/40 portfolio has returned ~6% a year on a nominal basis (not adjusted for inflation). Therefore, $100 invested over 30 years at this rate would return ~$575. Inflation of 2% over those 30 years would have shaved ~$250 from this return, while a 3% inflation rate would have subtracted an additional ~$80 from that return, totaling ~$330. A 4% inflation rate, an additional ~$60, and so on.**

For example, if inflation was 3% one would have to invest for an additional 10 years to obtain the same real return as if inflation were 2%.



*This is a hypothetical example for illustrative purposes only. Past performance may not be indicative of future results. There is no assurance these trends will continue. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs which would reduce an investor's return. The 60/40 Portfolio was 60% invested in the S&P 500 Index and 40% in the Bloomberg Barclays U.S. Aggregate Bond Index. The S&P 500 is an unmanaged index of 500 widely held securities. The Bloomberg Barclays U.S. Aggregate Bond Index contains approximately 8,200 fixed income issues and represents 43% of the total U.S. bond market. An investor cannot invest directly in these indexes.

In any case, even if the conditions that existed before the pandemic are no longer extant, we believe there is a zero probability that the Fed will change the target rate of inflation at this time because there are analysts saying that the Fed cannot achieve the current target rate of inflation! First of all, the target rate of inflation is a target. That is, the Fed is going to conduct monetary policy to bring the rate of inflation to the target rate, period, regardless of what any analyst believes. Second, before the COVID-19 pandemic recession, a 3.5% unemployment rate was consistent with a 2% inflation target. However, this may not be true today and monetary policy may have to be adjusted to allow for a higher rate of unemployment in order to achieve the target rate of inflation of 2%. Third, if after achieving 2% inflation over several years, the Fed decides that something different than 2% for the average inflation rate over the years is better than the current rate target, then it may decide to change it. However, this decision will be completely independent of one that says that it cannot attain the 2% target. The Fed will change the target if it believes that a different target is better for the economy than the target it has today, not because it cannot achieve that target.

Furthermore, the Fed strives to have well-anchored inflation expectations at two percent over the long run because if consumers and businesses expect stable prices, they can ultimately make sound decisions about their spending, saving, and investing. Similarly, stable inflation expectations lower wage pressures coming from workers. Overall, a two percent rate of inflation is still comfortable, manageable, and most importantly, sustainable, for both consumers and employers over the long run. Additionally, many retirement plans are based on the assumption that inflation will be 2% over the long run, and higher levels of inflation would compound over time and ultimately have severe impacts long term.

THE BOTTOM LINE:

The rate of inflation, after remaining below the Fed's 2% target for several years, has remained above target due to the severe COVID-19 pandemic shock and its policy aftermath. Although the Fed was caught off guard and reacted tardily to its inflationary impacts, the disinflationary process started in July of 2022 and has continued ever since.

It is true that inflation has remained above target for more than two years and thus it will take a longer to bring down, but the process is guaranteed by the Fed's commitment to achieving its 2% target over the years and thus, there is nothing—other than sticking to the target—that the Fed has to do to achieve that target.

Using the words of the Fed on its website when answering the question "Why does the Federal Reserve aim for inflation of 2 percent over the longer run?"[1] and adapting it to today's environment, we conclude that:

"Following periods when inflation has been running persistently above 2 percent, appropriate monetary policy will likely aim to achieve inflation modestly below 2 percent for some time. By seeking inflation that averages 2 percent over time, the FOMC will help to ensure longer-run inflation expectations remain well anchored at 2 percent."

KEY TAKEAWAYS:

- The Fed estimates that two percent for the Personal Consumption Expenditure (PCE) price index over the long run is the most favorable rate of inflation to support one of the institution's dual mandates: price stability. The Fed's second mandate is to keep the rate of unemployment as low as possible.
- Over time, there has been an inverse relationship between the rate of inflation and employment. If the rate of unemployment is too low, the rate of inflation would tend to increase, and vice versa. This is known as the Phillips Curve. But this relationship has broken down and a question for the Fed is whether the Phillips Curve will once again apply.
- Inflation occurs when there is a generalized increase in the level of prices in an economy. There are two ways in which inflation occurs, 'cost-push inflation,' which occurs when there is an increase in the cost of production in an economy, and 'demand-pull inflation,' which is when the demand for goods increases.
- Inflation has increased to the highest level in 40 years mostly due to consequences of the pandemic, including product shortages, supply chain disruptions, highly expansive fiscal policy, and strong consumer demand. Once these things normalize, inflation should return to the Fed's long-term target.
- The Fed is going to conduct monetary policy to reach its target rate of inflation. It is not going to change the target.

