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INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

The Evolution of Markets: Scarier Than Jurassic Park?

Steven Spielberg's sci-fi thriller *Jurassic Park* celebrates its 30th anniversary this year. An awe-inspiring technical marvel, it used computer-generated imagery to bring dinosaurs back to life. Three decades later, we're bringing them back to life as we borrow the film's memorable scenes—and some scientific and prehistoric concepts—to articulate our ten investment themes for 2023.

In the film, mastermind John Hammond collaborates with scientists to construct Jurassic Park—an island populated with genetically-engineered dinosaurs. As the state-of-the-art facility nears completion, its investors fret about the safety and viability of the park. To assuage these fears, a group of paleontologists are recruited for a tour. When the touted safety measures fail, the predators break free and begin to hunt the group.

What does that have to do with the economy and financial markets? Granted, these days there are plenty of concerned investors. But we're focusing on the theme of evolution instead: the ebb and flow, contraction and expansion that breeds stronger economies and financial markets over time. These natural shifts in the investment landscape present new situations to adapt to, but that also means there are new opportunities to discover. As we unearth our ten themes for 2023, we'll link each to a prehistoric or archaeological idea, but the implications are very relevant for today—and tomorrow. It's better to be prepared than petrified.

1 Months in the Making: A Mild Recession

Back then, they promoted *Jurassic Park* as "*An Adventure 65 Million Years in the Making*." It may seem like the looming recession has taken that long to develop, too. Economists, CEOs, consumers, and the media have been ringing the recession alarm for months. It might be the most telegraphed recession in history. Our base case is that the economy will experience a mild recession this year. But whether GDP is slightly positive, slightly negative, or flat (our estimate is 0.0%), there will still be plenty of adventure in *Investment Park*. Because of aggressive tightening from the Federal Reserve (the Fed), there is already a *power outage* in the more sensitive areas of the economy, such as housing, transportation, some retail, and even parts of tech. There are some glimmers of light: strong consumer fundamentals (e.g., excess savings, job openings) are acting as a buffer. Still, dwindling savings and weakening labor market conditions will stall the momentum of the economy by midyear. But at the risk of sounding like the scientists who doubted the possibility of the dinosaurs' escape, we believe that the contraction will be contained. That's because the on-going industry-specific 'rolling recessions' have already absorbed some of the downturn.

2 Fed Is the Predator, Inflation the Prey: But the Hunt Ends Soon

Like a *velociraptor clutching its prey*, the Fed is grappling with inflation. Fed rate hikes haven't been as swift as the predator's *sickle claws*, but the 425 basis point squeeze has been the most aggressive tightening since 1980. With the keen edge of the Fed's policy cutting into demand, inflation won't be at the *top of the market-risk food chain* for much longer. Prices for commodities, goods, and ser-

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> *"These natural shifts in the investment landscape present new situations to adapt to, but that also means there are new opportunities to discover."*

vices have already started to falter, and the pressures on food and shelter costs should *decompose* in the months ahead. But although the Fed is *battling the inflation beast*, a weakening labor market, and excessive speculation, that does not mean it *has the appetite* for rate cuts just yet. After pushing rates to an ~5% peak, the Fed is more likely to pause the pursuit than pivot by year end.

3 Our Chaos Theory: Reduced Volatility Ahead

On a tour of Jurassic Park, pessimist Dr. Malcolm shares his belief in *chaos theory*. In short, he suggests that things happen in an unpredictable fashion and that the next unpredictable event is just around the corner. Between a pandemic and a war, the last few years feel like the epitome of this dizzy thesis. Not to mention the COVID flare at the start of the year, economic troubles in China, and, of course, inflation and the risk of a recession. It's no wonder the S&P 500 saw the most 1% swings since 2008 and the 60/40 portfolio had its most volatile year since 1987. But the worst case scenario for many risks has already been priced in. The Russia-Ukraine war is no longer a daily front page story, the midterm elections are behind us, and China appears set to dismantle its zero-COVID policy. Therefore, it's likely that some positive developments will help put the volatility monster *back in the cage* in 2023.

4 Endangered or Extinct: Globalization Won't Go the Way of the Dinosaurs

What killed the dinosaurs? Was it an asteroid? Disease? Either way, we won't be *debating the fate* of globalization anytime soon. The supply chain disruptions throughout the worst of the pandemic had some market pundits trumpeting that a multi-national approach to business would soon be *extinct*. But there is evidence proving otherwise. First, it is worth noting that the headlines make the economic impact of reshoring seem more sizable than it is. More importantly, we'd counter that globalization isn't ending but *evolving*. The *competitive advantages* are still intact: cost and production efficiencies, scalability, and workforce growth—just to name a few. And as a result of this *new species* of globalization, our bias for large domestic multi-national companies is heightened. Whether it's smartphones or fast-food chains, US brands are leading across the globe. US companies with niche marketing outside the US are experiencing superior earnings growth.

5 Seeking Safety: Carbon Dating the Security Era

Jurassic Park was seemingly well-equipped with security measures—from electric fences to cameras and armed doors. But once the carnivores escaped their compounds, the park creators quickly wished more precautions were in place. After the last three bruising years, enhanced security will be at the forefront of 2023 and beyond. Governments, companies, and investors have learned painful lessons. Look for carbon-based security, like protecting oil and natural gas sourcing following the fallout with Russia. Or shifting the most critical supply chains, such as semiconductors and healthcare products, back to domestic sources. Or protecting power and internet grids from hackers. And, of course, replenishing our (and our allies') military capabilities will be a top priority.

6 Fixed Income Feast: Bonds Worth Sinking Your Teeth Into

The Tyrannosaurus Rex had 60 eight-inch-long serrated teeth with a jaw so powerful it could crush a car. While fixed income investors aren't so aggressive, they still are *ready to feast* on the higher rates they haven't had in years. Although rates seem to have reached their peak, yields are still attractive. And there's less risk! In fact, investors can obtain nearly as much yield on a 3-month Treasury bill today as they could on a high yield bond at the beginning of 2022. Over the course of the year, economic struggles and easing

Letter from the Chief Investment Officer *(cont.)*

inflation will lead to a lower 10-year Treasury yield (our year-end forecast: 3%). With many subsets of the yield curve inverted, investors should opt for quality (e.g., investment grade, municipals) over chasing more income from riskier high yield bonds.

7 Equities Not on the Rocks: Fundamentals Won't Fossilize

With the heightened probability of a recession, some speculate that equities are headed for another *rocky* year. However, investors must remember the equity market is a forward-looking indicator. Yes, the P/E multiple has been *chiseled away* in the two previous years. But P/Es tend to expand as interest rates fall, and the S&P 500 hasn't notched three consecutive years of P/E contraction since at least 1994. The consensus outlook for earnings growth (the *bedrock* for the rally coming out of the pandemic) has since been lackluster. However, if 2022 was about businesses having pricing power, 2023 will be the year of cost cutting. As companies enter *preservation* mode, margins will hold and, in turn, earnings will be better than previously believed. CEOs will also not *turn to stone*, and the shareholder-friendly activities we've witnessed in recent years (e.g., dividend growth, buybacks) won't *cease to exist*. As a result, our year-end forecast for the S&P 500 is ~4,400.

8 Excavating Opportunities: Digging in the Emerging Markets

Between the stronger dollar, Fed tightening, and weaker global growth, it was harder to uncover emerging market opportunities than unearthing a pearl in an archeological dig. Investors needed more than a sharp eye, handheld shovel, and a brush. But now, the headwinds that buried most emerging market regions underground have become tailwinds pushing them to the surface. Emerging market growth is expected to outpace that of the developed market by the widest margin since 2013. India's economy has been more resilient than most. China's decision to abandon stringent COVID policies should unleash domestic pent-up demand—just as we've seen in the US. Energy producing emerging market countries (e.g., Latin America) should rally if oil prices move higher, as we expect. Add in a weaker dollar and the end of Fed tightening and emerging market opportunities for both equities and bonds could *hatch* and grow faster than Jurassic Park's dinosaurs.

9 Surviving the Volcano: Don't Touch the Hot Spots

Volcanic eruptions during the Triassic era created the climate and conditions for many species of dinosaurs to emerge. But while the destruction of some life forms led to the creation of others … it took time. And time is not something every investor has on their side. Therefore, we caution most investors from *speculative hot spots* (e.g., meme stocks). 2023 will foster a *survival of the fittest environment*, and even though our expectation is for modest positive returns in the aggregate, *natural selectio*n will run its course beneath the surface. While we like to consider ourselves *new age avatars* rather than cave dwellers, sometimes you need to focus on the basics and let the fundamentals lead your portfolio decisions. Active money managers could have mammoth opportunities to outperform, given regional, sector, industry and even company-specific dispersion.

10 Don't Follow the Herd: Discover Attractive Alternatives

"They do move in herds!" exclaims Dr. Alan Grant, as he witnesses brontosauruses traversing the park for the first time. But just because *herd mentality* worked for dinosaurs, doesn't mean it will for investors. Look at recent history. Who foresaw the pandemic or the Russian-Ukraine war? It's hardly been the Roaring '20s that some pundits predicted just a few years ago. As we peer into 2023, Wall Street strategists are calling for a much weaker year than we've historically seen. But investors shouldn't blindly follow. In 2023, some of the best opportunities may require *moving in isola-*

> “... adapting to the times and working to discover opportunities has usually proven more successful than acting on fear or emotions.”

tion (contrarian). For example, REITs in the aggregate have sharply turned out of favor. But valuations are attractive, and for specific industries within the sector (e.g., cell towers, healthcare facilities), earnings should be less sensitive to the downturn. The Technology sector should also not be cast aside, as the more diversified or multi-faceted companies still display strong fundamentals.

Life, the Markets, And Investors Will Find a Way

The concept of evolution is the key to Jurassic Park. As one of the scientists states, “*Life finds a way*.” Change isn’t easy; sometimes it requires breaking through barriers and boundaries. Incessant gloom-and-doom headlines may make investors feel as though 2023 will be a lost year for the economy and the markets. True, the oncoming recession, like a charging T-Rex, isn’t in the rear-view mirror yet. Yet adapting to the times and working to discover opportunities has usually proven more successful than acting on fear or emotions. Remember: *Jurassic Park’s* heroes don’t prevail because they’re stronger or faster than the dinosaurs, but because they’re smarter—and stick together. Just as the film’s characters relied on one another in precarious situations, trust your financial advisor to *guide you through the jungle*. And we’ll be here too, providing updated investment insights as we explore this ever-changing investment landscape together.

We wish you a safe, healthy, and prosperous 2023!

