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INVESTMENT STRATEGY QUARTERLY

Letter from the Chief Investment Officer

City of Lights, Market of Opportunities

There's nothing better than rooting for Team USA! Therefore, we borrow from the upcoming Paris Summer Olympics for our quarterly theme—with a twist. Instead of using the most popular events (like gymnastics, swimming, and track & field) to express our views, we'll go beyond the spotlight. The reason: we advocate looking past the obvious and strive to find value in diverse market areas—because that's how you can add value to a portfolio over time. Just as the market has had its share of surprises recently, the Games will have a few as well. It will be the first opening ceremony not in a stadium, but on boats on the Seine River; the mascot won't be an animal but a hat (the French love fashion!), and each medal will be infused with iron from the Eiffel Tower!

Surfing has only been part of the Olympics since 2020 and will take place ~10,000 miles from Paris in Tahiti (an island in French Polynesia). Like a surfer itching to catch a big wave, the extraordinary pent-up demand during COVID *amped* the US economy. But spending is slowing, especially among lower-income consumers as the labor market softens and the impact of inflation takes its toll. The Federal Reserve (Fed) has been *riding the wave* of a healthy economy despite the most aggressive tightening in 40 years. But now, the Fed's *trick* is to extend this recovery by cutting interest rates in time to avoid a *wipeout* (aka recession) without further *swelling* inflation. There is an opening to *keep the surf up* if the Fed cuts rates twice by year end and then more next year.

Just as surfing is far from France, factors beyond the horizons of the consumer and the Fed will impact the economy. Watch for government spending in an election year and business spending concentrated on artificial intelligence (AI) to offset weakness in consumer spending. Keep an eye on oil prices—which could cause some economic *chop* if oil goes above our year-end target of $85/barrel. Overall, we remain optimistic, expecting GDP growth of 2.1% in 2024 and 2% in 2025.

Beach volleyball requires seamless cooperation between the two teammates. Similarly, the bond market has twin dynamics, dictated by the economy and inflation. With both *set* to cool gradually the remainder of this year, interest rates should *tip* lower by year-end (10-year Treasury yield target: 4.0%) and the next 12 months (target: 3.75%). That will *serve* bond market returns' modest capital appreciation. Beach volleyball is the newer, trickier version of indoor volleyball—playing in sand, adverse weather (heat/wind/rain), and in front of a raucous crowd. The modern-day bond market has new challenges as well: record government debt issuance, demand unease, and non-traditional Fed policy. Like a beach volleyball team, investors must read and anticipate market moves quickly. For example, cash investments have *scored* with yields above 5%, but that will likely not last long. So, as the Fed approaches its easing cycle, transitioning to longer-dated bonds seems prudent. Areas to consider: intermediate-maturity Treasurys, high-quality corporate bonds, and longer-maturity municipal bonds.

Like sport climbing, equities have *climbed* a wall—a wall of worry about recessions, higher interest rates, elevated valuations, and geopolitics. Thus far, the path higher has been relatively uninterrupted as the S&P 500 has had only one 5%+ slip this year and only one 10% *tumble* since the bull market started 21 months ago. In sport climbing, the courses get progressively more difficult. The quest for the market to move higher is getting more challenging, especially with valuations at the highest level since January 2022. In the near term, it may be harder for equities to find a *handhold* if volatility increases because of growing economic, earnings, and election uncertainty. Still, in the longer term, the equity market rally is likely nowhere near the top. It should get support from Fed easing, lower interest rates, and some of the ~$6 trillion in money market mutual funds transitioning into the equity markets. And remember, historically, the average bull market lasts over five years, so it should continue climbing! Our year-end and 12-month targets for the S&P 500 are 5,400 and 5,700, respectively. While the Tech sector has dominated, market performance should broaden as smaller company earnings accelerate. Across market capitalizations, we prefer the Technology, Industrials, Energy, and Health Care sectors.

Breakdancing, or breaking, will be in the 2024 Summer Olympics for the first time! Like breakdancing, AI used to be more 'underground' (I was breaking in the 80s!), but it has now emerged onto the brightly lit stage. Since computing capabilities have only recently supported advanced AI at scale, we are in the early stages of this cycle. AI-driven earnings growth should remain robust for semiconductors and cloud computing as well as software and hardware. AI's challenge is a *throwdown* to 'business as usual.' It's likely to continue to receive a standing ovation in the financial markets.

Speaking of ovations, the exploding popularity of women's basketball demonstrates that the US has the infrastructure to develop the most skilled and talented players. The team has been dominant, with no Olympic losses since 1992. It holds the record for the most consecutive team victories in all Olympic sports. The US equity market has similarly *jumped* above the global competition, outperforming developed market equities for eight of the last ten years by a cumulative 170%! The reasons are familiar: the US has the strongest economy (infrastructure) and the most fundamentally sound and profitable companies. The Dream Team of tech-related companies should earn the US another *gold medal*. This isn't a *slam dunk*, as the difference between the US and the rest of the world on both the court and in the equity market has narrowed. Both teams will have to play their best to win. The biggest competitors to US equity dominance are: first, Japan, where strong corporate governance, domestic inflows, and a strengthening yen could bolster performance; and, second, emerging markets, where attractive valuations, healthy earnings growth, and easing central bank policy should help.

In politics, President Biden and former President Trump have already begun wrestling—one of the oldest sports in the Olympics. The candidates are *locked in* and trying to score a *takedown*. The US election outcome in November could dramatically impact trade, immigration, tax policy, and industry regulation. As a result, expect increased market volatility over the summer and early fall. While polls show neither candidate in danger of being *pinned* yet, the match will most likely be determined in the six major swing states. Our base case is that the House and Senate shift power and result in a divided government. But we caution that the market is underestimating sweep scenarios that could lead to more significant policy shifts.

Asset allocation is more important than ever to investors' portfolios. It's like artistic swimming—above water, it is beautifully synchronized, but underwater, team members must do their part under pressure, using incredible strength and attention to detail—while holding their breath. That's our goal—to provide a well-designed asset allocation strategy without burdening you with all the complicated analysis our *top athlete* analysts do behind the scenes. Our goal is aligned with yours: podium-worthy performance for you. A skilled coach—your advisor—can help keep you in sound financial shape in both good times (like recently) and challenging times. But as gold medal-winning gymnast Simone Biles said, "The hardest days are best because that's when champions are made."

See you on the medal podium! Go U-S-A!

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

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2024 Election: Prepare For A Sweep?

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

With most of the focus of the 2024 elections on the rematch between President Biden and former President Trump, the race for Congress can easily get overlooked. Our analysis for the Senate shows a solid advantage for Republicans to win a majority of seats. In the House of Representatives, it is a closer call, but several factors have Democrats as the slight favorite for the majority. With divergent House and Senate calls, it is easy to assume that divided government is the most likely outcome, but we come to a different conclusion. In our view, if Democrats beat the odds and retain a Senate majority, that likely comes with a Biden reelection and a House majority. Conversely, if Republicans maintain a House majority, the chances of a Trump victory and Republican Senate majority also increase. As such, the combined odds of either a Republican or Democratic sweep should be considered. In a sweep, the ability to advance major policies on a party-line vote increases—important for the return of the debt limit in January 2025 and the expiration of the 2017 individual tax cuts on December 31, 2025.

ELECTORAL BACKGROUND: SWING STATES AND 'DOUBLE HATERS'

In assessing the presidential race there are multiple factors we actively track, including: which states are critical for each candidate as they seek 270 electoral college votes; the favorability of each candidate; and general sentiment of the country—such as recession indicators and polling data on whether voters view the country as "on the right or wrong track." At this time, both President Biden and former President Trump have more voters who have an unfavorable opinion than a favorable opinion, making it necessary for the winning candidate to convince some portion of voters to vote for him, despite having a negative opinion of his candidacy. The group of voters who have an unfavorable opinion of both candidates are referred to in the polling industry as 'double haters.' In 2016 Trump won a majority of this group and the presidency. In 2020, Biden won the majority of this group and the presidency. The winner of this group in 2024 is likely the winner of the presidency.