[1] https://www.federalreserve.gov/faqs/economy_14400.htm

The End of Globalization? Risks and Opportunities of a New Economic Era

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

Are the US and Chinese economies decoupling, or are we seeing a more strategic approach to national security priorities and supply chain resiliency? The answer to this question depends upon the policy decisions over the next several years and could have massive implications for the global economy and equity market. We are of the view that a broad-scale decoupling and the formation of regional economic blocs is less likely, but a trend of reindustrialization and de-risking will be a market theme that investors will navigate in the years ahead. We also argue that recent US policy decisions are the foundation for an industrial renaissance aimed at building up the economic base of our country and protecting it against some of the geopolitical and supply chain risks that have had significant impacts in recent years—most acutely felt during the COVID supply chain shortages of critical materials. Key aspects of this industrial renaissance are the series of 'carrots' in the form of tax subsidies and direct support vs. the initial phase of 'sticks' in the form of tariffs, blacklistings, and tech restrictions.

A trend of reindustrialization and de-risking will be a market theme that investors will navigate in the years ahead.

US AND CHINA AT A CROSSROADS: A SHIFT IN THE GLOBAL ECONOMIC ORDER

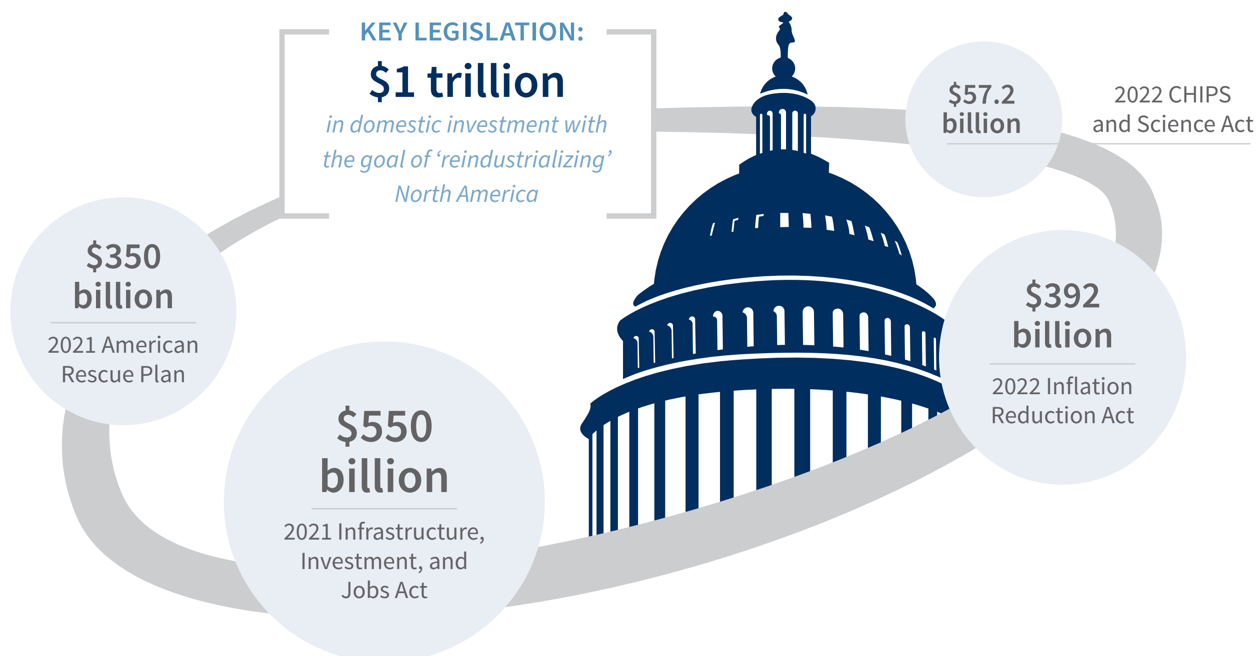
Concern over China's longer-term geopolitical ambitions and the threat posed by China's military to the US and key allies has been a major focus of US policy in recent years. During the Trump Administration, concerns about China's unequal market access and intellectual property theft led to the 2018 'trade war' with tariffs levied against a broad set of China's imports into the United States. A key concern was that US technology designed for civilian use could be repurposed for military application. This led to US policy viewing technology as a national security asset, thereby implementing new export restrictions and blacklisting various Chinese

companies from receiving access to US technology, especially in the semiconductor space. The flow of US capital into critical sectors in China that finance China's economic competition with the US also came under enhanced scrutiny. While this economic confrontation was initially driven by national security considerations, the COVID-19 pandemic exposed additional vulnerabilities around global supply chains, particularly with technology components and medical goods that drove shortages and spiked prices. These conditions set the stage for a rethinking of US-China economic relations that quickly became a bipartisan consensus in Washington.