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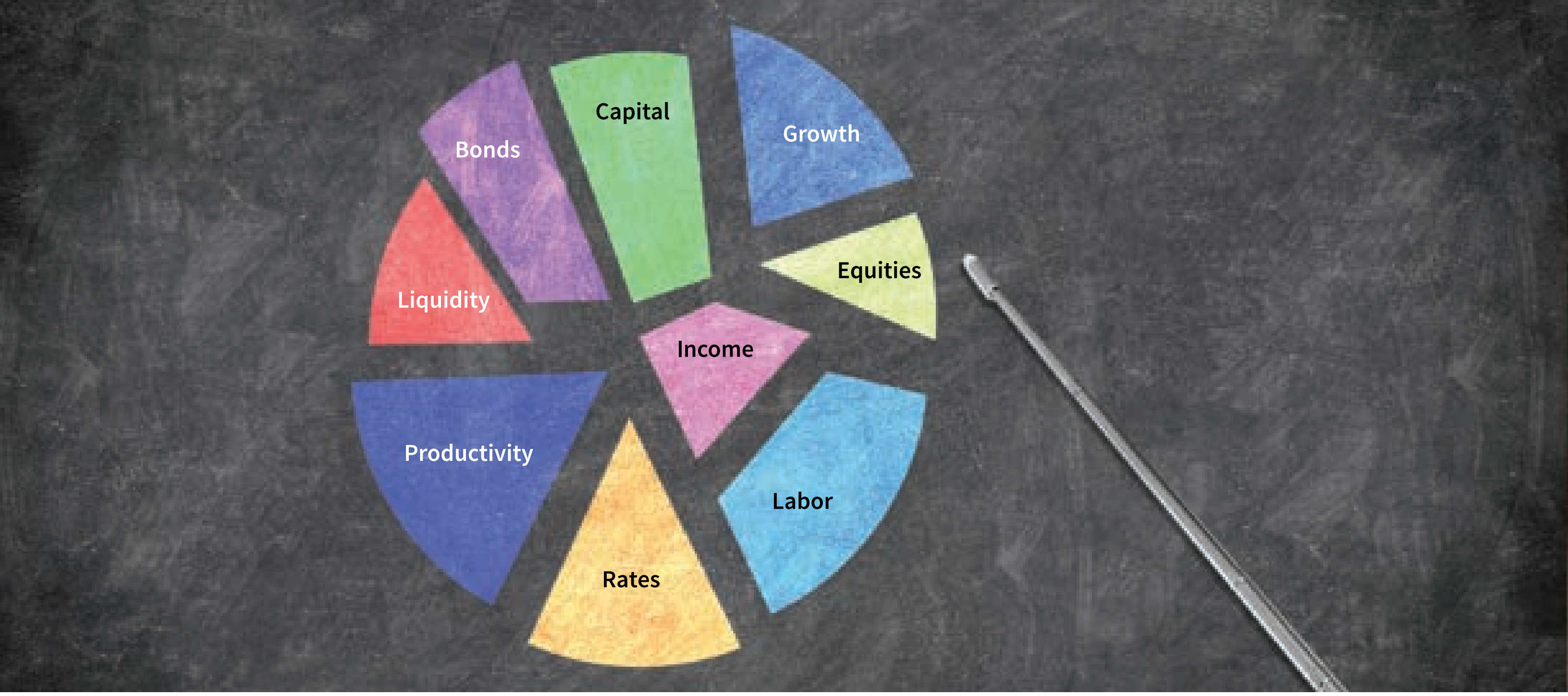

Recession Or Reorder: The Semantics And Reality Of Economic Slowdowns

James Camp, CFA, *Managing Director,* Strategic Income, Eagle Asset Management*

Economic history is replete with semantics regarding economic contractions. The Panic of the 1930s was euphemistically relabeled 'the Great Depression' by the Hoover administration, economic slowdowns became 'recessions' during the Carter administration and came full circle with the Global Financial 'Crisis' (also known as the Great Recession) of 2008. The Biden administration may be searching for yet another descriptor with an economic and earnings slowdown on the horizon.

Perhaps 'reorder' might fit the bill. The global economic and policy landscape has undergone seismic shifts during the past three years. Pandemics, like famine and war, have structural aftereffects that flow through society, the economy, and markets long after the immediate impacts abate. Inflation, a byproduct of turbo-charged fiscal and monetary policy responses, is the market death knell of boundless post-financial crisis liquidity. Inflation has surged to the highest level in decades and remains the most regressive tax on economies. Everyone pays for higher inflation and as a result, consumer spending power has fallen more than in any year since 1995. Policymakers' misjudgment of the inertia behind inflation has global central banks playing catchup. However, market observers are treating this period as a phenomenon within the normal business cycle—or in other words, 'transitory.'

> The backdrop for better long-term outcomes may be improving dramatically.

Consensus maintains that a probable US recession will be 'short and shallow' and inflation returns to its 2% long-run average. In short, the post-COVID-19 economy will look like the pre-COVID economy. This view misses key structural changes likely to be long-lasting and influential to capital markets and investment returns. Longer-term inflation will likely remain much higher than 2%. CPI has come in below estimates only three times in the past 21 months. Headline CPI began the year at 7.0% year-over-year (YoY) and will finish the year persistently above 7.0% YoY once again, suggesting the Fed must get and stay restrictive for longer. Peaking inflation is not as significant as the terminal rate of inflation being a long way from the 2% target.

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A Fed 'pivot' is not likely until core inflation falls below 4% or the labor market suffers significant strain. The policy of throwing liquidity at market volatility or economic weakness is no longer available. Fed Chair Powell hopes for, and is orchestrating, a slowdown. For markets reactive to any prospect of slowing tightening, pivot, or easing, a non-recessionary period may prove challenging.

The secular changes most likely to impact markets and the economy are the shift from globalization to on-shoring or near-shoring, the end of cheap and plentiful capital, and unsettled labor markets. The United States, once a champion of free trade, has become more protectionist. Supply chains are disrupted, and 'just in time' gives way to 'just in case'. Borrowing costs have increased sharply on more than one-third of global debt (previously negative yielding), and credit conditions are tightening. Mortgage rates have spiked, and the housing market is already in a recession. Certain parts of the population have exited the labor force, either by choice or necessity. Return to office metrics are hovering at 50% of pre-pandemic levels, even though economic mobility data show back to normal in travel, restaurants, etc. Almost three years after COVID-19 hit, companies are still struggling to get and retain talent.

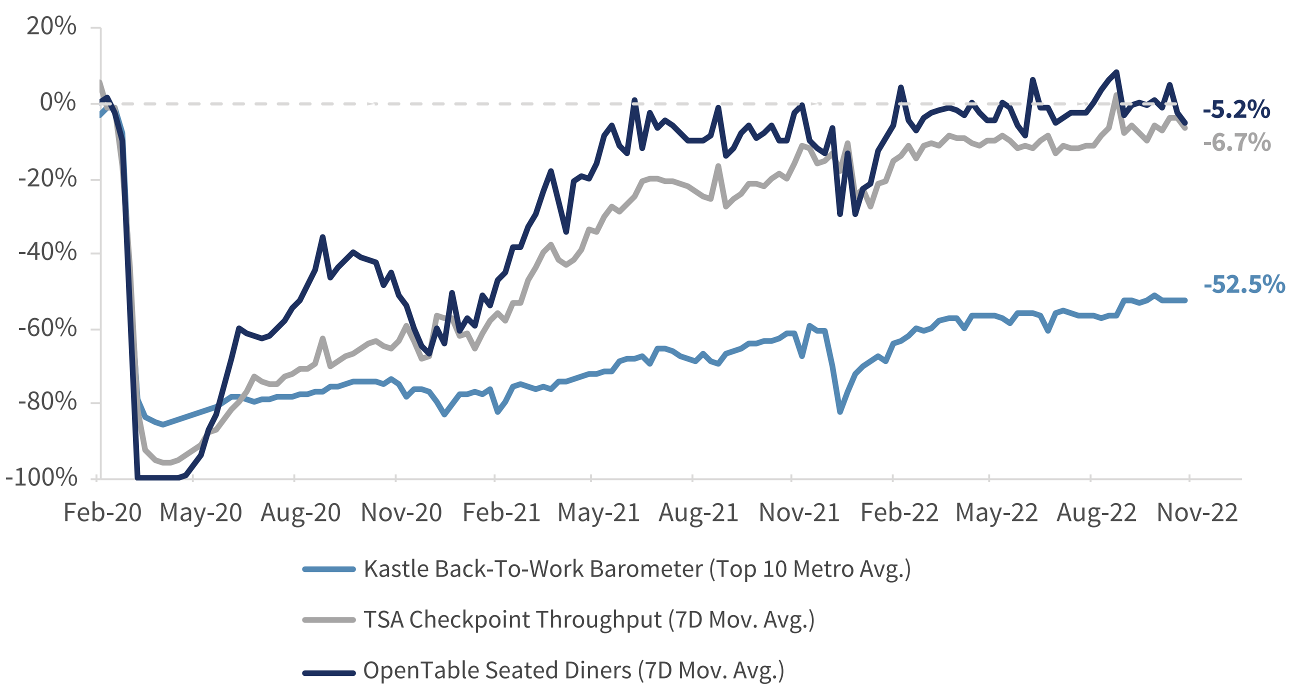
Labor shortages driven by a shrinking pool of workers are a result of population and immigration changes, but also changes in attitudes and preferences. More than ever, businesses need to be strategic in human resource management.

The starting point for employment is historically strong. Jobless rates for developed countries are the lowest since the early 1980s. But the Fed, at least for now, is willing to sacrifice the employment part of its mandate for price stability. White-collar industries such as technology, banking, and real estate, where staffing is above pre-COVID levels, are vulnerable. It will take time to 'reorder' that part of the labor force to industries in need of workers.

The two primary inputs of the economy, labor and capital, have been transformed. Near-term economic challenges are plentiful, but the backdrop for better long-term outcomes may be improving dramatically. There is growing evidence that companies are adapting to these challenges. A significant uptrend in capital expenditures along with an enduring, positive trend of investment in intellectual property products bodes well for productivity gains going forward.

In-Person Activities (% Change From 2019)

We're returning to normal, but not to the office.



Source: Kastle Systems, Transportation Security Administration, OpenTable, and Bloomberg; data as of November 9, 2022

> "We have moved from bond and stock markets driven by liquidity to markets that are now driven by fundamentals—ultimately a better, more stable model for growth and wealth creation."

Digital expenditures (robotics and the like) have grown by double digits over the past year. Companies embracing and optimizing the realities of the hybrid work model can gain a competitive advantage in a tight labor market.

The era of financial engineering is over. The successful businesses in this new regime will be those with efficiency in the deployment of labor and capital. The reset of the bond and equity markets sets the stage for capital allocations based on fundamentals, not speculation. The destruction of trillions in capital in instruments like crypto exchanges and non-fungible tokens (NFTs) marks an important inflection point in the capital allocation process based on easy money.

The financial press memorialized 2022 capital market returns as an epitaph for balanced investing. During such regime shifts, correlations across asset classes are high. A portfolio consisting of the S&P 500 and the 10-year US Treasury note suffered losses of around 15%; however, a portfolio consisting of intermediate investment-grade bonds and quality dividend stocks was down less than 10%. More importantly, the 'income' component of the income investing landscape is markedly improved with yields on bonds at decade highs and dividend style factors outperforming. Dividend growth—growth at reasonable prices—will continue to outperform the broader equity markets. Quality of balance sheet, management, capital deployment, and labor policies will be factors of performance in the post-COVID economy. We have moved from bond and stock markets driven by liquidity to markets that are now driven by fundamentals—ultimately a better, more stable model for growth and wealth creation.

For fixed-income investors, the worst is over. Historic mark-to-market losses on individual bonds should slowly recover as upward pressure on long-term rates slows and reinvestment begins to capture higher yield levels. It is noteworthy that bond prices have been largely driven by interest rates and liquidity, not credit events. Liquidity issues (due to continual selling from passive vehicles) are more pronounced in the municipal market, which resulted in long-term municipal yield ratios capturing 85% of the yield of US Treasurys versus 65% at year end 2021. This higher ratio made municipals more attractive, and combined with generally falling yields, they posted their best monthly performance in November since 1986.

