RAYMOND JAMES

VOLUME 15 | ISSUE 2 | APRIL 2023

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Letter from the Chief Investment Officer

Time Is On Our Side

Start me up! Why would this iconic Rolling Stones song keep racing through my mind? Because it seems like the drivers of this turbulent market—Federal Reserve tightening, inflation, recession worries and geopolitical fears—feel like they will *never stop*. They seem to have more staying power than lead singer Mick Jagger (who turns 80 in July). As we dig deeper into our more optimistic market and economic views, we'll unearth relevant lyrics from some of the Stones' impressive 422-song portfolio to make our case. With equities struggling and interest rates moving higher, investors could be seeking some *emotional rescu*e. But *time is on my side, yes, it is*, for two reasons. First, we believe we are closing in on the end of the equity bear market, peak yields, and Fed hawkishness. Second, we expect investors to be rewarded for enduring the current volatility as it should lead to robust performance for most asset classes in the long term.

The US economy remains resilient, driven by the *wild horses* of consumer spending. While consumers are shifting spending from goods to services, overall spending continues at a healthy clip. But three factors—dwindling excess savings, higher interest rates and softening job creation—should curb growth soon. Despite the outsized job gains in January and February, economic undertones suggest employment gains are already slowing. Withholding taxes' growth has slid lower on a year-over-year basis, companies have begun to lay off employees (particularly in tech-related businesses), and both online and professional recruiters have lamented slackened hiring. Indeed, the unemployment rate could climb near 5% from its current level of 3.6% by year end. Weakened consumer consumption is one reason our economist expects a mild recession in the second half of this year.

Another recession reason: The Federal Reserve (Fed) kept raising interest rates because it *can't get no satisfaction* with inflation until recently. Look for possibly another rate hike in the fed funds rate to 5.25% at the May meeting. The problem is this: Monetary policy acts with a lag of approximately one year. So, much of the economy is just starting to feel the impact of the first interest rate increases from about a year ago. As we progress further into the year, the accumulation of these rate boosts will crimp both capital spending and consumer spending. We've already seen a bit of this *beast of burden* in the Silicon Valley Bank failure. While we believe the SVB fallout will be contained before things go *all the way down*, it's an example of the Fed squeezing ... until things break. This year, there will be little, if any, help from Washington as lawmakers focus on the battle to avoid a government shutdown over the debt ceiling. We believe they'll avert a shutdown at the eleventh hour—as usual.

In bonds, investors have complained for decades that *you can't always get what you want* when it comes to higher interest rates and meaningful income. But wait ... now you can ... with interest rates soaring to levels not seen since 2008. The rate reset has flipped the script to focusing on attractive yields rather than stretching for yield in lower-quality bonds. In addition, improved yields afford investors the ability to balance their portfolios better. But the higher interest rate opportunity probably won't last long. We are still forecasting the 10-year Treasury yield to head lower toward 3.00%. Lower rates will enhance the returns of the sectors we favor, including Treasurys, munis, investment grade, and emerging market bonds. We still shy away from lower-quality high-yield bonds; their yields aren't compensating investors for the threat of a recession.

Equity markets want the Fed and inflation to *get off of their cloud*. Why? Because equities tend to rally when the Fed ends its tightening cycle, inflation decelerates, and interest rates fall. Assuming the Fed doesn't overtighten and take the economy into a severe recession, S&P 500 earnings should remain solid around $215. If anything, the economy's better-than-expected start this year gives us more confidence in the upside potential of those numbers. A weaker dollar, quickly improving supply chains, and easing commodity and labor costs should help support margins. The current decline in equities has likely already priced in a mild recession. When we finally get to the recession, sentiment should turn more positive—as markets anticipate coming out of it. As these factors improve, the S&P 500 should move higher, ending the year at ~4,400. While selectivity remains paramount, given the transi-

Investment Strategy Quarterly is intended to communicate current economic and capital market information along with the informed perspectives of our investment professionals. You may contact your financial advisor to discuss the content of this publication in the context of your own unique circumstances. Published 4/3/2023. Material prepared by Raymond James as a resource for its financial advisors.

tion of the economy, we continue to favor Technology, Health Care, and Financials, among others.

Internationally, we still favor the US over other developed markets. Europe has been like *Jumpin' Jack Flash* in a *crossfire hurricane* given its proximity to the Russia-Ukraine war. Europe has managed to navigate the effects of the war for now, thanks to the warm winter and unprecedented shift away from Russian natural gas. But the euro zone's recovery must survive tighter monetary policy as European Central Bank hawks focus on stubborn inflation and a tight labor market. Higher rates and a housing downturn may expose vulnerabilities in countries geared to shorter-term mortgages. While both the euro zone and the US will likely experience a recession, history suggests American companies are more adept at navigating slowdowns. Emerging market equities remain attractive as China has not yet felt the full boost from its much-touted post-COVID reopening, but the potential for robust growth still exists. If oil reaches our $90/barrel year-end target, Latin American equity indices should benefit.

The last year or so has been challenging for investors, with many assets, from fixed income to equities, still in the red. But we see that red and want to *paint it black*. If our assessment is correct, we are past the bottom in both the equity and fixed income markets, and we'll probably see performance improve into this year and next. Short-term volatility may rattle markets, but a focus on diversification and asset allocation should help guide us through those threats. As always, your financial advisor is there to take the lead or serve as backup to help harmonize your portfolio. Remember: patience and a long-term focus are vital. After 60 years, the Rolling Stones are still touring and filling stadiums—with Mick Jagger singing and Keith Richards still going on the guitar! Like them, focus on continuing success over the long run!

It's only rock 'n roll, but I like it!

Lawrence V. Adam, III, CFA, CIMA®, CFP®
Chief Investment Officer

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Labor Force Participation: Where Did the Workers Go?

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

Labor force participation refers to the percentage of the population who are either employed or actively seeking employment. Overall, labor force participation has declined in the US over the past several decades. Labor force participation for men has been steadily declining since the 1960s, and only the staggering number of women joining the workforce has allowed labor force participation to increase over the years. Labor force participation peaked at 67.3% in 2000, when women's participation also peaked, and steadily declined until 2015, when real wages and salaries seemed to have worked their magic to bring more individuals into the labor force. That is, higher real wages incentivized workers to join the workforce and brought labor force participation up slightly. The COVID-19 pandemic caused a significant drop in labor force participation, we are still 0.8% lower than what it was pre-pandemic, so where did all these people go?

> As of August 2021, there were slightly over 2.4 million excess retirements due to COVID-19, which is more than half of the 4.2 million people who left the labor force from the beginning of the pandemic to the second quarter of 2021.