GOVERNMENT RESPONSE: SECURING SUPPLY CHAINS & INVESTING IN THE DOMESTIC INDUSTRIAL BASE

In response to the dynamics, the US government has enacted policies with both 'sticks' and 'carrots' that create challenges and opportunities for investors navigating the shifting global environment. Export controls, tariffs, and economic restrictions through the blacklisting of certain companies have created revenue and cost challenges for US companies with significant exposure to China's market. Frequently, these policies are announced with little warning and carry high impact—raising headline risk for exposed sectors. However, policymakers have also unleashed more than $1 trillion in domestic investment across pandemic relief measures and new funding for domestic infrastructure, semiconductor manufacturing, and the energy transition. Key legislation on this front includes the 2021 American Rescue Plan ($350 billion in funding for infrastructure), the 2021 Infrastructure, Investment, and Jobs Act ($550 billion), the 2022 CHIPS and Science Act ($52.7 billion), and the 2022 Inflation Reduction Act ($392 billion). These new policies direct federal funds and catalyze private sector investment toward what we refer to as the 'reindustrialization' of North America. In combination, the goal of these policies is to fortify the US domestic industrial base and limit future economic dependencies that can drive economic disruptions or be used against the US as economic leverage. Even with this level of new investment, we still see significant appetite in Washington to build on and supercharge certain aspects of the domestic economic agenda. Permitting reforms, investments in critical minerals, and preserving a role for legacy energy to limit transition risks all contribute to economic growth prospects over the years ahead. The global impacts of the war in Ukraine add a national security imperative around these goals. Vulnerabilities experienced by countries with oil and gas dependencies following Russia's invasion of Ukraine have prioritized projects that build out legacy energy infrastructure and limit potential vulnerabilities around critical minerals as the energy transition gains pace. In this sense, policymakers are wary of replacing dependence in the oil and gas space for critical mineral dependencies with supply chains heavily

Permitting reforms, investments in critical minerals, and preserving a role for legacy energy to limit transition risks all contribute to economic growth prospects over the years ahead.



> "Overall, the events of the last several years have placed national security and economic disruption concerns as leading drivers of policymaking in Washington."

concentrated in China. Overall, the events of the last several years have placed national security and economic disruption concerns as leading drivers of policymaking in Washington.

As markets digest the impact of this trend, we see clear winners and losers from an investment perspective. As federal funding is deployed and the reindustrialization theme plays out, we expect Industrials to be a clear beneficiary. New investment and market opportunities for the energy transition will be a material boost for clean energy equities. We see the transition as balanced across the energy space with permitting reform boosting the buildout of energy infrastructure and increasing demand for liquified natural gas (LNG). In terms of potential headwinds, the Technology sector will be a space that is exposed to risks as the policy impact unfolds. Emerging technologies such as artificial intelligence (AI), quantum computing, and robotics will be in the crosshairs of new controls and regulations which can limit the ability of certain companies to scale and penetrate China's market. Biotechnology and pharmaceuticals are other areas to watch which could see similar controls in the future. In all, we expect material market impacts over the coming years as this economic transition takes shape.

WHAT'S NEXT

Investors should be aware of critical trends that will impact the evolution of this emerging theme. First, China's response can increase market risks if US policy actions are seen less as 'de-risking' and more as 'decoupling' by another name. US companies could be targeted as retaliatory steps, which can raise overall US-China tensions. The fate of Taiwan and the outcome of its presidential elections in January 2024 will also be important to monitor. While the Biden administration is taking steps to de-escalate tensions around the question of Taiwan's status, China perceiving Taiwan as moving closer to independence could accelerate the timeline for a regional conflict that could drive global economic disruption on a significant scale. Lastly, the inflationary impact of a shifting global economic order will have important consequences for the direction of monetary policy. Higher costs and elevated spending could weaken the Federal Reserve's tools to fight inflation and prolong high interest rates—a 'higher for longer' scenario. We expect attention to increase on these issues over the next year, especially as the US prepares for the 2024 presidential election campaign that will help determine the trajectory of a changing macro investment environment.

KEY TAKEAWAYS:

- We are of the view that a trend of reindustrialization and de-risking will be a market theme that investors will navigate in the years ahead.
- Recent policy decisions are the foundation for an industrial renaissance aimed at building up the economic base and protecting it against some of the geopolitical and supply chain risks that have had significant impacts in recent years.
- Concern over China's longer-term geopolitical ambitions and the threat posed by China's military to the US and key allies has been a major focus of US policy in recent years, leading to US policy viewing technology as a national security asset.
- The US government has enacted policies with both 'sticks' and 'carrots' that create challenges and opportunities for investors navigating the shifting global environment.
- We expect material market impacts over the coming years as this economic transition takes shape.

India: Is Geography Destiny?