THE SIGNIFICANCE OF CONGRESS

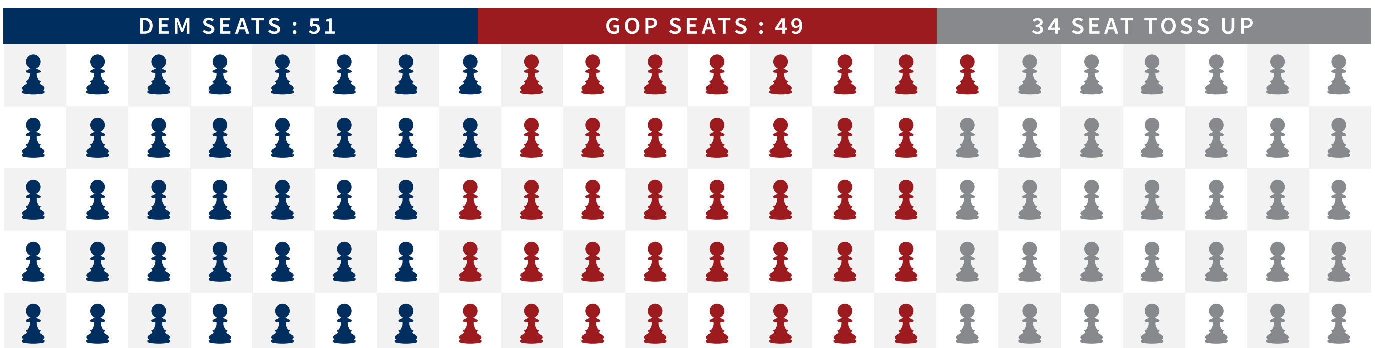
The largest policy changes in DC come when one party has full control of the House, Senate, and the White House. In recent years, Congress has been using the budget reconciliation process to enact sweeping legislation, including tax cuts, the Inflation Reduction Act, COVID relief, and major portions of the Affordable Care Act.

In 2025, we have two fiscal cliffs that Congress must address: the debt limit and the expiration of the individual portions of the 2017 Trump-era tax cuts. The winner of the presidency will largely dictate the terms of these debates, but the ability to enact sweeping changes would be unlocked if either party has full control.

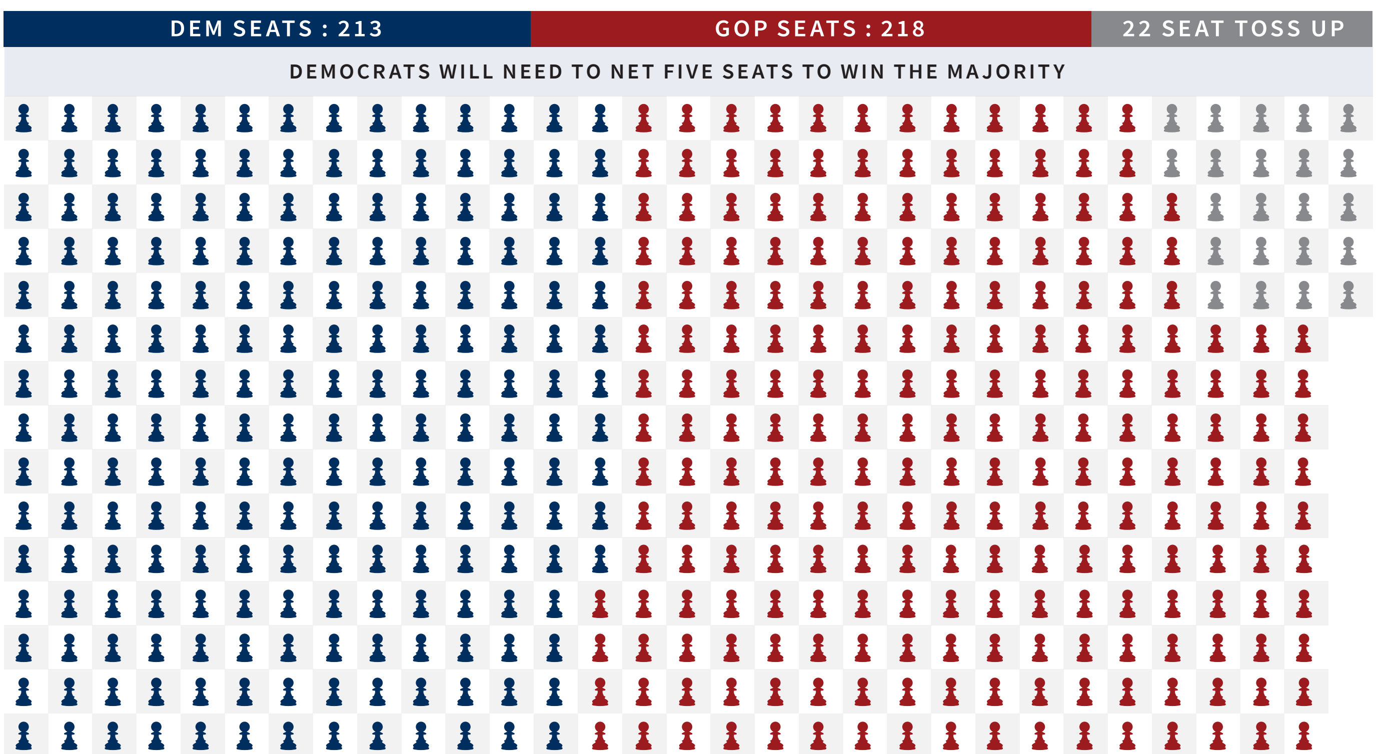
CONGRESSIONAL FACTORS SUPPORT OUR VIEW OF A SWEEP

In the House, where all 435 seats are on the ballot, Republicans currently have a 218-213 majority. Democrats will need to net five seats to win the majority and they should get some assistance with several states adjusting their congressional districts. The fights over the Speaker of the House have also slowed some Republican fundraising compared to past election cycles, adding to the Democrats' edge. However, with only 22 seats currently rated as toss-up and recent elections swinging the House toward the winner of the presidential election, a majority by either party remains a possibility.