The economy and capital markets may recede for a period, but the resiliency and 'reordering' of the economy sets the foundation for a more productive economy and balanced capital markets.

The Road Ahead For The US Economy

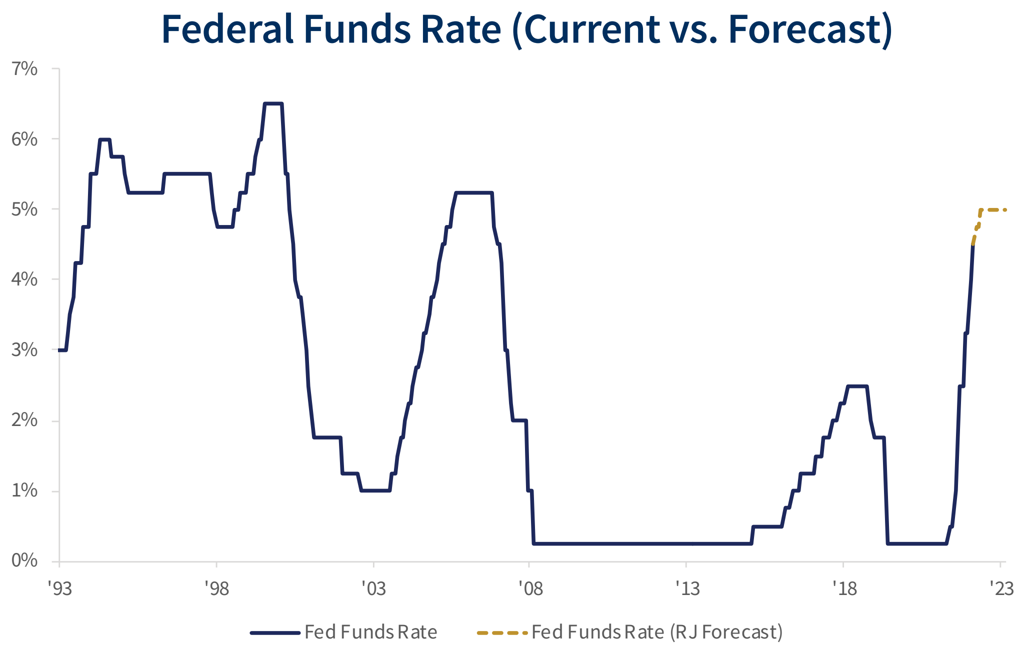
Eugenio J. Alemán, PhD, *Chief Economist,* Raymond James
Giampiero Fuentes, *Economist,* Raymond James

The current decade was dubbed by many as the 'new Roaring '20's. However, as we stated in our presentation of May 2021, "It would be unlikely as there are significant psychological, demographic, and structural dynamics that suggest the unfettered elevated growth trajectory of the 1920s will not be duplicated in the upcoming decade." In fact, in just three years the world has experienced a global pandemic, a recession, and many countries are likely to experience another recession in 2023 due to efforts by central banks to bring down inflation rates.

Although 2022 started with positive expectations of a fully reopened economy plus the view that inflation was transitory and that it would start turning the corner in the second quarter, the year was far from positive. Just before the end of the first quarter the invasion of Ukraine by the Russian military, and the start of the war severely impacted energy and food prices globally. Additionally, still-strained supply chains, the large accumulation of savings during the pandemic, and a strong labor market made it impossible for inflation to come back down. This triggered a very strong response from the Fed, which increased the federal funds rate by 425 basis points in 2022 and is expected to increase rates by a further 50 basis points until March of 2023, taking the terminal federal funds rate for this cycle to 4.75% to 5.00%. By increasing the federal funds rate, the Fed is trying to slow down the rate of growth of the economy, starting from the most interest rate-sensitive sector, investment, in the hopes of weakening the US job market.

> Our view is that the Fed will need two years to bring inflation back down, but this process started earlier this year, so we are probably halfway to achieving low and stable prices.

Although a federal funds rate of 4.75% to 5.00% is not very high historically, it is very high compared to what markets and investors have seen over the last several decades. Thus, the biggest problem today is that economic actors (i.e., individuals, businesses, the external sector as well as the US government) are trying to adjust to these new levels of interest rates. And the way in which these economic actors adjust to higher interest rates will determine the economy's path forward in 2023.



Source: RJ Economics, FactSet, as of 12/19/2022

Industries, firms, and individuals react differently to higher interest rates. We have already seen a strong negative response from the housing market. As short-term interest rates increase, longer-term interest rates (i.e., mortgage rates) surge. This increase in mortgage rates reduces the pool of potential home buyers and the sector slows down and/or goes into recession. The housing market is, typically, the most interest rate-sensitive sector of the economy.

The housing market and the economy are affected through different channels. First and foremost, there is a decline in residential investment as home construction firms reduce spending on new homes and reduce the need for workers. While residential investment has been negatively affected, firms have continued to add new construction workers, for now. A second effect of the reduction in the pool of potential home buyers is related to the income generated by commissions and fees earned by real estate brokers, mortgage banks and mortgage companies, as well as the individuals that sell their homes. A reduction in home sales affects commissions and reduces the need to hire/keep workers in the real estate industry.

Other sectors are less affected by interest rate increases. Within consumer demand, the most affected sectors are those that sell big-ticket items such as automobiles or large/long vacations, as these big-ticket item purchases use financing, which is affected by interest rate hikes. As is the case in the mortgage market, higher financing rates for automobiles reduce the pool of potential automobile buyers, helping to slow down the market, both for new and used vehicles. However, over the years, the negative effects of higher interest rates on the purchase of new cars have been limited by the ability of car manufacturers to use their financing arms to keep interest rates lower for customers in higher-income groups and with higher-than-average credit scores. However, lower income and lower credit score individuals remain priced out of the market, thus weakening the sector.

Service sectors are less affected by higher interest rates as services are, in many ways, smaller-ticket items, and individuals have the ability to pay for them in cash. For big-ticket items in the service sector, the most affected ones are purchases for which consumers use credit cards. However, the increase in interest rates for credit cards is currently not a big issue, but it could become one in the future, especially if employment starts to deteriorate and borrowers begin to struggle to make payments.

HIGHER INTEREST RATES TO COMBAT INFLATION

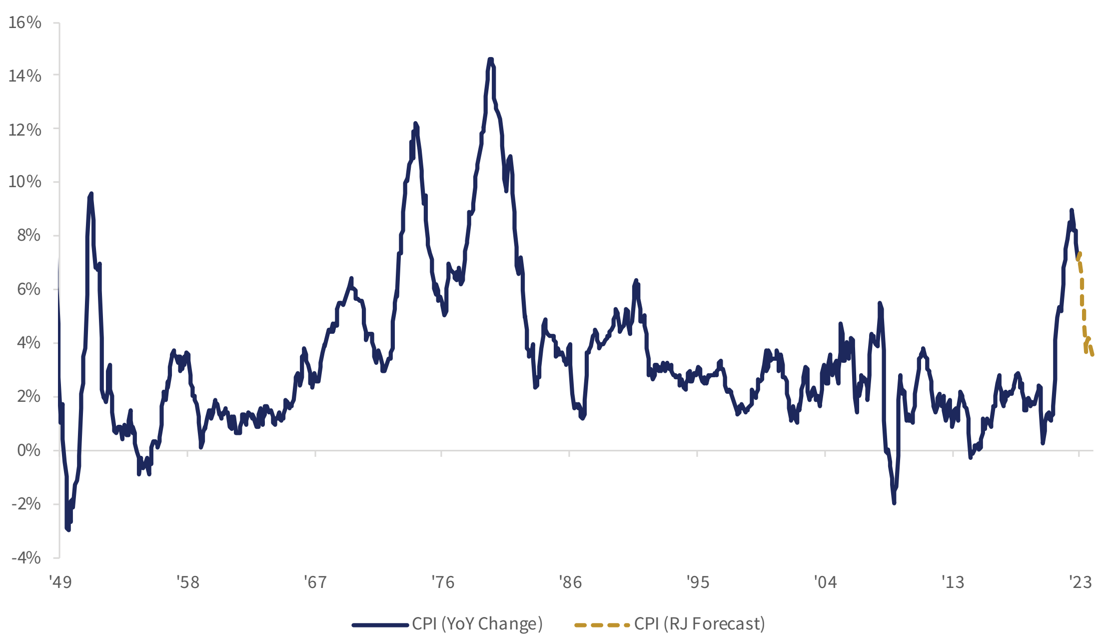
There are three primary reasons the Fed may increase the federal funds rate to levels that have the potential to trigger a recession in economic activity. Some of these reasons are found to affect the economy simultaneously and at other times, they may be independent of each other.

The three potential reasons for higher interest rates

Currently, the Fed intends to keep interest rates higher because the US economy is still growing at a rate that is higher than potential output and inflation is too high. Thus, the question for the Fed going forward is how high it will need to increase the federal funds rate and for how long in order to bring inflation down to its 2% rate target. Our view is that the Fed will need two years to bring inflation back down, but this process started earlier this year, so we are probably halfway to achieving low and stable prices. However, we expect inflation to be below 3% by the end of 2023. This will require the Fed to stay put for the whole of 2023 as inflation will not go down to the 2% target until well into 2024. This is the reason we are forecasting a mild recession in 2023, when we expect the economy to remain flat, and to start growing again at a rate of only 0.8% during 2024.

The biggest fear is a repeat of what happened during the 1960s and until the mid-1980s when monetary policy was highly erratic, allowing inflation to get out of hand. Thus, there are two important indicators to follow during 2023. The first one is core inflation. The Fed will be watching the evolution of core services prices and core goods prices to see if and when inflationary pressures start to slow down. The faster we see core goods prices and core services

Consumer Price Index (Current vs. Forecast)



Source: RJ Economics, FactSet, as of 12/19/2022

> "Once inflation is under control, the Fed will start relaxing monetary policy and the normal catalysts for growth will, once again, take over to deliver stronger economic growth."

prices slowing down, the sooner the Fed is going to start pivoting. The second important indicator is inflation expectations. So far, the Fed has been successful in keeping long-term inflation expectations contained. To win the battle against inflation, the Fed needs to keep long-term inflation expectations in check.

WHAT DOES THE US ECONOMY NEED TO START GROWING AGAIN?

The current economic cycle is very different from previous economic cycles in that the service sector is expected to continue to expand while goods sectors struggle. That is, big-ticket item purchases such as automobiles and homes, are going to continue to struggle until interest rates start to come down. Before that happens, high interest rates are going to continue to push the price of these items down, bringing these sectors into a better equilibrium. Both automobile prices and home prices are expected to decline in 2023, and this should help ease pressures on inflation as well as on affordability.

The health of the service sector will also be impacted by employment growth as well as real income growth. We expect employment to deteriorate during the year as we expect a mild recession, weakening real incomes further. Thus, we expect some weakening of the service side of the economy. However, if inflation continues to come down, the effect on real incomes is going to start taking over and this will help keep the economy from weakening further. The bottom line is that once inflation is under control, the Fed will start relaxing monetary policy and the normal catalysts for growth will, once again, take over to deliver stronger economic growth. That is, the housing market will start to grow again, and this will push residential investment higher as well as produce an increase in employment in the sector. The biggest risk for this year and into the next will be the labor market. The current labor scarcity is not expected to improve that much over the next couple of years, although weaker economic growth this year and next will help reduce the pressures coming from a tight labor market.