There are many hypotheses surrounding the whereabouts of the missing workers, and it's unlikely that economists will have a more precise answer for years to come. However, we believe that most of these missing workers are a combination of early retirees, individuals who passed away from COVID-19, those with long COVID, a reduced number of immigrant visas, men/women working from home during the pandemic who resigned and left the workforce once asked to go back to the office, as well as workers whose opportunity cost to return to work outpaced the monetary benefits.

Early Retirees: The stock market rally in 2021 is likely to have boosted retirement savings for many Americans at and about to

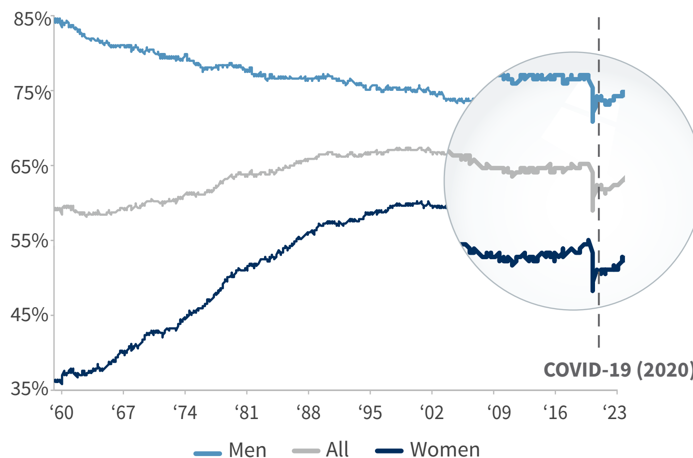
 Endnotes are listed on Page 19.

reach retirement age. This sudden and unexpected boost in wealth has probably allowed many to weigh their options and consider leaving the workforce early. Some people, especially those with pre-existing medical conditions, may have had health concerns about returning to workplaces and catching the virus. On the other hand, others might have just opted to downsize and move to a location with a lower cost of living rather than spending additional years accumulating wealth.

An Economic Synopses publication from the Federal Reserve Bank of St. Louis indicates that "As Baby Boomers began retiring, the percentage of retirees in the US population grew to 18.3% in February 2020, the eve of the COVID-19 outbreak. The percentage then increased at a much faster rate, reaching 19.3% in August 2021."[1] In this research paper, the author estimates that the difference between the 'normal' rate of retirement and the 'excess' retirement rate after February 2020 was higher by about 0.9%. "Based on those numbers, as of August 2021, there were slightly over 2.4 million excess retirements due to COVID-19, which is more than half of the 4.2 million people who left the labor force from the beginning of the pandemic to the second quarter of 2021."

Long COVID: In addition to those who passed away from COVID-19, there are many estimates of how many people are suffering from long COVID and are unable to work. We have seen estimates of this number at between one and five million Americans. Research by the Brookings Institution's Hutchins Center has this number at between 281,000 and 683,000.[2] However, another report from the Brookings Institution in August of 2022 reported that "new data shows long COVID is keeping as many as four million people out of work."[3] However large or small this number is, it is clear that long COVID may be a contributor to today's still low labor force participation rate.

Labor Force Participation



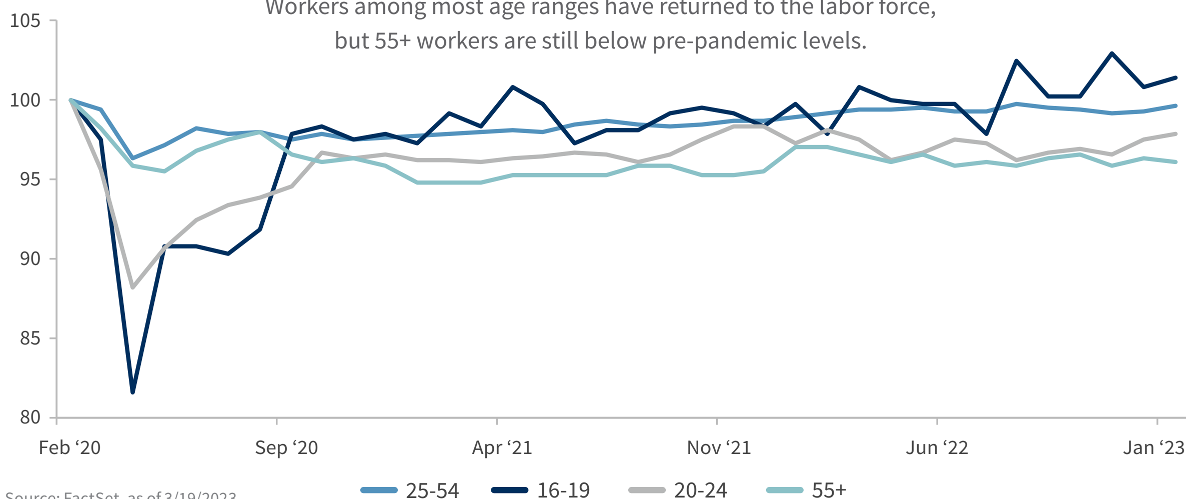
Source: FactSet, as of 3/17/2023

Immigration: The US has issued well over eight million visas yearly between 2012 and 2018. However, the COVID-19 pandemic caused a significant decline in immigrants legally able to work in the US. Overall, in the last three calendar years combined, there have been between eight and ten million fewer legal immigrants added to the workforce.

Opportunity cost: For those who were able to work remotely, returning to an in-person job can be costly, especially for families with young children, older parents, or those in other circumstances where a worker's presence at home would be beneficial.

Older Workers Aren't Coming Back

Workers among most age ranges have returned to the labor force, but 55+ workers are still below pre-pandemic levels.



Source: FactSet, as of 3/19/2023

In fact, sometimes the higher cost of services such as childcare and eldercare wipes out the benefit of having a dual-income household. Additionally, many families enjoyed the flexibility of working from home, and many are having a hard time giving it up. According to the Federal Reserve Bank of St. Louis, "the proportion of the population that reports being out of the labor force because of home care/family care" has increased considerably and has remained high after the end of the pandemic.[4]

WHAT IS THE IMPORTANCE OF THE LABOR FORCE FOR MONETARY POLICY?

A study by economists at the Federal Reserve Bank of Chicago in 2014 concluded that "the results from our models suggest that there may indeed be greater slack in the labor market than is signaled by the unemployment rate."[5] The importance of this finding at the time was that "the existence of such extra slack might imply that it would be appropriate for monetary policy to remain highly accommodative for longer than would otherwise be the case." In fact, the view that there was a larger labor slack during the pre-COVID-19 pandemic period kept the Fed highly dovish even in the face of very low rates of unemployment, as this greater slack in the labor market reduced the possibility of experiencing increases in wages and salaries that would have jeopardized the pursuit of the Fed's inflation target of 2.0%.