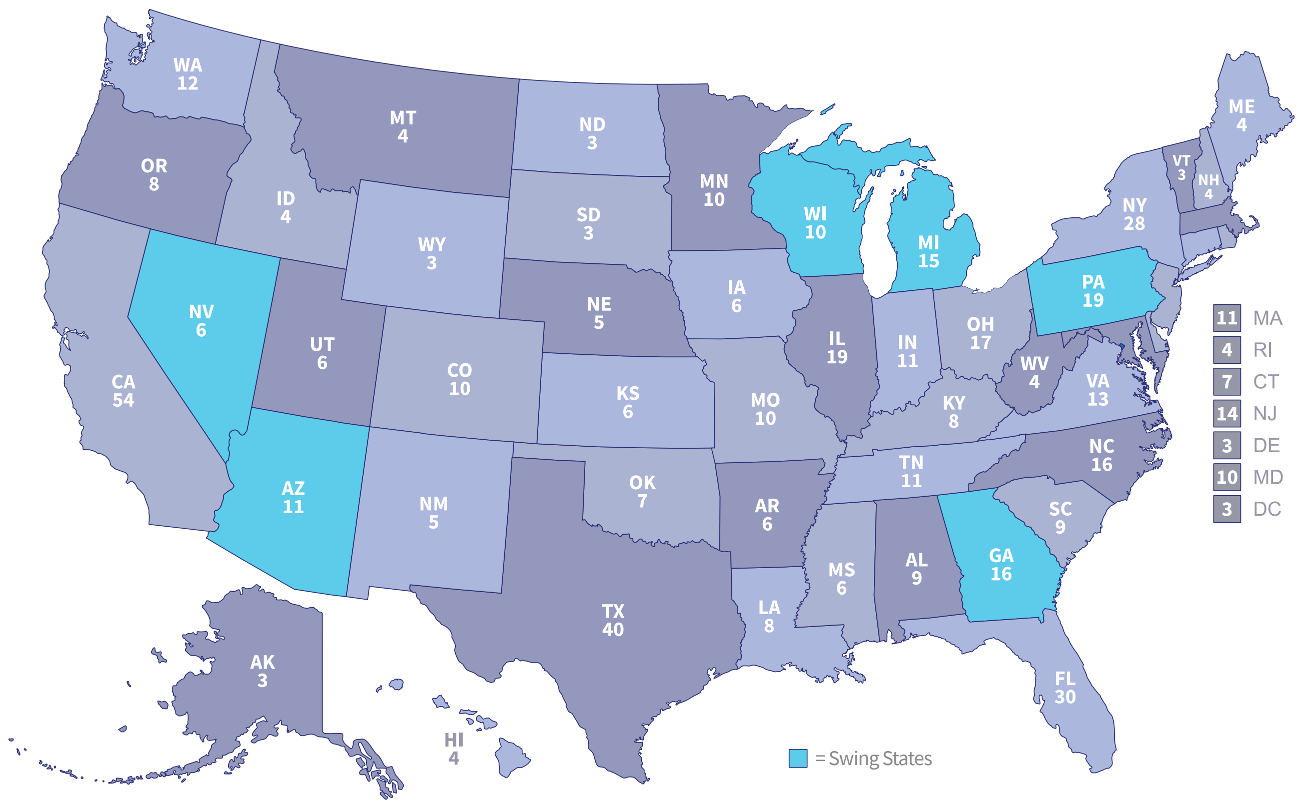
SENATE SEATS



HOUSE SEATS



Electoral College Votes By State



As for the swing states, this is an election that will likely come down to the winner of the majority of Arizona, Georgia, Pennsylvania, Michigan, Nevada, and Wisconsin. Underscoring the importance of these states, a swing of 45,000 in 2020 in AZ, WI, and GA would have resulted in a 269-269 tie. All indications point to a close contest again in 2024 in these states, but a number of known factors (i.e., debates/VP selection) and unknown factors (i.e., geopolitical events) between now and November could sway this election in either direction.

In the Senate, Democrats currently have a 51-49 seat majority, but are likely already down to a 50-50 majority when you factor in the upcoming retirement of Senator Joe Manchin (D-WV). In the Senate, one-third of the 100 seats are on the ballot every two years. This year, of the 34 seats on the ballot, 23 are currently held by Democrats and 11 by Republicans. The imbalance of seats comes from a strong performance by the Democrats six years ago in the 2018 midterm elections. Democrats are even more on the defensive in the Senate when you factor in the decline of ticket-splitting in recent years. Top Republican targets are the Democratic senators in Montana and Ohio, two states expected to vote for Trump in November. Despite a strong playing field for Republicans, we have also seen unexpected events in recent Senate elections, and it is not out of the question that Democrats are able to run the table and preserve a 50-50 tie. In a tie scenario, the vice president is the tie-breaking vote.

> The ability to enact sweeping changes would be unlocked if either party has full control.

RETURN OF THE DEBT LIMIT: WHAT TO WATCH

The debt limit will be an immediate concern for the next president, with it returning in January 2025 as either Trump or Biden is inaugurated for a second term. At midnight on January 1, 2025, the federal government will begin to deploy ‘extraordinary measures' to stave off a default; using the 2023 debt limit process as a guide, we expect that the 'X-date' (the date when the federal government is no longer able to meet its debt obligations) will fall during midyear. With a $35 trillion national debt and an almost $2 trillion annual federal budget deficit, and more than a $1 trillion annual debt service burden, lifting the debt limit has both political and market implications.

The return of the debt limit will raise the risk of brinkmanship, with negative impacts for volatility and broader market sentiment. A split government scenario would likely exacerbate these risks, as well as placing pressure on both parties to accept serious policy concessions to avert a default—especially if current concerns around the US fiscal trajectory continue to intensify. These concessions could include repeals to parts of the 2022 Inflation Reduction Act; while we do not expect the law to be fully repealed (even under a GOP sweep), certain provisions (such as the electric vehicle (EV) tax credit) could be targeted to offset the cost of new debt issuance. The debt limit is extremely likely to be lifted, but we could see the creation of a new effort to rein in the debt and deficit (with actual cuts unlikely in the near term).

WILL THE 2017 INDIVIDUAL TAX CUTS BE EXTENDED?

The second key fiscal cliff to watch will be the expiration of the individual provisions of the 2017 Tax Cuts and Jobs Act (TCJA) on December 31, 2025. We would expect the winner of the White House to dictate much of the 2025 tax debate—particularly under a sweep scenario in either direction, which would unlock the ability to use reconciliation to pass a bill with a simple majority.

A key factor to watch in the tax debate will be what Congress wants to pass versus any potential market volatility that could limit congressional action. A complicating factor for the extension of the 2017 tax bill is the growing price tag, which is now estimated at $4.6 trillion to extend for ten years. The growing cost of extension could reopen the debate regarding the corporate tax rate of 21%. The corporate tax rate was made 'permanent' in 2017, but members in both parties are discussing the potential need to increase this rate, as a way to pay for the extension of the expiring individual provisions of the 2017 law.

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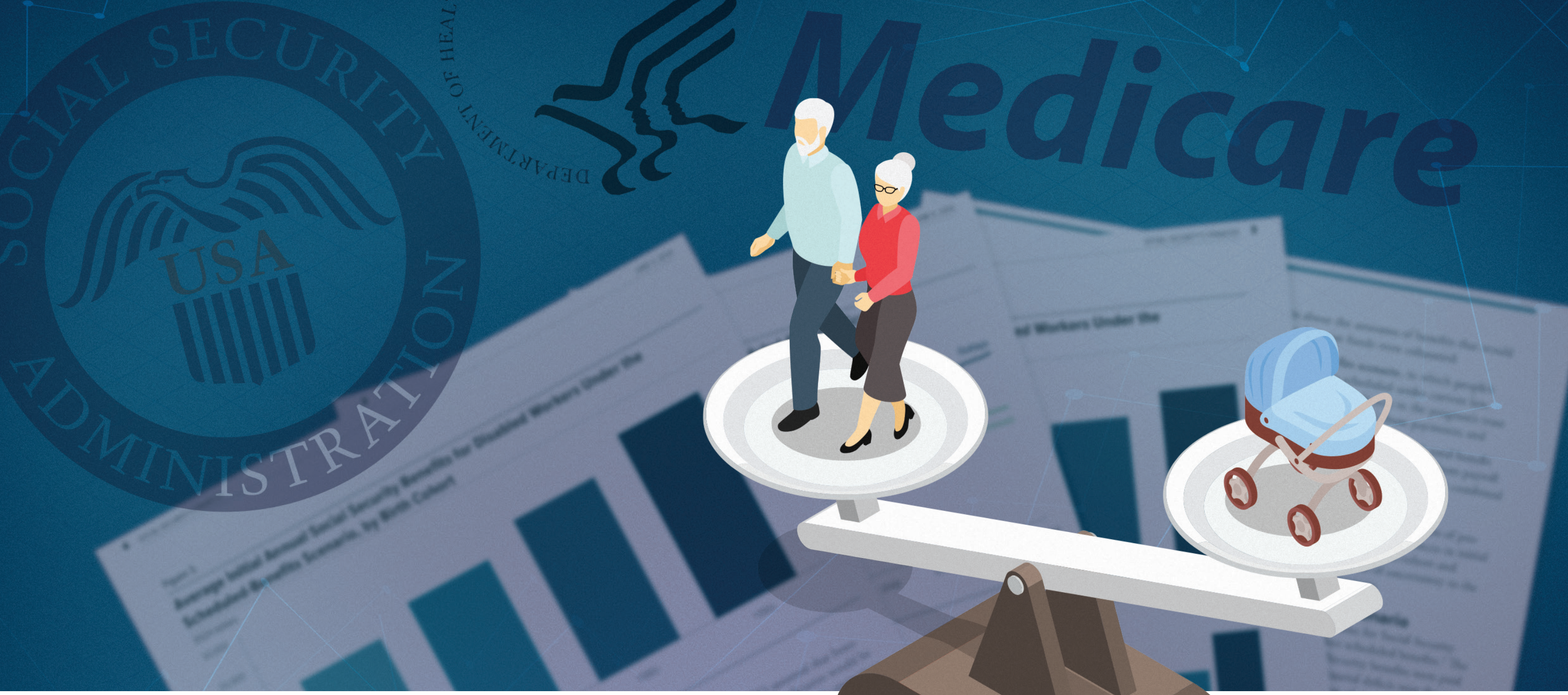
In a Democratic sweep scenario, there will be pressure to let the 2017 changes expire, as taxes would revert to the tax code under President Obama, including removing the $10,000 limit on state and local tax (SALT) tax deductions. The removal of the limit on SALT deductions would be a tax cut for many taxpayers in states with higher taxes, including many states represented by Democrats in the House and Senate. We ultimately view Democrats as likely to preserve lower income tax brackets for those earning less than $400,000, but allow higher taxes on individuals above that income level, as well as making changes to capital gains taxes to offset the cost.