KEY TAKEAWAYS:

- 2022 started on a positive note but was derailed by the Russian invasion of Ukraine which severely impacted food and energy prices globally.
- Still-strained supply chains, the large accumulation of savings during the pandemic, and a strong labor market made it impossible for inflation to come back down, triggering a very strong response from the Fed.
- The Fed is expected to continue increasing the fed funds rate until March of 2023, taking the terminal federal funds rate for this cycle to 4.75% to 5.00%.
- We expect inflation to be below 3% by the end of 2023. This will require the Fed to stay put for the whole of 2023 as inflation will not go down to the 2% target until well into 2024.
- We are forecasting a mild recession in 2023, during which we expect the economy to remain flat, and to start growing again at a rate of only 0.8% during 2024.

The ‘Income’ Is Back In Fixed Income

Doug Drabik, *Managing Director,* Fixed Income Research
Nick Goetze, *Managing Director,* Fixed Income Solutions

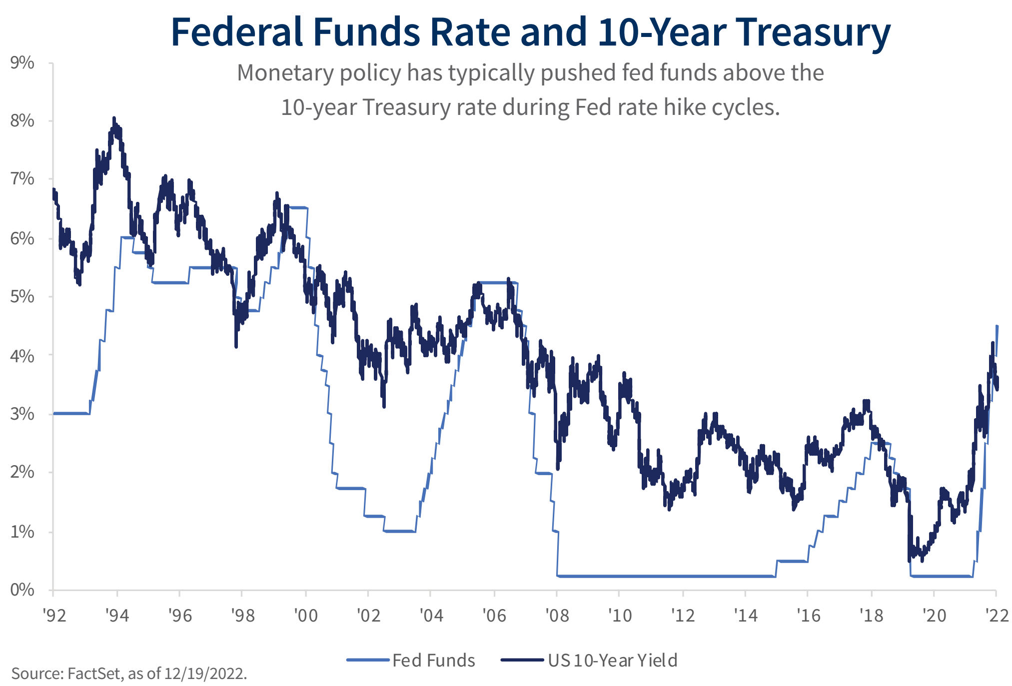
Persistent volatility accosted the bond market in 2022, creating prevalent investor uncertainty which could be attributed to various economic circumstances, including: inflation, geopolitical events, and recessionary fears. The general trend of interest rates throughout the year moved the 10-year Treasury yield in a range from 1.52% to 4.25%. As you may already know, there is an inverse relationship between bond rates and bond prices. A 10-year Treasury yield move in this range translates to an illustrative price move akin to $123.93 to $98.99, or nearly 25 points. The longer the maturity, the greater the price impact associated with large rate swings.

2022 underscored the distinction between two investor types: those seeking total return and those needing/wanting income. The price plunge decreases total returns (because of decreasing prices), yet the rate increase provides investors an opportunity to increase income. It has been a long time since investors had the opportunity to lock in these income levels. For this specific investment asset, locking in higher income can be achieved when purchasing individual bonds with stated maturity dates, allowing investors to receive purchased yields for a predetermined period of time (up to the maturity) that is not affected by interim price/rate moves.

> Market forces will likely continue to move the yield needle in a distorted pattern in 2023, yet investors seeking income and cash flow may relish in the current attainable yield levels.

DIFFERENT INVESTORS, DIFFERENT OPPORTUNITIES

Market forces will likely continue to move the yield needle in a distorted pattern in 2023, yet investors seeking income and cash flow may relish in the current attainable yield levels. High quality (investment grade) taxable and municipal tax-equivalent yields are well above 5% in modest duration investments. Historically, procuring income at a plus 5% level in an asset that primarily protects principal bodes well. As a relative benchmark for dedicated growth assets, the S&P Index since the turn of the century (~22 years from 12/31/99—12/16/22) experienced a total return of 6.29%.



Source: FactSet, as of 12/19/2022.

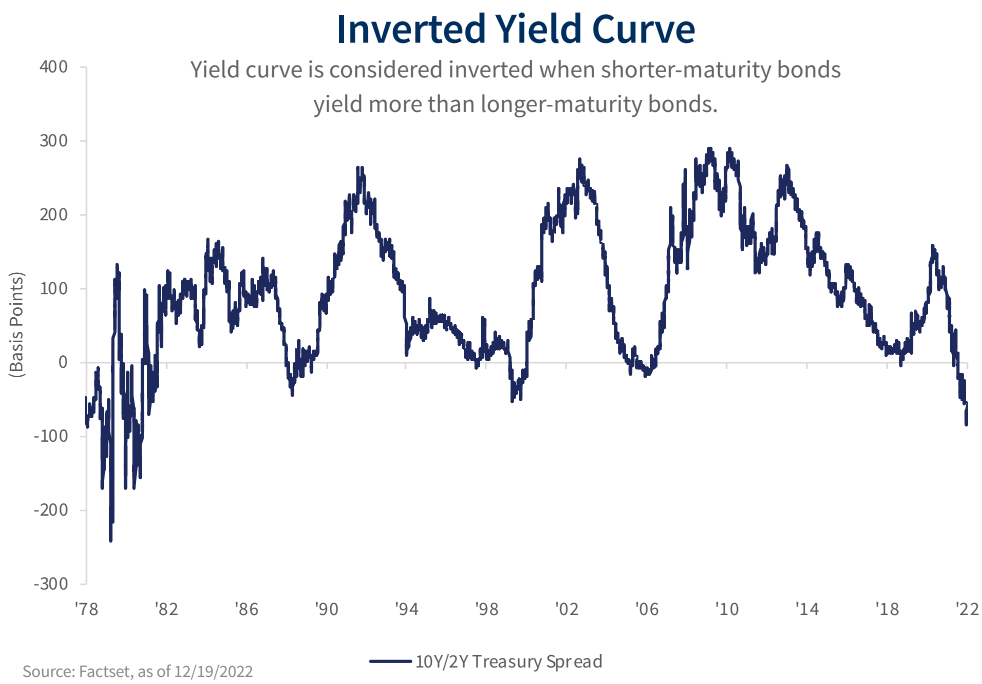
Yet, the potential fixed income benefits for 2023 may provide multiple benefits rewarding both total return investors as well as income/cash flow investors. Several interest rate curve behaviors might support this prospect. The Treasury yield curve behavior has been influenced by two economic notions: the Fed's handling of inflation through monetary policy and the uncertainty of a recession, present or near future. Fed Chair Powell has suggested, even in the face of economic pain, that the Federal Open Market Committee will fight inflation at any cost. Monetary policy has lifted the fed funds rate from January's 0.00%-0.25% upper/lower bound range to December's 4.25%-4.5% range, or already a 425 basis point increase. Monetary policy has typically pushed fed funds above the 10-year Treasury rate during Fed rate hike cycles. As the bond market often leads policy change, the 10-year Treasury yield begins falling prior to a program reversal when the Fed begins lowering the fed funds rate. The last several recessions occurred when core CPI (inflation) was sitting at 2.5% or lower. Core CPI peaked in September at 6.6% and sits at 6.0%. If the Fed holds true to fighting this still high inflationary figure, Treasury rates, particularly on the short end, may still climb.

ANALYZING THE INVERTED YIELD CURVE

Of particular note: the yield curve is already inverted. This means that short-term maturity rates are higher than long-term maturity rates. As of December 19, the 3-month Treasury bill was ~4.30% while the 10-year Treasury note was ~3.50%. With potentially more fed fund hikes, this inversion may spread wider. In the last 80 years, each recession was preceded by a yield curve inversion. Uncertainty swells with data divergence. Filling a gas tank or grocery bag is a more expensive endeavor today than a year ago, as consumers undoubtedly know. Home sales and auto sales are declining. Yet, GDP has turned positive, consumer spending is sound, the labor market is resilient—all while corporate and consumer balance sheets show strength. Will the Fed's tenacious push to suppress inflation prove to be the catalyst for a future economic slowdown as high interest rates foster a costly business environment?

The takeaway is that the inverted curve is an indication or an anticipation of future lower rates. In the interim, investors have a window to lock in high yields. Although short-term Treasury yields are higher versus intermediate to long-term Treasury rates, locking in for longer holds the potential for a longer-term benefit by lowering reinvestment risk. In other words, adding some duration to individual bond purchases may provide better long-term benefits. This opportunity has not gone unnoticed as individual bonds have had a substantial escalation in demand. The demand for securities often starts on the short end of the curve. It may be human behavior to seek superior yield (greed) yet hesitating (fear) may now mean taking on interest rate risk or losing out on even higher future rates. This has created a more expensive short end to the municipal and corporate yield curves.

In our view, the real value lies in the intermediate part of the curves. High quality investment-grade taxable bonds may provide 5.25% to 5.50% yields in the three- to seven-year maturity



Source: Factset, as of 12/19/2022

ranges where the corporate curve reflects an upward slope contrary to the Treasury's inverted slope. The municipal yield curve, hampered by too much short-term demand, reflects positive slope throughout the entire curve. Municipal bonds often have favorable call structures allowing investors to benefit with higher coupons for strong cash flow and maturities in the long-intermediate range. High quality investment-grade municipal bonds provide a 3.60%-4.15% yield range (tax-equivalent yields of ~5.72%-6.72% depending on the investor's Federal tax bracket) in the 12-20 year maturity range. Locking in these rates may give investors strong income benefits to work alongside individual bonds' protective asset qualities.

Total return investors may also have the dual benefit of income plus price appreciation. As the economic cycle turns and high interest rates end economic expansion, monetary policy often shifts back to easing or bringing interest rates back down from their peak. As interest rates begin to fall, prices will rise, thus potentially giving total return buyers an opportunity to see positive returns through price appreciation. Whether you are an investor seeking total return or just earning income, there appears to be a window of opportunity in fixed income.

KEY TAKEAWAYS:

- Income and cash flow investors are presented with an opportunity to lock in higher yield levels.
- The inverted yield curve is thought to precede a recession but is also an indicator of lower future rates. In our view, value lies in the intermediate part of the curves.
- Locking in these rates may give investors strong income benefits to work alongside individual bonds' protective asset qualities.
- Whether you are an investor seeking total return or just earning income, there appears to be a window of opportunity in fixed income.

> "In our view, the real value lies in the intermediate part of the curves."