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

On 14 March of this year the United Nations formally acknowledged that India had overtaken China to become the most populous nation on the planet. In truth, such is the nature of census gathering that the exact timing may have happened somewhat earlier, but the broader point is that possibly as soon as 2024 India will be the home of the world's largest pool of labour. Why does this matter and what might the implication be for investors seeking to augment portfolio performance with greater geographical diversity? Beyond that, how should investors feel regarding the country's studied lack of alignment in a fractured world? And what to make of the political dimension with important elections scheduled for April/May next year? Narendra Modi, leader of the ruling Bharatiya Janata Party (BJP), has proved the driving force behind a far-reaching reform programme which promises much, but he has many critics amongst his political opposition. Any analysis of India's attraction as an investment destination must take on board the often overlapping and regularly conflicting strengths, weaknesses, threats, and opportunities associated with a sprawling and diverse economy.

STRIKING GEOPOLITICAL BALANCE

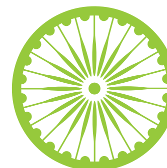
Since gaining its independence from Britain in 1947 India has fostered a studiedly unaligned position on the world's stage, a position now under close scrutiny given tensions between the United States and its NATO allies and both Russia and China. Since the onset of the Ukraine war India has steadfastly refused to join the Western sanctions programme and has been steadily increasing its oil imports from Russia, taking advantage of substantial price discounts in so doing. Beyond that, Indian delegates actively debated the establishment of a free trade agreement with Russian counterparts at a bilateral conference in April.

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

KEY GROWTH FACTORS

Young and rapidly growing working-class population

Growth in the manufacturing sector because of rising education and engineering skill level



Sustained growth of the consumer market driven by a rapidly growing middle class

Source: John Hawksworth and Anmol Tawari January 2011 – The World in 2050: The Accelerating Shift of Global Economic Power: Challenges and Opportunities PricewaterhouseCoopers

But while its relationship with Russia may be discomforting to the West, India's position with regard to China is much less friendly. Despite being a key member of the so-called BRICS+ group, India has a shared security interest with the United States in limiting China's power and influence. Beyond that, periodic military confrontation along the shared border serve to illustrate that the two countries harbour profound differences both to one another and in their approach to the wider world.

In a fractured global economy, one in which the global geopolitical and geoeconomic map is being swiftly redrawn, it remains to be seen how long India can remain on the fence. Despite periodically sharing the same stage, India's leadership is deeply mistrustful of China's overseas adventurism. Diplomatic relations between New Delhi and Beijing are arguably even more strained than are the latter's with Washington DC. This has manifested in steps already underway to reduce China's economic leverage in India, taking a hard line on Chinese apps and joining the US in banning Huawei and ZTE equipment for 5G networks.

Furthermore, India's position to benefit from the so-called 'friend-shoring' of manufacturing supply chains has been exemplified by April's high-profile meeting between Mr. Modi and Apple CEO Tim Cook. Albeit starting from a low base, iPhone production has tripled in India over the 12 months to March and a further strengthening of commercial relationships across a range of manufacturing activities seems highly likely.

This strengthening and broadening of commercial relationships has, at its heart, a clear understanding on India's part that its best interests are likely served by building closer ties with the US. Most notably, the US is much more economically significant to India than is China. Export volumes and values to the US are already much greater, as is direct investment into the subcontinent. In essence, what is being envisaged is the creation of a manufacturing ecosystem of multiconnective activities, a network of short supply chains the benefits of which would likely attract other multinational corporations to participate. Were what is envisaged to come to fruition, the foundations would be laid for a local manufacturing sector so competitive as to allow India to achieve growth rates akin to if not greater than the best performing emerging economies over the past few decades.

> In a fractured global economy ... it remains to be seen how long India can remain on the fence.

STRUCTURAL REFORM

Key to unlocking this undoubted potential is harnessing and focusing the hitherto latent power of the Indian workforce. The demographic dividend lies in unleashing the population into a globally competitive and, initially at least, a labour-intensive manufacturing sector. This is nothing new, the path to economic prosperity is characterised by boosting the productivity of previously low and unskilled workers through migration from an agrarian and (particularly in India's case, low-end services) into

highly mechanised factories. History shows only too clearly that this migration delivers labour productivity far greater in its early stages than does the service sector.