In a Republican sweep scenario, House Speaker Mike Johnson (R-LA) has previewed a swift passage of a reconciliation bill that could include additional individual tax cuts, pairing the bill with an increase in the debt limit, but also new immigration provisions. This was also a strategy after the 2016 election, but DC was not prepared for a potential Trump victory. While there is more preparation for a potential win in 2024, the potential negative reaction to increased government debt by the bond market becomes a new variable.

KEY TAKEAWAYS:

- Don't assume a divided Congress will be the outcome.
- At this time, both President Biden and former President Trump have more voters who have an unfavorable opinion than a favorable opinion. Winning over these 'double haters' will be necessary for victory.
- Eyes will be on the swing states of Arizona, Georgia, Pennsylvania, Michigan, Nevada, and Wisconsin.
- 2025 brings twin fiscal cliffs: the debt limit debate and the expiration of the individual portion of the 2017 Trump-era tax cuts.
- The return of the debt limit will raise the risk of brinkmanship, with negative impacts for volatility and broader market sentiment.



Beyond Demographics

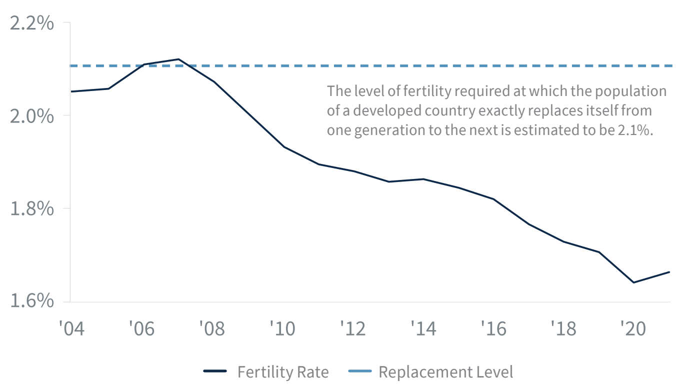
Eugenio J. Alemán, PhD, *Chief Economist,* Raymond James
Giampiero Fuentes, *Economist,* Raymond James

The global population has surpassed 8 billion and according to the United Nations, it is projected to reach 9.7 billion in 2050.[1] However, the rate of population growth is slowing and is expected to continue to decline. Seems counterintuitive, no? Under the current demographic trajectory, the global population will likely follow a sustained decline for the first time in recorded history starting toward the end of the century.

Two factors are reinforcing this trend. Global life expectancy continues to increase and is expected to reach 77.2 years by 2050.[2] This is an almost five-year increase compared to today's life expectancy, almost ten years higher compared to 1950, and more than thirty years higher compared to 1900. Second, the level of fertility at which a population replaces itself from one generation to the next, sometimes known as a country's population replacement level or total fertility rate (TFR), has been declining steadily for decades. The current world's TFR is ~2.3 but estimates suggest that the rate will fall below 2.1 around 2050. By 2100, 183 out of 195 countries will have fertility rates below population replacement levels.[3]

With improvements in public health, better living conditions, and overall environmental improvements, it is relatively easy to understand why human life expectancy has increased over the years. Additionally, the number of people living below the poverty line has declined over the last three decades from over 2 billion people to 700 million.[4] Fewer people will go undernourished and without access to safe drinking water. These trends are expected to continue, improving the quality of life among developing economies while increasing longevity.

US Fertility Rate Below Replacement Level



Source: FRED, data as of 12/31/2022

[1,2] https://www.un.org/en/global-issues/population
[3] https://www.healthdata.org/news-events/newsroom/news-releases/lancet-world-population-likely-shrink-after-mid-century
[4] https://www.worldbank.org/en/topic/poverty

Improvements in global quality of life may be contributing to declining fertility rates, especially in developed economies. Historically, many working-class families, especially in rural areas, had numerous children for several reasons. First, children could help around the farm; second, higher child mortality rates meant having more children would increase the probability that the children would look after parents in old age. Fast forward to today and developed economies no longer need to rely on child labor due to improvements in technology; child mortality rates have declined considerably; and contraception is more available. Moreover, especially in developed economies, the cost of having a child has increased exponentially and families have continued to delay having children.

THE WEST IS GETTING OLD

Who's going to fund programs like Social Security if the population is declining? Let's look at the numbers: in the field of demography, a country's population dynamic can be illustrated by the distribution of age group and gender. When the population is growing, this distribution is shaped as a pyramid, with more younger people at the bottom, and fewer older people at the top. The charts below illustrate what the United States population looked like in 1900, when the population was growing rapidly and how it looked in 2020.

Over time, the fertility rate in the US declined, the median age increased from ~23 to ~39 years old, and the pyramid started to widen in the middle-aged groups. As this trend persists over time, fewer younger people will mean fewer people giving birth. The bottom line is that over time, with the combination of higher life expectancy and lower births, the US population will likely continue to grow older, running into the risk of having an inverted population pyramid in the future.

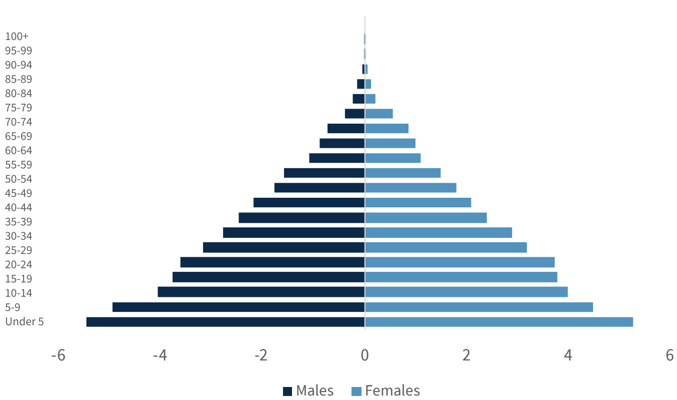
The US's TFR has been in a narrow range of 1.7 to 2.1 births per woman since the 1970s, and it's been below the replacement level for most of this period. However, during the same period, the US population has increased by roughly 120 million, with approximately half of that surge attributed to net migration. In fact, if it wasn't for immigration, the US would have likely already joined (or be close to joining) the likes of Japan, Italy, Greece, and Portugal, in having a shrinking population.

An inverted population pyramid is not good news when it comes to demographics and economics. This is because the age dependency ratio, which measures the dependent population (between the ages of 0 and 14, and older than 65), divided by the population typically in the labor force (between the ages of 16 and 64), increases. Growth in the age dependency ratio means that fewer working people will be available to support more dependents. For example, in the United States in the 1950s over six people supported each dependent, while today there are fewer than four people for each dependent, meaning fewer working-age people carry a larger burden.

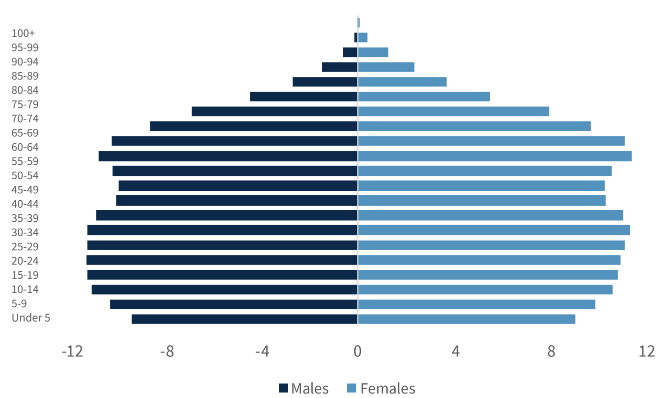
Demographic Shift

The two charts depict the transformation of the US population pyramid from a traditional triangle shape to a stationary pyramid with more equal proportion in each age group.