Compromise And Conflict On Capitol Hill

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

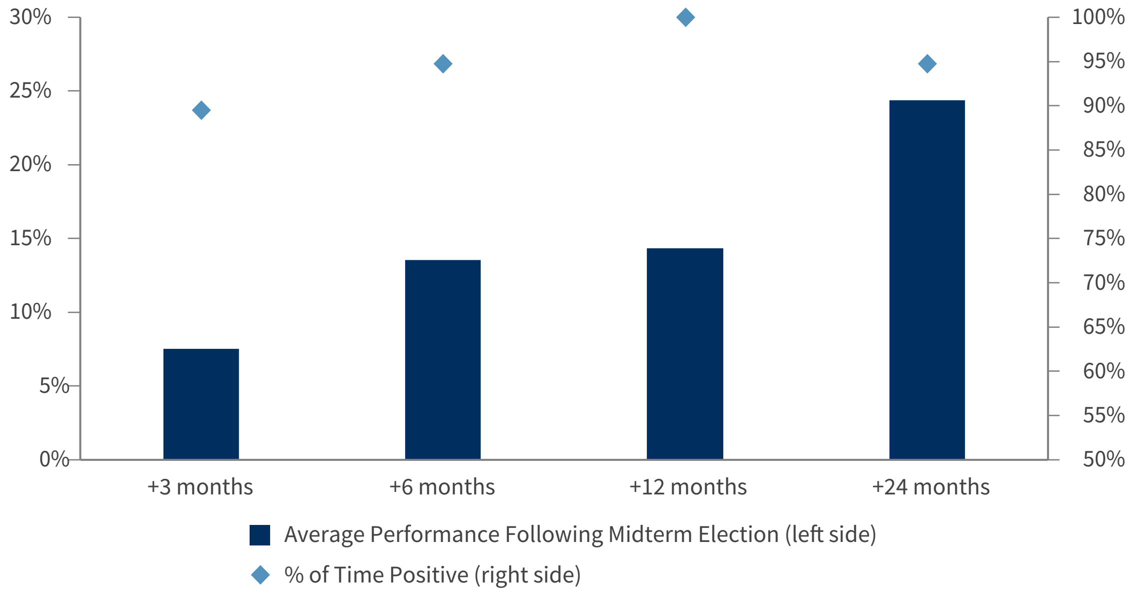
We view the outcome of the 2022 midterm election as a positive result for the market. The markets have historically favored split government as it reduces the policy uncertainty coming from DC. Additionally, we would highlight that since 1946, the S&P 500 has been positive 12 months following a midterm election. As for the election results, Democrats exceeded expectations and expanded their Senate majority by one vote (51-49), which will have a significant impact on confirmations by the Biden Administration. Republicans captured a majority in the House, but their nine-seat pickup was below the historical average of 23 seats for the opposition power in the last 40 years. The slim House majority for Republicans will be made even more difficult as Republicans are expected to scrap proxy voting, which was implemented by Democrats during the COVID pandemic. This will once again require members of the House of Representatives to be physically present for their vote to be counted, adding uncertainty to the outcome of floor votes.

Since 1946, the S&P 500 has been positive 12 months following a midterm election.

Turning attention to the 2023 agenda, we would focus on three things—must-pass legislation, potential areas of bipartisan compromise, and Senate confirmations (which have a significant impact on the regulatory agenda of the Biden Administration). We will also be monitoring external factors, especially the increased attention on geopolitical risk, the monetary policy decisions of the Fed, and the 2024 presidential election (in DC the next election starts the day after the last election is finished). As for the must-pass legislation, the debt limit fight and the annual government funding requirements will receive the most market attention and be the source of brinkmanship. We expect a 'tough on China' bill to lead the list of potential bipartisan compromises. The confirmation of regulatory picks that seek aggressive agendas will have some market impact, but we expect the reaction to be muted by recent court rulings that have sought to check the power of these regulators.

Performance Following Midterm Elections

Average market performance has been positive in the months following midterm elections.



Source: Factset, data from 11/5/1946-11/6/2020

DIVIDED CONGRESS: FISCAL BATTLES OR BIPARTISAN BREAKTHROUGHS?

Party power in the 118th Congress will be divided among the two chambers, with Republicans retaking control of the House of Representatives during the 2022 midterm elections and Democrats retaining the Senate. Overall, this dynamic produces a stronger incentive to pass legislation on a bipartisan basis and on compromise issues, which we view as an overall market positive result. However, there is also a high likelihood of gridlock and elevated headline risk around must-pass legislation. In the House, the GOP will govern with a slim 222-seat majority, which will prove challenging for the Speaker of the House in gathering the necessary support for bills. The small majority could give individual lawmakers significant leverage in extracting concessions during negotiations or in stalling legislation and could be further complicated by House vacancy trends and proxy voting reforms that heighten the impact of lawmakers not being able to vote on the House floor.

Following Senator Raphael Warnock (D-GA)'s victory in the Georgia runoff, Democrats will command a 51-seat majority in the Senate, boosting their ability to confirm officials for key regulatory and judicial posts. Senator Kyrsten Sinema (I-AZ) will be one to watch given her party switch (expectations are she will continue to caucus with Democrats), but her relative power and the power of Senator Manchin (D-WV) will be slightly diluted on certain issues, giving Senate Majority Leader Chuck Schumer (D-NY) more room to maneuver on legislative priorities or confirmations. However, the loss of the House makes the vote margin less important relative to 2022 given that any additional pursuit of reconciliation legislation will be off the table with the Democrats' loss of the House. Committee assignments will tilt in Democrats' favor, allowing the party to advance confirmations and legislation out of committee without additional procedures on the Senate floor that take up valuable legislative time. The 51-seat majority may be fleeting for Democrats as they face a tough map in 2024, where they will be defending 23 seats compared to 10 for Republicans.

OPPORTUNITIES FOR COMPROMISE AND CONFLICT IN THE 2023 LEGISLATIVE AGENDA

The debt limit, China, antitrust, cryptocurrency, and oversight will likely feature as core legislative themes in 2023. China policy will serve as a key area for bipartisan compromise with a slight tilt toward more hawkish policy decisions. We expect that Ukraine-related policy and spending will broadly continue to see bipartisan

> "Defense and national security rising as a key theme will focus oversight on export controls and financial/investment restrictions in 2023, aimed at critical emerging sectors across advanced technology, biotech, and clean energy."

support, but 'noise' around spending specifics should be expected from certain political factions. Similarly, antitrust and competition policy—particularly relating to tech—has overall bipartisan backing, but specifics on content moderation and consumer protection will be where fracture lines may emerge and extend timelines for any impactful legislation.

Cryptocurrency will see heightened legislative attention following the ongoing fallout around FTX Trading Ltd. Bipartisan interest in cryptocurrency regulation is strong, as are calls to more stringently regulate digital assets; however, a growing minority in Congress is advocating for a hands-off approach to crypto legislation (so not to legitimize an industry that has demonstrated limited viable socioeconomic benefits, in the eyes of some lawmakers).

The debt ceiling is primed to be one of the most contentious issues facing the new Congress in 2023, with Republicans poised to take a hard line in negotiations in exchange for Democratic concessions on social spending and entitlements. While this may cause a period of headline risk for markets (especially if lawmakers begin to push against a deadline), we ultimately expect Congress will settle on a compromise solution to avert a debt ceiling breach that threatens the credit rating of US government securities.

BIDEN'S REGULATORY AGENDA: FULL STEAM AHEAD

Given the gridlock in the new Congress, supercharged regulatory actions should be expected as a key mechanism to advance the priorities of the Biden administration in areas such as financial regulation, consumer protection, labor, climate, and competition policy. The Department of Labor will release a final rule which could begin to reclassify some gig economy contractors as full employees. We expect considerations around climate change to continue to be integrated into financial supervision and regulation, and the SEC is expected to release its long-awaited final rule on climate disclosures in early 2023 (whether this survives a court challenge will be a separate issue). Lastly, the Federal Trade Commission and the Department of Justice antitrust division will likely continue to expand their competition enforcement activities (with a particular focus on mergers) in line with the Biden administration's stated desire to take a "whole of government approach" to antitrust.

WHILE CHINA FRICTIONS WILL LIKELY PERSIST, SIGNS POINT TO FLATTENING ESCALATION

Years of escalating tensions across various economic, trade, financial, and national security issues have raised market concern over a trajectory of 'decoupling' and potentially direct conflict between the US and China as a key driver of risk. However, the most recent signals following China's leadership selections in October, the results of the midterm elections in the US, and the first in-person meetings between President Biden and China's Xi at November's G20 meetings point to a flattening of the escalation potential that raises the possibility of constructive progress. While the heads of both nations demonstrated the ability for their personal relationship to generally turn down the temperature, the political setup in the US and in China will continue to support frictions in 2023—especially around tech/financial restrictions and the fate of Taiwan.

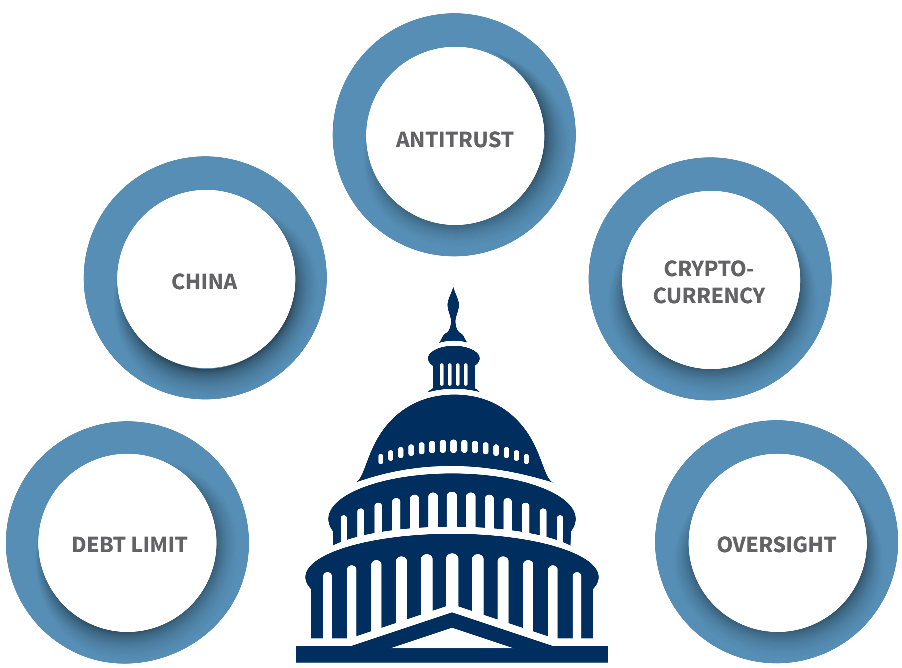
From a US perspective, a Republican-led House will attempt to challenge the Biden administration on foreign policy and push policymakers toward more hawkish positions on China issues. A Democratic Senate will serve as an insulating factor keeping some of these fights to Congress, but Republican House lawmakers will have opportunities to shape foreign policy decisions via oversight and leverage on must-pass legislation. Defense and national security rising as a key theme will focus oversight on export controls and financial/investment restrictions in 2023, aimed at critical emerging sectors across advanced technology, biotech, and clean energy. A more assertive US position on the defense of Taiwan and support for its military capability is also likely to support elevated frictions. While we do not see China becoming more aggressive militarily on the question of Taiwan, China's internal stability will be a factor to monitor as an input on China's political decision making. While it remains a tail risk, mounting domestic challenges at home could push China's leaders to become more assertive abroad as a means of redirecting attention from internal issues. While the overall trajectory is expected to flatten and relatively stabilize, pressure points should be expected in the year ahead that could test the relationship and elevate market risks. With China's Xi expected be hosted by Biden in Washington around the fourth quarter of 2023, we generally expect the year-end period to end on a more positive note in terms of US/China relations before the 2024 campaign kicks into gear.