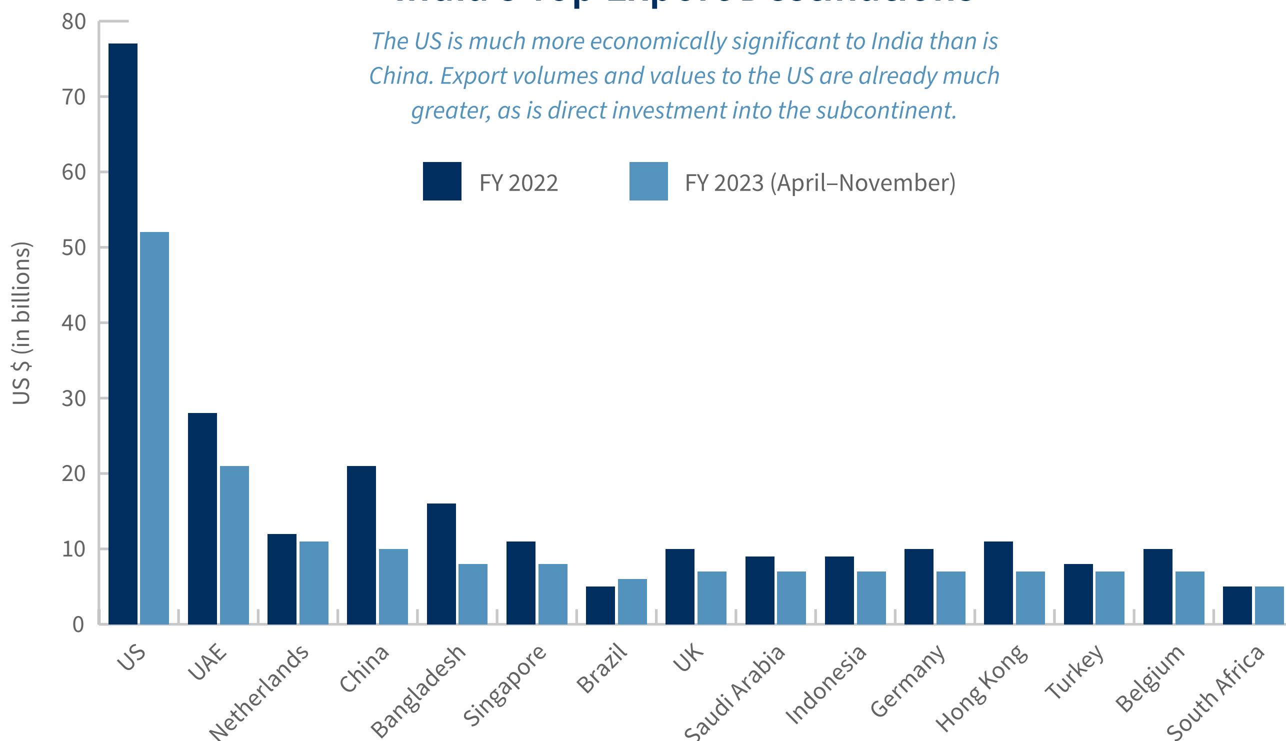
More important still is the potential associated with bringing women into formal work. As it stands female participation in the workforce amounts to just 20% according to World Bank data, extremely low relative to other equally deeply conservative countries including Saudi Arabia. Admittedly, the World Bank's conclusion may be misrepresentative as it likely does not take into account the large proportion of women engaged in very low skilled household activities. Be that as it may, the broader point is that until now Indian women have historically found it impossible to escape low productivity informal work.

Going forward, the evolution of India's manufacturing sector will provide the gateway for Indian women formally to enter the workforce for the first time. The benefits associated with so doing are already clearly apparent elsewhere in Asia including Vietnam and neighbouring Bangladesh. The creation of 'all-female' factories should serve to overcome deeply entrenched conservatism and an ancient caste system increasingly viewed as holding the economy back.

THE POLITICAL DIMENSION

If this potential is to be unlocked, the political determination and drive to achieve it must be maintained. India's political cycle is turning and the season ahead of 2024 elections is fast approaching. In the previous parliamentary election, in 2019, Prime Minister Modi's BJP Party won 303 seats out of 543 in the Lok Sabha (lower house), a substantial majority by the standards of the recent past and with it a strong mandate to push through reforms. Importantly, the run-up to the campaigning season has seen the main opposition Congress Party take control of the state of Karnataka on 10 May, causing political scientists to assess the possibility of an electoral upheaval and prior to that the possibility that the pace of reform might be dialed back as the ruling BJP seeks to preserve its majority.

At present it is thought likely that the BJP will win the forthcoming election, but with a reduced majority of around 270 seats. The Karnataka election result, whilst a setback, likely reflects the fact that local issues tend to assume preeminence, not issues of strategic national significance. History reveals that Karnataka has not elected an incumbent government of either leading party since 1985. More encouragingly, the majority of



Source: India Ministry of Commerce

> “Going forward, the evolution of India’s manufacturing sector will provide the gateway for Indian women formally to enter the workforce for the first time.”

the population recognise and have benefited from reforms undertaken thus far. Infrastructure improvements are important to this, but not so central as the overhaul of the country’s welfare programmes through the rollout of technological improvements. The improved speed, efficiency and reliability of welfare distribution explains why BJP support, historically located in the business and trading communities, has spread across the urban poor and rural constituencies. Other life-transforming programmes, particularly those associated with sanitation, are also proving popular.

Where Modi may encounter opposition is the perception that his party has exploited ethnic divisions within the country, emphasising a ‘Hindu first’ agenda deeply unpopular with the country’s Muslim population. This is not to be belittled, but neither is the widespread surge in popular aspiration since Modi was first elected in 2014, manifest in a growing awareness of the country’s significance on the world stage.