US Population By Age in 1900
(in Millions)



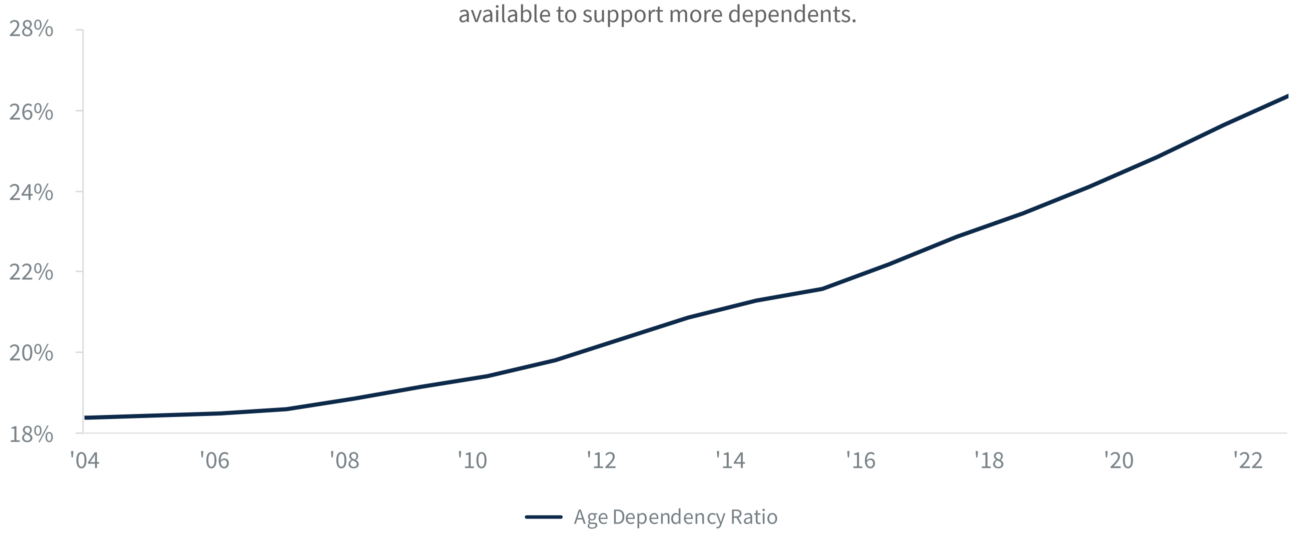
US Population By Age in 2020
(in Millions)



Source: US Census Bureau, data as of 12/31/2020

Age Dependency Trends: A Growing Challenge

Growth in the age dependency ratio means that fewer working people are available to support more dependents.



Source: RJ Economics, data as of 6/30/2024

A smaller working-age population contributes to shortages of workers and lower production capacity, which ends up hurting economic growth. Similarly, fewer workers means a tighter labor market, which can ultimately lead to higher labor costs as well as upward pressure on prices, i.e., higher inflation. Fewer workers also means lower tax revenues, which could deal additional blows to the already difficult pension commitments of governments. This could put even more pressure on the ability of the US government to support government programs, on fiscal deficits as well as debt levels over time. If these problems are not faced head-on, developed countries may be forced to issue more debt to support their respective aging populations over time, which combined with large issuance of debt to fight economic crises only adds to already large national debts long term.

In the United States, Social Security, Medicare, Medicaid, Children's Health Insurance Program (CHIP), and marketplace subsidies spending account for 10.7% of GDP, but according to Congressional Budget Office (CBO) projections, these expenses will account for 14.3% of GDP by 2050. [5] Furthermore, a declining working-age population will have a negative impact on tax revenues. While these projections are developed under current law, therefore assuming no changes in tax revenues and/or expenses, the increase in the aging population will continue to have an impact on the US budget.

IMMIGRATION PARADOX

Without a significant uptick in births, the United States will have to maintain, and soon increase, its net migration levels. Enhancements in productivity and the evolution of artificial intelligence (AI) offer hopes of alleviating the situation, but the country will still need more people to meet the growing needs of an aging population. Thankfully, the US is still considered by many as the land of opportunity, confirmed by the over 10 million nonimmigrant visa approvals and nearly 500,000 immigrant visa approvals issued in 2023.[6] The large number of immigrants to the US over the last few years has increased the supply of available workers, allowing the country to add a record number of jobs without putting excessive pressure on wages, and ultimately additional unwanted pressures on inflation. However, despite this large number of immigrants, the US still has ~8 million job openings that are going unfilled as employers struggle to find workers.

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[5] https://www.cbo.gov/system/files/2024-02/59710-Outlook-2024.pdf
[6] https://www.boundless.com/blog/state-department-visa-report/

Current immigration policies are unlikely to be adequate to meet the needs of the US economy.

When it comes to immigration, economic policies have not been updated since Ronald Reagan signed the Immigration Reform and Control Act in 1986, which requires employers to confirm employees' immigration status before hiring them. However, this policy hasn't been revised in over three decades (minor changes were implemented in 1990) and the annual immigration caps of the various visas are unlikely to be adequate for the needs of the US economy. For reference, real GDP in the US was $8.9 trillion in 1990 and it's now ~$23 trillion. The economic benefits of immigration reform would expand beyond addressing demographic shortfalls, but it could, for example, boost reshoring efforts as employers would be able to hire more skilled workers. Furthermore, proper immigration reform could reduce illegal immigration by providing additional pathways to those currently trying to come in illegally.

An increase in immigration typically addresses labor shortages in affluent nations like the US and other developed economies, while simultaneously alleviating issues with job scarcity in developing economies. Therefore, proper immigration reform alone could provide some relief to the declining demographics of the US economy, but it is unclear when and if the immigration quotas will be increased. However, the combination of additional labor and an increase in productivity could be the catalyst for future economic growth.

KEY TAKEAWAYS:

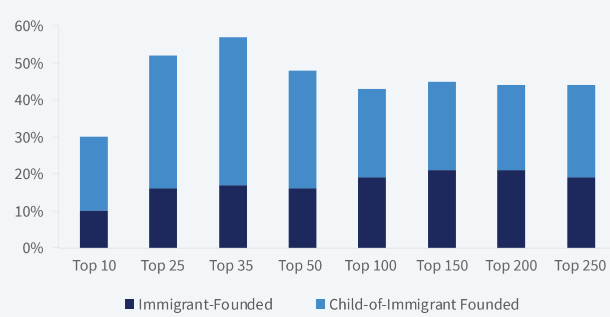
- The global population is heading into a sustained decline for the first time in recorded history.
- A shrinking US working-age population means fewer people to contribute to government programs like Social Security and Medicare.
- Without a significant uptick in births, the United States will have to increase its immigration levels to meet the need for workers.
- In the United States in the 1950s over six people supported each dependent, while today there are fewer than four people for each dependent, meaning fewer working-age people carry a larger burden.

IMMIGRANT CONTRIBUTIONS

Immigrants in the US account for ~13.6% of the US population and 78% of them are of working age. Just like native-born residents, immigrants use public services like education, healthcare, and public safety, but according to the American Immigration Council, 'immigrants' economic contributions far outweigh the cost of additional public services they incur. This segment of the population contributes over $500 billion a year in taxes, and it is estimated to have a spending power of approximately $1.4 trillion. Immigrant workers fill critical labor shortages in agriculture, hospitality, healthcare, and service jobs, and also in highly competitive STEM industries.

Immigrants have historically supported job creation in the US, with 45% of Fortune 500 companies founded by immigrants and/or children of immigrants, according to a study published by Brookings.[1] Similarly, according to the National Foundation for American Policy[2], 65% of the top AI companies in the US are founded or cofounded by immigrants, while 70% of full-time graduate students in AI-related studies are international students.