2024 ELECTION PREVIEW

Eyes have already turned to the 2024 presidential election after the November midterms, with several prominent names in the running to lead both parties. However, at this stage it is hard to accurately predict who will emerge as a front-runner and we would caution that conventional wisdom regarding presidential candidacies shortly post-midterm is often wrong. For the Republican presidential nomination, the primary will likely be highly competitive, with former President Trump's announcement of his candidacy and the expectation for many other Republicans to seek the Republican nomination, including Florida Governor Ron DeSantis (who emerged from the 2022 election cycle with a strong reelection). For the Democratic nomination, questions around whether Biden will seek a second term remain unanswered. The Democrats' stronger-than-expected showing during the elections—which was in part viewed as a referendum on President Biden's approach on key domestic policy issues such as inflation—has afforded the current President some breathing room in considering the path forward. If Biden ultimately does not lead the ticket, we expect Vice President Kamala Harris, a current Democratic governor (California's Newsom, Michigan's Whitmer), or high-profile cabinet secretaries (such as Transportation Secretary Pete Buttigieg) would round out the (early) top-tier of candidates. Overall, there is an eternity between now and the next election in political terms. If recent election cycles are a guide, expect curveballs ahead that challenge early conventional wisdom.

KEY TAKEAWAYS:

- We view the outcome of the 2022 midterm election as a positive result for the market. Markets have historically favored split government—as it reduces policy uncertainty. Additionally, we would highlight that since 1946, the S&P 500 has been positive 12 months following a midterm election.
- In the 2023 agenda, we would focus on three things: must-pass legislation; potential areas of bipartisan compromise; and Senate confirmations.
- The debt limit, China, antitrust, cryptocurrency, and oversight will likely feature as core legislative themes in 2023. China policy will serve as a key area for bipartisan compromise with a slight tilt toward more hawkish policy decisions.



Equities In Need Of Clarity

J. Michael Gibbs, *Managing Director,* Equity Portfolio & Technical Strategy
Joey Madere, CFA, *Senior Portfolio Analyst,* Equity Portfolio & Technical Strategy

2023 will be heavily influenced by three questions: to what degree will inflation moderate, how will central bank policy progress, and how much demand-driven pressure will the Fed need to inflict on the economy in order to bring inflation down?

The main issue continues to be that inflation is far too high. Because it has stayed at such a high level, it is putting increased pressure on consumer disposable income levels, saving rates, and when accompanied by weak asset prices, is resulting in weak purchasing power for the backbone of the US economy: the US consumer. The Fed does not have the ability to dampen inflation by improving supply, but it can negatively impact demand through rate hikes. Swift rate hikes throughout 2022 will act with a lag on the economy and are already starting to show up in the economic data; i.e., mortgage applications are at 25-year lows, leading economic indicators are negative, the yield curve is inverted, and layoffs/hiring freezes are being announced. We expect a recession to occur in 2023; but while the R-word can be scary, we believe it will be mild. A unique characteristic of the current environment is that supply has been hard pressed to meet demand, so we do not see widespread excesses on corporate and consumer balance sheets that can often plague downturns. Banks are also extremely well-capitalized (a lot has been learned/changed since the 2008 financial crisis). And importantly, we believe that inflation will indeed moderate over the next year—which will allow the Fed to back off, financial strains to ease, and equity markets to bottom and begin climbing into the next bull market.

FOCUSED ON THE FED

The path forward for inflation remains highly uncertain and will be a large determinant of Fed expectations, bond yields, and equity valuations. Because of this, investors will be highly data-dependent on the incoming inflationary readings. Two consecutive months of lower than expected consumer price index (CPI) data provided a potential light at the end of the tunnel. However, the Fed will need a series of improvements over time in order to raise conviction that inflation is indeed on track to a more reasonable level. We believe that inflation will moderate over the next year. Improved supply is catching up with demand, commodity prices have broadly declined since midyear, and other leading indicators such as economic surveys suggest that 2022 pressures should ease. But we also believe it will take time for this moderation to be convincing and clear enough for the Fed to become comfortable. Still-strong demand from the services side of the economy and high wage growth suggest the path to inflation improvement will likely not be quick or easy. And during that time, volatile economic data could result in volatile equity markets.

BULL, BEAR, AND BASE

Despite the potential for further volatility over the coming months, we do believe that we are in the late stages of this bear market. Recessionary bear markets decline 33% on average over 13 months, but we have seen a 25% contraction over 11 months already. We expect the economy and corporate earnings to weaken over the next year, as Fed tightening (which remains ongoing) works with a lag on the economy. And it will be very easy for investors to get sucked into the negative headlines and short-term volatility. However, a lot of negative news has been priced into equity valuations already; and valuations bottom well ahead of the economy and earnings in recessionary bear markets (often when the headlines are worst). On average historically, the S&P 500 has bottomed two to six months prior to recession end while earnings bottom eight to nine months after recession end. While equities may have further downside or time left before durable upside can occur, we do believe that the majority of this bear market is behind us at this point. Don't lose sight of the bull market opportunity that will occur on the other side of the current weak trend. Bear markets can go down 25-33% on average over a year or so, but bull markets can appreciate 152% over four to five years.

Taking all of this into account, our base case S&P 500 target for 2023 is ~4,400. This target incorporates a mild recession, moderation in inflation, and equities climbing out of the current bear market by year end. In a bull case scenario where inflation comes down quickly and the Fed navigates a 'soft-ish' landing for the economy, we see bull case potential near prior highs (~4,935). Conversely, if inflation proves much stickier than expectations, Fed policy becomes much tighter, and the economic backdrop becomes more painful, we use a bear case S&P 500 target of ~3,675 by year end (with potential for prices reaching a downside scenario of 3,000-3,200 along the way).

2023 Year-End Outlook

	S&P 500 TARGETS	FACTORS
Bull Case	~4,935	Soft landing, inflation comes down quickly
Base Case	~4,400	Mild recession, inflation moderates, equities exit bear market
Bear Case	~3,675	Inflation stickier than expected, Fed policy tightens

Source: Raymond James Equity Portfolio & Technical Strategy

VALUATION VIEWS

Given our 2023 expectation that inflation moderates and the Fed backs off, bond yields are likely to peak and valuations bottom. This will provide opportunity throughout the market, particularly in high-quality names where high inflation and bond yields have resulted in outsized pressure, i.e., high beta, Consumer Discretionary, and Technology-oriented areas. Small-cap equities are another area that we believe are set up for outperformance, but timing is important with these trades. For example, small caps trade at a 13x P/E, which is on the low end of their historical range (18x 20-year average) and has only been lower at the credit crisis low and COVID shutdown low. While valuation grabs our attention and has become compelling (as it has for many areas), valuation is not a great timing indicator. Additionally, many of the areas that may outperform in a recovery scenario are also likely to underperform should equities fall. Therefore, it is important to maintain balance in portfolios between managing risk while also keeping an eye on the longer-term opportunity. With this in mind, we recommend investors refrain from chasing the rally periods and build exposure to favored areas in the weak periods as long-term risk/reward improves.

KEY TAKEAWAYS:

- We believe that inflation will moderate over the next year which will allow the Fed to back off, but investor focus is likely to shift toward the damage done to the economy.
- Volatility is likely to continue for now, and the bottoming process and recovery may be elongated.
- Don't lose sight of the bull market opportunity that will occur on the other side of the current weak trend. We expect a mild recession in 2023, but equities will bottom well ahead of the economy and corporate earnings.
- We use ~4,400 as our base case S&P 500 target.

Amid War And Inflation, Energy Security And Diversification Are In The Spotlight

Pavel Molchanov, *Managing Director,* Energy Analyst, Equity Research

In a year of epic turbulence in geopolitics and economics, 2022 marked the fourth time in the past 13 years that investors enjoyed outperformance from oil and gas stocks. For the second straight year, energy was the best-performing sector of the S&P 500, up more than 40%. While some champagne may well be in order, let's keep in mind that the oil and gas industry's cash flow nearly doubled in 2022, so in that sense the stocks didn't do quite as well as some might have expected. The lesson here is that the market is always forward-looking: with the oil futures curve pointing to lower prices in the years ahead, the stocks are pricing in less stellar, though still solid, profitability in the future. In an even broader sense, Energy remains less than 5% of S&P 500 market cap—down from as much as 13% a decade ago—illustrating that this remains an under-owned, somewhat contrarian sector for investors.

> We forecast that West Texas Intermediate (WTI) crude will average $100/Bbl in 2023. Brent crude, the global benchmark, should remain a few dollars above WTI.

As we think about what 2023 has in store for the oil market, the past year provided ample reminders that events can come suddenly from the proverbial left field. During much of 2022, oil prices bounced around the $100/Bbl level for the first time since 2014, with Russia's war in Ukraine being a major factor for tightening the market. As the war is about to enter its second year, a potent combination of US/European government-enforced sanctions and energy company divestments is creating pressure on Russian oil exports. Another geopolitical variable that needs to be watched is the long-running nuclear talks with Iran. Meanwhile, to state the obvious, global macroeconomic volatility is always a fact of life: the only question is what form it takes in any given year. As central banks around the world continue to fight inflation, there is no avoiding demand-side risks, even without assuming outright recession. China's zero-COVID policy is also a question mark vis-à-vis demand. All that being said, we forecast that West Texas Intermediate (WTI) crude will average $100/Bbl in 2023. Brent crude, the global benchmark, should remain a few dollars above WTI.