RUPEE TO STRENGTHEN ON THE FOREIGN EXCHANGE

Typically, long-term exchange rate projections are based upon significant structural determinants, in particular perceptions regarding relative productivity growth, commodity terms of trade and inflation. The above analysis illustrates the productivity potential still to be unlocked. Beyond which India’s commodity terms of trade will drive an appreciation in the rupee’s relationship with the dollar. History shows clearly that the Indian currency’s trade weighted relationship with the dollar has trended higher during periods of rapid productivity growth, particularly during the 1990s. Combine this with the forecast that domestic inflationary pressure will fall faster relative to inflation in the United States points to an appreciation in the rupee over the next decade or so in both nominal and real terms.

"Geography is destiny" is a term first coined by Arab sociologist and philosopher Ibn Khaldan in the Middle Ages, and as it applies to modern geopolitics it remains hotly debated. Where a country stands in relation to wide-ranging issues depends, to a large extent, on where it sits. What is clearly apparent is that an increasingly self-assured India recognises its position in the world and is prepared both to unlock and to harness its economic potential. As the geopolitical map is redrawn new geoeconomic relationships are being forged. India has a pivotal role to play in this transformation.

KEY TAKEAWAYS:

- India has overtaken China as the most populous nation in the world.
- India has a shared security interest with the United States in limiting China’s power and influence.
- There is a clear understanding on India’s part that its best interests are likely served by building closer ties with the US.
- What is clearly apparent is that an increasingly self-assured India recognises its position in the world and is prepared both to unlock and to harness its economic potential.

Q&A: Opportunities in Munis

Doug Drabik, *Managing Director, Fixed Income Research*

Municipal bonds represent just one product in the fixed income market but offer a distinguishing feature by generating federally tax-exempt income. Some may consider municipal bonds a boutique product as they represent only 8% of the $53 trillion fixed income market, yet they can make a powerful impact on an investor's portfolio. Investors falling into high federal tax brackets and those residing in states with high tax rates can benefit from this tax-exempt status.

Debate has persisted over how taxes, tax laws, or government policy could change the municipal landscape. Although legal nuances change from time to time, we feel that the optional borrowing advantage available to municipalities benefits the masses (through infrastructure improvements, schools, sewer and water systems, public parks, city equipment, hospitals, etc.) and therefore will likely endure any political or radical agendas to divest this market.

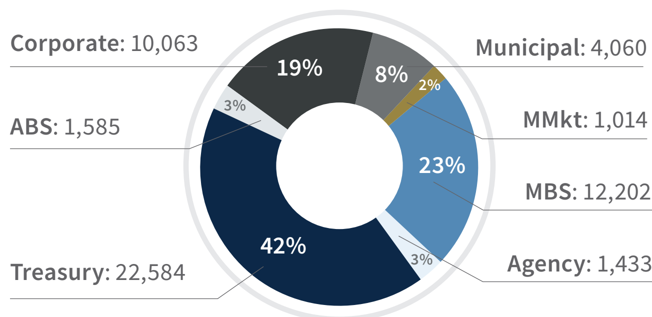
Currently, issuance is down at a time when Baby Boomers, who are attracted to tax-exempt options and are retiring at an unremitting pace, subsequently contribute to the overall demand that is exceeding supply. The mere size of the municipal market along with the increasing demand will likely keep upward yield constraints on the sector, but in recent times, bond market conditions have unfolded favorably thus providing positive investor value.

Q. How does the municipal curve compare to the Treasury curve?

A: We derive the relative fair value of municipal bonds by looking at AAA-rated muni yields as a percentage of the corresponding Treasury. Municipal bonds trade at a spread to the AAA curve. The 5-year, 10-year and 30-year AAA municipal yields as a percent of Treasurys have averaged around 82%, 90% and 101% respectively over the last ten years. Municipal bonds have traded extremely rich this year, meaning these ratios and therefore municipal yields have been low on a historic relative basis; however, recently municipal ratios have begun to rebound, thus they are producing more attractive tax-free income for investors.

US Fixed Income Outstanding

(in billions)



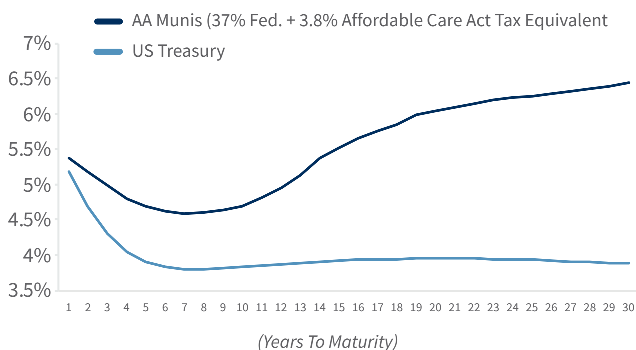
Source: SIFMA Data, Raymond James Data as of 12/2022

The Treasury curve has been inverted (short-term rates are higher versus longer-term rates) since October 2022. Although the very short end (inside three years) of the municipal curve is inverted, the greater part of it is upward sloping. This signifies greater income rewards for investors whose financial strategy aligns with taking on increased duration with longer maturity bonds.