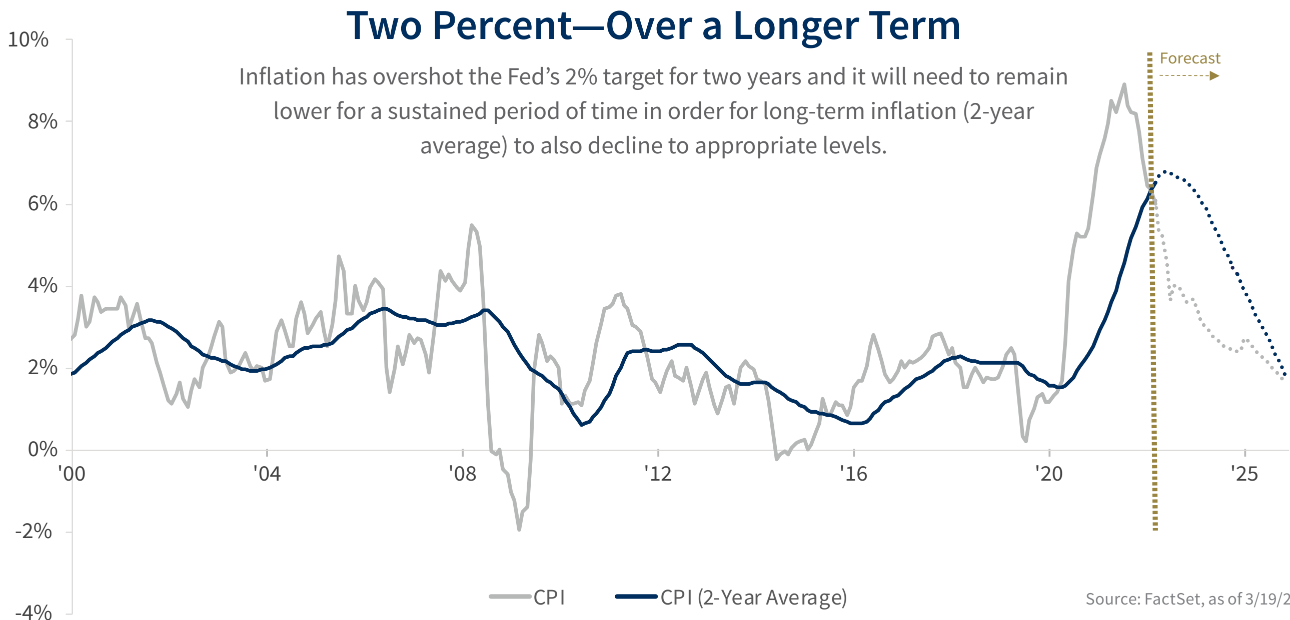
Today, the question of whether there is more or less slack in the US labor market is one of the most consequential questions for monetary policy going forward, as it will determine how high and for how long the Fed is expected to remain hawkish/dovish on the inflation front.

> We expect the Fed's stance to remain hawkish for longer, rather than return to a more accommodative stance.

New research has been published since the start of the COVID-19 pandemic addressing the potential changes that occurred in the US labor force. One of these papers, published in 2021 by economists at the Federal Reserve Bank of San Francisco and titled "The Divergent Signals about Labor Market Slack," argued that "The COVID-19 pandemic has disrupted the US labor market, causing unprecedented deviations from the normal historical relationships among a wide range of labor market variables. Indicators related to the manufacturing and small business sectors as well as to overall labor turnover suggest that there is less slack in the labor market than is reflected in the unemployment rate. By contrast, measures of labor force participation and the duration and reasons for unemployment all show more slack than the unemployment rate."

Another research paper concentrated on the effects of the Great Resignation on labor market slack and inflation, concluding that "by applying for jobs in a different firm, employed workers can spur wage competition between the current employer and prospective employers. As a result, labor becomes more expensive to retain or to hire, effectively corresponding to a tighter labor market from the perspective of employers."[6]

Meanwhile, economists at the Dallas Federal Reserve wrote a research paper that also pointed to a tighter labor market than



Source: FactSet, as of 3/19/2023

before the COVID-19 pandemic, saying that "Many employers throughout our district report that they are struggling to rehire former employees as the economy reopens, as many of their former employees are reluctant to return to their old jobs."[7] The research points out that these factors will probably fade out in the future but that this is not guaranteed.

The Fed has allowed the rate of inflation to overshoot its 2% target for two years and they need to push this 'over the longer-run' average down as fast as possible. In fact, as we have said before, the Fed will probably have to undershoot the 2.0% target on inflation for several years in order to achieve its 2.0% target 'over the longer run.' Thus, one of the factors potentially threatening this strategy is the strong US labor market. For this reason, we expect the Fed's stance to remain hawkish for longer, rather than return to a more accommodative stance in the short to medium term. Although many of the reasons for individuals not coming back into the labor force are almost impossible for policymakers to affect, the immigration issue is one of those partial solutions that could help increase the labor force participation rate and is in the purview of the political establishment to achieve.

KEY TAKEAWAYS:

- Labor force participation refers to the percentage of the population who are either employed or actively seeking employment. Overall, labor force participation has declined in the US over the past several decades.
- The COVID-19 pandemic caused a significant drop in labor force participation, we are still 0.8% lower than what it was pre-pandemic, so where did all these people go?
- Most of these missing workers are likely a combination of early retirees, individuals who passed away from COVID-19, those with long COVID, a reduced number of immigrant visas, and those who worked from home during the during the pandemic and don't want to return to the office.
- The question of whether there is more or less slack in the US labor market is one of the most consequential questions for monetary policy going forward, as it will determine how high and for how long the Fed is expected to remain hawkish/dovish on the inflation front.

Competition and Conflict: Market Impacts of Rising Geopolitical Risk

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

Markets are navigating a new global era. US-China tensions, COVID, and the war in Ukraine have highlighted that geopolitical risks are on the rise and becoming a more prominent part of the macro investment decision-making process. February 24 marked one year since Russia's invasion of Ukraine, prompting policymakers and investors to take stock of how the conflict has progressed, how it could begin to wind down, and what risks remain. The COVID-19 pandemic exposed domestic capability/production gaps, increasing focus on resiliency (and changing US industrial policy). The US-China relationship has raised concerns about a 'new Cold War' and a decoupling of the world's two largest economies. These national security issues have been increasingly difficult for investors to manage and deserve continued attention.

RUSSIA-UKRAINE WAR

A new major land war in Europe has renewed concerns over 'great power' conflicts versus the regional threats that the world and markets have navigated in the post-World War II era.

An optimistic assessment sees the war de-escalate toward a potential ceasefire and the beginning of a resolution process around the third quarter, but we caution that the first half of this year will continue to see a heightened risk of escalation. ...