NATURAL GAS DYNAMICS

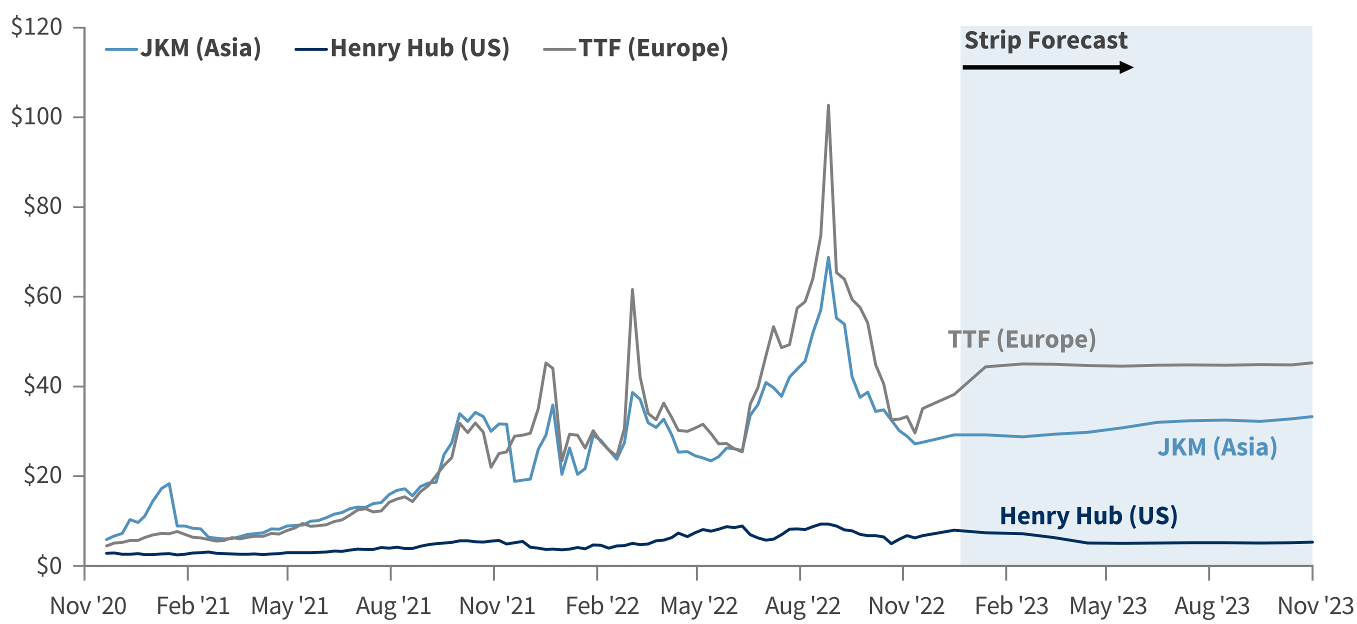
Natural gas is fundamentally regional in nature: prices on different continents can follow different patterns. Looking back at 2021, Europe already had been the standout for escalation in gas prices, but this was nothing compared to what happened in 2022. Since the start of the war, Russia has slashed gas supply into the European market as a deliberate policy of blackmail, i.e., using gas as a political weapon with the goal of pressuring European governments to make concessions (in particular, halting military support to Ukraine). As a result, Russian gas exports to Europe are the lowest in modern history, down 70-80% versus year-ago levels in the final months of 2022. The bad news—from the Kremlin's perspective—is that weaponization of gas supply is not working as a political strategy. In fact, the European Union (EU) entered the current winter with gas storage at 95% of capacity—thanks in large part to a massive infusion of liquified natural gas (LNG) supply from overseas. The problem is that emergency (spot market) LNG supply is very pricey. European gas prices have subsided since peaking in the summer at a stunning $100/Mcf but remain the most expensive in the world, and as a result several European countries have needed to bail out utilities and subsidize consumers. By comparison, the situation in the US gas market has been much more stable, though subject to normal seasonal choppiness. In 2023, we envision the domestic Henry Hub benchmark averaging $6.00/Mcf.

ENERGY LOOKS FORWARD

While share prices of oil and gas companies continue to fluctuate with commodities, there are numerous ongoing reminders that energy transition is an irreversible megatrend. The European energy crisis is accelerating the push to diversify the energy mix: not just away from Russian gas, but from imported fossil fuels more broadly. In this sense, energy security points in the same direction as climate considerations. With oil prices near $100/Bbl, there is unavoidable economic pain—particularly in countries (such as Argentina and Turkey) with weak currencies, in the context of a dollar-denominated oil market—but there is also acceleration of the electric vehicle adoption

Benchmark International Natural Gas Prices ($/MMBtu)

Tight supply/demand dynamics have widened US vs. international spreads.



Source: FactSet, Raymond James research, as of 12/19/2022. Conversion from EUR/mwh to $/MMbtu based on futures strip forecast

> There are numerous ongoing reminders that energy transition is an irreversible megatrend.

curve. In the US, for example, the cost of energy for driving one mile in an electric vehicle is currently around one-fourth the cost of fuel for an internal combustion engine. Meanwhile, as the climate crisis spurs worsening droughts around the world, there is an adverse impact on the productivity of hydroelectric power plants. This issue is especially problematic in hydro-dependent countries such as Brazil and Canada, and thus there is a need to expand other types of power generation that are less vulnerable to natural disasters.

Near the end of 2022, the annual United Nations climate conference, COP27, highlighted the limitations on international cooperation vis-à-vis climate policy. The political reality is such that there definitely will not be a global carbon tax, emissions trading program, emissions reduction mandate, or really anything that is remotely binding on governments. From country to country, and even within countries, there is a veritable hodgepodge of laws and regulations. In addition to carbon pricing, also important are sector-specific policies such as coal and petroleum phase-outs, renewable portfolio and fuel standards, building and vehicle efficiency mandates, and various incentives ('carrots') that are more politically popular than 'sticks.' in the US, for example, the recently passed Inflation Reduction Act was full of tax credits and other incentives for everything from wind projects to sustainable aviation fuel, but there is no chance of Congress approving mandatory decarbonization anytime soon. By contrast, the EU's European Climate Law includes a legally binding mandate for a 55% reduction in CO_2 emissions by 2030, en route to net zero emissions (carbon neutrality) by 2050. In 2023, we will also be watching the extent to which China reconciles its rhetorical pledge of decarbonization with the reality of producing and consuming half of the world's coal.

KEY TAKEAWAYS:

- Energy remains less than 5% of S&P 500 market cap—down from as much as 13% a decade ago—illustrating that this remains an under-owned, somewhat contrarian sector for investors.
- We forecast that West Texas Intermediate (WTI) crude will average $100/Bbl in 2023. Brent crude, the global benchmark, should remain a few dollars above WTI.
- Since the start of the war, Russia has slashed gas supply into the European market as a deliberate policy of blackmail with the goal of pressuring European governments to make concessions. As a result European gas prices remain the most expensive in the world, and several European countries have needed to bail out utilities and subsidize consumers.
- Energy transition is an irreversible megatrend. The European energy crisis is accelerating the push to diversify the energy mix: not just away from Russian gas, but from imported fossil fuels more broadly.

Global Economy On Uneven Path

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

Persistently high inflation and the monetary policy response are driving the global economy into recession. The coming global weakness will see sluggish growth or even outright GDP contractions in most developed economies outside the United States, with the eurozone likely to fare worst. Whilst comparisons are likely to be made between the pandemic-induced recession of 2020, or the Great Financial Crisis period, adjusting for changes in trend growth, the depth of the coming downturn is more likely to resemble that of the 1990s than anything more recent. A comparatively shallow recession is our base case scenario for the early part of 2023, followed by a relatively swift recovery thereafter. There is, however, no room for complacency; the risks are skewed towards a deeper and more protracted downturn.

It will be the developed economies that will deliver the largest peak-to-trough falls in real GDP, with the UK and Europe hit disproportionately hard. But this is an unusual economic cycle and very unlike those of the recent past. Potential GDP growth has slowed over time, and a given fall or slowdown in GDP growth will thus have differing implications for the degree of spare capacity in an economy (or the size of the output gap) and, by extension, inflation and the policy response.

> The global central banks most likely to pivot soonest are the Bank of Canada and the Reserve Bank of Australia where inflationary pressure is expected to fall relatively sharply.

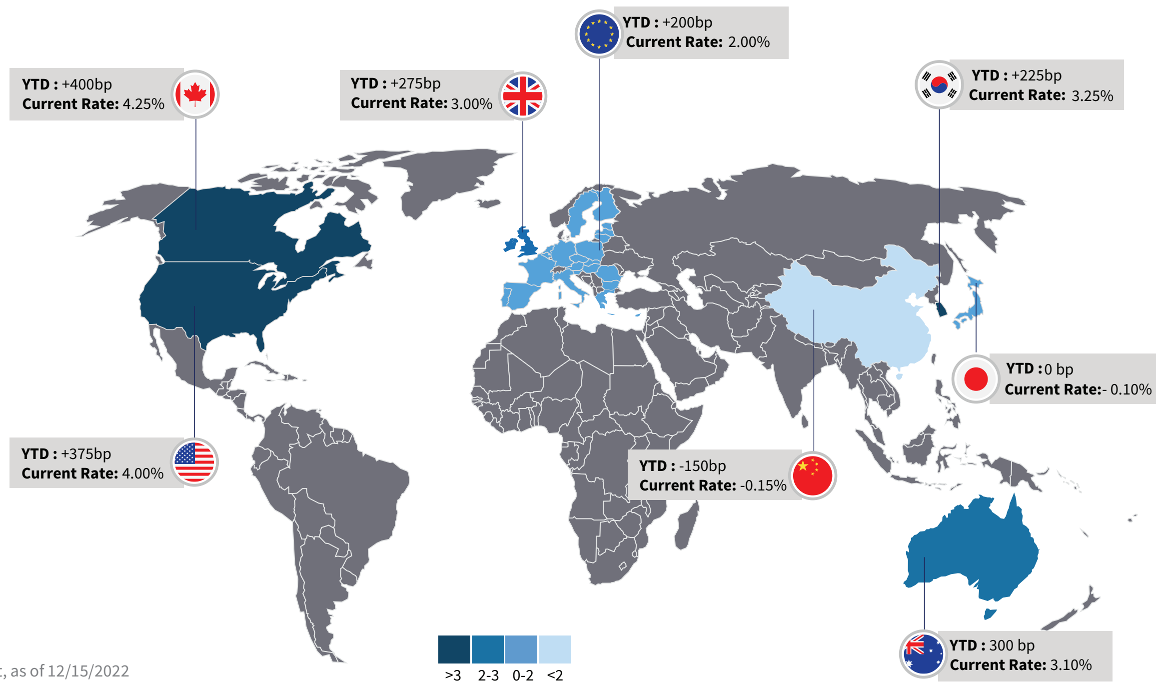
GLOBAL INFLATION WILL DISSIPATE IN 2023

Inflationary pressures are thought likely to dissipate as 2023 progresses, especially so at the headline level as commodity prices (ex-energy) continue their slide in response to weak global demand. Underlying inflation may prove ‘stickier’ but any diminution should encourage systemic central banks to slow the pace of monetary policy tightening, then pause and ultimately pivot lower. There will, however, be significant geographical variance in both the timing and nature of the eventual pivot.

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

When Will Global Central Banks Change Direction?

Relative to all other major central banks, the Fed has been the most aggressive in the 2022 tightening cycle.



Source: FactSet, as of 12/15/2022

The European Central Bank is thought unlikely to cut regional rates at all over 2023, and, while the proposed fiscal tightening may limit the scope for aggressive rate hikes in the UK, underlying price pressures are unlikely to encourage the Bank of England into an easier policy stance until the back end of the year. The global central banks most likely to pivot soonest are the Bank of Canada and the Reserve Bank of Australia where inflationary pressure is expected to fall relatively sharply, and earlier policy tightening weighed more heavily on domestic economies. The Bank of Japan is under severe pressure to adjust or conclude its persistent intervention to control government bond yields, but risks, both to the domestic economy and the global financial system more widely, associated with stepping away are so profound that a change in the policy stance is unlikely. Several central banks in Latin America and Emerging Europe have signalled that the rate hiking process is likely over, while those in Asia may have a little further to go.

THE RECOVERY WILL BE RAPID

The economic recovery across developed economies, although slow to start, will be relatively rapid and gather momentum into 2024. Typically, recoveries tend to be more protracted in the wake of a downturn induced by a financial crisis, periods during which credit creation is subdued. Although not to be taken lightly, current levels of financial and household sector leverage across developed economies are lower now than they were ahead of the financial crisis period. This is not to say that the eventual recovery is cast in stone. The eurozone recovery could take longer were the region's energy crisis to persist or leave a deeper scar. More widely, the aggressive pace of monetary policy thus far undertaken could serve to expose fragilities in the financial system (akin to the problems faced by the UK pension industry in late September). But these are risks to the base case and do not form a core part of the outlook.