Q. Are municipal bonds a relatively 'safe' product choice?

A. According to Moody's Investor Service data, 98.9% of their rated municipal bonds are issued with investment-grade quality ranking, which compares to only 61.7% of Moody's rated corporate bonds. Looking at a 5-year, cumulative default rate average from 1970-2021, only 0.04% of investment-grade Moody's-rated municipal bonds defaulted. Put another way, 99.96% did not default. The 10-year investment-grade cumulative default rate average is only 0.09% (99.91% did not default). Credit events activated by extreme market fluctuations, policy changes or even pandemics can change financial metrics and can trigger rating changes. It is important to recognize that downgrades are not defaults but signals of tighter financial conditions expected during tougher times. The bottom line is that investment-grade municipal bonds are among the most secure investment choices.

Yield Comparison



Source: FactSet, as of 6/16/23

Q. Are there specific municipal bond structures and/or opportunities that you like more than others?

A. There are some general characteristics that may benefit most investors but in practice, one size does not fit all. The first and most fitting response is that municipal bonds are underwritten with a wide array of features and therefore promise a decent chance of fitting various investors with differing financial needs/goals.

Recent bond market shifts have created an on-and-off opportunity to buy 4.0% coupon bonds at or close to par. A Florida resident in a 37% tax bracket who buys a 4.0% coupon, A-rated, New York issued bond priced at $98.87 would benefit from a 4.083% tax-exempt yield or a tax-equivalent yield to maturity of 6.48%. To put this in perspective, the average annual total return of the S&P 500 Index from the turn of the century to the present (23.4 year span) is 6.58%. A New York resident would receive a 7.84% tax-equivalent yield given that the New York state tax rate is high, and a resident would not pay in-state tax on a bond issued from their state.

Municipal offerings with 5.0% or higher coupons may afford a different opportunity. Since most municipal bonds are structured with call dates inside of ten years, longer maturing municipals often boast higher yields to the shorter call versus non-callable municipal bonds with shorter maturities. If the bond is not called, it is said to be a 'kicker bond,' meaning that the yield earned 'kicks' higher the longer it remains outstanding. For example, a Florida resident in the 37% tax bracket would earn a tax equivalent yield of 7.14% and a New York resident 8.64% to maturity since it is a New York-issued bond.

The steep and upward shape of the municipal curve ten years and out provides the optimum return profile for long-term investors; that is, investors are compensated for taking additional interest rate risk.

Past performance may not be indicative of future results. 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.

Economic Snapshot

EUGENIO J.ALEMÁN, PhD
Chief Economist

The growth of year-over-year inflation is now less than half of what it was a year ago, and it is likely to continue to trend lower as shelter costs slow in the second half of the year. Despite positive news on the inflation front, Federal Reserve (Fed) officials remain very hawkish, and the June Summary of Economic Projections suggests that the Fed is likely to move one or perhaps two more times before the end of this tightening cycle. While the unemployment rate ticked higher, the labor market remains very strong. This, combined with excess savings left from the pandemic—albeit to a lesser extent than before—continues to support consumer spending, which could be a headwind in the Fed's journey of bringing inflation down over the long term. Higher interest rates have sent the more interest-rate-sensitive manufacturing and housing sectors into recession, but the service side of the economy continues to expand, though at a slowing rate. Despite some volatility over the last quarter, the US dollar remains at the same level as it was 40 years ago. Central banks globally continue to tighten monetary policy to fight inflation, and differences in inflation as well as interest rates between the US and the rest of the world are likely to keep the US dollar from weakening too much from current levels.