Looking back over the last year, the war's macro impact on the market and global economy has elevated geopolitical risk premiums and threatened disruptions for key global commodities. The two most impacted areas have been energy and defense—a trend we expect to continue. As we move into year two, attention will focus on whether an off-ramp becomes clearer and market pressures ease, or if the larger geopolitical risk premium is here to stay. An optimistic assessment sees the war de-escalate toward a potential ceasefire and the beginning of a resolution process around the third quarter, but we caution that the first half of this year will continue to see a heightened risk of escalation that can drive periods of volatility.

Ukraine's armed forces have reclaimed about 50% of territory captured by Russia. The success and stability of Ukraine's defense—

which was not a given at the start of the war—has prompted western nations to increase their support for Ukraine's military and economy with total US support reaching around $113 billion (about 0.5% of US GDP). However, we view the spring and summer as a potential turning point in the war. Advancements by both sides are expected to slow substantially, potentially settling into a frozen conflict on the nearly 600-mile front in eastern Ukraine. Should this occur, the question for markets will be whether conditions support the start of a resolution process. Recent headlines have indicated that western leaders are beginning to plan around a post-war scenario, and the key factors that could form an off-ramp are twofold:

1. *Will Ukraine and western allies see any move toward a peace settlement as durable and sustainable?*

2. *Will Russian president Vladimir Putin assess that the costs of continuing the war outweigh the benefits?*

Both of these factors support a period of heightened escalation potential ahead before any off-ramp becomes a clearer possibility. Ukraine and the western coalition will look to increase the costs for Russia to deter similar action in the future, and Russia is likely to challenge western unity and solidify control over currently occupied territory to increase its leverage in any settlement negotiations. This generally positions the first half of this year as an 'escalate to de-escalate' setup—a military strategy term which can be adopted to fit the trajectory of the conflict. We would expect market volatility at the beginning of any escalation, but any off-ramp would be viewed as a market positive.

It is also important to consider less optimistic paths. The two more concerning possibilities include a protracted war that continues to place a drag on global economic growth and an expansionary conflict that sees a direct confrontation between NATO forces and Russia. A principal Russian goal would be to degrade support for Ukraine among western allies. An environment of persistent inflation, mounting domestic fiscal challenges, and no end in sight to the conflict could weaken unity among western allies and ease Russia's path toward heightened regional power. A more escalatory path to the conflict involves a decision by Russia's policymakers that a war lost to NATO directly is less damaging to the stability of the Putin regime than losing a war to Ukraine. While this path may be unlikely at this stage, the range of possibilities related to the conflict warrant continued caution given the level of uncertainty ahead.

Even as markets look to a potential post-war scenario, we expect certain sector impacts to be longer lasting. Particularly, energy and defense trends are undergoing a structural transformation driven by the longer-term policy implications of the war. For energy, part of the war's impact has been an expansion of national security concerns around economic linkages from advanced technology prior to the invasion to include legacy and mature sectors with high concentration risk. Oil, natural gas, and energy infrastructure are likely to see persistent policy impacts as the availability and expansion of these economic inputs is more acutely seen as a core national security interest. This trend is likely to drive new investments into securing and diversifying energy supplies with a focus on avoiding concentrations that could lead to future vulnerabilities, such as with critical minerals for renewables technologies.

Energy and defense trends are undergoing a structural transformation driven by the longer-term policy implications of the war.

On defense, global military spending will be on a longer-term growth trajectory as governments invest in military capabilities to deter new wars and conflicts among nations. The Biden administration's recent National Security Strategy describes the decade ahead as "a significant inflection point" that sees renewed tensions between global powers. From a US standpoint, investment in defense will particularly be driven by the desire among policymakers to project a credible degree of capability for the US to defend its security interests in multiple hotspots as this global competition increases. A recent expansion and escalation of tensions with China will be a further tailwind for increased defense spending, in our view. A lesson learned from Russia's invasion of Ukraine is that the threat of severe economic sanctions is not sufficient as a means of deterrence, which will place renewed emphasis on military power as a critical national security consideration.

US-CHINA RELATIONSHIP

Economic competition between the US and China is here to stay, with the Biden administration taking a wide-reaching approach to its "competition, not conflict" China agenda. Bilateral relations deteriorated ahead of a long-awaited trip by Secretary of State Anthony Blinken to China following the discovery of a Chinese-operated balloon in US airspace, which was postponed as bilateral tensions increased. The Chinese government additionally ratcheted up its criticism of US tech restrictions, describing the policies as "containment, encirclement, and suppression." These developments point to the US and China entering a period of heightened tensions and an increasingly combative tone in the bilateral relationship, elevating the risk level around potential

> “China-related legislation has picked up in activity in recent months, serving as one of the few areas of bipartisan compromise in the new Congress. ...”

future flashpoints such as maritime accidents in the Taiwan Strait or South China Sea.

Priorities for the Biden administration in its “competition, not conflict” agenda have included export control agreements, industrial policy, and an upcoming screening mechanism for US investments in China. International coordination has been a major theme of the administration’s strategy, with the US striking agreements with the Netherlands and Japan respectively for a multilateral export control regime targeting China’s access to advanced semiconductor manufacturing technology as a key milestone—which could limit the addressable market and lower revenues for global equipment providers. During the release of the first round of applications for $39 billion in semiconductor manufacturing incentives, the administration further stressed the importance of cooperating with allies as part of a broader vision to make the US into a global leader in semiconductor production and innovation. Recipients of the funding will have to comply with new rules that prevent most forms of investment in China-based semiconductor manufacturing capacity. On a broader level, a long-awaited outbound investment screening mechanism is expected to be released in the coming months, which would regulate certain outflows of US investment into China. Regulating outbound investment in this manner is uncharted waters for the US and would introduce a level of uncertainty to cross-border capital flows; Congress is working on parallel legislation to clarify the details of the review.

In Congress, China-related legislation has picked up in activity in recent months, serving as one of the few areas of bipartisan compromise in the new Congress; however, differences in priorities and implementation may slow the progress of bills. TikTok has been in the spotlight as a core focus for China-related legislation, with a flurry of bills being filed since the new Congress began in January—including a House Foreign Affairs bill that passed out of committee on party lines and newly-introduced Senate legislation with backing from the White House. Impacts are likelier to be seen in the longer term rather than immediately, but the momentum highlights the increasingly critical stance that Capitol Hill is taking on Chinese tech—and the potential secondary impacts for the technology sector at large.

KEY TAKEAWAYS:

- Geopolitical risks are on the rise and becoming a more prominent part of the macro investment decision-making process.
- Oil, natural gas, and energy infrastructure are likely to see persistent policy impacts as the availability and expansion of these economic inputs is more acutely seen as a core national security interest.
- A lesson learned from Russia’s invasion of Ukraine is that the threat of severe economic sanctions is not sufficient as a means of deterrence, which will place renewed emphasis on military power as a critical national security consideration.
- Economic competition between the US and China is here to stay.