The Diversity of Fortune 500 Founders



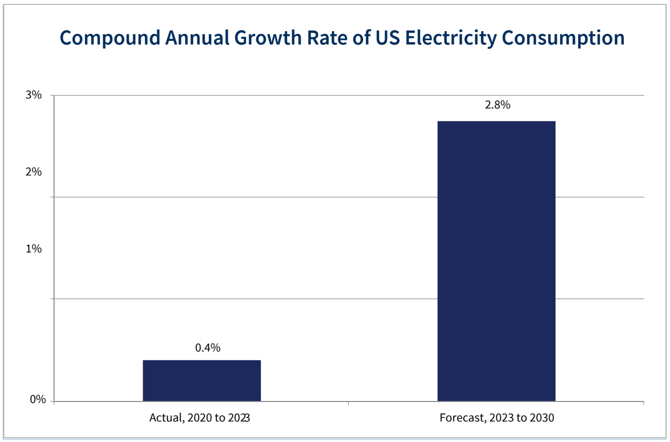
Source: American Immigration Council, data as of 08/29/2023

[1]https://www.brookings.edu/articles/almost-half-of-fortune-500-companies-were-founded-by-american-immigrants-or-their-children/
[2]https://nfap.com/wp-content/uploads/2023/06/AI-and-immigrants.nfap-Policy-Brief.2023.pdf

When It Comes To US Electricity Demand, Chatbots Matter More Than Cars

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

Whether or not you enjoy sitting in front of a computer and conversing with a human-seeming artificial intelligence platform (i.e., a chatbot), the AI boom will, if nothing else, affect your energy bill. AI is set to become a game changer for the electric power industry—especially, though not solely, in the United States. Principally as a result of AI, US electricity demand is about to start posting meaningful growth for the first time in two decades. Enabling the power grid to manage this growth in demand, while simultaneously shutting down aging coal-fired power plants, will require an all-of-the-above strategy. At Raymond James, analysis of this trend has involved a collaborative, cross-industry effort between the technology and energy research teams.



Source: EIA, Raymond James Equity Research

DEMAND FOR ELECTRICITY SET TO SKYROCKET

It may come as a surprise to some of our readers that US electricity demand has been flattish over the past quarter-century—even as population and GDP have continued to grow. The reason is energy efficiency: everything from lightbulbs to air conditioners is more efficient than the older equipment being replaced. US electricity demand in 2023 was up only 10% from 2000, equating to average growth of only 0.4% per year. AI is about to change that in a big way. We forecast that US electricity demand will grow at an average of 2.8% per year through 2030, with AI-related demand comprising two-thirds of incremental demand. The other one-third comprises electric vehicles and, well, everything else! Data centers supporting the AI boom are extremely energy-intensive, even more so than data centers that have been around since the early days of the Internet. Simply put, whenever someone engages with a chatbot—and this is happening countless times every day—a hefty amount of electricity is used. Furthermore, data centers provide a textbook example of mission-critical electricity users: they cannot afford to lose power even for a minute. Data centers run by the large third-party providers and hyperscale cloud companies typically have sufficient on-site generators and temporary battery backup to remain operational during grid outages.

So, is this good news or bad news for the electric power industry? The short answer is: good. Utility companies obviously want to sell more electricity to their customers, and as mentioned earlier, they have had very little organic growth (on the whole) for a long time. That said, utilities also face the risk of managing a power grid that is unprepared for the increasing demand. In the worst-case scenario, it could lead to systematic load shedding—deliberate power outages affecting a large proportion of the population—as a way of reducing the stress on the grid. We are not the only ones who see the risks. In its latest Report Card for America's Infrastructure, the American Society of Civil Engineers gave electric power infrastructure a lackluster C– grade and forecasted an investment shortfall of $200 billion by 2029.

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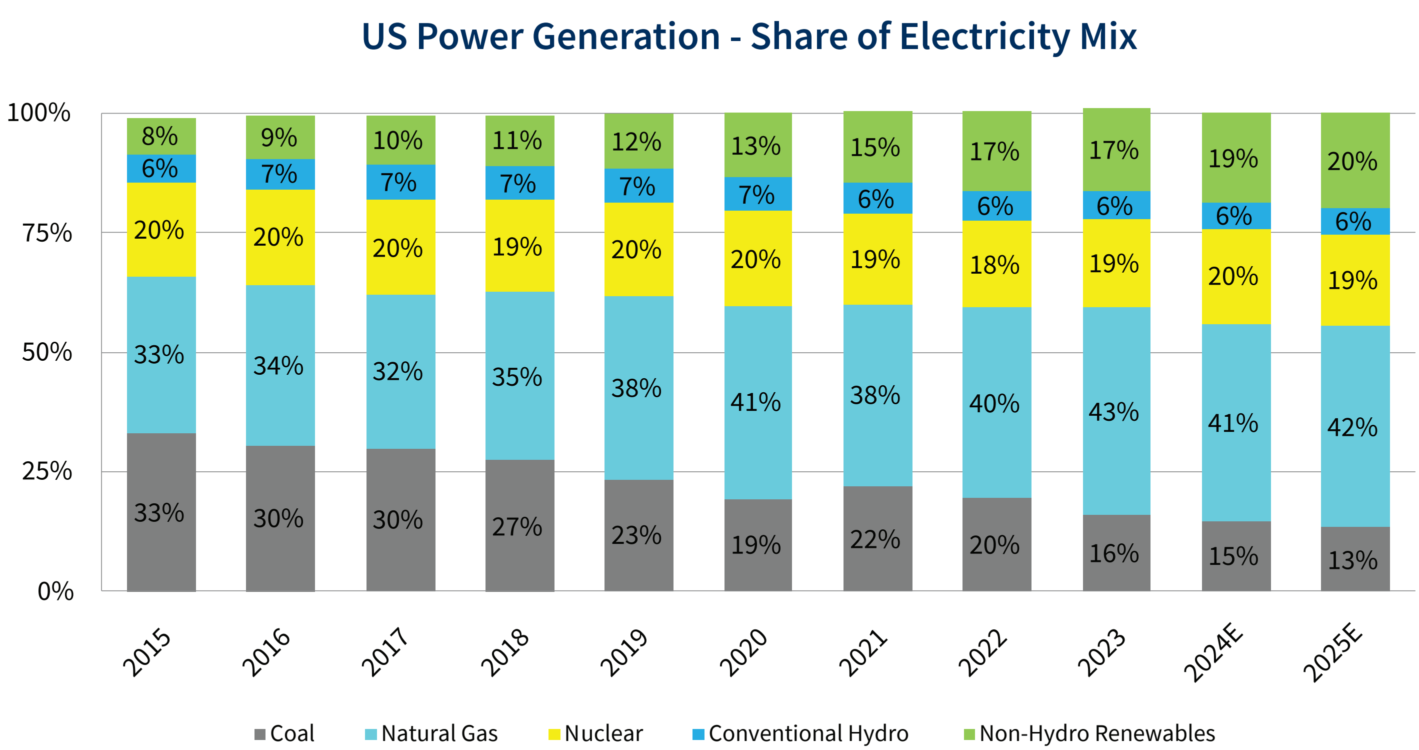
Where will the electricity come from? First, let's look back at the past two decades. During a period of stable electricity demand, coal's share of the US electricity mix plummeted from 50% in 2008 to 16% and was displaced by a combination of natural gas and renewables (mainly wind and solar). In 2023, natural gas provided the largest portion of US electricity (43%) followed by renewables at 23% and nuclear power (which is slowly trending down) at 19%. Looking toward 2030, coal is set to continue shrinking, plus overall



Source: EIA, Raymond James Equity Research

> As part of infrastructure upgrading/modernization across the board, what needs to happen is for connectivity between the regional grids to be greatly bolstered.

demand is set to grow. Natural gas, wind, and solar all must expand, by significant amounts—there is no single panacea here. In thinking about these various sources of electricity, there are geographic considerations to keep in mind. The AI data center buildout is predominantly taking place in the eastern US, notably Virginia and Ohio. The proximity to the giant Marcellus shale resource in the Appalachian Basin makes natural gas an excellent choice to supply the turbines and fuel cells that will be needed for these data centers. While there is lots of wind and solar development taking place all across the country, an outsized proportion of the wind and (especially) solar development is taking place in the western half. Not as many data centers are being built there, but on the flip side, states such as Colorado and Wyoming have coal plants that need to be shut down.