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	THE DOLLAR	The US dollar had weakened somewhat compared to the levels experienced last year but has regained some traction as of late, and positive macroeconomic data is likely to support this trend further.
NEUTRAL	GROWTH	GDP growth is expected to continue to moderate over the next several quarters and we expect the recession to start in 4Q23.
NEUTRAL	EMPLOYMENT	Nonfarm payrolls have remained strong during the year's first half, but we expect the labor market to cool during the second half of the year.
NEUTRAL	CONSUMER SPENDING	Consumer spending has remained relatively strong, supported by a very tight labor market, slowing inflation, and complemented by continued strong credit card lending. Excess savings from the pandemic continue to positively contribute to consumer spending, but is starting to wane in many segments of the population.
NEUTRAL	BUSINESS INVESTMENT	Higher interest rates for longer will continue to negatively impact the strength of business investment in the near future.
NEUTRAL	HOUSING AND RESIDENTIAL CONSTRUCTION	The housing market continues to find its footing and is no longer falling. However, we expect the sector to remain weak in the coming quarters as high mortgage rates and affordability challenges reduce the pool of potential buyers.
NEUTRAL	INFLATION	Inflation is likely to continue to slow as economic activity weakens in the second half of the year. Furthermore, we expect shelter costs to slow down considerably and push headline inflation lower.
NEUTRAL	MONETARY POLICY	The Fed remains very hawkish and is likely to have at least one more hike, likely after the summer months, before reaching its terminal rate and keeping rates higher for several more months.
NEUTRAL	LONG-TERM INTEREST RATES	The yield curve remains deeply inverted as expectations for Fed rate hikes continue to linger. We expect the curve to remain inverted until the Fed pivots to an easier policy stance next year; however, longer-maturity yields should gradually decline as growth and inflation decelerate.
NEUTRAL	FISCAL POLICY	The debt ceiling issue is now in the rearview mirror, and contributions to GDP from government spending this year are unlikely to change significantly.
NEUTRAL	REST OF THE WORLD	We continue to expect a weakening global economy during 2023 as central banks continue to increase interest rates.
UNFAVORABLE	MANUFACTURING	Although the ISM Manufacturing Index remains in contraction, manufacturing output, as measured by the Manufacturing Production Index, has remained positive but weak.

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.

These recommendations will be displayed as such:

J. MICHAEL GIBBS
Managing Director, Gibbs Capital Management*

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	COMMENTARY
OVERWEIGHT	HEALTH CARE	13.6%	Health care is a favored 'defensive' sector to water-down potential volatility in the current environment, given that valuation is much cheaper than other low-beta areas. Recent comments from companies regarding improved supply and labor issues, along with normalizing hospital utilization and medical demand, provide some optimism on fundamental trends.
OVERWEIGHT	CONSUMER DISCRETIONARY	10.6%	While potential economic volatility is a concern for equities in general, the consumer has been resilient. We remain encouraged by positive earnings trends for the sector, which support relative performance trends.
OVERWEIGHT	COMMUNICATION SERVICES	8.5%	Still ~25% off its highs with improving fundamental and performance trends, we recommend an Overweight while acknowledging the sector may be due for some consolidation after a 35% move year-to-date.
OVERWEIGHT	INDUSTRIALS	8.5%	We want to build exposure to what we believe will be a major theme over the next economic cycle, i.e., US onshoring and infrastructure buildout (AI, semis, EV, etc.). We acknowledge the economic risks ahead, but Industrials' recent price breakout and relative strength, in conjunction with positive earnings trends, support an increased stance.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	28.0%	Fundamental strength and AI enthusiasm are undeniable for Technology, and we would look to accumulate on a pullback. But after a 20+% move over the past two months, the group is at overbought levels. We stay with an Equal Weight, which is still sizable portfolio exposure in the market's largest weighting.
EQUAL WEIGHT	FINANCIALS	12.4%	Liquidity issues and economic uncertainty continue to lead to tighter bank lending, as management teams take a risk-off approach with capital. Valuation is more compelling, but earnings trends remain a headwind to performance.
EQUAL WEIGHT	CONSUMER STAPLES	6.8%	Earnings revision trends have deteriorated lately for Consumer Staples, as pricing power (the main source of its fundamental strength) fades. This warrants a decreased stance in our view, lowering our recommendation to Equal Weight.
EQUAL WEIGHT	ENERGY	4.1%	Downward trending oil prices, resulting in downward earnings revisions, are headwinds to sector performance. Low valuation and still robust free cash flow generation keep us from becoming too negative.
EQUAL WEIGHT	MATERIALS	2.5%	Global economic concerns and the potential for US dollar strength are headwinds to performance. Weak earnings and relative strength trends support a cautious stance.
UNDERWEIGHT	UTILITIES	2.7%	Positive earnings trends, along with our expectations of market volatility ahead, support a more favorable stance to Utilities. However, we prefer Health Care and Consumer Staples as our low-beta, 'defensive' areas for now.
UNDERWEIGHT	REAL ESTATE	2.5%	Tight bank lending and economic concerns place a dark cloud of uncertainty on areas of Real Estate. Valuation is low for the sector, but high leverage ratios and weakening earnings trends lead us to an Underweight recommendation. Weak relative performance trends support this stance.

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

DISCLOSURE

All expressions of opinion reflect the judgment of the author, the Investment Strategy Committee, or the Chief Investment Office 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.

US government bonds and Treasury bills are guaranteed by the US government and, if held to maturity, offer a fixed rate of return and guaranteed principal value. US 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 US 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 indexes mentioned 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 Bloomberg Barclays U.S. Aggregate Bond Index contains approximately 8,200 fixed income issues and represents 43% of the total U.S. bond market.

The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. The JP Morgan Emerging Market Bond Index tracks U.S. dollar denominated Brady bonds, loans and Eurobonds.

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