Debt Ceiling Primer

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

The debt ceiling is back in the spotlight after the US government hit its statutory borrowing limit earlier this year. While there are steps the government can take to continue paying its obligations, these measures only extend for a limited amount of time. Unless policymakers can agree to raise, suspend, or eliminate the debt limit soon, the government could run out of cash to pay its bills as early as this summer. Failure to reach an agreement would have serious economic consequences, including the risk that the US government defaults on its debt. The stakes are high, and it appears likely that our deeply divided government is headed for another debt-ceiling showdown. Divided governments have typically been good for the markets; however, they often spell trouble when it comes to negotiating fiscal matters.

INTRO TO GOVERNMENT FINANCES

Everyone has bills to pay, and that includes the federal government. The government collects revenue through a variety of taxes and uses the funds to pay for everything ranging from Social Security, healthcare, military spending, education and other priorities established by Congress. When the government collects enough revenue to cover its spending, it runs a budget surplus. Conversely, when it does not collect enough revenue to cover its spending obligations, it runs a budget deficit. For the last two decades, the US government has been running a budget deficit. In fiscal year 2022, the government spent ~$1.4 trillion more than it collected. The Treasury Department is authorized to cover the budgetary shortfall by issuing new debt. The cumulative amount of money the government has borrowed over time is referred to as the national debt. The US national debt has exploded over the last 20 years, rising from $6.4 trillion in 2003 to $31.4 trillion today.

WHAT IS THE DEBT CEILING?

The origins of the debt ceiling can be traced back to 1917 when the US was in the midst of World War I. The new law was initially created to simplify the process of issuing debt to fund war operations. In 1939, Congress established an aggregate debt limit, which has been routinely increased or suspended over the years. Since the 1960s the debt ceiling has been raised 78 times. The purpose of the debt ceiling is to establish a maximum amount of

debt the US government can have outstanding. Once the limit has been hit, the federal government cannot increase the amount of outstanding debt until Congress authorizes a new debt limit or suspends it for a period of time. Adjusting the debt ceiling has historically been a routine matter that did not garner much media attention or rattle the markets; however, in recent years it has turned into a political hot button. The most notable confrontation, which pushed the US close to the brink of default, occurred in 2011. Past debt-limit showdowns have typically occurred when there is a Democrat in the White House and Republicans have control of Congress.

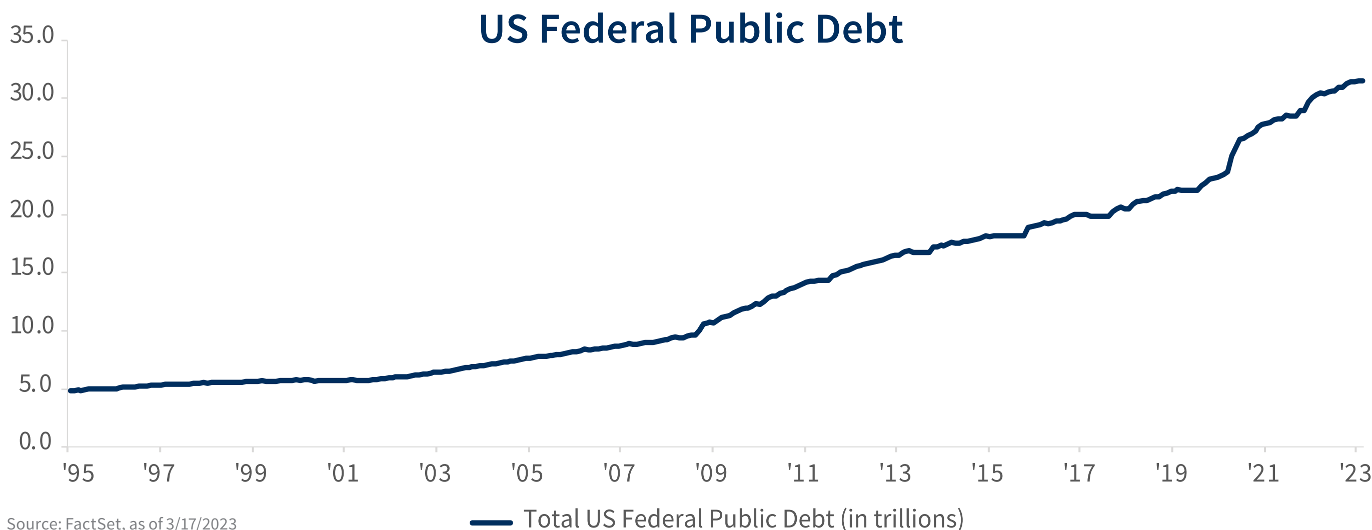
WHAT'S BEHIND THE CURRENT IMPASSE?

The US government is on an unsustainable fiscal path, with debt and spending growing at an alarming pace. With the huge inflation spike the US experienced last year, fiscal discipline is back on the radar again. House Republicans have made it clear that they intend to push the current administration for budget concessions in exchange for raising the debt limit. Warnings from Treasury Secretary Janet Yellen, Federal Reserve Chair Jerome Powell and other high-profile economists about the potential consequences of not raising the debt limit have thus far been ignored. The White House refuses to negotiate as it wants to pass a clean debt limit increase—that is, not tying an increase in the debt limit to the current budgetary process. This is a key point as raising the debt limit is not about new spending, but rather a legislative procedure that allows the government to finance past spending that has now come due. With neither party showing a willingness to negotiate or budge from their positions, it appears likely that we are heading for another showdown in the months ahead. This is important because as we get closer to the 'x' date—the date the US government would officially run out of money—the closer the US gets to defaulting. If this were to happen, it would send shockwaves through the financial markets.