POWER GRIDS IN DEPTH

An important but not always understood feature of the US electric grid is the extent of its geographic bottlenecks. The two major grids—Eastern and Western Interconnections—have minimal connectivity, for reasons that go back to the first half of the 20th century. As it stands, there is very little transfer capacity between them. Data center operators in the east need to rely upon physical electricity supply that is also in the east. Likewise, coal plants being shut down in the Rocky Mountain region will be mostly replaced by the wind and solar projects located in the west. Texas, the ERCOT grid, is largely isolated from both the Eastern and Western Interconnections. This presented a major problem during the snowstorm in early 2021, when, despite sky-high power prices, Texas was unable to source urgently needed electricity from its neighbors. In the long run, as part of infrastructure upgrading/modernization across the board, what needs to happen is for connectivity between the regional grids to be greatly bolstered.

AROUND THE WORLD

Let's also look at the situation internationally. Just as the AI boom is proceeding at varying speeds in different parts of the US, the same applies to different parts of the world. The US has approximately one-third of the world's data centers, followed by 16% in Europe and 10% in China. Meanwhile, the baseline growth rate of electricity demand can also be very different: since 2010, it was 6% in China, -1% in Europe, and 2% for the world as a whole. The mission-critical attributes of data centers face heightened challenges in many emerging markets. Above and beyond grid-related mishaps, there are parts of the world where electricity supply and demand are chronically out of balance, such as South Africa's long-running problems with load shedding, and the periodic drought-related difficulties facing hydropower in Brazil.

A MARATHON, NOT A SPRINT

What we have discussed in this article encompasses a multi-decade story. In the electric power industry, nothing changes on the spur of the moment—in other words, do not expect any immediate transformation. Utility management teams and policymakers alike are aware of what needs to be done, but complex infrastructure projects are always prone to delays. The capital to make these investments is available, and so is the technology, though labor can be a constraint. This is a proverbial marathon rather than a sprint, which means that a wide range of companies stand to benefit from these opportunities for decades to come.

KEY TAKEAWAYS:

- The AI boom will, if nothing else, affect your energy bill. AI is set to become a game changer for the electric power industry as energy demand, which has been flattish for 25 years, is about to increase.
- We forecast that US electricity demand will grow at an average of 2.8% per year through 2030, with AI-related demand comprising two-thirds of incremental demand.
- There's no single silver bullet for where the electricity will come from. Natural gas, solar, and wind all must expand.
- This is a proverbial marathon rather than a sprint, which means that a wide range of companies stand to benefit from these opportunities for decades to come.

Q&A: Small Caps Have Slowed, Not Stopped

Matt McGeary, CFA, *Portfolio Manager, Eagle Asset Management**

Guest contributor Matt McGeary, CFA, is a portfolio manager with the Eagle Vermont team, focused on small-cap and mid-cap stocks.

Q: What happened to the small-cap rally everyone was looking for?

A: In late 2022, it appeared to us that this lengthy large-cap cycle was looking a bit extended and several variables, ranging from valuation to inflation and interest rate trends, were setting up well for a potential small-cap recovery. It's now 18 months later and small caps have yet to close the gap with their large-cap peers. What happened?

First: the much-anticipated Federal Reserve rate cutting cycle has failed to materialize. Just a few months ago, the market was pricing in five or six rate cuts. Now it looks like we may get one or two cuts. In general, small-cap companies are longer duration assets with higher levels of variable rate debt on their balance sheets. Lower interest rates would clearly improve valuations of and sentiment around small-cap stocks. Prior periods of declining rate regimes support the strong correlation between small caps and rates.

The second issue is that small-cap fundamental performance needs to improve. The first quarter of 2024 was yet another quarter showing superior sales, earnings and cash flow performance for large caps relative to small cap. This has been true for much of the past decade and is particularly glaring among the mega-cap technology cohort. Attractive relative valuation is not a sufficient catalyst. Small caps need to offer investors a compelling fundamental reason to allocate capital to the asset class.

Finally, much has been written about the extraordinary degree of concentration in the equity market most obviously characterized by the Magnificent 7.** While market breadth has improved a bit, this market remains extremely narrow and clustered almost entirely around the theme of the AI infrastructure buildout. Such an endeavor requires an enormous amount of capital and thus far a small handful of mega-cap technology companies are fueling the fire. While we believe that the ultimate beneficiaries of AI will include a much broader set of businesses, investors are currently allocating capital to the most obvious early drivers of this powerful theme.

Q: What has to happen for small caps to rally? What are the catalysts?

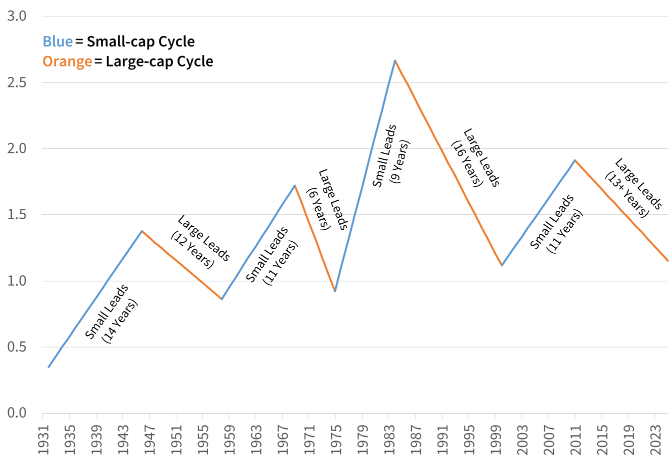
A: As noted above, some easing of interest rates would go a long way to improving small-cap sentiment as it would improve investor concerns around the long duration and higher

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

**Magnificent (aka "Mag") 7: The Magnificent Seven stocks are a group of influential companies in the US stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

Market Cap Cycle

Small-cap/Large-cap Relative Index (1931 to Now)



Source: Furey Research

indebtedness of the asset class in general. There is significant historical precedent for small-cap outperformance during prior rate cutting regimes. We do not think a return to near-zero rates is necessary. Rather we think a more stable real rate environment would go a long way to freeing up broader economic activity that seems to be stifled in part by uncertainty around the current interest rate outlook.

More important for a small-cap resurgence is a return to a market where valuation matters again. We are not thinking about value versus growth per se but rather a market environment where investors consider the value of a franchise relative to its future stream of cash flows and earnings. The market is currently

> More important for a small-cap resurgence is a return to a market where valuation matters again.

allocating capital almost exclusively to momentum factors revolving around the narrow theme of AI. This is clearly a real and powerful secular growth story in our economy. However, many great businesses are being ignored and trading at very reasonable valuations. On a number of relative valuation measures, small caps are trading at 50-year lows versus large-cap peers. Extremely wide valuation gaps such as these have historically been very rewarding for long-term oriented investors.

Q: What sectors in the small-cap universe are attractive?

A: Given the current concentrated and thematically narrow equity market, in addition to historically low small-cap relative valuations, we have identified several areas of interest. We are finding high-quality businesses that are generating solid returns and trading at reasonable valuations across several sectors. The Health Care sector offers some interesting opportunities. The sector was negatively impacted post-COVID but headwinds stemming from inventories, supply chain and labor seem to be normalizing. We are seeing opportunities in life science tools companies including those with exposure to bioprocessing.

Software is another interesting industry right now. Small-cap software is out-of-favor currently as technology investors are focused exclusively on the hardware-centric AI infrastructure buildout. However, we think that much of the value of AI will ultimately be realized by software that is able to harness the power of AI to drive efficiencies and value for the end user. We have identified a number of companies where valuations fail to reflect the durability of their business models.

The current valuation disconnect between small- and large-cap stocks continues to create investment opportunities. While we cannot predict the exact timing of a small-cap recovery, we can and are constructing portfolios of high-quality businesses that stand to benefit meaningfully upon this eventuality.

KEY TAKEAWAYS:

- The expected small-cap stock rally has so far failed to materialize as large-cap tech dominance continues.
- Conditions favorable for a small-cap rally include falling interest rates, improving market breadth, and a focus on the importance of valuation.
- Quality and selectivity are key when it comes to selecting smaller-cap stocks.

Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. The prices of small company stocks may be subject to more volatility than those of large company stocks.