Emerging market equities enjoyed a strong revival over the autumn, the MSCI Emerging Markets Index exceeding the performance of the MSCI World Index of developed market equities by a comfortable margin, albeit indices are still well below levels they started the year. Overall performance masks significant regional divergence, with emerging Asian equities performing strongly, boosted by speculation regarding a possible easing in China's draconian zero-COVID policies, while emerging Europe, Middle East, Africa and Latin America have proved much more subdued. Concerns regarding the near-term health of the global economy and

> "As 2023 progresses and the dark clouds shrouding the global economy begin to disperse, we expect the outlook to become more constructive for risk assets."

its adverse impact on corporate earnings may weigh on investor appetite as the New Year commences, even excluding uncertainty surrounding China and the duration of military conflict in Ukraine, but sentiment and performance should stage a steady improvement with key benchmarks ending 2023 above prevailing levels with further gains likely in 2024 led by Latin America and India.

A PREFERENCE FOR THEMES

Despite the welcome rebound across developed global equity markets, we enter 2023 defensively positioned with a preference for specific themes (renewable energy, energy infrastructure rebuild) and for sectors and stocks thought more resilient to the economic cycle. We feel investors' earnings expectations, despite on a falling trend, are still too optimistic given the subdued global economic backdrop. A global economic recession, albeit shallower than those of the recent past, will weigh on the more economically sensitive sectors, and thus we anticipate that lowered expectations for both the corporate top and bottom lines will act as a headwind.

Admittedly, any central bank pivot could place downward pressure on real yields and prove supportive to equity valuations. But whilst limiting overly aggressive downside, history confirms that valuations have tended to fall at the onset of a recession as the deterioration in risk appetite more than outweighs the offsetting impact of any decline in safer asset yields.

However, equity markets are discounting assets and inhabit the future as much as being informed by the present. As 2023 progresses and the dark clouds shrouding the global economy begin to disperse, we expect the outlook to become more constructive for risk assets. Benchmark equity indices should stage a decent rally into year-end 2023 and build on those gains into 2024.

The combination of ebbing inflationary pressures and easing central bank policy should prove a constructive backdrop for emerging market local currency government bonds. One limiting factor likely to impact in the very near term is a broad-based diminution in risk appetite as the global economy slips into recession. More encouragingly, that recession is thought likely to be shorter and shallower than the pandemic-induced collapse of 2020 and the Great Financial Crisis period. Yields should start declining on a more sustained basis from mid-2023 onwards as the global economy revives, inflationary pressures diminish and central banks cut rates.

A similar trajectory is likely across dollar-denominated emerging market bonds. Yields have dropped sharply since late October, reflecting narrowing yield differentials and notably lower 'risk free' yields as rate hike expectations in the US pared back. That this has taken place at the same time as the rally in share prices provides strong evidence that the improvement has been built on a revival in investor risk appetite. Again, the near-term sustainability of this rally is open to question as the global economy weakens, but as above, sentiment should improve as 2023 progresses and yields should fall further in 2024.

KEY TAKEAWAYS:

- The coming global weakness will see sluggish growth or even outright GDP contractions in most developed economies outside the United States, with the eurozone likely to fare worst.
- A shallow and short global recession, coupled with ebbing inflationary pressures and an easier monetary policy outlook as 2023 progresses should underpin a revival in investor interest.
- We enter 2023 defensively positioned with a preference for specific themes (renewable energy, energy infrastructure rebuilding) and for sectors and stocks thought more resilient to the economic cycle.
- The outlook for emerging market government bonds and dollar-denominated sovereign debt should brighten as 2023 progresses while the outlook for equity markets will become increasingly positive as the global economy revives. Latin America and India look appealing for longer-term investors.

Economic Snapshot

EUGENIO J. ALEMÁN, PhD
Chief Economist

We've gone from global synchronized monetary easing to most central banks tightening monetary policy at unprecedented speeds. The Fed raised rates by 425 bps and despite that, the US economy has remained strong, but it's likely to moderate as the impact of the tightening influences the real economy. The US labor market continues to be strong and beat expectations. Barring unexpected external shocks, inflation is on a clear disinflationary trajectory, and we expect it to continue on this path. Despite the current resilience of the US economy and our expectation that inflation will continue to decline, we expect the restrictive stance of monetary policy to push the economy into a mild recession. We expect three quarters of negative growth starting in the second quarter, with 0.0% growth for 2023, followed by a weak recovery of 0.8% in 2024.

	ECONOMIC INDICATOR	COMMENTARY
NEUTRAL	GROWTH	GDP growth is expected to continue to moderate in 1Q23 and enter negative territory over the following three quarters.
NEUTRAL	EMPLOYMENT	Nonfarm payrolls have slowed but are still very strong. Expectations are that nonfarm payrolls weaken in 2023 while the unemployment rate increases.
NEUTRAL	CONSUMER SPENDING	Despite inflation trending lower, prices remain elevated, and as excess savings from the pandemic continue to dwindle, consumer spending is likely to weaken next year.
NEUTRAL	BUSINESS INVESTMENT	Interest rates will continue to negatively impact the strength of business investment in 2023.
NEUTRAL	INFLATION	Inflation remains the biggest risk for the economic outlook but barring any external shock (such as energy prices increasing again), we believe the worst is behind us and we should see inflation below 3% by the end of 2023.
NEUTRAL	LONG-TERM INTEREST RATES	The yield curve ended the year near its deepest inversion in over four decades, but bond yields have retracted considerably since their highs. We expect long-term interest rates to decline further, especially toward the end of the year or in 2024 as the curve will likely remain inverted until the Fed pivots to an easier monetary policy stance.
NEUTRAL	FISCAL POLICY	Contributions to GDP from government spending in 2023 are unlikely to change significantly as it is improbable that with a gridlock scenario in Washington, Congress will be able to agree on items that will expand spending.
NEUTRAL	THE DOLLAR	The US dollar should remain strong relative to other currencies as the Fed maintains its hawkish stance and the global economy falls into recession. However, the US dollar has weakened recently, and should weaken further if and when the Fed pivots to an easier policy setting.
NEUTRAL	REST OF THE WORLD	COVID-19 is still a factor globally. The Russia-Ukraine war will have a bigger impact on Europe's economy than that of the US. Inflation is higher everywhere, which is an issue for emerging economies. Repeated droughts, floods, and other natural disasters continue to negatively impact crops, housing, and more.
UNFAVORABLE	MANUFACTURING	Manufacturing was supported by strong export demand in 2022 but has started to decline over the last few months, and we expect this trend to continue in 2023.
UNFAVORABLE	HOUSING AND RESIDENTIAL CONSTRUCTION	The housing market is and will remain in recession as the strong increase in mortgage rates impacts affordability. We should continue to see weaker housing data and further declines in home prices.
UNFAVORABLE	MONETARY POLICY	The Fed has slowed the pace of rate increases, and we believe it will slow it further in the first half of 2023. However, we estimate the terminal rate at 5%, and this restrictive level is likely to lead to a recession in 2023.

Sector Snapshot

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

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

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

These recommendations will be displayed as such:

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

Equal Weight: expect in-line relative performance

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

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

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	HEALTH CARE	15.2%	Health Care continues to be our favored 'defensive' area for the current volatile market backdrop, due to positive relative strength trends and cheaper valuations. For example, Health Care trades near the midpoint of its 10-year P/E range at 17x, which compares favorably to Consumer Staples and Utilities trading near the higher end of their historical P/E ranges.
OVERWEIGHT	FINANCIALS	11.6%	The weakening global economy is a headwind to performance, but the banks are well-capitalized and valuation is cheap. The sector P/E of 14x is in line with its 10-year average and second-lowest of all sectors. The market's preference for Value over Growth is also benefitting relative performance with Financials being the second-largest weighting within Value. Moreover, the P/C insurance sub-sector continues to be a solid performer given its low beta and the hard P&C pricing market.
OVERWEIGHT	ENERGY	5.1%	WTI crude oil prices have pulled in near their lowest levels of the year, but this is still resulting in strong fundamental trends for Energy. Earnings estimates continue to get revised higher, and this relative earnings strength (vs. the S&P 500) is supportive of relative performance trends in our view (89% correlation between the two historically). Moreover, valuation is cheap at a sector-low P/E of 9.4x and sector-high FCF yield of 11.9%.
EQUAL WEIGHT	INFORMATION TECHNOLOGY	26.4%	Valuations have become more reasonable, particularly if interest rates have peaked. But earnings estimates continue to get revised downward at a quicker rate than for the S&P 500, which is a headwind for the sector in our view. Many quality Tech companies are trading well off their highs and offer long-term opportunity. But uninspiring relative performance, along with negative estimate revisions, keep us cautious for now.
EQUAL WEIGHT	CONSUMER DISCRETIONARY	10.4%	We believe that inflation is set to moderate over the next year, which should result in improved market trends and rotation into some of the harder-hit areas (like Consumer Discretionary). Valuation has also become attractive for much of the sector, presenting a good setup for long-term returns. However, in the shorter term, we believe sustainable upside for equities may take time and do not want to chase the recent outperformance. We stick with an Equal Weight recommendation on Consumer Discretionary for now.
EQUAL WEIGHT	COMMUNICATION SERVICES	7.5%	Communication Services remain a very unloved sector, and for good reason. Earnings missed Q3 estimates by the worst of all sectors and forward estimates have been revised downward at the sharpest pace of all sectors. This steady downtrend in relative earnings momentum has correlated strongly with the steady downtrend in Communication Services' relative strength over the past year. That said, the sector trades at a very low valuation—its 17.3x P/E is in line with the 2018 trade war and 2020 COVID shutdown lows. Valuation is often a poor timing indicator, but it does increase potential over the long term.

Continued on next page

EQUAL WEIGHT	INDUSTRIALS	8.4%	Despite a weakening global economy, the Industrials have shown strong relative performance trends this year. The strength has been predominantly due to Aerospace & Defense (low beta, elevated geo-political risk) and Machinery (0.89 beta, exposure to Agriculture and 'clean energy' incentives) making up 43% of the sector. While trends in those areas show promise, the historical negative influence of a weakening economic backdrop on Industrials relative performance keeps us at Equal Weight for now.
	MATERIALS	2.7%	The US dollar is showing signs of moderating its ascent—a positive development for Materials given their global exposure and sensitivity to commodity prices. Valuation has also become more compelling. However, the US dollar appears oversold in the short term; and fundamental trends remain unattractive with earnings estimates still in decline.
	REAL ESTATE	2.7%	We believe a lot of negative news has been priced in already, but we maintain an Equal Weight recommendation on Real Estate with 2023 earnings estimates in decline and interest rates still in an overall uptrend.
UNDERWEIGHT	CONSUMER STAPLES	7.0%	Consumer Staples have benefitted from their low beta, more defensive status in this year's volatility. However, we view fundamentals as unattractive and valuation as expensive (current P/E of 22.5x is near the upper end of its 10-year range). While the sector is likely to hold up better in a potential down leg for equities, we find other areas more compelling over the next 12 months.
	UTILITIES	3.0%	Utilities relative strength trends have become more sideways over the second half of 2022, and the sector's relative P/E of 1.07x is near the upper-end of its 10-year range. While the sector's defensive qualities (low beta) and US-centric business may provide support in volatile market periods, we are more interested in other areas at this stage of the bear market.

Disclosure

All expressions of opinion reflect the judgment of the authors 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 are unmanaged and an investment cannot be made directly into them. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The S&P 500 is an unmanaged index of 500 widely held securities. The Shanghai Composite Index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.

The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The MSCI China A Index measures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges. The MSCI Pacific Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in the Pacific region. The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the US market. The MSCI Europe index is a European equity index which tracks the return of stocks within 15 European developed markets.

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