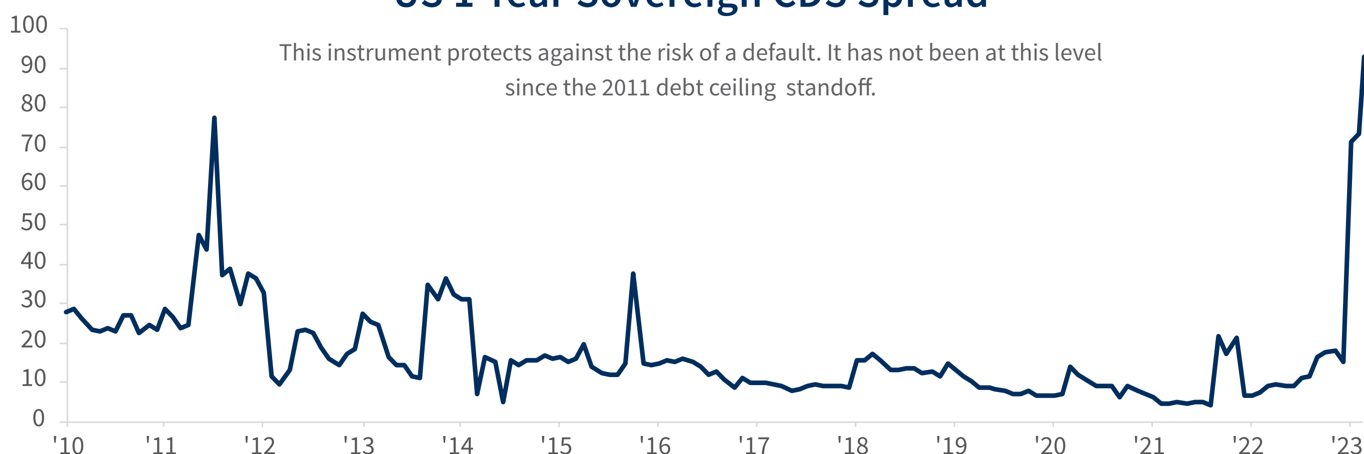
> The debt limit is not about new spending, but rather a legislative procedure that allows the government to finance past spending that has now come due.

POTENTIAL CONSEQUENCES FOR NOT RAISING THE DEBT CEILING

The US government has never defaulted on its debt; however, the market is getting increasingly concerned about the possibility. This is most evident by looking at the US 1-year Sovereign Credit Default Swap Rate (CDS), which protects against the risk of a default. It has spiked to a level last seen in the 2011 debt ceiling standoff. In 2011, the political battle pushed the US the closest it has ever been to defaulting on its debt. The uncertainty created by the political brinkmanship sent the financial markets into a tailspin. With no



Source: FactSet, as of 3/17/2023



Source: FactSet, as of 3/17/2023

agreement in place and the calendar getting very close to that 'x' date, US equities plunged nearly 15% in just a matter of weeks. The uncertainty spilled over to the international equities markets, which fell nearly 30% while the drama was unfolding in the US. The dysfunction in Washington also led to a downgrade in the US' sovereign debt rating. The market volatility was a key factor that drove the political parties to the table to forge an agreement.

Only time will tell if history is going to repeat itself, but the stakes are high leading into this year's debt negotiations. The rating agencies have warned that a default would be a catastrophic blow to the US economy, raising borrowing costs across the board and negatively impacting the broader asset classes. And, with US Treasury debt considered the world's benchmark safe asset, uncertainty about the 'full faith and credit' of the US government would have significant spillover into the international markets.

CONCLUSION

We have been down this road many times before and if history is any guide, lawmakers will eventually strike a deal and raise the debt ceiling. There really isn't another option, unless there is political will to repeal the debt ceiling law that was established in 1917. Given the deep political divides, it appears we'll follow a similar track to 2011, where a debt limit agreement is reached, but at the last possible moment. Since we are still months away from the "x" date, the impact on the financial markets has been limited. But, as we draw closer to the "x" date, market turbulence is likely to pick up. However, past experience indicates it will likely be short-lived.

If history is any guide, lawmakers will eventually strike a deal and raise the debt ceiling. There really isn't another option. ...

KEY TAKEAWAYS:

- The US government has hit its statutory borrowing limit.
- The debt limit is not about new spending, but rather a legislative procedure that allows the government to finance past spending that has now come due.
- Failure to reach agreement on the debt limit has serious, potentially catastrophic consequences for the financial markets.
- We expect that in the end, lawmakers will strike a deal and raise the debt ceiling; however, they will likely wait until the last possible moment.

Q&A: Earnings, and Multiples, and Performance, Oh My

J. Michael Gibbs, *Managing Director,* Gibbs Capital Management*
Joey Madere, CFA, *Senior Portfolio Analyst,* Gibbs Capital Management*

The Price-to-Earnings (P/E) multiple is a key valuation metric in equity market analysis: a company's share price compared to its earnings per share. Despite predicted downside for earnings in the months ahead, we believe the Fed will be successful in its battle against inflation and that P/E multiples will expand by year-end 2023. This will be the driver of higher equity markets. However, much depends on the path of inflation, Fed policy, and the economy.

Q: Let's start with S&P 500 earnings—where do you think they finish 2023?

A: Due to our expectations of a mild economic recession later this year, we believe that earnings will be lower than in 2022 and use a $215 base case estimate. Bottom-up consensus estimates have been drifting lower (toward our estimate) since mid-2022 as companies guide toward uncertainty and economic weakness. This is a trend that we believe will continue and risks skew to the downside on our estimates, as earnings decline in recessions (by an average of -22% historically).

Q: If earnings contract this year, will S&P 500 market returns be negative?

A: Not necessarily—market returns are a function of earnings and valuation (what investors are willing to pay for those earnings). It is important to remember that stocks discount the future. Valuation multiples have already compressed considerably on expected earnings weakness, and valuations also often bottom well ahead of the economy and fundamentals. For example, earnings typically bottom eight to nine months *after* a recession ends, whereas the market has bottomed two to six months *prior* to recession end. So, multiple expansion can drive positive market returns despite lower earnings—which is our expectation and has been the case coming out of recessions historically.

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Q: Tell me more about P/E multiples—where do you think they go by year end?

A: The degree of inflation moderation, central bank policy, and ultimately how much damage is inflicted on the economy (in order to bring inflation lower) will be significant influences on markets in 2023. We believe that the Fed will be successful in bringing inflation down, but it will take time and likely economic weakness to do so. As investors eventually gain a degree of clarity on inflation and the economy, valuation multiples will start increasing in our view, but that clarity will be a lumpy process with corresponding market volatility along the way. Due to our expectation that markets will be climbing by year end, we use a ~20x P/E in our ~4,400 year-end S&P 500 target.

Q: How have the recent banking concerns altered your view?

A: To be sure, the news ratchets up risk in the short-term, and there may be other players that come under pressure. Unprecedented policy (during COVID and post-COVID) runs the risk of unintended consequences—and we're seeing some of that now. But importantly, these liquidity issues are coming on 'money-good' bonds, not widespread defaults. Liquidity is much more easily solved than credit worthiness. Additionally, central banks have been quick to respond/add support, which should reduce concerns of widespread contagion. In the aftermath, bank lending is likely to tighten even further, which increases the already high likelihood of economic weakness to come. That said, a silver lining for equities may be that financial conditions are tightening for the Fed right now—shifting up the timeline for an end to the Fed's tightening cycle. And a market that has been highly sensitive to Fed policy may find support from easier policy down the road.

Q: What does that mean for equity markets in the shorter term?