Economic Snapshot

EUGENIO J. ALEMÁN, PhD
Chief Economist

Despite concerns, the current economic landscape is marked by cautious optimism. GDP growth has moderated but shows promise of reaccelerating by year end. Despite a cooling labor market, employment remains positive, though a further slowdown is anticipated in 2024. Consumer spending has weakened somewhat, with high prices straining lower-income households, making it difficult for many to manage credit card payments. Business investment is navigating higher borrowing costs, yet legislative boosts from the IRA and CHIPS Act are providing support. After a brief expansion, manufacturing has contracted, but recovery is on the horizon as we expect the Federal Reserve (Fed) to ease rates by year end. High mortgage rates and building costs continue to plague the housing sector, but steady home prices due to constrained supply and possible rate reduction in the second half of 2024 give promise. Recent legislative initiatives have the potential for increasing government spending, bolstering fiscal policy, while higher interest rates relative to other countries and a healthy economy support the US currency.

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	THE DOLLAR	With the US dollar being a safe-haven currency during times of global instability and slower growth overseas, global banks are expected to increase their asset allocation to the US dollar, which should continue to support it short term.
FAVORABLE	LONG-TERM INTEREST RATES	The deceleration in inflation, a cooling economy, and anticipated rate cuts are all likely to contribute to lower long-term interest rates.
NEUTRAL	GROWTH	GDP growth is expected to continue to moderate in the third quarter and to reaccelerate in the fourth quarter.
NEUTRAL	EMPLOYMENT	The labor market has been cooling and we expect it to weaken further in 2024 but remain positive.
NEUTRAL	BUSINESS INVESTMENT	Despite higher interest rates raising borrowing costs, the passage of several bills, including the Inflation Reduction Act (IRA), the CHIPS & Science Act, and the Infrastructure Bill are contributing positively to business investment.
NEUTRAL	MANUFACTURING	The ISM Manufacturing Index briefly entered expansion territory for the first time since 2022 but returned to contraction shortly after. The sector should start to recover in the second half of the year as the Fed starts to ease rates.
NEUTRAL	HOUSING AND RESIDENTIAL CONSTRUCTION	High mortgage rates and rising construction costs have kept this sector in contraction for several quarters, but it has shown some improvement lately. The low supply of homes has kept prices somewhat stable, and anticipated rate cuts in 2024 might provide some additional relief.
NEUTRAL	INFLATION	Inflation has remained sticky, but it is likely to continue its disinflationary trend as economic activity weakens over the next quarters. Shelter costs should continue to slow, and, with energy prices stabilizing, inflation should fall under 3% by year end.
NEUTRAL	MONETARY POLICY	The Fed is likely to keep rates at current levels for several more months before starting to lower them as it has suggested that it is not convinced that the fight against inflation is over. Given this, we anticipate the first rate cut to come in September.
NEUTRAL	FISCAL POLICY	With increased investment through the Inflation Reduction Act (IRA) and CHIPS Act, government spending is likely to continue to contribute to economic growth.
NEUTRAL	REST OF THE WORLD	We continue to expect a weakening global economy in 2024 despite central banks worldwide turning more dovish.
UNFAVORABLE	CONSUMER SPENDING	Consumer spending has weakened, with more than half of lower-income households struggling to pay their credit cards as higher prices continue to take a toll on their financial situation.

Sector Snapshot

MIKE PAYNE
Investment Strategy Analyst

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. The views presented here are based on current market conditions and are not necessarily reflective of our thoughts for the entire year.

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

These recommendations will be displayed as such:

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

Market Weight: expect in line relative performance

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

	SECTOR	S&P WEIGHT	COMMENTARY
OVERWEIGHT	INFORMATION TECHNOLOGY	31.8%	AI momentum continues to surprise to the upside across multiple verticals leading to a 31% YTD return for the sector. Despite stellar outperformance, we maintain our Overweight stance on the sector as AI should continue to propel earnings going forward. Use cases have begun to broaden beyond first derivative beneficiaries (semiconductors) and monetization should broaden into second derivative beneficiaries (software applications and hardware devices) in 2H24. Any short-term consolidation should be viewed as an opportunity to build positions in this multi-year innovation cycle.
	HEALTHCARE	11.6%	Non-operating M&A charges in the pharmaceutical industry weighed on sector earnings in 1Q24 and forward estimates. However, roughly flat sector performance during a period where forward guidance was reset lower creates a favorable set up moving forward. Additionally, the sector PEG ratio of ~1x is the most attractive of all sectors. We believe earnings estimates will trough in 2024 as these idiosyncratic charges should be one-offs allowing the sector to form a base before moving higher. Medical devices are an area of strength as the post-COVID inventory normalization appears complete.
	INDUSTRIALS	8.0%	Supportive fiscal spending dynamics (IRA, CHIPS and Science Act, and IIJA), reshoring of global supply chains, and fixed investments in data centers driven by AI should outweigh cyclical headwinds in transports enough to mark an earnings trough in 2024. Our Overweight stance is focused on direct beneficiaries including conglomerates, electrical components, construction, and construction machinery.
	ENERGY	3.4%	With WTI trading near the bottom of our forecasted range for the year, we believe there's upside to oil prices and the Energy sector as we move through 2024. The sector trades at 12x 2024 earnings with an 8% FCF yield which we think is already discounting risks of the global economy slowing further than we expect, and the industry disruption from electrification. In addition, shareholder-friendly capital allocation strategies (3.5% dividend yield and 4% buyback yield) should support healthy total returns.
MARKET WEIGHT	COMMUNICATION SERVICES	9.9%	Communication Services boast some of the strongest earnings growth expectations this year driven by robust digital ad spend and significant efficiency initiatives. However, the sector has become highly concentrated with mega-cap tech representing ~60% of the segment's market cap. We view mega-caps in the Technology sector as better positioned to capture the initial earnings benefit from AI.
	CONSUMER STAPLES	6.3%	Sales growth within the sector has evaporated to low single digits Y/Y driven by both disinflationary pricing trends and weaker volumes. EPS growth is improving on the heels of easing supply chain and input costs but forward estimates continue to be outpaced by the broader market. We don't see much room for outperformance without material weakness in the broader market which would make the sector's earnings stability more favorable. Our neutral stance on the sector offers stability in portfolios if volatility arises while also providing a source of funds to take advantage of any dislocations in markets if they were to arise.
	FINANCIALS	12.6%	The risk/reward equation in Financials appears to be balanced leading to our neutral stance on the sector. Stable markets and improving CEO confidence should support a gradual recovery in investment banking activity at the banks along with continued strength in fee-based revenues within financial services broadly. Regional banks with high CRE exposure and rising delinquencies in low-income consumers are areas of concern but both risks appear manageable thus far.

UNDERWEIGHT	REAL ESTATE	2.1%	Resilient economic data have kept interest rates firmer than many investors expected. If the economy keeps holding its ground, bond yields may remain a headwind for this highly rate-sensitive sector. While there's selective opportunity in Industrial REITs with exposure to ecommerce logistics and data centers, weak earnings trends and ongoing challenges in Commercial Real Estate urge patience with the sector.
	UTILITIES	2.2%	Despite strong performance early in 2Q24 following a technical breakout, we believe the recent shift in sentiment in Utilities as a "transformational AI beneficiary" is overstated in the near term. In aggregate, growth in electricity demand is expected to move from flat to ~2% per year driven by increased data center consumption. However, we believe increased demand will be more than offset by higher fixed investment by Utilities to support demand while borrowing costs are elevated. We remain Underweight until we have greater visibility into the impact to earnings and free cash flow.
	CONSUMER DISCRETIONARY	10.0%	Consumers have begun to push back on elevated pricing throughout most of the sector consistent with our expectations. Firms have responded by lowering prices and focusing on value which should continue to pressure sales growth and margins in the quarters ahead while consumers become more discerning in their discretionary spending. Technology/AI exposure within the broadline retail industry is an area of strength in the sector that we would prioritize.
	MATERIALS	2.1%	A slowing economy along with a firm US dollar should continue to put pressure on the Materials sector. However, valuations relative to the market are trading near historical averages. We'd like to see more attractive valuations before closing our sector underweight. There are selective opportunities within construction materials where forward estimates are benefitting from industrial tailwinds.

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.

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. There are additional risks associated with investing in an individual sector, including limited diversification.

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 Russell 2000 Index is a small-cap US stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

This is not a recommendation to purchase or sell the stocks of the companies pictured/mentioned.

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