A: We expect choppy trading over the coming weeks and months, as investors digest the economic dataflow and sentiment swings may occur due to elevated uncertainty on inflation, Fed policy, and ultimately economic growth. The highest odds are that the normalization process (from pandemic/record stimulus) will create confusing data along the way with upside runs and pullbacks to follow for equities. Until we get some clarity regarding inflation and the economy, a market run to new all-time highs is a low probability.

Q: Why aren't you more negative?

A: On the one hand, you have an economic and earnings backdrop that will weaken. But on the other hand, stocks have already pulled back significantly. On average, recessionary bear markets go down 33% over 13 months, and this bear market has declined 25% over the last 14 months. Additionally, equities have regained prior highs out of recessions on average 23 months following a bottom—a

COMPANY A

Price per share: $24 | Earnings per share: $2

PE Ratio Formula = Price per share: **$24** / Earnings per share: **$2**

PE Ratio (Multiple) = **12x P/E**

> “Multiple expansion can drive positive market returns despite lower earnings ... ”

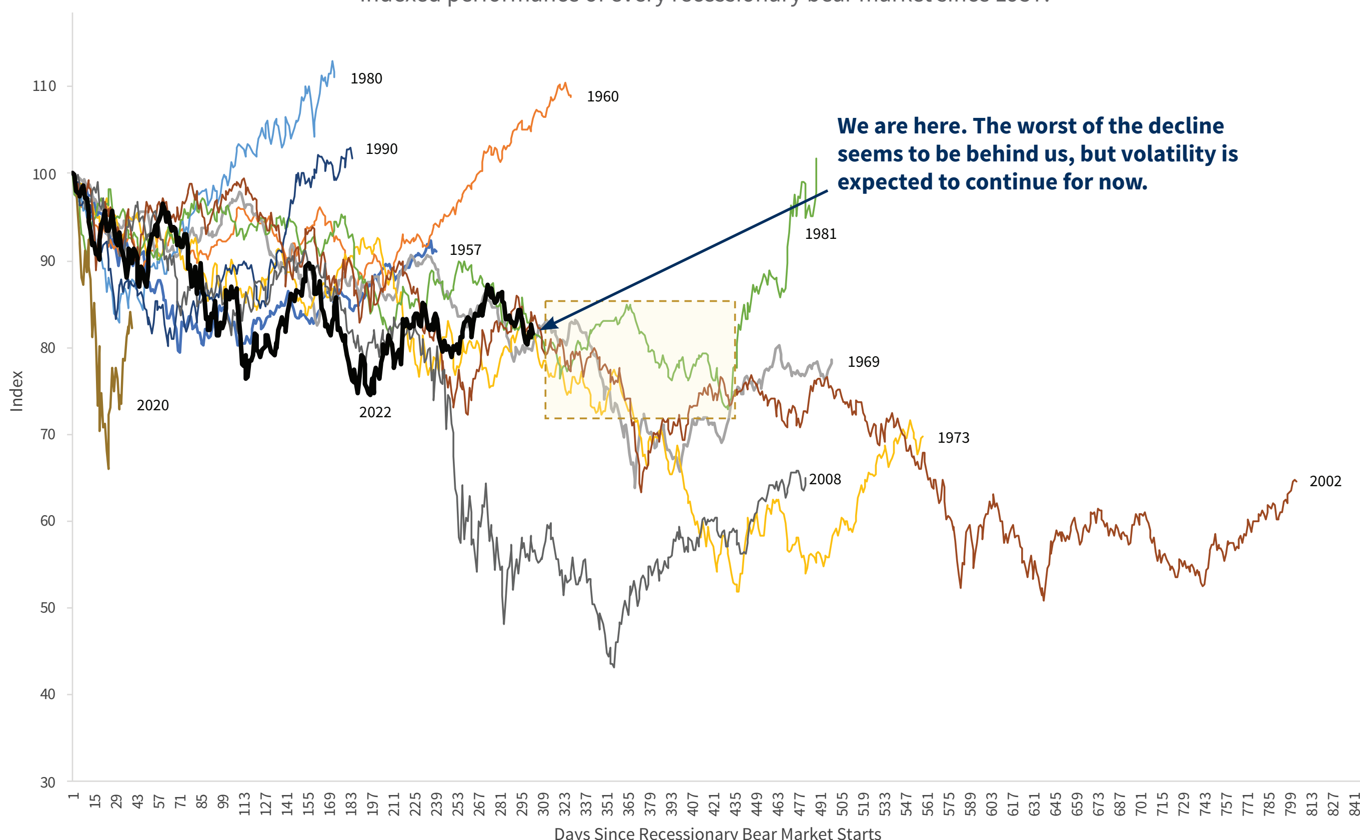
bottom that typically comes when the news is the worst. Importantly 5- and 10-year inflation expectations have declined to the 2-2.5% range recently (recessions are deflationary), which has been consistent with the highest P/E multiples historically—a positive for long-term potential equity values. Therefore, despite the likelihood of increased volatility and potentially more downside, we remind investors to not lose focus on their long-term goals. We firmly believe that equities will once again print new highs at some point when the dust settles, as they have following every recession over time.

Q: How should investors be positioned?

A: Given our belief that the bear market is in its later stages but also that a V-bottom is unlikely at this time, we recommend investors use drawdown periods as opportunities to accumulate favored areas and stocks within a long-term perspective. Use partial positions to build exposures as the trends evolve and further information is gained on inflation, Fed policy, and the economy. We acknowledge that volatility is likely to persist so investors will want to exercise some patience and pragmatism in positioning. But, we also do not want to lose sight of the next bull market at this stage of the bear market. Bear markets can go down ~33% over one year or so on average, but bull markets can appreciate 152% and last four to five years.

Recessionary Bear Markets

Indexed performance of every recessionary bear market since 1957.



Source: FactSet, as of 3/17/2023

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. Performance based on the S&P 500, an unmanaged index of 500 widely held stocks that is generally considered representative of the US stock market.

Economic Snapshot

EUGENIO J.ALEMÁN, PhD
Chief Economist

After several years of fiscal largesse due to the efforts to minimize the effects of the COVID-19 pandemic, the Fed embarked on a campaign to increase interest rates in an effort to slow down economic activity. This fiscal largesse plus the closing of the economy during the pandemic-generated excess demand and produced levels of inflation not seen since the 1980s. However, while higher interest rates have slowed the most interest-sensitive sectors of the economy like investment, and especially investment sectors linked to the housing market and manufacturing, the service side of the US economy has continued to expand. This has kept the US labor market strong, and provided continued strength to income, especially as inflation, which hit a 40-year high by mid-2022, slowed down to about 6% by February of this year. But while the Fed's interest rate hikes have not been able to slow down the service sector, they seem to have created strains in the banking system, as bad investment decisions at several banks have increased concerns about financial stability, resulting in the FDIC and other regulatory institutions stepping in to contain any potential damage. Furthermore, these strains seem to have spilled over into international markets as long-standing issues with one international bank also pushed Swiss regulators to broker a deal to save Credit Suisse, the second largest bank in Switzerland.

	ECONOMIC INDICATOR	COMMENTARY
NEUTRAL	GROWTH	GDP growth is expected to continue to moderate over the next several quarters and we expect a recession to start in 3Q23.
NEUTRAL	EMPLOYMENT	Nonfarm payrolls have remained strong during the first months of the year, with other labor market indicators also showing a still tight labor market.
NEUTRAL	CONSUMER SPENDING	Consumer spending has remained relatively strong, supported by a very tight labor market and slowing inflation, and complemented by still-strong credit card lending. However, we expect credit card lending to start slowing down in the coming quarters.
NEUTRAL	BUSINESS INVESTMENT	Interest rates will continue to negatively impact the strength of business investment in 2023.
NEUTRAL	INFLATION	We expect inflation to continue to slow down as economic activity continues to weaken. Furthermore, we expect shelter costs, which continue to be elevated, to help the disinflationary process, starting in the second half of 2023.
NEUTRAL	LONG-TERM INTEREST RATES	The yield curve recovered from its deepest inversion in over four decades as the market anticipates the Fed's tightening cycle is coming to an end. This has driven yields across the curve significantly below their recent peak. We expect yields to grind lower as slower growth and declining inflation pressures allow the Fed to pivot to an easier monetary policy stance, which we expect in early 2024.
NEUTRAL	FISCAL POLICY	Contributions to GDP from government spending this year are unlikely to change significantly, while we remain concerned about the coming fight to raise the debt ceiling.
NEUTRAL	THE DOLLAR	The US dollar has weakened somewhat compared to the levels experienced last year but differences in inflation as well as interest rates between the US and the rest of the world will help keep the US dollar from weakening too much from current levels.
NEUTRAL	REST OF THE WORLD	We continue to expect a weakening global economy during 2023 as central banks continue to increase interest rates. The only exception will be China, which is trying to boost demand by expanding monetary policy after abandoning its 'Zero COVID' policy late last year.
UNFAVORABLE	MANUFACTURING	Manufacturing production has been weakening for some time, and we expect this weakness to continue. We expect manufacturing to weaken further in the coming quarters.
UNFAVORABLE	HOUSING AND RESIDENTIAL CONSTRUCTION	Although some sectors of the housing market have stabilized and are no longer falling, we expect the sector to remain weak in the coming quarters as interest rates and affordability reduces the pool of potential buyers.
UNFAVORABLE	MONETARY POLICY	The Fed has likely one more hike to go this year, which will bring the terminal rate to 5.25%. Contrary to the market, we believe that the Fed will hold rates steady at restrictive levels for the remainder of 2023.

Sector Snapshot

J. MICHAEL GIBBS
Managing Director, Gibbs Capital Management*

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:

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	14.5%	We value Health Care's defensive qualities (0.64 beta) given our expectation of choppy trading ahead for the general market. Valuation is also cheap—trading at a 16x P/E which is near the lower end of its 10-year range.
OVERWEIGHT	FINANCIALS	13.0%	Banking concerns have flared up of late, leading to outsized pressure on the Financials sector. While risks ratchet higher (and other players may be exposed), we view the issues as narrow in nature for now. Additionally, liquidity issues on 'money-good' bonds are more easily solved than widespread defaults—and the government appears set to support these liquidity issues as needed. After such a sharp decline in a short period of time, we stick with our current recommendation for now.
OVERWEIGHT	CONSUMER DISCRETIONARY	10.0%	Improved relative earnings trends are supporting improved relative performance for Consumer Discretionary stocks. Valuations are also reasonable (in line with pre-pandemic for the average stock). While the group's higher beta may lead to volatile periods, we believe the sector can outperform over the next 12 months and would accumulate on weakness.
OVERWEIGHT	COMMUNICATION SERVICES	8.1%	Valuation is coming from record lows and being accompanied by improved estimate revision trends. Many of the most prominent names in the sector saw their earnings' estimates tick higher in the Q1 earnings season, resulting in the first relative earnings improvement for the sector in two years. We believe this provides a more supportive backdrop for performance and with the sector still ~35% off its highs, we recommend an increase in exposure.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	25.8%	Technology has performed well to start the year with outperformance coming from the semiconductors (often a good leading indicator for intermediate-term sector and market performance). However, relative earnings trends have not improved to the same degree as price, and valuation is relatively elevated. The sector has also performed well in the recent bank volatility. If things calm down and interest rates tick higher, Tech may consolidate some of its recent gains.
EQUAL WEIGHT	INDUSTRIALS	8.7%	The historical influence of declining ISM new orders on performance gives us some pause for the sector broadly, but good fundamental and price performance from the sector's largest industries (i.e., machinery and aerospace & defense) are supportive. Sideways relative strength trends over recent months supports our Equal Weight stance.
EQUAL WEIGHT	ENERGY	4.5%	Capital discipline and oil prices continues to support strong free cash flow generation. Additionally, valuation is attractive—EV/EBITDA of 5x is well below the 7-8x historical average and FCF Yield of 12.5% is over twice as high as the next closest sector. However, oil prices have pulled back significantly over the past year, relative earnings trends are rolling over, and after two years of significant outperformance, the sector is likely to at least slow down in 2023.
EQUAL WEIGHT	MATERIALS	2.6%	Valuation is below average (9.4x EV/EBITDA vs 10x 10-year average), but earnings estimates are still trending sharply lower (a headwind to performance). Additionally, the US dollar has been a strong inverse influence on performance historically and its trend is becoming more sideways in our view.
EQUAL WEIGHT	REAL ESTATE	2.5%	Real Estate is 30% off its highs, and valuation (P/FFO) is at the lower end of its 10-year range (17.2x P/FFO vs. 21x 10-year average). This grabs our attention; however, higher leverage ratios are a headwind in volatile markets. Weak price and relative strength trends support our cautious stance.
UNDERWEIGHT	CONSUMER STAPLES	7.3%	Consumer Staples have given back some of 2022's outperformance to begin 2023. While the low-beta sector has held up better in the recent pullback and likely will do so in volatile periods, we find other areas more compelling over the next 12 months. Valuation is expensive and the sector's relative strength has become more sideways since mid-2022.
UNDERWEIGHT	UTILITIES	2.9%	Utilities have given back relative performance to begin 2023, as the market rotated towards 2022's more beaten-up areas. While the group's low beta may provide support in volatility, valuation is expensive and we are more interested in other areas at this stage of the bear market.

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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.

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

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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.

END NOTES

Labor Force Participation: Where Did the Workers Go?

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